Trex Company, Inc.

First Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Jim Cline - *President, Chief Executive Officer*

Bryan Fairbanks - *Vice President, Chief Financial Officer*

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

Viktoriia Nakhla - *Investor Relations*

PRESENTATION

Operator
Good evening and welcome to the Trex Company First Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*" then "1" on your telephone keypad. To withdraw your question, please press "*" then "2." 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 all 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 is Bill Gupp, Senior Vice President, General Counsel and Secretary, as well as other members of Trex management.

The company issued a press release today after market closed containing financial results for the first quarter of 2018. This release is available on the company's website. This conference call is also being webcast and will be available on the investor relations page of the company's website 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
Thank you, Bill and thank you all for participating in today's conference call. This was a strong quarter for Trex, representing our fifth consecutive quarter of record revenue and net income and a positive start to another growth year for the company. First quarter of 2018 sales results reflect the expected high single-digit growth in Trex residential products.

In the December through March time period, we focus on stocking orders from our distributors and dealers to ensure that an adequate inventory is available in advance of the peak decking and railing season. Our year-over-year residential organic demand for the first quarter and for the first four months of this year indicates a much stronger low double-digit demand curve.

Economic forecasts support our expectation for continued progress in 2018. First, the repair and remodeling market is expected to grow at a high single-digit rate in 2018 and exterior property improvement, the subsector that most closely aligns with Trex Residential is expected to capture 34% of the home improvement spending. At the same time, consumer confidence is at its highest level since 2004. This index historically correlated well with Trex residential sales.

From a company perspective, our data analytics shows that the North American consumer has been very active in the marketplace so far in 2018. Despite the long winter that has persisted in parts of the country, we are seeing record activity on our website and our trade partners continue to report positive point-of-sale data.

Also, with lumber pricing increasing, the Trex value proposition for decking and railing has become even more attractive to consumers and it's not just a question of pricing. The quality of certain wood species is not as good as it was in the past. All of this underpins our conviction that the composite category will continue to gain share from wood.

As the undisputed category leader, we believe that Trex is capturing more than its share of the conversion from wood. This represents an excellent return on the investments we have made in our targeted marketing programs that we rolled out over three years ago.

We also reported during the first quarter that Trex was honored with awards from the 2018 Builder Brand Use Study. For the 11th consecutive year, Trex was named as the Brand Most Used and the Brand Most Used in the Past Two Years for composite PVC decking category. Trex also took the top position in quality category in this year's study.

Trex commercial products also had an improved first quarter and its performance was consistent with our expectations, reflecting a solid backlog, as well as, new project wins. As you know, we are a leading provider in the domestic commercial railing market which we estimate at approximately $1 billion.

We continue to be the market share leader for major stadium projects with about 85% of all major stadiums and arenas in North America. A good example of a recently completed project is the Little Caesars Arena in Detroit, which is the home to the NBA Pistons and the NHL Red Wings.

The project included over 18,000 feet of Trex commercial railing. The Arena was designed to engage fans and features gondola-style seating that is suspended above the playing area, accompanied by several hundred feet of strong secure glass track rail provided by Trex Commercial Products.

Our involvement in a project of this scope can last for several years from planning to final installation, but we also bid for refurbishments of college stadiums and smaller athletic venues like soccer and tennis stadiums that have a much shorter project cycle.

We are pleased with our first quarter gross margin performance as it was in line with our expectations for continued expansion of our residential and commercial gross margin. In residential the drivers of the high gross margin were similar to the prior quarters which Bryan will detail later.

One of our major manufacturing cost savings initiatives which I mentioned last quarter involves improvements to our production lines that will provide a step change in the manufacturing process of our deck boards. We began implementing the first phase of these manufacturing enhancements in the first quarter of 2018. We will complete the retrofit to the remaining lines by the end of this year.

In the first quarter, we utilized one of our production lines for a significant number of trials and the results of those trials of the first phase were outstanding. When the first phase of this is completed in the fourth quarter of this year, available capacity will increase by at least 20%. More to come on this as the year progresses.

