Trex Company, Inc.

Third Quarter 2016 Earnings

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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, Secretary*

Jon Friedman – *MBS Value Partners*

PRESENTATION

Operator
Good morning, and welcome to the Trex Company Third Quarter 2016 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your telephone keypad. To withdraw your question, please press star then two. Please note, this event is being recorded.

I would now like to turn the conference over to Jon Friedman. Please go ahead.

Jon Friedman
Thank you, everyone, for joining us today. With us on the call are Jim Cline, President and Chief Executive Officer; and Bryan Fairbanks, Vice President and Chief Financial Officer. Joining Jim and Bryan will be Bill Gupp, Senior Vice President, General Counsel and Secretary, as well as other members of Trex's management team.

The company issued a press release yesterday after market close, containing financial results for the third quarter of 2016. This release is available on the company's website. The conference call is also being webcasted on the Investor Relations page of the company's website where it will be available for 30 days.

I'd now like to turn the call over to Bill Gupp. Bill?

Bill Gupp
Thank you, Jon. 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 risk 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 good morning, everyone. We appreciate your participation in today's call to discuss our third quarter operating and financial results and our business outlook.

As you have seen from our earnings release yesterday, 2016 has been an outstanding year for Trex, and the third quarter represented another period in which we report very strong year-on-year comparisons across all operating metrics. Total revenue increased 13% to a record $106 million in the third quarter, and trailing 12 months' revenues were up 11%. This strong showing underscores the strength of the Trex brand. The Trex brand strength is driven by our ability to capture a greater share of the growing composite decking and railing market.

In fact, our analytics confirm that consumer recognition of the Trex name has never been higher. The Trex brand is closely associated with the exact attributes it represents, namely, highly designed outdoor living products that retain their luster with minimal maintenance, enhance the resale value of residential property, and are manufactured with 95% recycled material.

We're very proud to announce that our company received The Home Depot Environmental Vendor of the Year Award. The award recognizes Trex's leadership in the environmental stewardship in addition to our circular economic model where Trex takes plastic waste from Home Depot stores, which contributes to the finished product that is sold in stores.

We continue to roll out programs that strengthen our brand relationships with consumers and the trade. For example, Trex Online provides homeowners the tools to design, price and order samples for their dream decks as well as to locate recommended TrexPro contractors and retailers in their areas. This enables us to assist the consumer throughout the sales process from design to installation.

We have seen an overwhelming increase in the retailers, contractors and other partners who have visited Trex University since it launched in early March of this year. We have gotten great feedback on the educational and training benefits that they have taken away from their experience.

Our year-to-date sales growth reflects the ongoing strength of our core decking and railing business in North America, but we are also quite pleased with our efforts to build awareness and sales of Trex products outside of North America. Year-to-date sales outside of North America increased at a significantly faster pace than North American sales. We are expanding our sales channels internationally and also the brand awareness. And based on the results of our successful 2016 campaign, we're sure that international sales will be an important long-term growth driver for Trex.

I'm pleased to report that we converted 13% sales growth into a 92% increase in diluted earnings per share in the third quarter, thanks to another quarter of significant gross margin expansion. This quarter's gross margin increased by 460 basis points due to many of the same dynamics we saw in the first half of the year, namely lower input cost, manufacturing cost savings and higher capacity utilization. On an adjusted basis, excluding the impact of the warranty reserve charges related to legacy products, the third quarter gross margin expanded by 820 basis points year-over-year.

Our investment spending has been directed to new product development and to fast return cost savings projects. These projects are designed to ensure that we are able to meet increased market demand more efficiently and effectively than the competition. Our industry-leading on-time shipping rate of over 98% is a good illustration of this commitment.

Additionally, despite the increased marketing and research and development spend, our year-to-date SG&A as a percent of sales grew by just 15 basis points. By the end of 2016, we expect our annual research and development spending on new products and cost reduction initiatives will increase by over 2.5 times our 2015 spend. We anticipate that this rate will continue into 2017 due to our expanding focus on new product development and cost reduction initiatives. Finally, we are again benefiting from a lower share count as a result of stock repurchases earlier this year.

With that, I will hand the call over to our CFO, Bryan Fairbanks, to provide a detailed review of the second quarter financial results. Bryan?

Bryan Fairbanks

Thank you, Jim, and good morning, everyone. As Jim mentioned, this was an excellent quarter for Trex in which we achieved record sales, grew significant margin expansion and reported substantial year-over-year growth in earnings per share. Net sales for the third quarter were $106.2 million, an increase of 13% over the prior year.

