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TREX - Q3 2017 Trex Company Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the Trex Company Third Quarter 2017 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Lynn Morgen. Please go ahead.

Lynn Morgen - MBS ValuePartners, Inc. - Founding Partner

Thank you all for joining us today, and thank you, operator. 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 third quarter of 2017. 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'd now like to turn the call over to Bill Gupp. Bill?

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

Thank you, Lynn. 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.



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

Thank you, Bill, and thank you all for joining us this afternoon to review our third quarter results and discuss our outlook for the remainder of 2017. By all measures, this was an outstanding quarter for Trex. We again achieved record sales with organic sales growth of 23%, virtually all of it coming from volume gain. This growth rate is well above the projected mid-single-digit growth rate for the industry and is a clear indication of how well we are engaging with consumers and our trade partners. We believe that our strong revenue growth is, in part, a function of Trex's proven ability to gain incremental share in composite market and the composite market's increasing appeal to consumers.

But that represents only one part of the story, with the rest reflecting our success in gaining share from the large entrenched wood market, which, in 2014, accounted for about 84% of all the residential decking and railing in North America. Two years ago, we launched a major offensive to gain a meaningful share of the wood market. Our campaign has been comprised of television, print and digital advertising, paired with the continuous enhancement to strengthen our brand relationships with consumers and dealers.

It is clear that we are beginning to see the results of our influence with the consumer. The Trex brand is associated with high-quality and low-maintenance outdoor living products that enhance the resale value of a residential property, and as our sales momentum increasingly reflects, changing consumer behaviors, our dealers and distributors are benefiting considerably from their connection to the brand.

In 2015, after we initiated our national advertising campaign to educate the consumer on why to buy Trex versus wood, other composite manufacturers also started to direct some of their marketing effort to the conversion from wood to wood-alternative products. This increased industry spend has driven greater demand for composite.

Based on data from Principia Partners, Trex has gained 4% of additional market share of the residential composite market from 2014 to 2016. This growth is a result of continuing to take direct share from other manufacturers of composite as well as successfully converting a greater share of wood market to Trex.

In addition, the results of this year give us the confidence to say that we will continue to expand our share on both fronts. Along with our impressive organic growth, our third quarter revenue also includes a \$9 million, 2-month contribution from Trex Commercial Product. Including this contribution, the Trex consolidated revenue growth for the quarter was 32%.

Our newly acquired commercial railing products are best in class, and our engineering capabilities have been greatly enhanced. The SC engineering and management team is enabling us to significantly accelerate the time to develop and introduce new railing product into the residential marketplace.

Projects that we had expected would take about a year to jointly develop will be introduced in several months. This is just one example of how we have been able to leverage our collective strength in a short period of time since the completion of the acquisition.

Revenue synergies and margin enhancement opportunities of this acquisition are consistent with our initial expectation. Much of what is required for the success of this acquisition is what the same management team accomplished with the Trex turnaround. The good news is that this can be accomplished with the existing SC team with very little distraction to the residential products team.

With that, I'd like to turn the call over to Bryan Fairbanks for a detailed review of our third quarter result. Bryan?

Bryan Horix Fairbanks - *Trex Company, Inc. - CFO and VP*

Thank you, Jim, and good afternoon. Once again, we had record sales and strong performance across the board, resulting in record profitability. Also, our recent acquisition of SC Company, which, for financial purposes, will be referred to as Trex Commercial Products in our financial statements, was accretive to EBITDA.

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Before I begin, I want to remind you that EBITDA, net income and earnings per share for the third quarter and first 9 months of 2016 were adjusted to reflect the adoption of the new FASB standard related to deduction of stock compensation. Also, when I mention 2016 adjusted figures, I'm excluding the effect of the \$9.8 million warranty charge in last year's third quarter.

Net sales for the third quarter amounted to a record \$140 million, up 32% over the prior year, with Trex Commercial Products contributing \$9 million for the 2 months of August and September as projected. Trex Residential Products revenue increased 23% and benefited from volume growth, reflecting continued market share gain and a robust remodeling sector.

Consolidated gross margin was 39.4% compared to last year's reported gross margin of 28.2% and up 190 basis points when compared to the last year's adjusted gross margin of 37.5%. This strong performance was driven by 3 key factors: manufacturing cost reduction program, lower raw material costs and increased capacity utilization.

