Trex Company, Inc.

First Quarter 2017 Earnings

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CORPORATE PARTICIPANTS

Jim Cline - *President and Chief Executive Officer*

Bryan Fairbanks - *Vice President and Chief Financial Officer*

Bill Gupp - *Senior Vice President, General Counsel and Secretary*

Viktoriia Nakhla - *MBS Value Partners*

PRESENTATION

Operator
Good morning and welcome to the Trex Company First Quarter 2017 Earnings 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 a question you may press star, then one on your telephone keypad. To withdraw your question, please press star, then two. Please note, this event is being recorded.

I would now like to turn the conference over to Viktoriia Nakhla. Please go ahead.

Viktoriia Nakhla
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 management.

The company issued a press release yesterday, after market closed, containing financial results for the first quarter of 2017. This release is available on the company's website. This 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 would now like to turn the call over to Bill Gupp. Bill?

Bill Gupp
Thank you, Viktoriia. 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
Thanks, Bill, and thank you all for joining us this morning to review our first quarter results and discuss our business outlook. We are pleased to report our first quarter record results for Trex, reflecting strong execution across the board.

Revenue for the quarter increased 10% year-over-year. Operating leverage and continued focus on cost reduction initiatives, including ongoing success with our procurement strategy, drove the substantially higher gross profit. Net income and diluted earnings per share were up 18% and 20%, respectively, compared to last year's first quarter. If you will recall, last year we had a significant success with our revised procurement strategy. While this year will not contribute at the same level as last year, we clearly have a lot more runway on this initiative.

The double-digit revenue growth we achieved in the first quarter clearly demonstrates that our performance again outpaced the decking and railing sector by a significant margin. Our ability to consistently gain market share is a function of the positive recognition of the Trex brand with both consumer and the trade, the strength of the outdoor living category, and the success of our marketing programs aimed at taking share from wood. We believe this is a good indication of the increased demand for composite decking of the quality that only Trex can provide. It is noteworthy that we were able to achieve this quarter's strong revenue growth despite the fact that we did not have the same weather tailwinds that benefitted last year's first quarter.

Again this year, and for the last ten years running, Trex captured three first place rankings in *Builder* magazine's annual Brand Use Study—winning top honors for Brand Familiarity, Brand Used the Most, and Brand Used in the Past Two Years. This is one of several recognitions that we have received this year that support the positive feedback we are getting from the trade customers about the quality and versatile design capability of our high-performance product line-up.

Consumer response to our marketing and advertising programs and our online design tools has been equally positive. In the first quarter, we also saw a strong demand from the DIY sector. Outside of North America, revenue growth is even more robust, especially in Europe. The number of dealers stocking Trex products has expanded consistent with our expectations and the growth in demand has been stronger than last year. We plan to continue to invest in these successful branding and marketing initiatives both domestically and outside of North America in the oncoming periods as we drive further market penetration.

In summary, our first quarter performance has set the stage for another year of positive developments at Trex. We are at the forefront of the outdoor living market, which analysts expect will exceed $7 billion this year. In a recent article, *Principia* predicted that overall composite market penetration will surpass the prior peak of 17% in the next five years, reaching 20% on a volume basis. I believe the industry will achieve this prediction more quickly.

This growth is and will be driven in part by advancements in all-weather materials that have allowed outdoor spaces to function as extensions of the home, as well as, improved aesthetics and other performance characteristics that are in development. Outdoor kitchens and entertainment centers are good examples of this trend. Trex products are tailor-made for this environment. Additionally, we expect to benefit from Trex's appeal to consumers who are attracted to "green building" alternatives. This is likely to be an increasing draw for us, as sustainability becomes more integrated into the consumer lifestyle choices.

Now I would like to turn the call over to Bryan Fairbanks, our Chief Financial Officer, to provide a financial review of the quarter. Bryan?

Bryan Fairbanks

Thank you, Jim, and good morning, everyone. We had a strong start to 2017 and are pleased to report record revenue and profit, solid gross margin expansion, and double-digit growth across key financial metrics.

We reported record first quarter net sales of $144.8 million, a 10% increase from our last year's $131.7 million. This reflects healthy demand and solid performance across our full suite of outdoor living products with decking and railing products being the major growth contributors.

This quarter's gross margin was 45% compared to 43.8% last year. We reported a 120 basis point gross margin improvement as a result of increased capacity utilization, lower poly input prices, and continued focus on manufacturing efficiency programs. Our incremental margin for the quarter was

57%.