Our revenue growth was primarily driven by higher volumes in our core decking and railing business, reflecting Trex's brand strength and continued ability to outpace industry growth rates. Similar to the first half of the year, the impact of our specialty materials business on third quarter revenue was negligible, as low virgin poly prices continued to be a headwind in developing that business line.

Strong gross margin comparisons in the third quarter were driven by several positive factors, in line with the elements that contributed gross margin expansion in the past two quarters, namely reduced raw material cost, execution of our manufacturing cost improvement initiatives, and increased capacity utilization.

Our reported gross margin was negatively impacted by a non-cash legacy warranty reserve charge of $9.8 million. This relates to the surface flaking issue that affected a small portion of products produced at our Nevada plant before 2007. To put the charge in perspective, we spent $4.2 million year-to-date against our operating cash flows of $82 million year-to-date. This warranty spending is down 21% from the same period prior year. During 2015, we spent $7.2 million, which was down 19% from the prior year against total operating cash flow of $63 million. The cash effect of this charge and the existing reserve will be incurred over the next 15 plus years.

Gross margin increased 460 basis points in the third quarter to 28.2%. On an adjusted basis, excluding the warranty reserve, gross margin expanded by 820 basis points to 37.5%.

SG&A for the quarter totaled $19.4 million, up 23% from the third quarter of 2015, reflecting an increase in incentive compensation due to improved performance against targets, increased R&D and higher branding expenses. Increased branding expenditures were strategically redirected from the first quarter to the second and the third quarters of the year. On a year-to-date basis, SG&A as a percentage of sales was 16.9%, closely in line with the 16.7% reported in the same period last year.

Interest expense declined to $77,000 from $157,000 and the effective tax rate in this year's third quarter was 34.2% compared to 40.5% in the 2015 third quarter due to non-deductible tax items recognized in 2015 and research and development tax credits in 2016.

Net income increased 84% to $6.9 million and diluted earnings per share were up 92% to $0.23 in the third quarter compared to last year's third quarter. Excluding the $9.8 million warranty reserve, diluted EPS was $0.45, an increase of 96% year-over-year.

Our third quarter diluted weighted average number of shares outstanding was 29.5 million, down from 31.5 million shares in the same period last year, reflecting share buybacks last year and earlier this year.

We had substantial year-to-date cash flows from operations of $82 million, which reflected higher earnings and reduced accounts receivable related to the timing of customer payments.

During the quarter, capital expenditures were $3.3 million while year-to-date investments totaled $8.5 million. Our capital spending strategy is focused on new product development and quick return investments to capture manufacturing cost savings. These investments allow Trex to meet the market's increased demand and corresponding volume requirements resulting in greater profitability and cash flow. Based on expenditures to date, we've lowered our guidance for 2016 CapEx to a range of $15 million to $18 million, as we were able to complete certain projects below budgeted cost and we're pushing others out to future periods.

To summarize some items to take into consideration, as you fine-tune your modeling for Trex's full-year 2016 performance. We've continued to see a notably strong flow-through of our incremental margin performance year-to-date totaling 93% on an adjusted basis. As a result, we've increased our guidance for full-year 2016 incremental margin, adjusted for warranty reserves, to average 95%, up from our previous forecast of 80%.

Not only did we see a more rapid delivery of cost savings in the third quarter, but by implementing these projects below expected cost, we've been able to further drive the growth in incremental margin. We will also run our plants at a higher capacity utilization to achieve the appropriate level of inventory to support 2017 growth objectives. We expect this year's effective tax rate to be approximately 34%, down from last year due to the non-recurrence of non-deductible tax items and increased utilization of the R&D tax credit.

We ended the first nine months of 2016 in a strong position, as we continue to deliver record results. Year-to-date, diluted EPS increased 45% to $1.81, and on an adjusted basis, diluted EPS was $2.03 or 49% above the first nine months of last year.

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

Jim Cline
Thank you, Bryan. Third quarter operating results put us on track for record results in 2016. This reflects the strength of this Trex brand, the positive dynamics of our market and the tremendous efficiency in our manufacturing and organizational infrastructure. We expect the fourth quarter revenue to be approximately $93 million or 4% ahead of the prior year. As you may recall, in 2015, we reported an exceptional weather-driven revenue growth of 20% above 2014. At this guidance level, our 2016 annual sales will be up by over 8%. This increase includes the effect of the significant reduction in purchases and resale of excess recycled polyethylene year-over-year.

