

TREX CO INC
Form 10-Q
August 06, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2013

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number: 001-14649

Trex Company, Inc.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

54-1910453
(I.R.S. Employer
Identification No.)

160 Exeter Drive

Winchester, Virginia
(Address of principal executive offices)

22603-8605
(Zip Code)

Registrant's telephone number, including area code: (540) 542-6300

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.:

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act): Yes No

The number of shares of the registrant's common stock, par value \$.01 per share, outstanding at July 30, 2013 was 17,224,088 shares.

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PART I
FINANCIAL INFORMATION

Item 1. Financial Statements**TREX COMPANY, INC.****Condensed Consolidated Balance Sheets**

(In thousands)

| | June 30, 2013 (Unaudited) | December 31, 2012 |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 15,583 | \$ 2,159 |
| Accounts receivable, net | 50,959 | 26,542 |
| Inventories | 14,963 | 17,521 |
| Prepaid expenses and other assets | 1,706 | 2,188 |
| Income taxes receivable | 809 | 435 |
| Deferred income taxes | 3,858 | 3,792 |
| Total current assets | 87,878 | 52,637 |
| Property, plant, and equipment, net | 100,955 | 104,425 |
| Goodwill and other intangibles | 10,546 | 10,550 |
| Other assets | 1,195 | 1,003 |
| Total assets | \$ 200,574 | \$ 168,615 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 15,020 | \$ 11,161 |
| Accrued expenses | 20,026 | 18,818 |
| Accrued warranty | 7,500 | 7,500 |
| Line of credit | | 5,000 |
| Total current liabilities | 42,546 | 42,479 |
| Deferred income taxes | 7,073 | 7,353 |
| Non-current accrued warranty | 17,747 | 21,487 |
| Other long-term liabilities | 2,402 | 3,310 |
| Total liabilities | 69,768 | 74,629 |
| Stockholders equity: | | |
| Preferred stock, \$0.01 par value, 3,000,000 shares authorized; none issued and outstanding | | |
| Common stock, \$0.01 par value, 40,000,000 shares authorized; 17,222,232 and 17,010,493 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively | 172 | 170 |
| Additional paid-in capital | 100,663 | 98,638 |
| Retained earnings (deficit) | 29,971 | (4,822) |

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| | | |
|--------------------------------------------|------------|------------|
| Total stockholders' equity | 130,806 | 93,986 |
| Total liabilities and stockholders' equity | \$ 200,574 | \$ 168,615 |

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

Table of Contents**TREX COMPANY, INC.****Condensed Consolidated Statements of Comprehensive Income**

(Unaudited)

(In thousands, except share and per share data)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------------------------|--------------------------------|------------|------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| Net sales | \$ 98,551 | \$ 94,279 | \$ 206,430 | \$ 190,379 |
| Cost of sales | 61,629 | 60,689 | 127,649 | 121,369 |
| Gross profit | 36,922 | 33,590 | 78,781 | 69,010 |
| Selling, general and administrative expenses | 23,392 | 20,866 | 43,234 | 39,467 |
| Income from operations | 13,530 | 12,724 | 35,547 | 29,543 |
| Interest expense, net | 210 | 4,299 | 461 | 8,710 |
| Income before income taxes | 13,320 | 8,425 | 35,086 | 20,833 |
| Provision for income taxes | 96 | 86 | 293 | 182 |
| Net income | \$ 13,224 | \$ 8,339 | \$ 34,793 | \$ 20,651 |
| Basic earnings per common share | \$ 0.78 | \$ 0.54 | \$ 2.05 | \$ 1.33 |
| Basic weighted average common shares outstanding | 17,012,046 | 15,571,207 | 16,947,935 | 15,522,492 |
| Diluted earnings per common share | \$ 0.76 | \$ 0.48 | \$ 2.01 | \$ 1.22 |
| Diluted weighted average common shares outstanding | 17,392,270 | 17,210,177 | 17,336,714 | 16,964,082 |
| Comprehensive income | \$ 13,224 | \$ 8,339 | \$ 34,793 | \$ 20,651 |

