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TREX - Q4 2017 Trex Company Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, and welcome to the Trex Company Fourth Quarter 2017 Earnings Conference Call. (Operator Instructions) 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 close containing financial results for the fourth quarter of 2017. This release is available on the company's website, and 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?

William R. Gupp - *Trex Company, Inc. - SVP, General Counsel and Secretary*

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.

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Thank you, Bill, and good afternoon, everyone. Thanks for participating in today's call to review our fourth quarter and full year results and discuss our outlook heading into 2018. 2017 was Trex Company's fifth consecutive year of record revenue and earnings. Over the last 5 years, our revenue growth has averaged 13% and our EBITDA has grown by about 25%. This is a clear confirmation of the continuation of the positive trends we have seen in our business and our ability to capture market share, drive consistent production and process improvements and manage our cost structure.

Our fourth quarter results represented a strong finish to another excellent year. Revenue growth from Trex Residential Products was 15%, reflecting strong organic activity during the quarter as well as positive dealer and distributor response to our Early Buy Program.

Current industry data can be hard to come by, but it's safe to say that our industry continues to gain share from the dominant wood market. As the brand leader with our targeted advertising and marketing campaigns, we are confident that Trex is gaining a significant share of this conversion from wood. Our website analytics for full year 2017 tell the story and support our confidence in our future growth. Traffic to the purchase indicator areas of our website drove a double-digit increase compared to 2016. Data coming from our markets outside of North America was even more robust.

Similar to prior quarters in the last several years, we were able to convert our strong top line growth in Residential Products to a much stronger growth to profitability. Several factors contributed to the significant operating leverage that we achieved in the fourth quarter. Gross margin expansion reflected our success in the execution of significant manufacturing cost savings initiatives, reduced global demand for recycled polyethylene and new sources of lower-cost material and higher-capacity utilization. I know there's been a significant interest in how we're able to continuously drive reductions of the magnitude that our performance implies.

So here is one example of an initiative that is underway. In the fourth quarter, we completed the testing of the first phase of various improvements to our decking lines that will provide a step-change in the manufacturing process for our deck boards. In the first quarter of 2018, we began to implement the production line enhancements and will complete this phase by the end of the year. This retrofit not only provides material expansion of our decking capacity, but also drives significant cost savings that we will begin to realize in the second half of 2018. This is the type of high-return, high-impact initiatives that our operations and R&D teams are focused on to propel our business forward. As we move ahead into 2018, we'll provide additional color on this project.

At the same time, we continue to allocate a portion of our SG&A spending on the future. These investments include personnel, R&D and branding to support the expansion of both our top and bottom line in the periods ahead.

In the fourth quarter, the strong performance of our Residential Products segment more than offset softer results from Trex Commercial Products, where revenues were slightly lower than expected due to project-related timing. Additionally, we continue to make progress on execution issues, primarily associated with legacy commercial projects. These challenges are similar to what we experienced at Trex in 2008 through 2010. We are working together with the Commercial Products team to implement the improvements necessary to deliver margin enhancements by the beginning of the third quarter of 2018 as we've previously discussed.

The acquisition of SC has brought additional capabilities and efficiencies to our Residential Product development initiatives. We met with many of you at the 2018 International Builders' Show, where we introduced the new Trex Signature rod rail, which combines a view enhancing design with the trendy industrial style that has captured the attention of the homeowners and has the look, durability and low maintenance qualities that define Trex products. We are able to bring that product to market in about 1/3 of the time that it would have taken us without the combined support of the commercial and residential engineering teams.

This is important, because over 2/3 of the decks sold in the United States today are fitted with railing. We see this as a continuing growth pattern -- platform for Trex, and you can expect us to continue to roll out additions to our railing product offering throughout 2018. We will also continue to drive innovation in the commercial railing space, similar to the product showcased and the impressive array of custom railings at the January 2018 International Building Show.

To sum up 2017, it was a year of continued strong support for Trex products driven by successful branding campaigns, strong relations we have with our business partners and the attributes of our products: high quality, low maintenance and environmentally responsible, all of which are increasingly important to the homeowners today. At the same time, we executed well across the organization, achieving manufacturing cost savings and efficiencies while also focusing our SG&A spend on current as well as future opportunities. This is the same formula that has supported our record results over the last 5 years.

I would now like to turn the call over to CFO, Bryan Fairbanks, who will provide additional insight to our financial performance. Bryan?