We do not expect a further year-over-year reduction of recycled polyethylene sales to occur in 2017. We expect our gross margin will continue to benefit from lower input costs, cost savings and modestly higher capacity utilization in the fourth quarter.

We see several important revenue growth drivers for Trex, as we look ahead to 2017 beyond. First, market research firms project mid-single-digit growth for the North American composite decking and railing market over the next several years. We are confident that Trex will be able to continue to grow at a faster rate than market, given our leadership position and brand equity.

Second, we expect to see additional market growth from conversion to composites from wood. Initial metrics show the advertising and marketing campaigns we launched in the second quarter of this year to highlight the aesthetics, performance and sustainability benefits of Trex versus wood are resonating with both trade and consumers. Conversion is a major opportunity for Trex, as every 1% of market share we take from wood correlates to an additional $50 million of revenue for us.

Third, we expect our sales growth outside of North America to significantly outpace North American sales gains in 2017, as our brand recognition continues to build and we grow our relationships with retailers.

Fourth, new product development remains a priority. During our distributor and sales meeting, we shared one product in development with our sales and distribution team. It is a high-performance product that will be focused on the top end of the market with outstanding aesthetics and performance. Based on the reaction from our distribution partners and sales team, we are confident that it will receive excellent market response in the niche market it addresses when it is introduced. We also consider potential acquisitions as part of our long-term growth strategy, and we continue to evaluate opportunities to leverage the strength of the Trex brand by adding complementary products to our portfolio.

Finally, we expect to continue to achieve meaningful operating leverage in the periods ahead, thanks to the potential to increase capacity utilization, our ongoing cost savings initiatives, and continuous improvements in operational efficiencies.

At this point, operator, I'd like to open the call up for questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press star then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause momentarily to assemble our roster.

Our first question comes from Keith Hughes of SunTrust. Please go ahead.

Keith Hughes
Thank you. Couple of questions. I guess first on raw material cost, you had listed those as being positive coming up in the fourth quarter. Would those positives start to fade in 2017 and roughly what quarter would that start to happen?

Bryan Fairbanks
Yes, so raw material costs, we've clearly seen a benefit from it this year. We would expect to see a declining incremental benefit from those poly improvements as we move into 2017.

Jim Cline
Yes, and Keith, it will begin in the first quarter. It will be a minor impact on the first quarter, growing primarily through the third quarter.

Keith Hughes
Okay. And are there any signs of inflation that you're going to potentially have to deal with in 2017?

Jim Cline
Nothing that we've seen.

Keith Hughes
Okay. And production rates in the fourth quarter, how will they compare to what we saw in the fourth quarter of prior year?

Bryan Fairbanks
We should be seeing production rates up about 10% on a year-over-year basis.

Keith Hughes
Ten percent. Are you doing that in response to pre-buy for the next season or what's driving them?

Bryan Fairbanks
Yes, two things, first, the increased guidance for the quarter and, second, to get our year-end inventory back to more of a normalized level. Last year, our finished goods inventory did finish below what we considered optimum to service the marketplace. So we'll be getting that more to a normalized level.

Keith Hughes
Okay. And I guess, finally, you had highlighted one new product. When will that be launched formally into the market? And then also I know there're some private label products that have been—there's some bidding going on. Any update you can give us on that.

Jim Cline
Yes. We haven't identified the launch date for that product. We wanted to provide our distribution partners the opportunity to see what we're working on, and we will announce that closer to the time when we see the introduction will take place. We have no final information from our major retail partners with regard to the lineup of the products for 2017, so I can't give you an update on that.

Keith Hughes
Okay. Thank you.

Operator
Our next question comes from Alex Rygiel of FBR. Please go ahead.

Alex Rygiel
Good morning. Very nice quarter.

Jim Cline
Thank you.

Alex Rygiel
Jim and Bryan, can you give us a little bit more direction on thinking about incremental margins in 2017? Clearly in 2015, you were sort of around the mid-45% range, this year 95%, but we're going to sort of walk back towards something that's a more normalized rate. If you could kind of try to guide us a little bit better on that, it would be gratefully appreciated.