Consistent with our guidance on the last earnings call, we had both higher branding and R&D spend in the first quarter of 2017 as we continue to invest in marketing programs and product development to support company growth. These were the primary drivers of the $2.7 million year-over-year increase in SG&A costs to $23.3 million from $20.6 million in the comparable period last year. Our expanded sales this quarter supported this additional cost without a significant increase in SG&A as a percentage of sales, which was 16.1% in the 2017 first quarter compared to 15.7% a year ago.

The tax rate in the first quarter was 33%, compared to 35% in the last year's comparable quarter due to higher tax benefits related to excess tax benefits on employee share-based awards recognized in income tax expense. For the full year 2017, we still expect the tax rate to be approximately 35% as we previously indicated.

As Jim mentioned, we succeeded in converting 10% revenue growth into an 18% increase in net income to $27.9 million and a 20% increase in diluted earnings per share to $0.95. This is our sixth consecutive quarter of double-digit net income and diluted EPS growth. Please note that last year's first quarter net income of $23.7 million, or $0.79 per diluted share, has been adjusted to reflect our adoption of the new FASB tax treatment related to employee share-based payment accounting.

To summarize several items that you should take into consideration for financial modeling, we expect net sales of $160 million in the second quarter. Full-year guidance for incremental margin is in excess of 50%. We are projecting SG&A to be in line with prior year as a percentage of revenue. And we expect the full-year tax rate to be approximately 35%.

I'll now turn the call back to Jim for closing remarks.

Jim Cline
Thanks, Bryan. In summary, we see several key organic growth drivers ahead for Trex. As the market leader, we are in a strong position to continue to achieve share gains in a growing sector. We expect that new product development currently underway will accelerate our drive to take additional share from the wood market and, based on our full-year 2016 as well as our first quarter results, we expect sales outside of North America to continue to expand at a substantially faster rate than North America.

In addition to market share gains, we expect favorable margin impacts continue to benefit full-year 2017 results. Acquisitions continue to be a focus of the management team and remain part of our growth strategy.

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

Operator
Thank you, sir. 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 our roster.

The first question comes from Trey Grooms of Stephens. Please go ahead.

Trey Grooms
Good morning, gentlemen.

Jim Cline
Morning, Trey.

Trey Grooms
Congrats on a great quarter.

Jim Cline
Thank you.

Trey Grooms
Jim, with, I guess, the bumping up of the incremental margin guidance to above 50%, what are the primary drivers there versus where we were a few months ago when you guys gave the guidance of 45% to 50%? Is it the scrap poly or raw materials coming in a little better than you thought? Is the procurement initiative, the runway you've got there a little better than you thought and coming along better? Can you talk about some of the drivers there of bumping that up?

Obviously, in the first quarter you guys were closer to 60% than you were 50% and the new guidance being above 50%, should we expect a flattening as the year progresses to get closer to 50% for the full year or is the high-50%s range that we saw in the one quarter a possibility as we look to the rest of the year?

Jim Cline
Sure. You've got a lot going on there.

Trey Grooms
Yes, I know.

Jim Cline
We are seeing success in the procurement strategy and that procurement strategy really focuses on a couple of things. The primary driver, though, is being more selective in the material that we're buying and identifying new sources of polyethylene that ends up driving our cost down, and we have been very successful with that process.

In addition, we've had a couple of sizeable cost-reduction initiatives that, quite frankly, the team was able to pull on a little bit sooner than we had expected. You saw a little bit of that in Q1, you start to see more of that impacting Q2 and going forward.

If you go back and look at where we've been on incremental margins, absent last year, which was a bit unusual, I think you'll see that it's a little bit more lumpy, a little bit stronger in the first half of the year, and then typically drops off a bit in the second half. And, that's what we'd expect to see in this year.

Bryan Fairbanks
Trey, you also mentioned scrap poly sales. So, we did talk quite a bit about that last year with the declining amount of revenue from scrap poly sales. On a year-over-year basis we expect that to equalize this year. So we're not expecting a significant fall off. The total amount of those scrap poly sales at this point are immaterial from an overall perspective.

Trey Grooms
Got it. Okay. That's helpful. Then, looking at your initiative to take share from wood, of course, it sounds like you guys have been seeing some success there. But as you continue with that initiative, and you also mentioned starting to see more activity with the DIY customer, do you feel like over time

that your mix could shift more towards the entry level or lower-end products, or at least in a bigger way than what we have traditionally seen? And, if that's the case, do you feel like any new product introductions at the low end will be necessary or are you pretty comfortable with what you have there?