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

Table of Contents**TREX COMPANY, INC.****Condensed Consolidated Statements of Cash Flows**

(Unaudited)

(In thousands)

| | Six Months Ended June 30, | |
|-----------------------------------------------------------------------------------|--------------------------------------|----------------|
| | 2013 | 2012 |
| Operating Activities | | |
| Net income | \$ 34,793 | \$ 20,651 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 8,341 | 8,704 |
| Debt discount amortization | | 5,450 |
| Stock-based compensation | 1,797 | 1,693 |
| Deferred income taxes | (346) | |
| Loss on disposal of property, plant and equipment | 220 | 16 |
| Other non-cash adjustments | (337) | (314) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (24,411) | (19,654) |
| Inventories | 2,557 | 15,459 |
| Prepaid expenses and other assets | 482 | 185 |
| Accounts payable | 3,859 | 1,692 |
| Accrued expenses and other liabilities | (4,080) | 2,129 |
| Income taxes receivable/payable | 265 | (64) |
| Net cash provided by operating activities | 23,140 | 35,947 |
| Investing Activities | | |
| Expenditures for property, plant and equipment | (5,110) | (2,938) |
| Proceeds from sales of property, plant and equipment | 174 | |
| Purchase of acquired company, net of cash acquired | | (11) |
| Notes receivable, net | 63 | 57 |
| Net cash used in investing activities | (4,873) | (2,892) |
| Financing Activities | | |
| Financing costs | (73) | (750) |
| Restricted cash | | (8,938) |
| Borrowings under line of credit | 74,500 | 77,700 |
| Principal payments under line of credit | (79,500) | (52,700) |
| Repurchases of common stock | (3,153) | (2,784) |
| Proceeds from employee stock purchase and option plans | 3,383 | 462 |
| Net cash provided by (used in) financing activities | (4,843) | 12,990 |
| Net increase in cash and cash equivalents | 13,424 | 46,045 |
| Cash and cash equivalents at beginning of period | 2,159 | 4,526 |
| Cash and cash equivalents at end of period | \$ 15,583 | \$ 50,571 |

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Supplemental Disclosure:

| | | |
|-----------------------------------------------------|--------|----------|
| Cash paid for interest, net of capitalized interest | \$ 344 | \$ 2,931 |
| Cash paid for income taxes, net | \$ 375 | \$ 293 |

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

Table of Contents**TREX COMPANY, INC.****Notes to Condensed Consolidated Financial Statements****For the Six Months Ended June 30, 2013 and 2012****(Unaudited)****1. BUSINESS AND ORGANIZATION**

Trex Company, Inc. (the Company) is the world's largest manufacturer of wood-alternative decking and railing products, which are marketed under the brand name Trex®. The Company is incorporated in Delaware. The principal executive offices are located at 160 Exeter Drive, Winchester, Virginia 22603, and the telephone number at that address is (540) 542-6300. The Company operates in one business segment.

2. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the accompanying condensed consolidated financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal and recurring adjustments) considered necessary for a fair presentation have been included in the accompanying condensed consolidated financial statements. The consolidated results of operations for the six months ended June 30, 2013 are not necessarily indicative of the results that may be expected for the full fiscal year. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements as of December 31, 2012 and 2011 and for each of the three years in the period ended December 31, 2012 included in the annual report of Trex Company, Inc. on Form 10-K, as filed with the Securities and Exchange Commission.

