

Trex Company Inc.

Q2 2018 Earnings Conference Call

Monday, July 30, 2018, 5:00 PM Eastern

CORPORATE PARTICIPANTS

Jim Cline - *President and Chief Executive Officer*

Bryan Fairbanks - *Executive Vice President and Chief Financial Officer*

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

Viktoriia Nakhla - *Investor Relations*

PRESENTATION

Operator

Good afternoon and welcome to the Trex Company Second 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, Executive 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 second quarter of 2018. 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.

Now, I would 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 joining us to review our second quarter operating and financial highlights and to discuss our business outlook heading into the second half of this year.

This was another very strong quarter for Trex, representing our 11th straight quarter of record revenue and our sixth consecutive quarter of record revenues and earnings. We think the trends are clear. Our residential business continues to benefit from high consumer confidence levels and increasing repair and remodeling spend.

Within this environment, outdoor living remains an important growth category that aligns with lifestyle trends and adds value to the home. The Trex brand continues to resonate with residential customers who increasingly recognize the competitive nature and advantage of our

decking and railing products, both compared to other composites and with a growing importance compared to the large wood market, which we began aggressively targeting three years ago.

Taken together, the positive macro-environment and our brand leadership resulted in a 20% increase in the Trex residential sales in the second quarter. The commercial segment provided \$17 million of sales and a solid margin expansion, consistent with our plan.

Related to Trex residential products, our data analytics continue to point to an engaged consumer. We have experienced record activity on our website, where the consumer can browse our products, order samples, estimate the cost of the deck, and even find step-by-step checklists for building a deck.

Additionally, our channel partners are reporting positive point of sales data along with higher lumber prices, specifically for cedar and redwood, which have further enhanced the Trex value proposition.

Given the strong demand that we are seeing, we expect the 2018 data will show conversion from wood, increasing by 1 percentage point in a single year, a milestone that took two years to achieve in prior years. The third-party data will not be available until mid-next year, so we'll have to wait a bit for the independent statistics.

As a point of reference, a one percentage point conversion from wood equals approximately \$50 million in sales for composites, and we believe, as the category leader, Trex is gaining a greater portion of these incremental sales.

We continue to focus our marketing campaigns on the advantages of Trex decking over wood, as well as, development of new products that will capitalize on our manufacturing brand and distribution advantages. Also in the second quarter, we invested in certain assets that will materially expand our appeal to potential deck buyers.

In addition to expanding our digital footprint within the category, we are increasing our market opportunities and we expect our investment to drive a material increase in specific areas of our web traffic and expand unique visitors in future quarters.

Buy signals from consumer interactions with specific areas of our website historically have been an excellent indicator of demand. It is also important to note that our channel partners continue to execute at a very high level and meet increasing demand for the residential products. They have adapted their supply chain management practices to accelerate purchases to overcome the tight freight market.

Trex commercial products also performed well in the second quarter, winning new projects and maintaining a solid backlog heading into the second half of the year. We completed several notable projects, including the Milwaukee Bucks Arena, as well as, the Los Angeles football club, and the DC United Audi's field, which were designed to create a connection between the players and the fans.

We continue to leverage the significant engineering talent of our commercial segment to bring attractive new railing designs to our residential portfolio, which have come to market in record time and have been received well by our retail and trade consumers.

Both Trex residential and commercial products, reported improved gross margin in the second quarter. In residential, this means year-over-year expansion, thanks to the same factors that have resulted in margin growth in prior quarters, namely our lower raw material costs, resulting in part from our ability to identify, qualify, and procure new lower cost recycling product streams, manufacturing efficiencies, which are part of an ongoing program, and higher capacity utilization.

These factors drove higher gross margin comparisons in the second quarter, despite additional expenses related to the major improvements to our production lines that are underway to significantly increase throughput by the end of this year, increased product innovation costs, and higher freight costs.

In commercial, we saw a substantial sequential improvement in gross margin, driven by improved execution and cost reduction initiatives. We continue to execute a number of process improvements and high return capital improvement projects that will not only allow us to improve our quality of the products, but will also allow us to improve our margins in the second half of this year.