Bryan Fairbanks
Yes. It's fair to say that we will walk back to more of a normalized rate next year. We will see the normal rate of improvements in capacity utilization, internal improvements in our operational efficiency and other cost-saving projects. And then as we talked about earlier, there will still be some year-over-year improvements in raw material cost, but not as great as what we're seeing in the 2016 calendar year.

Alex Rygiel
Okay. And as it relates to SG&A, sometimes it's up a little bit in the fourth quarter from the third quarter, sometimes it's down a little bit. It sounds like you're going to have less branding expense in the fourth quarter. Could the SG&A dollars be down in the fourth quarter from the third quarter?

Bryan Fairbanks
I wouldn't expect them to be down significantly. I think if you look at it on a full-year basis, we'll be looking at SG&A in line or just slightly ahead from a percentage of revenue basis due primarily to management compensation, higher R&D spending and a full-year increase in branding spending.

Alex Rygiel
And then lastly, your Trex Online has started to give you some unique insight into the consumer and how active they are. Any update there on some of the data you've collected in and what the consumer is telling you?

Bryan Fairbanks
Yes. So we have seen a very strong feedback from our customers online. A couple of things that we do look at are the number of people that come online and look at it. But more importantly, we want to understand what are the buying behaviors of those consumers. So we do have certain sections of the website where we try to capture that stronger interest in buying and use that as a lead for the organization. We've got a cost calculator, so customers are able to understand what the cost of the Trex material would be. They have the ability to find a dealer or a contractor on the website, and they also have the ability to buy samples.

So these are all strong indicators of somebody that has more than a passing interest in our Trex products and those numbers are up significantly on a year-over-year basis. Total visits to our website are up over 30% year-to-date. So for the size of the company we are, the type of volume that we bring in, we're very pleased with that type of continued interest and the effectiveness of our marketing campaigns.

Alex Rygiel
Thank you very much.

Operator
Our next question comes from Al Kaschalk of Wedbush Securities. Please go ahead.

Al Kaschalk
Hi, guys. Can you hear me, okay?

Jim Cline
Yes. Good morning.

Al Kaschalk
Okay. Sorry about that. I want to focus on one area in particular and that's the operating environment. In particular, I think historically you said not so much to focus on capacity utilization or that was sort of a metric that you weren't having us look at, but clearly, there's some benefit that's going on with the volume that's going through. So can you help us where are you at in terms of utilization and where do we expect that to go?

Bryan Fairbanks
Yes, we still don't believe capacity utilization is a particularly good indicator for modeling purposes because of the continuous improvement driven through operations as well as the capital investments we are making. That being said, we are running more of the capacity that we have on an annualized basis due to the growth, but the incremental margin because of these other changes is still a better way to look at the business.

Al Kaschalk
Okay. But according to the prior question, we should see that step down in terms of 2017.

Bryan Fairbanks
We will be providing guidance for 2017 as we come out with our year-end call.

Al Kaschalk
All right.

Jim Cline
But certainly, the incremental margins you've seen in 2016 will not be ongoing in 2017. We do expect it'll become a more normalized incremental margin. If you go back over the last several years, I think we've ranged primarily between the low 40%s and, I think, as high as maybe 50%.

Al Kaschalk
Okay. All right. And then second, it sounds like you have some good traction on the marketing spend in the online category. It sounds like there's more growth coming from the Pro channel. So maybe just some comments there in terms of where that is in terms of mix of business in relative to 2017 to 2016, I would imagine you expect that percentage to be higher. So maybe just some commentary on that part of the business because I assume that comes at a lower price point.

Jim Cline
Yes. Our growth in the business is pretty well balanced between the Pro channel and the major retailers. We still run between 25% and 30% of our business with the major retailers. It's a great business for us. The margins are similar between the two categories, not dramatically different from one versus the other.

Al Kaschalk
Okay. That's all I have. Thank you.

Jim Cline
Thanks, Al.

Bryan Fairbanks
Thank you.

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

John Baugh
Thank you. Good morning. And congratulations on a great quarter and year-to-date. If I could ask, were there any price adjustments on the product lines for next year coming out of the distributor meeting? And am I to assume that's a deck board product that's the niche thing at the high end?

Bryan Fairbanks
We didn't announce any new cost increases for next year. It doesn't mean that there won't be any, but we haven't announced anything to the market.

John Baugh
And the deck board, is it the deck board the new product?