Trex Residential Products margin expanded to 40.6% at -- for the quarter, an improvement of 310 basis points. As we noted in the last call, both Trex Residential and Trex Commercial Products segments will be further detailed in the 10-Q.

Following the recent acquisition of SC Company, Trex will amortize \$4.9 million of intangibles over 12 months. In the third quarter, EBITDA increased 47% to \$35 million, up from adjusted EBITDA of \$24 million in the year-ago quarter. Residential EBITDA increased 43% against the prior year third quarter and Commercial EBITDA contributed \$800,000 to the quarter.

SG&A for the quarter was \$25 million. Although the total dollar amount increased 29% in the third quarter compared to the same period last year, SG&A as a percentage of revenue declined to 17.8% compared to 18.3% in the year-ago quarter, a 50 basis point improvement. The increase in the absolute dollar amount was mainly attributable to the SC Company acquisition and branding expenses.

On a year-to-date basis, SG&A as a percentage of sales was 17%, relatively flat with the 16.9% reported in the same period last year, and in line with our full year guidance.

The effective tax rate increased to 33.7% compared to the effective tax rate of 25.8% in the third quarter of 2016, primarily due to higher excess tax benefit related to the settlement or vesting of restricted stock or restricted stock units recognized in income tax expense during the 2016 quarter.

Net income was \$20 million or \$0.68 per diluted share, ahead of net income of 70 -- ahead of net income of \$7.8 million or \$0.26 per diluted share reported in the prior year. Third quarter net income improved by 34% after removing the effects of the prior year warranty reserve.

Our third quarter weighted average number of shares outstanding was 29.6 million. Just to reiterate several items that should be taken into account for financial modeling purposes. We expect consolidated incremental margin for the full year 2017 to be in excess of 50%. SG&A is projected to be in line with last year as a percentage of revenue, and we fully expect the full -- we expect the full year tax rate to be approximately 35%.

Our year-to-date results are emblematic of a strong demand for Trex outdoor living products and demonstrates our ability to leverage strong revenue growth into stronger earnings, turning a 15% year-to-date net sales increase into 40% growth and diluted EPS to \$2.60, or 25% ahead of last year on an adjusted basis. Additionally, we've generated \$93 million in operating cash flow, which allowed Trex to fund the \$71.5 million purchase for SC Company with cash during the quarter.

With that, I'd like to turn the call back to Jim for his summary comments. Jim?

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

Thanks, Bryan. To sum it up, our year-to-date results reflect our continued ability to expand our support to the consumer and deliver meaningful and measurable value to our business partners. The success of this path speaks for itself with projected record sales and earnings growth for the full year of 2017, and it sets the stage for continued progress in 2018.



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We speak a lot about the strength of the Trex brand, but the underpinning of that brand recognition are the highest-quality outdoor living products available. Products that retain their luster with minimal maintenance and that represent an environmentally responsible choice for consumers. This presents a compelling proposition for consumers, as the upfront material premium that they pay for a Trex deck is quickly offset by reduced annual repair and maintenance over the 20-year guaranteed life of their Trex deck.

Looking ahead to the fourth quarter, we expect total revenue to be approximately \$119 million, with the Trex Residential Products revenue of \$104 million representing organic growth of 9%, and a \$14 million contribution from Trex Commercial Products. Based on this guidance, revenue would be up 17% for the full year 2017, with organic growth reaching 12%.

During 2018, we expect to build upon the momentum that we have seen in our residential market. Macro trends and consumer confidence and strength of the repair and remodeling market continue to be on a strong trajectory. We are currently analyzing the data from the latest Principia industry report, which we believe will show that Trex has continued to gain share in composites and from wood.

In Commercial, we see a -- multiple opportunities to develop revenue synergies. I mentioned the new product introduction example earlier, but there are a number of other cross-selling and cross-product development initiatives underway.

We will host an Investor Day at our Winchester facilities on Thursday, December 7, during which we'll be able to provide more industry data, debuting new railing products and provide additional color on our growth strategies for both residential and commercial markets. We hope you will be able to participate. Feel free to contact Lynn Morgen of MBS or our offices for further detail.