The commercial gross margin recovered from the fourth quarter levels reflecting the roll-off of several legacy projects. We continue to make progress on margin improvement with the execution of a number of cost reduction initiatives and improved acquisition of estimating and project management. We continue to be confident in our ability to drive margin improvement through the second half of this year.

I will now turn the call over to Bryan Fairbanks, our Chief Financial Officer, to provide further insight into our financial results for the period. Bryan?

Bryan Fairbanks
Thank you, Jim. Good afternoon, everyone. We are pleased to report strong year-over-year comparisons driven by increased recognition of the Trex brand and operational performance. First quarter 2018 consolidated net sales amounted to $171 million, representing an 18% year-over-year increase, as higher volumes in Trex residential products drove 7% sales growth to $155 million. We are also pleased with Trex commercial products contribution of $16 million.

Consolidated gross margin was 44.8%, compared to the 45.0% reported in the first quarter of 2017. The impact of the inclusion of lower margin Trex commercial products was almost completely offset by the strength in Trex residential where gross margin expanded 260 basis points to 47.6%. This significant margin expansion was due mainly to material cost advantages and manufacturing cost savings which together accounted for approximately 80% of the year-on-year improvement and higher capacity utilization, which represented 20% of the increase.

Trex continues to benefit from the use of low cost raw material streams which provides a significant cost advantage. Also, we are investing in R&D programs to develop processes that will allow us to use a greater variety of scrap material including lower cost and harder-to-recycle sources.

Trex commercial products gross margin at 17.7% for the first quarter improved from the fourth quarter 2017, as lower margin legacy contracts began to roll off. As Jim mentioned earlier, we are confident in our ability to improve commercial gross margins this year. The challenges we see in the commercial business are similar to the ones we faced at Trex a number of years ago and our teams are working together to deliver margin improvement by the beginning of this year's third quarter.

SG&A for the quarter totaled $29 million, brand related expenses that drive market share gains, the inclusion of Trex commercial products and $1.2 million in non-cash amortization of intangible expenses related to our recent acquisition resulted in a $5.7 million increase in SG&A. This represented 16.9% of sales compared to 16.1% of sales in the year ago quarter. Exclusive of amortization expense, SG&A was 16.2% of sales for the quarter, 10 basis points above the comparable quarter in 2017.

Net income amounted to $37 million, or $1.25 per diluted share, representing year-over-year increases of 33% and 32%, respectively, from $28 million, or $0.95 per diluted share, reported in the last year's first quarter. This increase was partially attributed to timing related to a lower tax rate of 22% which resulted from reduced federal statutory rate and benefits realized in the quarter on divesting of stock compensation.

With respect to capital allocation, in the first quarter we invested in a number of fast return projects that will result in future manufacturing cost savings, process improvements and other operating efficiencies.

Additionally, we repurchased 50,000 shares of our outstanding common stock for a total outlay of $5 million as part of the share buyback program authorized by the board of directors in February 2018.

For financial modeling purposes, please note the following items. We expect consolidated incremental margin for the full year 2018 to be approximately 45% to 50%. We project the improvement to be second-half weighted related to the manufacturing process enhancements noted by Jim and margin improvements in the Trex Commercial Products segment.

Full year capital spending is projected between $20 million and $25 million. SG&A is expected at approximately 17.5% of sales for the year. The remaining intangible expense related to the SC acquisition is approximately $1.7 million and will be fully amortized by the end of the third quarter.

We expect the full year tax rate for 2018 to be 25%. The board of directors approved a 2-for-1 stock split of the company's common shares in the form of a stock dividend to be distributed on June 18, 2018, to the shareholders of record at the close of business on May 23, 2018.

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

Jim Cline
Thanks, Bryan. We're off to a solid start in 2018. The environment for consumer spending on home improvement and for outdoor living in particular, remained strong, and we are seeing positive comparisons in Trex Commercial. At the same time, we have begun to benefit from the cross-product development between our residential and commercial operations.