Jim Cline
Over the last year I think we've talked quite a bit about the area that we believed the market would go. The largest share of the wood market is at the opening price point. It's serviced by a number of products today that are relatively low priced, anywhere from $1.60 to $1.75 at retail. We think to see significant conversions at that price, so it will probably end up being at a lower level than that.

We are developing products at a multitude of levels. We aren't ready to announce anything today, we always do that directly to our business partners, but we're very focused in development of products. Have been since this management team came on board back in 2008. So, I would anticipate you'll see new products.

With regard to where the growth will be you're absolutely right. The growth will be the greatest at the opening price point, but as we've seen in the past, we've been very effective at trading up to the next level. And that's beneficial to everyone, the consumer as well as the retailer, as well as our distributor and dealer business partners. So, that's the same model we continue to focus on going forward.

Trey Grooms
Great. Okay, thank you for that. And, then my last one, and I'll turn it over is I believe during the prepared comments, Bryan, you might have mentioned that SG&A as a percentage of sales should be similar to last year and I may have misunderstood that, so correct me if I'm wrong there. But, also just looking at the cadence of SG&A as we look through the year, should we see—2Q was up a little bit last year, should we see something similar from a timing perspective? Just any color on that would be great.

Bryan Fairbanks
We talked about additional spending in the first—in the end-of-the-year call as well as in the comments for this call related to higher R&D spending as well as brand spend. That brand spend, we'll continue to expand that as well as R&D into the second, third, and fourth quarter of the year. So, yes, I did say that we would have flat year-over-year SG&A spending. And our heaviest branding tends to come through in the second quarter, so you can expect to see that there will be a higher percentage of SG&A in the second quarter.

Trey Grooms
Okay, that's it for me. Thanks a lot, guys. Good luck.

Jim Cline
Thank you.

Operator
The next question comes from Matt McCall of Seaport Global Securities. Please go ahead.

Matt McCall
Thanks, good morning, guys.

Jim Cline
Morning, Matt.

Matt McCall
So, let's go back to that procurement, the savings—am I connecting the right dots? I remember a conversation around a new poly source and, forgive me if you just said this, but was that the source, the procurement savings in Q1?

Jim Cline
Actually, we have a number of new poly sources that we utilize today compared to what we did a year ago. It's been an ongoing practice for Trex to search out new and better sources of recycled polyethylene. We've happened to hit some very interesting sources for us over the last year, year-and-a-half, and every time you introduce those it requires some work to be able to develop the process to utilize those. In some cases we can't use 100% of it, we can only use a selective percentage of it, much lower than 100%. That has worked extremely well.

We are always testing new sources of poly as we are today, and we see great opportunities going forward.

Matt McCall
Okay. So, maybe this is a bit repetitive to one of the last questions, but when I think about that 57% some of the benefits and some of the sources of pressure, I assume the procurement, you cited it as one of the incremental sources of pressure. As we progress through the year, I understand the seasonal pattern, that makes sense just given the volume levels, but what are some of the other items to take into account? So, for instance, you have some savings from a new poly source but you didn't get the full run rate of the savings in Q1 and more of that will come, or you got the full run rate and less of that will come. I'm just trying to understand what other factors could impact your contribution margin as we progress through the year.

Jim Cline
In Q1 we didn't see the full impact of certain cost savings initiatives that are coming on board. I'll give you one example. We had a new process that was scheduled to come on board in July. And we've started to generate benefits this month on it. So, it's well in advance of when we expected it to begin to contribute to additional earnings, it's a substantial project that we had just anticipated we would not be able to get up and running. The guys did a great job, pulled everything together, and got it started up early.

Matt McCall
Okay. Can you give us an idea of the magnitude of the opportunity there or the incremental opportunities as you progress through the year beyond the normal fixed-cost leverage?

Jim Cline
I think the best thing for me to do is just say, if you look at the guidance, we've guided up from the 45 to 50 to a 50-plus. It's included in that guidance. We are not going to get in the point of detailing each and every cost-savings initiative. Obviously, all of our competitors would love to know the types of things we're doing that, potentially, they could utilize to enhance their business. And, it's fair to say that this is just one of many cost reduction initiatives that are in the state of completion. Some will complete this year, some won't even complete until next year. It's an ongoing process at Trex.

Matt McCall
Alright, that's fair. Can you talk a little bit about new products, potentially new channels? I know we've had the channel conversation a lot recently, but any update on the product side, new channel partners, anything like that, or enhanced channel partner relationships?

Jim Cline
I'm reminded by my vice president of sales that discussing individual changes with business partners is probably not a good idea. We hold those relationships very confidential for mutual benefit. So, I can't get into those but, certainly, we have had success with some of our business partners, expanding our relationship and when those changes take place, it's always beneficial for both parties. The timing of that is really up to them and not up to us with regard to disclosure.