In short, we are very pleased with our performance to date and our prospects for future growth.

Operator, we'd now like to open the call up to question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question comes from Keith Hughes with SunTrust.

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

A couple of questions. First, these are outstanding numbers, particularly organic growth within Trex. Can you talk more how the quarter went? What specifically worked so well that put out the best organic growth I think we've ever seen [in the company]?

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

Yes. I think there were a couple of things that came together for us. The strength began early in the quarter. Typically, what we see is we see that demand beginning to drop off as we get into the month of August; demand continued forward. We think it was driven by a couple of things. One is the Northeast had a delayed start to the season. We believe that the strength in the northern part of the United States certainly was part of what drove those numbers. In addition, we exercised a great deal of discretion in the expenditure of branding expenses. And our people, on a real-time basis, made certain decisions to expand certain branding spends, and we believe they were very effective in driving additional interest in Trex product.



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

Okay. Second question, the inventory levels were up pretty significantly year-over-year. Talk about where you are in inventory and what kind of production rates you (inaudible)?

Bryan Horix Fairbanks - *Trex Company, Inc. - CFO and VP*

Yes. So as consistent, during the third quarter, we did pull back a little bit on our production. But as you saw with the higher sales figures and with our guidance over the fourth quarter, we have been running inventories a little bit ahead of where we had been in the prior years. So I would expect to see us to get to a normal days inventory on hand by the time we get out to the end of the year, and I really wouldn't put anything more into that.

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

Will you be running production under demand rights in the fourth quarter to get there?

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

We'll be running production at a higher level than what we ran last year.

Operator

Okay. The next question comes from John Baugh with Stifel.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Jim, Bryan, could you tell us was it -- how the home center business was? Or any sense of the Pro business? Did you see financing increase of any note? Just curious as to what revenue bucket maybe moved.

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

Yes, John, what we saw was widespread higher demand across all markets. There was nothing notable, one market versus the other. We don't have a financing program in place for consumers, so we really don't have any direct information relative to that to see that. Typically, these projects were lined up a number of months ago, so those sales that we see taking place now would have been for, basically, immediate demand that were related to projects that TrexPros had established probably about 30 to 90 days ago.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And then it sounds like it was volume-driven, so should I read through that the mix was relatively constant year-over-year?

Bryan Horix Fairbanks - *Trex Company, Inc. - CFO and VP*

Yes. Mix was relatively constant. We look for the areas of benefit during the quarter. You've got 3 key areas: first, our cost-improvement initiatives; second would be lower-price polyethylene; and third would be over capacity utilization. Each of those accounted for about 1/3 of the benefit.



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John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And then, you gave us a little tease or, I guess, on new railing for next year. Have you had your distributor meeting yet? Have you discussed with them? And could you discuss with us product plans for next year and pricing, [if a] decision's already been made or not?

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

Yes. That meeting occurs in the month of November. And so we haven't had the opportunity to talk to our distribution partners yet on that, John. So as you're aware, we make a commitment. We talk to them first. You've got a preview, in that we've said that there are new railing opportunities that we're going to be presenting to The Street. By the time we have that meeting for the Analyst Day, we will have talked to our business partners.

Operator

The 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 Bryan, you just mentioned the bucket and you mentioned lower poly cost. I think there's various declines we've heard bantered about on the recycled poly front post the China announcement. But did the lower poly cost that you saw in the quarter, did they kind of reflect the declines, we've heard as much as 50% -- I know that's not going to translate perfectly for you guys, but I guess, the question is, is there more to come based on what we've seen post the China announcement?

Bryan Horix Fairbanks - *Trex Company, Inc. - CFO and VP*

Yes. The 50%-type numbers you're hearing are not accurate in the marketplace. The reductions that we've been seeing related to China have been something we've been seeing that started back in 2016. China has been pulling away from that market for quite some time now. Earlier this year, they announced they'd be pulling away in totality at the beginning of 2018. So you saw significant drops in 2016 during the first quarter. We saw some additional drops on a year-over-year basis. Second quarter was relatively flat. And as we talked about in prior calls, we expected that to begin to pick up again during the second half of the year, and we did see that happen during the third quarter. We do not expect to see the type of decreases that we saw back in 2016, but we do believe there is the opportunity for gradual declines as we go forward.