While we're seeing some increased costs in transportation, metals and certain other categories, we have clearly been able to more than offset these increases with cost-reduction initiatives and favorable capacity utilization.

In the second quarter, we expect to report consolidated sales of $191 million. We anticipate that Trex Residential sales will be $174 million and Trex Commercial Products will contribute $17 million. This will represent a year-on-year growth of 10% for Residential and 21% on a consolidated basis.

Reflecting our positive long-term outlook, and as Bryan mentioned, the board of directors has approved a 2-for-1 stock split to be distributed on June 18 to shareholders of record on May 23rd of 2018.

Operator, I'd now like to open the call to questions.

QUESTION AND ANSWER

Operator
We will now begin the question and answer session. To ask a question, you may press "*", then "1" on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys, to withdraw your question, please press "*", then "2."

Our first question comes from Matt McCall with Seaport Global Securities. Please go ahead.

Matt McCall
Thank you. Good afternoon, guys.

Jim Cline
Good afternoon.

Matt McCall
Bryan, first, thanks for the details around the drivers of the gross margin improvement. That was helpful. Maybe on that note, you'd originally talked about 45% gross contribution margin last year. You've inched that a little bit higher. I was curious about which one of those buckets has given you the comfort to take that range higher. Where is the incremental benefit coming from?

Bryan Fairbanks
Yes, the guidance that we provided is consistent with what we talked about a year end for the full calendar year 2018. We see very similar type benefits of what we've seen in the past couple of years. We'll still have strong operational savings from our cost initiative programs. We'll see utilization. The raw material benefits won't be driven as much through pricing. We've talked in the past about gradual declines in pricing in the marketplace. But more so related to the efforts that we have from an internal perspective with R&D and operations to find different classes of material that can be used that may not be actively sought after today. So we'd expect that the categorization of those savings to fall roughly into the same buckets and not too different of amounts.

Matt McCall
Okay, okay. That's helpful. Jim, you talked about the expected step function and the capacity you're going to open up later this year. And I know you're talking about some cost efficiency efforts maybe. Are the two separate, or are we talking about the same thing? What I'm getting at here, you talk about step function from a utilization perspective. What about from a margin perspective? What about from a revenue perspective? Are you going to be able to benefit on the top line from the debottlenecking you referenced?

Jim Cline
Well, we've been able to service our customers within a two-week lead time in season. So it really doesn't expand our capabilities to handle more sales. It's really two things. It adds a buffer on our capacity that is something that we need to pay attention to as we go forward. This is the first of at least four phases that we've identified. So we see follow-on opportunities clearly beyond this first move. There will be cost reductions that we'll start to see in the second half of this year, but the full benefit of this first phase won't be recognized until 2019.

Matt McCall
And are those cost reductions reflected in the new contribution margin outlook?

Jim Cline
They are for 2018.

Matt McCall
2018. Okay, and then the last question I had, you talked about the initial stocking period and how that's been encouraging. You talked about a low double-digit demand curve. So I want to make sure I understand what you're referencing there. I think you were up 7% in the quarter, but sounds like the incoming order rate might be higher than that. I know you've talked in the past about some of the pricing actions that your competitors took. Any indication if that's turning into incremental volume for Trex in the form of restocking or anything like that?

Jim Cline
Yes. It's too early on any effect related to competitor pricing but compared to the 7% we showed on sales to load the channel, clearly the organic sales in the first quarter was substantially greater than that 7%. Also, as we went into April, we again saw very strong organic demand that basically is much closer to that point-of-sale information that we like to track. It is not unusual for us to start out with a lower percentage, because we do a very heavy load-up when the material is not really required, so that we get it downstream so that we've got both the distributor and dealer with product on the ground ready to be able to respond to the demands of the consumer at the retail level.

Matt McCall
Okay. Thank you, Jim.

Jim Cline
You're welcome.

Operator
Our next question is from Alex Rygiel with B. Riley FBR. Please go ahead.