With that, I will turn the call over to our CFO, Bryan Fairbanks, for a financial review on the second quarter. Bryan.

Bryan Fairbanks

Thank you, Jim. Good afternoon, everyone. We are pleased to report on an exceptional quarter, reflecting favorable market conditions and strong consumer demand for Trex residential products and notable progress at Trex commercial products.

Before we begin, I want to remind you that we distributed a stock dividend in the form of a two-for-one stock split on June 18th. Consequently, all per share data for 2017 and the first six months of 2018 in our earnings release and prepared remarks have been adjusted accordingly.

Second quarter 2018 consolidated net sales amounted to \$207 million, an increase of 31% year-over-year, mainly driven by higher volumes in Trex residential products, where revenue grew 20% to \$189 million. Trex commercial products contributed \$17 million this quarter, in line with our expectations.

Consolidated gross margin in the second quarter was 44.1% compared to 45.6% reported in the second quarter of 2017, reflecting the impact of lower gross margin profile of Trex commercial products.

Trex residential products gross margin expanded by 30 basis points to 45.9% due to the sustained benefits of lower polyethylene material costs due in large part to product substitutions along with manufacturing efficiencies and higher capacity utilization. The benefits were partially offset with additional expenses related to the improvements to our production lines that are underway to significantly increase throughput, increased product innovation costs, and higher freight costs.

As we've mentioned in the past, Trex has undertaken improvement 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 production line enhancements and we will complete this phase by the end of this year. This retrofit not only provides an expansion of our

decking capacity, but will drive further utilization cost savings in the future. This is the type of high return and high impact initiative that our operations and R&D teams are focused on.

Trex commercial products gross margin showed continued sequential improvement in the second quarter, expanding by 690 basis points to 24.6% as project execution by the commercial team improves. Also, lower margin legacy contracts are being replaced by newer ones that have been negotiated with a more disciplined approach to ensure project profitability projected in our quotations is obtained.

SG&A expenses in the second quarter of 2018 were \$34 million. The total dollar amount increased by \$6 million, reflecting higher personnel and brand-related expenses. The inclusion of Trex commercial products and \$1.2 million in non-cash amortization of intangible expenses related to the SC acquisition.

As a percentage of revenue, SG&A was 16.2% compared to 17.2% in the year ago quarter. Exclusive amortization expense, SG&A was 15.6% of sales in the second quarter.

Net income amounted to \$43 million, or \$0.73 per diluted share, both up 49% from \$29 million or \$0.49 per diluted share reported in the second quarter of 2017. These positive year-over-year conversions, comparisons, were driven by a significant sales increase and by a lower effective tax rate of 25.2% compared to 35.4% in the year ago quarter. Additionally, Trex commercial products was modestly accretive to EPS in the second quarter.

To briefly sum up our performance, for the first six months of 2018, we reported a 25% increase in consolidated sales, organic revenue growth of 14%, and net income of \$80 million, or \$1.35 diluted earnings per share, up from \$0.96 per diluted share in the 2017 first half.

First half capital expenditures were \$18 million, which was primarily allocated to planned cost reduction initiatives and other production improvements. In the second quarter, we purchased certain internet domain names and related functionality for \$6.6 million to create additional awareness for Trex decking and railing.

With respect to capital allocation, in the second quarter, we repurchased 150,000 shares of our outstanding common stock for a total outlay of \$8 million as part of the share buyback program authorized by the board of directors in February of 2018.

For financial modeling purposes, please note the following items. We reaffirm our expectation for full year 2018 consolidated incremental gross margin of approximately 45% to 50%. SG&A is expected at approximately 17.5% of sales for the year. We expect the full year tax rate for 2018 to be approximately 25%. Full year capital spending was projected between \$20 million and \$25 million. This is now projected at the high end of the estimate. The remaining intangible expense related to the SC acquisition is approximately \$400,000 and will be fully amortized by the end of July.

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

Jim Cline

Thank you, Bryan. 2018 is developing into another year of strong growth for Trex. Our second quarter performance brought the first half total sales growth to 25%. Residential products year-to-date revenue growth was 14%.