Jim Cline
Yes. Basically, it is a deck board however we also introduced a renaming of our aluminum railing line. Our Reveal line has been rebranded as Signature, and we've introduced additional options with that

such as curved rail as well as lighting applications.

John Baugh
Okay. And it sounds like, Jim, you mentioned, I think, the volume of railing and decking were the primary drivers, but it also sounds like international is helping. I'm just curious lighting, licensed revenue on furniture sales, whatever, how much other categories other than decking and railing are helping or assisting revenue growth.

Jim Cline
Certainly, we have a broad line. You mentioned the licensing agreements. They're doing extremely well, but they're relatively low contributors from a sales dollar impact. We also have the lighting, we have the hidden fasteners, the elevations. All of those are growing, but certainly the core product offering, decking and railing, is the workhorse that's driving the majority of the sales.

John Baugh
Got it. And the lowered CapEx, you mentioned, pushing out some projects as well as coming in below budget. Anything more granular there.

Bryan Fairbanks
Yes. To give you an idea of a cost saving-type project we're doing, often we're looking at what opportunities we have to in-source a finished good item or manufacturing an internally used product that we previously purchased on the outside. These projects are moving the needle on cost and we expect it to continue to in 2017.

A good example, Jim mentioned, we're rebranding our aluminum railing line from Reveal to Signature. We're in the process of in-sourcing that to Trex. We've been working with a very capable supplier over the past years, but given the growth of the business, we thought it prudent to bring that production inside where we're able to control the output on a daily basis. We've got other projects like this in the pipeline. We'll continue to execute them as we move forward.

Jim Cline
The other thing, John, is we have focused an awful lot of energy on certain R&D projects that consumes people's time, makes them unavailable for certain projects. In addition, while we've been expanding, our engineering support staff hasn't expanded as quickly as we probably should have, and therefore keeping up with those projects is a little bit more difficult.

John Baugh
Okay. And my last question was just around marketing. And you mentioned the online traffic as a metric. Are there any other metrics you're looking? You mentioned, I think brand awareness is at a record. I'm just curious in your mind, how the campaign to attack wood market share has gone year-to-date and what numbers you're looking at to measure the effectiveness of it. Thank you.

Jim Cline
Yes. We've basically seen people being driven to the website in a specific area that relates to transition from wood to composites. And we are also getting input from other retail accounts that give us feedback on what's happening with their wood business versus what's happening with their composite business. And so basically, we draw a correlation between all of those factors to make the determination of how we're seeing the improvement. But I think the most impactful for us has been the number of people being driven to that specific area in our website and how long they spend in that area of the website.

John Baugh
Thank you. Good luck.

Bryan Fairbanks
Thanks.

Operator
Our next question comes from Jim Barrett of C.L.K. & Associates. Please go ahead.

Jim Barrett
Good morning, everyone.

Jim Cline
Good morning, Jim.

Jim Barrett
Jim, a question for you. Given the success of the advertising campaign against treated wood, are you expecting to materially increase your advertising against wood in 2017?

Jim Cline
Certainly. We expect to see an expansion of the advertising in that specific portion of the campaign. But what we've been able to do in the past and been very successful is find ways where we can be more impactful with a minimal amount of expanded spending on the branding. But, yes, short story is yes, we're going to spend more money on that, and we'll spend more money in branding overall year-over-year.

Jim Barrett
I see. And Bryan, a question for you. The inventory charge, based upon your current trends in terms of claims and the cost per claim, is this likely to be the last inventory charge we see for the next two to three years or how should we look at that and can you update us on what you're seeing in very recent trends? I certainly see what's in the Qs and the Ks, but I wanted to get a recent update.

Bryan Fairbanks
Yes, sure. So we do an annual deep dive review into the claim spending and number of claims that are coming in; that's done between us and an external actuary. We pull together a number of different assumptions based off of our knowledge of what's happening in the market, what's happening with cost and number of claims that have come in.

In 2016, the claim rate came in slightly higher than what we were expecting. And that resulted in us taking a charge. Those are based off of the best assumptions that we have available to us, and the expectation is that that covers for the future liabilities. But again, we'll be looking at it regularly as we go forward. If those assumptions change, potentially the reserve could change.

Jim Cline
One thing, I think, that's interesting, Jim, is when I look at this reserve, if you look at the spending against the reserve over the last several years, it has been declining quite nicely and the backlog of claims has not been increasing. So it's one of those things where you get a number of claims coming in, it represents a potential future obligation. We're obliged to recognize that and record those additional expenses.