Bryan Horix Fairbanks - *Trex Company, Inc. - VP, CFO & Principal Accounting Officer*

Thank you, Jim. Good afternoon, everyone. I'm pleased to report on another year of record sales, gross margin and net income. Before I get into the quarter and year-end results, as a reminder, EBITDA, net income and earnings per share for the 2016 fourth quarter and full year have been restated to reflect the adoption of the new FASB standard related to deduction of stock compensation. Also, when I discuss 2016 adjusted figures, I'm excluding the effect of a $9.8 million warranty reserve charge taken in the third quarter of 2016.

Fourth quarter sales increased 28% year-over-year to $122 million, reflecting robust organic growth of Trex Residential Products, where sales amounted to $110 million, a 15% increase from the year-ago quarter. As in recent quarters, this growth was virtually all related to volume. Trex Commercial Products contributed $13 million to fourth quarter sales, modestly below our expectations, which was driven by timing of projects. Consolidated gross margin expanded by 170 basis points to 41.7%. Trex Residential Products gross margin was 45.9%, 590 basis points ahead of last year, thanks to manufacturing efficiencies, lower input costs and higher capacity utilization.

Trex is perfectly positioned to continue to benefit from China's ban on waste materials. Recycling market is pressuring scrap prices, continuing to provide Trex a significant raw material advantage. We also continue to invest 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.

SG&A for the quarter amounted to $26 million, up 39% from the same quarter in 2016. This growth was as a result of the addition of Trex Commercial Products, branding and personnel-related expenses to support future growth. Also, SG&A this quarter included $1.2 million in non-cash amortization of intangible expenses related to the acquisition of SC Company. Exclusive of amortization expense, SG&A was 19.9% of sales for the quarter.

In the fourth quarter, EBITDA increased 29% to $30 million, up $23 million in the year-ago quarter -- up from $23 million. Commercial EBITDA was negative for the quarter due primarily to legacy low-margin contracts. We expect these contracts to continue to weigh on commercial gross margins through the first half of this year, though the impact will diminish through the first half. Residential EBITDA increased 38% to $32 million compared to last year's fourth quarter.

Net income was $18 million or $0.62 per diluted share, year-over-year increases of 45% and 44%, respectively. Our net earnings included a onetime positive impact of $1.9 million or $0.06 per share as a result of the revaluation of deferred tax assets and liabilities in light of the recently enacted Tax Cuts and Jobs Act. Due primarily to the lower-margin legacy contracts I mentioned at Trex Commercial Products, they had a $0.07 negative impact on the earnings for the quarter.

Full year 2017 sales amounted to $565 million, an 18% increase from 2016 with Trex Residential Product sales up 13% to $543 million. This increase was driven mainly by volume growth that was positively impacted by continued strength in the remodeling sector, market share gains from wood and share gains within the composite industry. The remaining $22 million was Trex Commercial Products sales contribution from the period from the date of the acquisition of July 31, 2017, through year-end. You can find further details on both Trex Residential and Trex Commercial Product segments in the 10-K, which will be filed today.

Consolidated 2017 gross margin was 43.1%, a 410-basis point improvement from last year and 200 basis points higher than the 2016 adjusted gross margin, reflecting primarily cost-reduction initiatives, lower-cost raw materials and increased capacity utilization at our Trex-branded decking and railing plants.

Our SG&A expenses for 2017 were $101 million compared to $83 million in the prior year. As a percentage of sales, however, we saw a 60-basis point increase to 17.9%. This percentage was slightly ahead of our guidance or flat year-over-year percentage. The increase was primarily related to the acquisition of SC Company. SG&A costs related to the acquisition include $2.5 million of intangible amortization and other transaction costs.

The effective tax rate for the year ended 2017 finished at 33%, down 100 basis points from a year ago, primarily due to the recently enacted Tax Cuts and Jobs Act and as a result of deferred tax assets and liabilities revaluation.

Net income for the full year amounted to $95 million or $3.22 per diluted share, year-over-year increases of 40% and 41%, respectively. For full year 2017, operating cash flows were a record $102 million, 19% ahead of prior year, and capital expenditures were $15 million, similar to the prior year. The SC acquisition was fully financed with internally generated funds.