The latest data we have seen indicates projections for the growth of the repair and remodeling market remain the same at the high single digit rate for 2018. This provides an excellent backdrop for Trex as the brand leader in composite decking and railing, a growing category within outdoor living, and one that is gaining more attention from traditional rail buyers.

Additionally, our product appeal to the increasing number of consumers seeking eco-friendly products who are attracted by our high recycled content for decking and the environmental processes we use in our manufacturing operations. At the same time, our commercial business continues to move forward, in line with our expectations. We continue to see collaboration on a number of projects between residential and commercial products that will drive further revenue synergies and profit improvements.

I would like to emphasize to new investors that Trex is primarily a repair and remodeling play. Significant swings related to new housing builds have a little effect on our core business. Residential repair and remodeling tracks better with consumer confidence and the sale of existing dwellings.

Trex's consolidated profile today is approximately 83% residential repair and remodeling, 12% commercial, and only 5% residential new construction. We do expect that the growth in residential new construction in which Trex participates in both multi-family and single-family will expand over the next several years as we approach the next peak in new housing starts. However, we do not expect residential new construction will exceed 10% of our sales during this cycle.

In the third quarter, we expect to report consolidated sales of \$173 million, up 23% compared to 2017. We anticipate that Trex residential sales will account for \$154 million, representing an 18% growth and that Trex commercial products will contribute approximately \$19 million.

As you can see, we expect our positive momentum to continue. This reflects the commitment and the drive for excellence by the entire management team. You may have noticed we have introduced announcement of three executive promotions in a release issued last week. These expanded leadership roles are part of an executive structure that Trex committed to as our continued growth in the residential and commercial products and to maximize economic value for our shareholders.

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

QUESTION AND ANSWER

Operator

And at this time, if you would like to ask a question, please press "*", then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys, to withdraw your questions, please press "*", then "2."

And our first question will come from Frank Camma with Sidoti & Company. Please go ahead.

Frank Camma

Good evening, guys. How are you doing?

Jim Cline

Great, how about you?

Frank Camma

Good. Hey, Jim, you mentioned that it sounds like the conversion from wood to composites is accelerating. Can you give us a sense of how much of that could be caused by either rising wood costs or lack of certain types of wood in your estimate?

Jim Cline

It's pretty difficult to bifurcate between people becoming more knowledgeable and appreciative of the second generation composites. I can tell you in the west coast, the prices of cedar, as well as, redwood caused many times the pricing of our product to be extremely competitive, and therefore it is driving market share on the West Coast. But the wood market is pretty volatile, you've seen increases lately, you've seen reductions in the price. So overall, we believe it's a bit of a tailwind, but I think the appreciation of the performance characteristics of the composites in the second generation products is what's carrying it for the most part.

Frank Camma

Okay, you know, obviously compared to my model, your residential numbers were much better. I guess, the only thing I would pick apart, maybe it's just the way I modeled it, was so the expansion that I had modeled in the gross profit. And I am wondering, is that because the freight cost, I think, you mentioned freight a couple of times Bryan. Did the freight costs sequentially become more challenging or is that untrue. I am just trying to figure that out like if in Q2, it was more challenging for freight?

Bryan Fairbanks

Yes. It's fair to say that was more challenging on a sequential basis. Over the quarter, we continue to show improvements related to lower cost recycled materials, our cost initiatives, and capacity utilization. But some of that was offset with increased freight, higher raw material costs, as well as, Jim mentioned increased development costs, as it relates to the higher throughput projects we are working on, as well as, certain product development trials that were occurring at our plants.

Frank Camma

Okay. And then, we will see those improvements later in the year or does that take...how long do you continue to invest in those improvements where you might not see the gross profit margin compared to the sales increase [inaudible]?

Bryan Fairbanks

So, yes, our incremental margin guidance is unchanged between 45% and 50% for the year. We will continue to have investments in the throughput trials as we go through the rest of the year and then, product development will continue as well, and that's inclusive in the guidance that we have provided.

Frank Camma

Okay, great. Thanks, that's all I have for now guys. Thanks.

Jim Cline

Thanks, Frank.