But the million dollar question is when will these be paid out and will they in fact be paid out at all? We have a number of open cases that are probably more than three years old where people have just not come back to complete the transaction necessary to do the repairs and this has been an ongoing issue. We've tried sending letters. We've made phone calls, but for whatever reason people get into the process of doing these, they just don't continue.

So while we have done a number of these reserve adjustments and the spend is going to overall be greater than we expected, the implications on our cash flow are really fairly modest. The numbers that Bryan provided you before, I believe, are all pre-tax numbers and of course when that spending takes place, it's after tax. So on a $9 million, let's call it, a $10 million reserve spread over 15 years on an after-tax basis, it's a relatively minor impact year-over-year.

Jim Barrett
Understood. And thank you, both.

Jim Cline
Thank you, both.

Bryan Fairbanks
Thanks.

Operator
Our next question comes from Michael Conti of Sidoti. Please go ahead.

Michael Conti
Hi, good morning.

Jim Cline
Good morning, Michael.

Michael Conti
Yes, just on the gross margin expansion, can you just quantify for us each driver, how much it contributed to the overall expansion?

Bryan Fairbanks
Yes, approximately 50% of the gains were through lower raw material cost and other cost saving initiatives, while the remaining 50% was capacity utilization and other operating efficiencies. So very similar to what we've seen during the first two quarters of the year.

Michael Conti
And that's on the adjusted number?

Bryan Fairbanks
That's correct.

Michael Conti
Okay. And then you mentioned you expect to anniversary on consuming lower-priced resin in the first quarter of next year, but what if resin prices were to increase from these levels, would that be a short-term impact to gross margin? And then, if so, what can help offset that?

Bryan Fairbanks
As I mentioned, we do have continuing cost initiatives in place, so would it affect the amount of it?

Clearly, yes, if we were to see poly prices go up rather than continue at the level it is today. But we don't see any indicators in the market right now that would tell us that we should be seeing increases through 2017.

Michael Conti
Got it.

Jim Cline
The other thing to remember is we do buy recycled material, and recycled material does not change as quickly and as significantly as virgin polyethylene. So while you could see an increase of virgin polyethylene in the next several months, we wouldn't expect to see much of any impact for probably five or six months after that if we saw anything. We've been very effective at going to new vendors and being able to contain the cost increases on poly quite effectively over the last eight years.

Michael Conti
Got it. Okay. And then on the international side you mentioned you expect that to outpace North America growth. But can you just give us an idea on the product mix on the international side, if it's more weighted against the good, better or best?

Jim Cline
It's really a split bag. It's probably focused more on the top end of the product category, but we are seeing more traction starting to occur at the opening price point.

Michael Conti
Got it. Okay. And then just a comment on your priorities for free cash flow. How should we be thinking about what Trex looks like in 2017 as free cash flow continues to ramp up here and then as you benefit from additional market share gains?

Bryan Fairbanks
Yes. First priority would be internal growth opportunities through capital spending. Our second priority would be strategic acquisitions, Jim mentioned in his comments. And then the third would be share buybacks. We've bought back $173 million worth of shares over the past three years. We have an open program for an additional 1.6 million shares through the end of the year.

Michael Conti
Got it. Thanks, and good luck.

Bryan Fairbanks
Thank you.

Operator
And again, if you do have a question, please press star then one. Our next question comes from Morris Ajzenman of Griffin Securities. Please go ahead.

Morris Ajzenman
Good morning, guys.

Jim Cline
Good morning, Morris.

Morris Ajzenman
Hi, just a follow-up on international sales. Based on the momentum you have there, how many years down the road would it be rather soon or several years down the road where it will become significant of an amount where you just have to break it out?

Jim Cline
Yes. Morris, my guess is it will be a few years before we see a requirement to split that out. One of the reasons is a very strong growth in the North American market that basically is helping to hold that percentage down below the 10% level. Again, the North American sales is the real workhorse here, but we do see nice incremental sales occurring internationally and we're very pleased with what we saw in 2016 thus far.

Morris Ajzenman
Okay. Switching gears, over the last handful of years, you had highlighted in the past increased penetration with dealers, etc., etc. How is that playing out this year and is there any initiative going forward to increase that or are you comfortable where you stand currently?