Matt McCall
Got it, okay. One question, lumber prices have been in the news a lot. I know you're up against pressure-treated more so than framing, but is there any impact on that cost dynamic you talked about earlier and the $1.60, $1.70, potentially that number starts to move higher, or are we talking about apples and oranges here?

Jim Cline
On the stick lumber, the prices you see on random-length lumber, I believe that most of that has already been priced into the market. With regard to treated lumber, we have not seen a significant movement in treated lumber. It's been relatively stable.

Matt McCall
Okay. Thank you, Jim.

Jim Cline
You bet.

Operator
The next question comes from John Baugh of Stifel. Please go ahead.

John Baugh
Good morning, Jim. Good morning, Bryan, and congrats on a great quarter. I wondered if we could talk product mix and/or channel mix. You mentioned DIY was strong. Is that something that maybe was a slight offset to the gross margin improvement you had, or are you seeing a lot of action on the Pro deck there so there wasn't an influence within your product? Is Transcend still the same percentage or is that growing?

Jim Cline
The demand in the first quarter was pretty well represented across the board. The do-it-yourself channel was probably more influenced on a greater level of composite sales versus lumber sales. We believe, based on what we see across the board, that we're seeing an expansion there.

With regard to margins, the margins were not significantly impacted by either channel growth.

John Baugh
Okay.

Bryan Fairbanks
Or product lines either.

John Baugh
Okay. Are you working on a cooler deck solution? Is that something that would be high priority, low priority, won't discuss, which unfortunately will probably be the answer you'll give me.

Jim Cline
I'll give you a little background. Trex's worked on ways to cool decks a number of years ago and we were very successful in those tests to develop decks that could reduce the temperature of the deck. At the end of the day our findings were they did not reduce the temperature of the decks sufficiently that it was an advantage to the consumer. We have not tested any products that reduce the temperature of a deck significantly that you would want to spend any extra money on it. Our tests with consumers has indicated, at the price we believe we need to charge, they were uninterested in paying that extra amount.

John Baugh
Got it. Thank you for that. My final question is you mentioned how strong Europe and international is and I guess the simple question, if you're not going to give us precise percentage of international or what it grew, is the consolidated revenue growth we're looking at more or less what the domestic market is doing or is there enough influence that that's higher as a result of international?

Bryan Fairbanks
By far, the lion's share is still going to be the domestic market and is a good indicator, gauge, for this marketplace.

John Baugh
Great. Thanks for the answers and good luck.

Jim Cline
Thank you.

Operator
The next question comes from Morris Ajzenman of Griffin Securities. Please go ahead.

Morris Ajzenman
Morning, guys.

Jim Cline
Morning, Morris.

Morris Ajzenman
On the question related to the market share gains and you've highlighted that you've really grown on your share wooden deck market. What about the composite competitors? There are a couple of large players out there. Do you think you're garnering share still from the other composite players or is it more so from the wood deck market?

Jim Cline
Morris, the conversion from wood is something that we, based on all of the sources we've seen, we're clearly seeing movement on. It's pretty difficult this time of year to judge share gains, because in the first quarter most of the sales that occur in the first quarter are load-in to the distributors and into the dealers. So, until you get that sell-through, you really don't know for sure what's happening with regards to taking share from other composite manufacturers.

Morris Ajzenman
And, have you received industry data that gives us the most recent update over the past year or so in what the US share is in the composite market?

Jim Cline
We have not seen anything on that and I think that that's scheduled to come out later in the spring, late spring early summer.

Morris Ajzenman
Okay. And, lastly here, you highlight in the presentation, increased capacity utilization. I think I've asked this in the past, I think you've said north of 50%, but can you give us some idea of what increased capacity utilization means, where it is approximately, and where it was, let's say, a couple years ago?

Bryan Fairbanks
The same issues with capacity utilization and our manufacturing improvements is it doesn't reflect the financials of the company, particularly, while using that as an indicator. We did indicate last year that we were over 50%. You can see where our sales growth is, we're running at a higher level this year, but it still doesn't model the company, whereas the incremental margin guidance, because of those additional efficiencies that we have in our operations from a rate-and-yield perspective provide a better capability to model the company.

Morris Ajzenman
Okay, and, if we then use a little better than 50% capacity utilization, that would mean your revenue run rate, without much expansion, can approach $900 million, if not more. Is that fair? Not that we see any new capacity, new building a factory, but you could get there based on that sort of assumptions? Is that fair or not?