The Company's critical accounting policies are included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

3. INVENTORIES

Inventories, at LIFO (last-in, first-out) value, consist of the following (in thousands):

| | June 30, 2013 | December 31, 2012 |
|---------------------------------------------|--------------------------|------------------------------|
| Finished goods | \$ 25,122 | \$ 23,172 |
| Raw materials | 13,560 | 18,068 |
| Total FIFO inventories | 38,682 | 41,240 |
| Reserve to adjust inventories to LIFO value | (23,719) | (23,719) |
| Total LIFO inventories | \$ 14,963 | \$ 17,521 |

Under the LIFO method, reductions in inventory cause a portion of the Company's cost of sales to be based on historical costs rather than current year costs. The Company recognized no benefit during the six months ended June 30, 2013 compared to a \$0.9 million benefit during the six months ended June 30, 2012 due to a reduction in inventory.

An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management's estimates of expected year-end inventory levels and costs. Since

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inventory levels and costs are subject to factors beyond management's control, interim results are subject to the final year-end LIFO inventory valuation.

Table of Contents**4. ACCRUED EXPENSES**

Accrued expenses consist of the following (in thousands):

| | June 30, 2013 | December 31, 2012 |
|-----------------------------------|--------------------------|------------------------------|
| Accrued compensation and benefits | \$ 6,132 | \$ 10,080 |
| Accrued sales and marketing | 4,885 | 3,402 |
| Accrued legal contingency | 3,391 | |
| Accrued manufacturing | 1,149 | 1,351 |
| Accrued rent obligations | 1,112 | 1,103 |
| Other | 3,357 | 2,882 |
| Total accrued expenses | \$ 20,026 | \$ 18,818 |

5. DEBT

The Company's outstanding debt consists of a revolving credit facility.

Revolving Credit Facility

On January 6, 2012, the Company entered into an Amended and Restated Credit Agreement (the Credit Agreement) with Branch Banking and Trust Company (BB&T), Wells Fargo Capital Finance, LLC and BB&T Capital Markets (the Lenders). Under the Credit Agreement, the Lenders agreed to provide the Company with one or more revolving loans in a collective maximum principal amount of \$100 million. The Credit Agreement replaced the previous revolving credit facility in its entirety.

On February 26, 2013, the Company, as borrower; BB&T, as Administrative Agent and as a Lender; and Wells Fargo Capital Finance, LLC, as a Lender; entered into a First Amendment (First Amendment) to their Amended and Restated Credit Agreement dated as of January 6, 2012. Pursuant to the First Amendment, the Credit Agreement was amended to temporarily increase the maximum amount of the revolving loans from \$100 million to \$125 million during the period from February 26, 2013 through and including June 30, 2013, and reduce certain interest rate margins and costs. In conjunction with the First Amendment, the Revolver Notes executed by the Company to each of BB&T and Wells Fargo dated as of January 6, 2012 were amended and restated.

Amounts drawn under the Credit Agreement are subject to a borrowing base consisting of certain accounts receivables, inventories, machinery and equipment and real estate. At June 30, 2013, the Company had no outstanding borrowings under its revolving credit facility and available borrowing capacity of approximately \$78.4 million.

Compliance with Debt Covenants and Restrictions

The Company's ability to make scheduled principal and interest payments and to borrow and repay amounts under any outstanding revolving credit facility, and continue to comply with any loan covenants depends primarily on the Company's ability to generate sufficient cash flow from operations.

As of June 30, 2013, the Company was in compliance with all of the covenants contained in its debt agreements. Failure to comply with the loan covenants might cause lenders to accelerate the repayment obligations under the credit facility, which may be declared payable immediately based on a default.

6. FINANCIAL INSTRUMENTS

The Company considers the recorded value of its financial assets and liabilities, consisting primarily of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and other current liabilities to approximate the fair value of the respective assets and liabilities at June 30, 2013 and December 31, 2012.