Jim Cline
Yes, I think what we've seen is a greater, greater expansion there of the number of dealers, but not so much. Just the number, it's the amount that each dealer is buying. So we're getting a little bit better concentration with dealers who are only partially Trex. They're growing a little bit stronger and that's enabled us to see a good growth at this point.

Going forward, we'd expect really more of the same of that, where we see more, more sales going through the dealers that we have as opposed to an expansion of the number of dealers.

Morris Ajzenman
Last question. Do you have any new data on market share, as it relates to your share of composites or the composite share of the entire industry?

Jim Cline
The most recent report we have from Principia was the 2014 report. We expect that they will issue a 2016 report sometime in the first half of 2017.

Morris Ajzenman
Thank you.

Jim Cline
Thank you.

Operator
Our next question is a follow-up question from Keith Hughes of SunTrust. Please go ahead. Mr. Hughes, your line is open.

Keith Hughes
Can you hear me now?

Jim Cline
Yes, Keith.

Keith Hughes
Okay, sorry about that. I had a bad connection. The question is about raw materials. Raw materials have always been just a side story on Trex. This year, it's really helped you out. Has the raw material market changed, and I'm speaking of poly here, versus four to five years ago, and just any kind of flavor for what—if there's been structural changes in the market?

Jim Cline
Yes. I think there's been a couple of things that have changed, Keith. One is we made a conscious decision, as a company, to cut back on the amount of polyethylene that we buy. In prior years, we would buy a lot more polyethylene knowing that part of that would need to be recycled. The margins that we were trading on with that were very, very small and got to the point where it was questionable whether or not we could consistently make money on those sales. So we terminated that buying activity.

The other thing that occurred is we always had longer term agreements, one-year to two-year agreements with suppliers. When the price was going up, we had a gentlemen's agreement that we would pay them a little bit more money. When the prices started going down, they were supposed to agree to a reduction, but a number of them failed to remember that portion of the equation.

So what we've done is we've modified the way we do business with them. We've changed it to typically a quarterly pricing. In some cases, it's a monthly pricing. And we aren't jerking the price up and down, trying to aggravate our suppliers, but certainly we want to be fair to both the company and the supplier. The combination of those two certainly has had an impact on the way that we generate our cost and the savings that we've realized over the last year.

Keith Hughes
Okay. Thank you.

Jim Cline
You bet.

Operator
And our next question is another follow-up from Al Kaschalk of Wedbush Securities. Please go ahead.

Al Kaschalk
Jim and Bryan, can you comment, I think you said earlier there has been little investment on the pellet side of the business and new opportunities. How much revenue in the quarter and what's the prospect here near term for that business given where pricing in the market is?

Jim Cline
Yes, the revenue the past quarter has been minimal. It is a line of sales that we believe over time we will be able to, even at these depressed prices, be able to participate in. But we believe that we probably won't see anything materially happening on that for at least six months.

Al Kaschalk
And Jim, is that clearly just a function of price and therefore the economics of a recycled product, for lack of better word?

Jim Cline
I think it's two things. Price is certainly one of them, but the other is supplying the type of product that we believe the market would be willing to buy in this environment. So we are working on development

of some of those products that we believe will be able to drive that market to where we originally thought, albeit at a much slower price point.

Al Kaschalk
Okay. Thanks a lot. Good luck.

Jim Cline
Thank you.

Operator
Our next question is a follow-up from Michael Conti of Sidoti. Please go ahead.

Michael Conti
Yes. Bryan, what's the breakout between volume and price for the quarter?

Bryan Fairbanks
There really wasn't any price in the quarter. We did have little bit higher sales incentives, primarily through improved performance from the channel along the lines of the sales growth that we've been seeing. So, that offset any of the year-over-year pricing.

Michael Conti
Got it. Okay. And then I guess historically when you guys approach any price increase to your customers is just inflation plus an adder for you guys?

Bryan Fairbanks
I wouldn't necessarily say that that would always be the case. We look at the market. We look at each one of our product lines, understand where its best fit is, are we at the most competitive price level possible in the marketplace with the Trex brand. So I wouldn't necessarily say it's directly related to inflation. It's more about the market and where we see that we can have the greatest benefit for growth for the company and profitability.

Michael Conti
Perfect, thanks.

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

CONCLUSION

Jim Cline
Well, thank you, everyone, for joining us today. This was an outstanding quarter for Trex. Our year-to-date sales and income are records for the company. We look forward to discussing our full-year results in the first quarter of next year with you. Thank you, and have a good Thanksgiving.

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