For financial modeling purposes, please note following items: We expect consolidated incremental margin for the full year 2018 to be approximately 45%. Recall that Trex will have a 12-month effect from the SC Company acquisition, which carries lower margins than the residential segment versus 5 months that were included in the 2017 financials. Full year capital spending is projected between $20 million and $25 million. SG&A is expected at 17.5% for the year, down 40 basis points from 2017. Recall that 2018 also includes $900,000 of intangible amortization over the amount expensed in 2017. Intangible amortization related to SC acquisition in 2018 will total approximately $2.9 million. In light of the recently enacted tax cut, the company currently estimates the related reduction in corporate tax rate will result in an effective tax rate of approximately 25% for 2018.

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

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Thanks, Bryan. We expect 2018 to be another year of exciting opportunities for Trex. First, there are the macro tailwinds. Projections are for continued growth in the repair and remodeling market, and consumer confidence levels remain strong, 2 indicators that we track closely. At the same time, the composite market is clearly taking share from wood, and Trex continues to gain share of composites, all pointing to the positive momentum that we will expect to benefit Trex in 2018. Additionally, we expect to continue to capitalize on the structural benefits of our unique recycling business model and our ongoing manufacturing cost-reduction initiatives to continue to expand our margins.

As Bryan mentioned, the tax reform act will result in a significant reduction in our effective tax rate in 2018. Based on historical experience, we believe that consumers will utilize a portion of their reduced taxes to improve their homes by investing in outdoor living.

With respect to our capital allocation program, our priorities remain the same: organic investments, acquisitions and share buybacks. As for the latter, our Board of Directors just authorized a new share repurchase program of up to 2.9 million shares of our outstanding common stock. This replaces the plan that was in place prior to the end of the year.

Looking ahead to the first quarter of 2018, we expect to report consolidated sales of $172 million, representing a 19% growth. This is comprised of $157 million from Trex Residential Products, about 8.4% organic revenue growth and $15 million of Trex Commercial Products. I'd like the listeners to remember that with regard to Trex Residential Products, the first quarter of the year is primarily a load end to distribution as well as dealers and does not represent a sell-through of our product.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Alex Rygiel with B. Riley FBR.

Alexander John Rygiel - *B. Riley FBR, Inc., Research Division - Analyst*

A couple quick questions. First, in the fourth quarter, you mentioned that there was some positive dealer and distributor responses that drove a part of the strength in the fourth quarter. Can you quantify that and discuss any that might follow through in the first quarter?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Yes, it is correct that we did see a greater level of participation than what we had anticipated when we provided the guidance. The incremental sales you saw in residential primarily was a result of that. As far as getting into further details, I don't think we will on this call.

Alexander John Rygiel - *B. Riley FBR, Inc., Research Division - Analyst*

Fair enough. And then as it relates to the commercial segment, obviously, running a little bit below plan partly due to project timing. Can you expand upon that project timing? Have the projects now moved forward? And is that volume coming through in the first quarter and the second quarter? Are those projects that have been permanently delayed of some sort?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Yes. It's merely a timing. Those projects, we started to see the impact of those actually in January. So we expect that we will, in fact, pick those projects up. This related to a long, long lead time project. The timing, which, as we've mentioned before, cannot be exactly predicted as to when the user will take the product.

Operator

Our next question comes from Matt McCall with Seaport Global Securities.

Matthew Schon McCall - *Seaport Global Securities LLC, Research Division - MD and Furnishings & Senior Analyst*

So maybe -- I think I might be repeating the last question. I just want to make sure I understood. So you talked about Early Buy, and I assume that's what we're talking about with the dealer and distributor response. But is this -- I'd asked once before any indications of benefits from some competitors raising prices and you not having to. Is that -- how much of an impact do you think that's having? Or is that not yet having an impact?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Yes. I don't think you see much of that in the Early Buy, Matt. With regard to prices, you're correct. One of our major competitors did, in fact, increase prices. Trex did not follow those increases as we have been able to offset increases in certain areas with a variety of cost-reduction initiatives, both material and operational related. This time of year, the December through, basically, March is when we load the channel up. And for example, the mid-Atlantic has seen pretty decent weather over the last week, and what we try and do is we try and put product into the hands of the dealers so that we can participate in any early takeaway that might open up due to favorable weather conditions.