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The following table sets forth the computation of basic and diluted earnings per share (in thousands, except share and per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------------------------|--------------------------------|-------------------|------------------------------|-------------------|
| | 2013 | 2012 | 2013 | 2012 |
| Numerator: | | | | |
| Net income available to common shareholders | \$ 13,224 | \$ 8,339 | \$ 34,793 | \$ 20,651 |
| Denominator: | | | | |
| Basic weighted average shares outstanding | 17,012,046 | 15,571,207 | 16,947,935 | 15,522,492 |
| Effect of dilutive securities: | | | | |
| SARs and options | 286,869 | 445,178 | 308,472 | 447,932 |
| Convertible notes | | 1,155,920 | | 965,967 |
| Restricted stock | 93,355 | 37,872 | 80,307 | 27,691 |
| Diluted weighted average shares outstanding | 17,392,270 | 17,210,177 | 17,336,714 | 16,964,082 |
| Basic earnings per share | \$ 0.78 | \$ 0.54 | \$ 2.05 | \$ 1.33 |
| Diluted earnings per share | \$ 0.76 | \$ 0.48 | \$ 2.01 | \$ 1.22 |

Diluted earnings per share is computed using the weighted average number of shares determined for the basic earnings per share computation plus the dilutive effect of common stock equivalents using the treasury stock method. The computation of diluted earnings per share excludes the following potentially dilutive securities because the effect would be anti-dilutive:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|------------------------------------|--------------------------------|---------|------------------------------|---------|
| | 2013 | 2012 | 2013 | 2012 |
| Restricted stock and stock options | 371 | 127,014 | 16,621 | 131,267 |
| Stock appreciation rights | 57,661 | 177,758 | 44,207 | 157,084 |

8. STOCK-BASED COMPENSATION

The Company has one stock-based compensation plan, the 2005 Stock Incentive Plan (the Plan). The Plan is administered by the Compensation Committee of the Company's Board of Directors. Stock-based compensation is granted to officers, directors and certain key employees in accordance with the provisions of the Plan. The Plan provides for grants of stock options, stock appreciation rights (SARs), restricted stock and performance share awards. As of June 30, 2013, the total aggregate number of shares of the Company's common stock that may be issued under the Plan is 3,150,000.

The fair value of each SAR is estimated on the date of grant using a Black-Scholes option-pricing formula. For SARs issued in the six months ended June 30, 2013 and 2012, respectively, the assumptions shown in the following table were used:

| | Six Months Ended June 30, | |
|---------------------------------------|---------------------------|----------|
| | 2013 | 2012 |
| Weighted-average fair value of grants | \$ 23.35 | \$ 14.01 |
| Dividend yield | 0% | 0% |
| Average risk-free interest rate | 0.7% | 0.8% |

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| | | |
|-----------------------|-----|-----|
| Expected term (years) | 5 | 5 |
| Expected volatility | 64% | 66% |

The following table summarizes the Company's stock-based compensation grants for the six months ended June 30, 2013:

| | Stock Awards Granted | Weighted-Average Grant Price Per Share |
|---------------------------|----------------------|----------------------------------------------|
| Stock appreciation rights | 60,306 | \$ 43.87 |
| Restricted stock | 39,660 | \$ 43.88 |

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The following table summarizes the Company's stock-based compensation expense for the three and six months ended June 30, 2013 and 2012 (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------|--------------------------------|--------|------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| Stock appreciation rights | \$ 307 | \$ 418 | \$ 638 | \$ 720 |
| Restricted stock | 586 | 530 | 1,123 | 933 |
| Employee stock purchase plan | 9 | 9 | 36 | 40 |
| Total stock-based compensation | \$ 902 | \$ 957 | \$ 1,797 | \$ 1,693 |

Total unrecognized compensation cost related to unvested awards as of June 30, 2013 was \$6.7 million. The cost of these unvested awards is being recognized over the requisite vesting period of each award.

9. INCOME TAXES

The Company's effective tax rate for the six months ended June 30, 2013 and 2012 was 1.0% and 0.9% respectively, which resulted in expense of \$0.3 million and \$0.2 million, respectively.