Jim Cline
Morris, as you're well aware, over the years we've put a number of processes in place that actually expand our throughput and, therefore, our capacity available. I think that level is not possible without certain expansions of certain bottlenecks. We have a number of active programs in place that would assist us in overcoming that, but the biggest problem any manufacturer has is dealing with the peak season, which basically is from May through July. And, at that point, if you didn't have the inventory or that expanded capacity, that'd be somewhat of a bottleneck.

Morris Ajzenman
Okay. Let me phrase it differently and I'll move on from here. In the next handful of years there's no need for the company to think about adding a new plant?

Jim Cline
We model that on a regular basis to make a judgment, because obviously, if you need a new plant, you have to plan that several years in advance, and we do not have any new plans at this point for construction of a new facility. We believe our existing capacity is more than adequate to cover the next several years, at least, without any changes or improvements in our processes.

Morris Ajzenman
Thank you.

Operator
The next question comes from Keith Hughes of SunTrust. Please go ahead.

Jake
This is actually Jake on for Keith. I was hoping I could just get a little bit more color on some raw

materials. It looks like in the fourth quarter you experienced lower cost. Have you seen any sequential changes and then maybe what do you see going forward?

Bryan Fairbanks
We're not really seeing, if we're addressing poly specifically, a change in the price in the marketplace, but more so the sourcing strategy, the types of materials we're going after. We've mentioned before that we see that poly market being relatively stable from a price perspective. So, now it's more on the capability of our sourcing team to be finding the right materials and becoming more efficient as we go forward.

Other raw material supplies have been relatively stable as well, but what's more important are the cost reduction initiatives that we continue to work on and the team is executing.

Jim Cline
One of the things we have seen, as you're probably aware, Trex uses recycled polyethylene. Over the last year we have, in fact, seen an increase in virgin polyethylene prices, both for linear load density, which is what we use, and also high density polyethylene.

With the AUS-SPEC resin which some people use to fill in their demand, that has been relatively stable and quite attractive, but you can't buy your whole source from that. So, we do see a little bit of pressure on some of our competitors from a cost standpoint.

Jake
Okay, great. Thanks. Then, also, any insights onto channel inventories right now? How are those looking?

Bryan Fairbanks
We're very comfortable with where the channel is at this point. As Jim mentioned, first quarter is primarily a sell-in quarter and when we look at it on a year-over-year basis, we work with our distributors, understand what they have moving into the season, and we're very comfortable moving into the second quarter.

Jake
Alright, great, thanks. That's all I have, guys.

Operator
Again, if you have a question, please press star, then one.

The next question comes from Jim Barrett of C. L. King & Associates. Please go ahead.

Jim Barrett
Good morning, everyone.

Jim Cline
Morning, Jim.

Jim Barrett
Jim, you reiterated that the March quarter is generally a load-in quarter. I'm just trying to understand the strong volume performance, given the fact that it was winter time, even though it is a load-in quarter, historically sales have been affected by the weather. So, with March being a wintery month, there was a lot of rain out west, can you elaborate as to did your distributor simply buy product

regardless or was the growth concentrated in Jan-Feb?

Jim Cline
Our distributors are focused on being able to service the market when the weather breaks. They began taking material in December and that was relatively undisrupted. The weather conditions we saw, in Northeast you had the one snowfall that came in late that did slow the Northeast market a bit, and also you remarked on the wet weather out west that certainly did have a temporary impact on the California and the Pac Northwest. That seems to have picked up the shortfall by now and that's pretty much behind us.

Jim Barrett
Good. And you typically provide pricing and volume stats in your 10-Q. Can you tell us what that is? You touched upon it earlier, given your mark—would appear to be market share gains possibly. How are your competitors reacting to those gains?

Bryan Fairbanks
Let me take the pricing first. We didn't take any pricing going into this year and any new pricing we would communicate to the channel, so that gain that you're seeing is all volume.

Jim Barrett
Good. And, Jim, any reaction by your competitors to your performance?

Jim Cline
As we talked about last year, we do have one competitor who is putting aberrant programs out there that, as they try and disrupt the market and gain share back, they have been essentially ineffective with that. It creates more distrust by the people that they're trying to recruit than wins their hearts. So, we haven't seen any fall out from that.

Jim Barrett
Good. Well, thank you, both.

Jim Cline
Thank you.

Bryan Fairbanks
Thank you.

CONCLUSION

Operator
This concludes our question-and-answer session. I would now like to turn the conference back over to Jim Cline for any closing remarks.

Jim Cline
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 weekend.

Operator
The conference is now concluded. Thank you for attending today's presentation. You may now disconnect your lines. Have a great day.