Matthew Schon McCall - *Seaport Global Securities LLC, Research Division - MD and Furnishings & Senior Analyst*

Okay, okay. You talked about the savings that you expect to show up from the enhancements that you're making to your lines in the back half. Given the pricing dynamic and the relative pricing and cost advantage you already have, what should we expect to be the result of that? Are those going to be used to drive top line further? Are those going to be used to expand margins further? How do you want us to think about the progression because of those benefits as we progress through the year?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Yes. I think it was merely to be an example of one of the more meaty type of projects that we're implementing. It's a one of many. We just went through a listing today, and it's about a 3-page listing of cost-reduction initiatives that are in place. Some of them are meaty like this one. Some of them are much smaller. We, like a number of businesses, are experiencing pressure in a variety of areas from a cost standpoint. We see, for example, transportation costs going up, and more importantly, the availability of transportation becoming a greater challenge not only for us but also for our customers. This is not unique to Trex. This will be something that will affect every company across North America. Transportation is going to be a challenge, and one way to alleviate that challenge is to pay additional money for those shipments. So our view is that we've got a good cost-reduction model. It's very similar to the number of projects we had in prior years, a little bit more exciting with some of the projects we have already launched. But nonetheless, probably we'll deliver similar savings as you've seen in the past.

Bryan Horix Fairbanks - *Trex Company, Inc. - VP, CFO & Principal Accounting Officer*

Matt, we also see that investment like this will benefit us both from a top line as well as from a margin perspective. We're able to produce our product more efficiently if we can get it to the customer on a more timely basis, especially during the busiest parts of the season, something that we've really excelled at for a number of years now. And then from a margin perspective, I think that speaks for itself with the performance we've had over the past couple of years as well as the incremental margins that we're expecting going forward. And this project is included within that guidance.

Matthew Schon McCall - *Seaport Global Securities LLC, Research Division - MD and Furnishings & Senior Analyst*

Okay, okay. And then I have one on that same line of questions. The -- you brought up China's ban on imported trash, and I was wondering if you can give any more color behind that. What's expected? I'm assuming, since you're bringing it up on the call, that there's still some benefit flowing through. What kind of benefit is assumed in that gross contribution margin outlook?

Bryan Horix Fairbanks - *Trex Company, Inc. - VP, CFO & Principal Accounting Officer*

Right. So we started to see benefits coming out of China in late -- it was really pretty much the end of '15, not as much the benefits but we see -- started to see the market change. We started to generate the benefits in 2016 and into '17. When they officially came out with the announcement, it was midway through '17 that they were backing away from a market in a more formalized basis. We were already well down the road. We do expect some continued benefit not to the same extent that we've seen over the past 2 years in that marketplace, but we do see there's pockets of materials. There are alternative recycled materials that our R&D team and manufacturing teams are extremely active in vetting. So it's not just the China ban. There are other materials that aren't as widely used that the organization is focused on.

Operator

Our next question is from Keith Hughes with SunTrust.

Keith Brian Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Just wanted to get your read on channel inventory on the sell in with the -- where you think those stand. And also, are you seeing any mix changes in your products higher-end versus lower-end zone?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Yes. With regard to channel inventory is -- I know you're aware, we don't have an exact read on the channel inventory, but our best information indicates very typical for this time of year. I would say the channel inventory is slightly higher because the expectations of our customers and the resulting dealers is for a stronger year this year than what we had in 2017. So from that standpoint, we believe that very normal inventory positions.

Keith Brian Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay. Another question on the commercial business. The -- you're describing a ramp in gross margin in 2018. Do you think in the first or second quarter -- first half, let's call it, do you see the same kind of gross margins you did in the fourth?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

We don't expect the margins to be consistent with what we saw in the fourth. We believe they'll be better. They'll be improving throughout the first half. The only question is how quickly they will improve. We had a number of contracts that were in place when the acquisition was completed. And while some of those projects, actions could be taken, in many of those, the die was cast, and what we need to do is just fulfill them and move forward.

Operator

(Operator Instructions) Our next question is from Trey Grooms with Stephens Inc.

Trey Grooms - *Stephens Inc., Research Division - MD*

This is a little bit of a follow-up on one of the earlier questions. But just on the 45% incrementals that you guys are looking for, I mean, it definitely sounds like some of these production line enhancements and other things you have going are going to really benefit the back half. So I guess, the question is around the cadence and any more detail around kind of how to think about, as we ramp through the year, to get to that 45%. And just to make sure that I understand, that 45% incremental you're talking about is the average for the entire year?