The Company continues to maintain a valuation allowance against its net deferred tax asset, the effect of which is to substantially reduce the Company's effective tax rate as the tax expense or benefit recorded at the statutory tax rate is offset by a corresponding expense or benefit resulting from the change in the valuation allowance. As a result of the Company's valuation allowance, its annual effective tax rate, and changes to it, is primarily a function of the Company's expectations of the cash taxes paid to various jurisdictions as a result of taxable income exceeding available net operating loss carry-forwards or alternative minimum tax calculations. The Company expects cash taxes paid to be materially consistent with amounts paid in the prior period. The Company will analyze its position in subsequent reporting periods, considering all available positive and negative evidence, in determining the expected realization of its deferred tax assets.

The Company operates in multiple tax jurisdictions and, in the normal course of business, its tax returns are subject to examination by various taxing authorities. Such examinations may result in future assessments by these taxing authorities, and the Company has accrued a liability when it believes that it is more likely than not that benefits of tax positions will not be realized. The Company believes that adequate provisions have been made for all tax returns subject to examination. As of June 30, 2013, tax years 2009 through 2013 remain subject to examination by federal and certain state tax jurisdictions.

10. SEASONALITY

The Company's operating results have historically varied from quarter to quarter, in part due to seasonal trends in the demand for Trex®. The Company has historically experienced lower net sales during the fourth quarter because holidays and adverse weather conditions in certain regions reduce the level of home improvement and construction activity.

11. COMMITMENTS AND CONTINGENCIES*Contract Termination Costs*

In anticipation of relocating its corporate headquarters, the Company entered into a lease agreement in 2005. The Company reconsidered and decided not to move its headquarters. The lease, which extends through June 30, 2019, obligates the Company to lease 55,047 square feet. As of June 30, 2013, the Company has executed subleases for the entire 55,047 square feet it currently leases. However, a sublease for 4,028 square feet expires on July 31, 2013. The Company is currently marketing this space to find a suitable tenant. The remaining subleases expire in late 2014 to 2019. The Company estimates that the present value of the estimated future sublease rental receipts, net of transaction costs, will be less than the Company's remaining minimum lease payment obligations under its lease for the office space and has recorded a liability for the

expected shortfall.

To estimate future sublease receipts for the periods beyond the term of the existing subleases, the Company has assumed that the existing subleases will be renewed or new subleases will be executed at rates consistent with rental rates in the current subleases. However, management cannot be certain that the timing of future subleases or the rental rates contained in future subleases will not differ from current estimates. Factors such as the availability of commercial office space, poor economic conditions and subtenant preferences will influence the terms achieved in future subleases. The inability to sublet the office space in the future or unfavorable changes to key management assumptions used in the estimate of the future sublease receipts may result in material charges to selling, general and administrative expenses in future periods.

As of June 30, 2013, the minimum payments remaining under the Company's lease relating to its reconsidered corporate relocation over the years ending December 31, 2013, 2014, 2015, 2016 and 2017 are \$0.8 million, \$1.7 million, \$1.7 million, \$1.8 million and \$1.8 million, respectively, and \$2.8 million thereafter. The minimum receipts remaining under the Company's existing subleases over the years ending December 31, 2013, 2014, 2015, 2016 and 2017 are \$0.7 million, \$1.6 million, \$0.7 million, \$0.7 million and \$0.7 million, respectively, and \$1.1 million thereafter.