Alex, your line is live, you may proceed with your question, please.

Alex Rygiel
Thank you. Congratulations on a nice quarter, gentlemen.

Jim Cline
Thank you.

Alex Rygiel
As it relates to lumber inflation, can you talk about how that affected your business? And have you seen pressure-treated lumber inflate as well?

Jim Cline
Yes. What we're seeing is, with cedar and redwood in particular, prices have gone up considerably on both of those. Quality is not as good as what it has been in the past. And so we are extremely competitive now in both of those arenas. We have not seen a movement on the pressure-treated of any significance. I think at some point we will see they have the same inflationary dynamics that affect them with regard to the raw lumber. And I think it's a matter of time before they will be looking at price increases to the marketplace.

Alex Rygiel
As it relates to the commercial business, can you discuss the second-half outlook as it relates to the top line with regards to seasonality and the backlog and visibility it gives you?

Bryan Fairbanks
Yes. We do have a backlog that goes out between generally 6 to 18 months related to our projects. We do have visibility that of when the projects and the revenue will be coming through on it. There is some seasonality to the business, not to the extent that we see in the decking and railing business, but we are projecting that the business will grow in excess of what the residential segment will be growing on a full year basis.

Alex Rygiel
Thank you.

Operator
Our next question is from Frank Camma with Sidoti & Company. Please go ahead.

Frank Faiella
Hey, guys. It's Frank Faiella on for Frank Camma. I have a question on the raw materials, but more so on the commercial side. Past calls, you've talked about stainless steel and aluminum. I was wondering if you could talk about some of your sourcing for those too.

Bryan Fairbanks
Yes. We have sourcing agreements for both stainless steel and aluminum through a number of different suppliers. It's both within the Residential as well as the Commercial segment. We have seen some inflationary measures there with some of the recent tariffs. And there's also been some volatility in those markets as well. For the bids we put together, we do try to include enough provisions to be able to protect for the price increases as we go forward or have clauses that allow for repricing as necessary. And it's something that we are aware of and we monitor closely as we are estimating these projects and having that direct information and on a timely basis is important, as we are preparing these estimates on projects that can range out to 18 months.

Frank Faiella
Okay, thanks that’s helpful. And then just staying on the same subject, last quarter, it sounded like commercial business was a little behind, but it was really just a timing thing. I was just wondering if that's still the case or if any of that timing of projects or if you could talk anything about that?

Bryan Fairbanks
It was just really the catch up from the fourth quarter, we were a little bit below where we expected to be in the fourth quarter and came in a little bit higher in the first quarter of this year. As we said, these projects, to exactly when the revenue gets booked, it can move from quarter-to-quarter. We've got good visibility, but within a couple of million dollars, it can move from quarter-to-quarter. So that was really the only dynamic that we saw in the first quarter.

Frank Faiella
Great, thanks. That’s all I had. Thank you.

Operator
Our next question comes from John Baugh with Stifel. Please go ahead.

John Baugh
Thank you. My congrats as well for another terrific quarter. Jim, I was wondering, the raw material cost input, are you still seeing a like-for-like decline in that or is that flattened out or is all the benefit from being able to source lower-quality, lower-cost waste streams?

Jim Cline
You are referring to the poly, in particular, I think, right?

John Baugh
Yes.

Jim Cline
Yes, we really look at this in two ways; if you did a like-for-like on the poly it seems to be a slightly weakening market. We have been very focused at trying to qualify new materials, as Trex has been very successful with this approach in the past, but we are trying to qualify these new materials that basically nobody else wants. And what that means is, we can take materials that are lower price and being able to use those, maybe 25% or even 50% of what our material costs would be at these lower price items that helps drive our overall cost profile to a lower level. And that's something we've always done. I think we are getting a little better at it. And we've been pretty successful over the last 12 to 18 months, in particular.

John Baugh
Right, and then the process improvements in capacity, is there any way to give us a sense for, I know you don't want to give out your capacity utilization numbers, but I am just trying to figure out how this may or may not influence capital spending plans out into some period in the future in terms of being able to push that out. Or put another way, when would we might expect you have to meaningfully spend more capital to expand capacity or to solve that problem for several years?