Bryan Horix Fairbanks - *Trex Company, Inc. - VP, CFO & Principal Accounting Officer*

That's correct. That is for the entire year. We're not going to get into trying to do incrementals on a quarterly basis. If you look quarter-over-quarter historically, it can be somewhat volatile, and it will change depending upon the performance of that quarter. We have been very accurate when you look at it on a full year basis, and I think that's the best way to go with modeling. Jim is correct when he mentioned that we expect that investment to assist us in the back half of the year, but there's other things we'll be doing from an operational perspective that will benefit us in the first half of the year as well.

Trey Grooms - *Stephens Inc., Research Division - MD*

Okay. So we wouldn't take -- we shouldn't read into this -- the commentary about the back half benefit from some of these line enhancements and things to mean that the 45% incrementals are going to be largely back half weighted.

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

That's correct. And also, just remember, this is the consolidated corporation. This includes both commercial and residential.

Trey Grooms - *Stephens Inc., Research Division - MD*

Right, right, right. Got you. Okay. And then on the topic of the commercial business, I know this can be more of a lumpy business. But not being as familiar with that one, with that side of the company as we are the res, the residential side, the -- I guess, on the timing of just the natural lumpiness of this, outside of that, is there any real seasonal trends that we need to be aware of as we kind of look at the commercial business when we're modeling through the year?

Bryan Horix Fairbanks - *Trex Company, Inc. - VP, CFO & Principal Accounting Officer*

No, there really isn't a seasonal nature of that business. It is project driven. For smaller projects, the more even it's going to be, but when you get some of these larger projects, that can change the timing of it. But it's not really related to seasonal.

Trey Grooms - *Stephens Inc., Research Division - MD*

And with the backlog that you guys are seeing in that side of the business, I don't know how much you can go into this. But maybe just helping us to think about how to level out the -- or how lumpy or not the results of that business could be. Is it more dominated by some of these smaller projects? Or are there any other big ones that we need to be aware of that can still lead to some lumpiness?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

There are some large ones, but to give you an idea of lumpiness, for example, in the fourth quarter, the movement, I think, was under a $2 million movement from 1 quarter to the other compared to what we had anticipated were going to take place. So it's not really material to the consolidated results, but it does become lumpy. Now having said that, there are some major contracts that we are engaged in a bid process on that are of a magnitude that could generate something greater than a couple of million dollar swing. But those would be contracts you wouldn't see until perhaps the end of '18 at the earliest and more likely in 2019.

Trey Grooms - *Stephens Inc., Research Division - MD*

Got it. Okay. And then lastly as we're kind of sticking with this commercial business, anything that we should be aware of on the raw material trends in that business? I mean, obviously, the res side, the legacy business is still benefiting from lower raws. But what about the commercial side? Anything we need to be watching there?

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Well, their materials are split primarily between 2 things: stainless steel and aluminum, primarily stainless steel though. Now what we do is we have to monitor what we believe is going to be happening with the future cost of that material and build those into our quotations. So I would say, you can monitor that and expect that we would generally be including expected inflation within those contracts. So from a margin perspective, we would not anticipate adverse impact on the contracts.

Trey Grooms - *Stephens Inc., Research Division - MD*

Got it. All right. Well, actually I do want to sneak one more in here. Just on the production line enhancements, the cost associated with that, I know you talked about -- you've given us kind of some guidelines on how to think about CapEx. But anything you can get -- I guess, that's inclusive of anything that would be included with that and just any goalposts around cost.

Bryan Horix Fairbanks - *Trex Company, Inc. - VP, CFO & Principal Accounting Officer*

So the CapEx number provided is inclusive of those investments and really nothing further. It was just an example of the type of programs that we have in place to be able to continue driving the financial benefits of the company.

Operator

(Operator Instructions) And at this time, I'm showing no further questions. I would like to turn the floor back over to Jim Cline for any closing remarks.

James E. Cline - *Trex Company, Inc. - President, CEO & Director*

Thank you. I know that it's not lost on all of you that it is not a single group of people but rather a full team of the Trex employees that have driven these fantastic results for 2017. It's the same team that's going to deliver on an outstanding 2018. I've been privileged to work with this group for 10 years now. The time has just flown by. Can hardly believe it. And they've never ceased to amaze me with their dedication and focus on delivering both top line and bottom line results. We look forward to talking to you again with our first quarter results, and I want to thank everyone for participating today. Have a good evening.

Operator

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