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The following table provides information about the Company's liability related to the lease (in thousands):

| | 2013 | 2012 |
|------------------------------------------------------|----------|--------|
| Balance as of January 1 | \$ 1,103 | \$ 452 |
| Net rental receipts (payments) | (111) | (19) |
| Accretion of discount | 41 | 18 |
| Increase in net estimated contract termination costs | 79 | 39 |
| | | |
| Balance as of June 30 | \$ 1,112 | \$ 490 |

Product Warranty

The Company warrants that its products will be free from material defects in workmanship and materials. This warranty generally extends for a period of 25 years for residential use and 10 years for commercial use. (With respect to TrexTrim® and Trex Reveal® Railing, the warranty period is 25 years for both residential and commercial use.) With respect to the Company's Transcend®, Enhance® and Universal Fascia product, the Company further warrants that the product will not fade in color more than a certain amount and will be resistant to permanent staining from food substances or mold (provided the stain is cleaned within seven days of appearance). This warranty extends for a period of 25 years for residential use and 10 years for commercial use. If there is a breach of such warranties, the Company has an obligation either to replace the defective product or refund the purchase price.

Historically, the Company has not had material numbers of claims submitted or settled under the provisions of its product warranties, with the exception of claims related to material produced at its Nevada facility prior to 2007 that exhibits surface flaking. The Company continues to receive and settle surface flaking claims and maintains a warranty reserve to provide for the settlement of these claims. In 2009, the Company agreed to a settlement of a class action lawsuit covering the surface defect, stipulating its responsibilities with regard to such claims. Estimating the warranty reserve for surface flaking claims requires management to estimate (1) the average cost to settle each claim and (2) the number of claims to be settled with payment, both of which are subject to variables that are difficult to estimate.

The cost per claim varies due to a number of factors, including the size of affected decks, the type of replacement material used, the cost of production of replacement material and the method of claim settlement. Although the cost per claim does vary, it is less volatile and more predictable than the number of claims to be settled with payment, which is inherently uncertain.

The key component driving the Company's potential liability is the number of claims that will ultimately require payment. To estimate the ultimate count of future paid claims, the Company utilizes actuarial techniques to quantify both the expected number of claims to be received and the percentage of those claims that will ultimately require payment. Estimates for both of these elements (number and percentage of claims that will ultimately require payment) are quantified using a range of assumptions derived from the recent claim count history and the identification of factors influencing the claim counts, including the downward trend in received claims due to the passage of time since production of the suspect material. For each of the various parameters used in its analysis, the assumed values that drive the results represent the Company's best estimate for the ultimate number of claims to be settled with payment.

A number of factors make estimates of the number of claims to be received inherently uncertain. The Company believes that production of the suspect material was confined to material produced from its Nevada facility prior to 2007, but is unable to determine the amount of suspect material produced or the exact time it takes for surface flaking to become evident in the suspect material and materialize as a claim. Furthermore, the aforementioned 2009 class action settlement and related public notices led to a significant spike in claims received in 2009 and disrupted the claims data and settlement patterns. Lastly, the Company is not aware of any analogous industry data that might be referenced in predicting future claims to be received.

The number of surface flaking claims received peaked in 2009 in conjunction with the class action settlement and then declined significantly in 2010 and 2011, consistent with the Company's belief that the effect of the 2009 spike in claims was largely an acceleration of claims previously expected to be filed in future periods. As a result of the effects of the class action settlement and because the suspect material had not been produced since prior to 2007, the Company anticipated that the rate of decline in claims received would accelerate and the number of claims received would continue to decline significantly in 2012.

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Due to extensive use of decks during the summer outdoor season, variance to annual claims expectations is typically observed during the latter part of the Company's fiscal year. During the third quarter of 2012, based on an analysis of additional claims activity, the Company observed that the actual rate of decline in claims received in 2012 would fall short of its anticipated rate of decline. As a result, the Company revised its estimate of the future claims to be received to reflect a rate of decline that incorporated levels experienced in 2012. Although the number of claims received continues to decline each year, the effect of reducing the anticipated rate of decline increases the number of claims expected in future years. As a result of these changes in estimate, the Company recorded an increase to the warranty reserve of \$20 million during the three months ended September 30, 2012.

The Company monitors surface flaking claims activity each quarter for indications that its estimate of the number of claims expected requires revision. Through the six months ended June 30, 2013, both the number of claims received and the cost per claim are unfavorable, while the number of claims settled with payment against the reserve is favorable. At June 30, 2013 the Company believes that claims information received to date provides evidence that its warranty reserve is sufficient to cover future surface flaking payment obligations.