Jim Cline
Yes, when we look out at our capacity requirements, we are basically going out three to four years and looking at our capacity requirements. Before this 20% improvement, we did not have a need for an additional building for the next three to four years. So this further pushes out the need for additional production facilities with this first phase. And again, I mentioned first phase, we do have four phases of this process that we've identified. And it's our belief that we can eventually push the requirements for an additional manufacturing facility out considerably further with the additional phases. As with anything, you take a low-hanging fruit first with the lowest CAPEX spend and the best bang for your buck and that's what we've done for 2018. It starts to get more expensive as you go into 2019-2020 and beyond. But at this point, we are basically doing the first phase as a straight add-on. Second phase will be replacing equipment that needs to be replaced anyway with better equipment that will enhance our throughput. So part of this would be replacement capital but with additional throughput capabilities on the replacement side.

John Baugh
Great, thanks and congrats on that. Last question, can you give us any sense, and maybe you need to look backwards at calendar 2017, as opposed to the first four months of this year, but I am trying to get a sense on the residential market. If you are growing in that 10% area, how much of that you think, is you getting some share from wood versus maybe how you are doing versus your WPC competitors?

Jim Cline
Yes. It’s a tough number to come by. The overall market change, I think when we end up this year, I wouldn't be surprised to see the wood market lose about 1 point of share. That would be about $50 million. Now, that would be spread between us and other competitors. We believe, because of our campaign that we've been very active on, the customers that we have, we think that we pick up a greater percentage of that wood add. I think the benefit there moves us certainly above the expected high single-digit of growth that the market is expected for composite material.

John Baugh
Great, thanks for that color. And congrats, good luck.

Jim Cline
Thank you.

Operator
And again, if you would like to ask a question, please press "*" then "1".

Our next question is from Keith Hughes with SunTrust. Please go ahead.

Keith Hughes
Thank you. You were giving a description of the step change of manufacturing, and the first phase this year was an add-on. Is this something in the first phase? Does this increase production speed, or does it lower cost, or is there something that uses less material? I don't really understand what you mean an add-on.

Bryan Fairbanks
Well, basically, it's a retrofit of the production equipment. We are adding additional equipment and that gives us a better throughput profile, better quality than what we had before.

Keith Hughes
Okay, and your discussion earlier of double-digit or order pace for double-digit gains for the year, you had a phenomenal organic growth in the second half of last year. Are those tough comps going to slow down the rate at all or is that irrelevant to what the year looks like?

Jim Cline
Yes, it's difficult to say how this is going to fall. And I think other people on calls have brought this issue up. But part of the issue that every company is running into right now is transportation. And it tends to make the sales for everybody a little bit lumpy. Things that you expect will drop in the second quarter may end up dropping in the third quarter. We are playing heads-up ball on that. We've seen this impacting us. For example, in the first quarter where we had several million dollars worth of orders that were scheduled to be shipped out, couldn't get wheels under it because of transportation. That problem is going to be worse in June. And so, we are working to move orders so that we can not have that bottleneck at the end of the quarter. I think it ends up being a little bit different mix than what we expected at the beginning of the year and being driven more by transportation than consumer demand.

Keith Hughes
Alright, thank you.

Jim Cline
You bet.

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

CONCLUSION

Jim Cline
Thank you. We do not publicly give credit often enough to one of our greatest competitive advantages, our people. Our ongoing success would not be possible without the best team in the business. We recently did an employee engagement survey related to Trex and looked at our overall results, it indicated three dimensional strengths that were quality and customer focus, clear and promising direction and employee engagement. These were significantly above industry norms and underscores where our team has been so successful, not only with our operating results but equally important with our customers and consumers. To all of our employees, thank you for your support of the company. And to our shareholders, we thank you for your confidence in Trex. Wish everybody to have a good evening. Thank you.

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