Operator

And our next question comes from Matt McCall with Seaport Global Securities. Please go ahead.

Matt McCall

Thank you, good afternoon, guys.

Jim Cline

Good afternoon, Matt.

Matt McCall

So the high return capital investments we talked about, I mean, I go back to my notes, and I remember talking more about capacity, opening up, unlocking or debottlenecking some capacity. I feel like there was more of a conversation around margins, I understand the incremental throughput, but can you give us an idea of the margin opportunity that you are referencing there, and how much maybe we are going to see beyond the second half of this year?

Jim Cline

We haven't provided guidance for next year, but with the additional capacity...additional capacity, you will see the utilization improvements continue into the future. You also see us doing a better job, leveraging the labor that's already in the system at this point. So again, for this year, it's inclusive within the guidance we've provided, but the real benefits we will start to see as we move into 2019.

Matt McCall

Okay. That's helpful. And Bryan, maybe you hit on the input cost a little bit. In the past, we've talked about the potential for some new material streams, any updates that you can provide and either for what's included in the back half if any or opportunities beyond the back half, not necessarily guidance, but just potential for some incremental savings?

Bryan Fairbanks

Sure, we do continue to see improved pricing with polyethylene. As we mentioned in our comments, it's not as much pricing related to the same material streams, but our sourcing team and our R&D team is working to use alternative streams, which we can then use at a lower price through our production. So we did continue to see improvement in that, even net of the higher freight cost, inbound freight costs that we saw during the quarter. As we move through the back half of the year, we expect to see continued opportunities. But as we said before, that will decline as the year goes on, as the benefit that we will have for reduced poly pricing won't be to the same degree that we saw over the past two years.

Matt McCall

Okay, that's helpful. And last one from me. Any competitive pricing moves that you've noticed year-to-date, and can you just give me an idea on what your thoughts are on price relative to some of this. I am taking price relative to some of this inflation that you are facing?

Jim Cline

Yes, for the most part, the competition has been relatively rational, although we do see a bit of aberrant behavior from one of our competitors from time to time. Pricing has not been a button that most have tried to push. I think in part that's due to the fact that because of our low-cost position, starting a price war is not something that's in anybody's interest and certainly they probably don't want to be going down that path and kicking the dog.

With regard to future price increases, we will evaluate as we get later in the year whether or not the cost increases we see necessitate a price increase. Thus far, we've been able to continue to make expansions in our margins through other ways and not adversely impact our customers. We would try and do that going forward, but at some point, if the costs accelerate, we may have to increase prices.

Matt McCall

Okay, thank you, Jim.

Operator

And our next question comes from Alex Rygiel with B. Riley FBR. Please go ahead.

Alex Rygiel

Thanks, very nice quarter.

Jim Cline

Thank you.

Alex Rygiel

Jim, I think, in your prepared remarks, you've made a statement that said something along the lines of second quarter you invested in certain assets that will improve the appeal to deck buyers. What did you mean by that?

Jim Cline

There are certain assets that we purchased that we believe will help generate a greater level of interest in the Trex products in the future.

Alex Rygiel

Okay. And then can you comment on...within the commercial business, maybe the level of backlog in the bidding environment, higher/lower, feel free to be general and not exact?

Jim Cline

Yes, what we found is, it is a competitive industry. We knew that when we got into it. Our view, as we got into it, is if we could improve execution, introduce some opportunities for high return investments with related cost savings. That's where our margin expansion would come from, and that's basically what we've seen. It has not been on the backs of our customers by increasing prices, but rather better execution and cost reduction initiatives.

Alex Rygiel

Excellent. Thank you very much.

Jim Cline

Thank you.

Operator

And again, if you would like to ask a question, please press "*", then "1." And at this time, I am showing no further questions. So I would like to turn the floor back to Jim Cline for any closing remarks.

CONCLUSION

Jim Cline

Well, thank you for your interest and support of the Trex Company. I would like to thank all the members of the Trex team, including our distribution partners, Trex pros, and our retailers. This is a challenging time of the year for them and they are performing magnificently. We look forward to meeting with you in person at one of our upcoming conferences. Thank you for attending the call today. Goodbye.

Operator

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