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

And Matt, our view on that, Matt, is that it's going to be a multiyear reduction. It's going to move down very slowly at first. It'll continue probably for the next 3 years, and different types of scrap will move at different rates. And that's why, when you identify that you're seeing 50% drops, it really depends on what kind of waste material it is. If it's very, very contaminated material, that would make sense because there are fewer and fewer people interested in that because higher grades of material are available at lower prices.

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

So any way to give us an idea of the magnitude of the decline that you experienced, and how that compares to what you expect as we move out in the future quarters? I'm just trying to make sure I understand the opportunity relative to what you just experienced.



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

Yes. We don't get into the details of what we're seeing with regard to material cost reduction, but I think, as you start to model for next year, when you get to the end of this year, what you're seeing happening this year is probably fair for 2018. If we see that getting better or worse, we'd be glad to give you guys an update. But right now, I think consistent with what you've seen this year is what we expect for next year.

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

Okay, that's fair. And then, the other question kind of the other side, virgin poly prices have moved higher post the hurricane, specifically Harvey. And then wood prices have also been higher post the hurricane, just in general. I'm just wondering if you've seen any benefit. I would assume that would be more on the top line as your cost position gets better. Are you seeing any benefit there? Did that help explain any of the strength in the quarter? Or would you point to some of the other items you mentioned?

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

Yes, we really haven't seen any competitors raising prices relative to the cost of the polyethylene. It'd be very unusual for them, mid-season, to make that change. With regard to the wood prices, we have not seen pressure-treated moving dramatically. The 2 main markets affected, the Southeast and the Houston area markets, are not ones that would -- we'd normally expect to see any significant impact, either plus or minus, from a weather-related event.

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

Okay, that makes sense. So then I guess the follow-up on that when you said, you haven't -- it would be abnormal to see them raise price in the middle of the season, would -- I mean, would it be abnormal to see them raise price and reflect this higher spot market with next pricing? Is that where you would expect the change to occur?

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

We -- if they believe that they were going to be longer term, we would expect that they would, in fact, increase prices. We did have one competitor who announced a price increase. I'll let Adam Zambanini detail what that was. Do you recall what the number was, Adam? Was it 4% to 6%?

Adam Dante Zambanini - *Trex Company, Inc. - VP of Marketing*

(inaudible).

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

Something in the 4% to 6% range. They announced it being effective, I think, sometime in the third quarter, but it's our belief that their distribution channel will shield their customers from that increase until probably the first of the year.

Operator

(Operator Instructions) The next question comes from Alex Rygiel with FBR.



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Alexander John Rygiel - *FBR Capital Markets & Co., Research Division - Director of Research*

Jim and Bryan, could you give us a quick update on international growth? And any other changes in distribution strategy in the international market?

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

International is moving consistent with our expectations. It's been expanding at a rate that is consistent with a level higher than the domestic market. We anticipate that will grow in the coming year, and as I think we've mentioned before, we have been putting a fair amount of effort as well as dollars behind expanding our business internationally, primarily Europe and Australia, in particular. And we're extremely happy with the results we've seen thus far and are committed to continue down that path of expanding our presence there.

Alexander John Rygiel - *FBR Capital Markets & Co., Research Division - Director of Research*

And in the commercial product side right now, you mentioned some number of new products. Look forward to learning about those. But if you had an extra dollar to spend today, are you more interest in spending it on R&D? Or are you also looking at acquisitions on the Commercial side to expand that business?

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

It would depend on the R&D projects. Trex is a huge cash generator, as you're well aware. The acquisition we just did, essentially, was paid with cash. We had plenty of money to pay for that, so we think we can do both, and expanding into the commercial space with the right type of acquisition would be something we would be interested in. But we would not starve the R&D on the residential side in any shape, way or form. That has been a huge driver of our business, and it's one of the reasons why you're seeing margin expansion occurring over the last several years, is that commitment to continue [running] that R&D through.

Operator

This concludes our question-and-answer session. I would like to turn the call back over to management for any closing remarks.

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

Well, thank you for your interest in Trex and participating with us in today's call. We are excited about the prospects for the future and look forward to discussing this with you on future earnings call and during our Investor Day in December. Thanks, again, and have a good evening.

Operator

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



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