The Company's analysis is based on currently known facts and a number of assumptions. However, projecting future events such as the number of claims to be received, the number of claims that will require payment and the average cost of claims could cause the actual warranty liabilities to be higher or lower than those projected which could materially affect the Company's financial condition, results of operations or cash flow. The Company estimates that the number of claims received will continue to decline over time. If the level of claims received does not diminish consistent with its expectations or if the cost to settle claims increases, it could result in additional increases to the warranty reserve and reduced earnings in future periods. The Company estimates that a 10% change in the expected number of remaining claims to be settled with payment or the expected cost to settle claims may result in approximately a \$3.0 million change in the warranty reserve.

The following is a reconciliation of the Company's warranty reserve (in thousands):

| | 2013 | 2012 |
|---------------------------------------------------------|-----------|-----------|
| Beginning balance, January 1 | \$ 28,987 | \$ 16,345 |
| Changes in estimates related to pre-existing warranties | | 1,487 |
| Settlements made during the period | (3,740) | (3,891) |
| Ending balance, June 30 | \$ 25,247 | \$ 13,941 |

Legal Matters

As reported in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, on January 19, 2009, a purported class action case was commenced against the Company in the Superior Court of California, Santa Cruz County, by the lead law firm of Lief, Cabraser, Heimann & Bernstein, LLP and certain other law firms (the Lief Cabraser Group) on behalf of Eric Ross and Bradley S. Hureth and similarly situated plaintiffs. These plaintiffs generally allege certain defects in the Company's products, and that the Company has failed to provide adequate remedies for defective products. On February 13, 2009, the Company removed this case to the United States District Court, Northern District of California. On January 21, 2009, a purported class action case was commenced against the Company in the United States District Court, Western District of Washington by the law firm of Hagens Berman Sobol Shapiro LLP (Hagens Berman) on behalf of Mark Okano and similarly situated plaintiffs, generally alleging certain product defects in the Company's products, and that the Company has failed to provide adequate remedies for defective products. This case was transferred by the Washington Court to the California Court as a related case to the Lief Cabraser Group's case.

On July 30, 2009, the U.S. District Court for the Northern District of California preliminarily approved a settlement of the claims of the lawsuit commenced by the Lief Cabraser Group involving surface flaking of the Company's product, and on March 15, 2010, it granted final approval of the settlement.

On March 25, 2010, the Lief Cabraser Group amended its complaint to add claims relating to alleged defects in the Company's products and alleged misrepresentations relating to mold growth. Hagens Berman has alleged similar claims in its original complaint. In its Final Order approving the surface flaking settlement, the District Court consolidated these pending actions relating to the mold claims, and appointed Hagens Berman as lead counsel in this case. On December 3, 2010, Hagens Berman filed an amended consolidated complaint in the United States District Court, Northern District of California relating to the mold growth claims (now on behalf of Dean Mahan and other named plaintiffs).

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On December 15, 2010, a purported class action case was commenced against the Company in the United States District Court, Western District of Kentucky, by Cohen & Malad, LLP (Cohen & Malad) on behalf of Richard Levin and similarly situated plaintiffs in Kentucky, and on June 13, 2011, a purported class action was commenced against the Company in the

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Marion Circuit/Superior Court of Indiana by Cohen & Malad on behalf of Ellen Kopetsky and similarly situated plaintiffs in Indiana. On June 28, 2011, the Company removed the Kopetsky case to the United States District Court, Southern District of Indiana. On August 11, 2011, a purported class action was commenced against the Company in the 50th Circuit Court for the County of Chippewa, Michigan on behalf of Joel and Lori Peffers and similarly situated plaintiffs in Michigan. On August 26, 2011, the Company removed the Peffers case to the United States District Court, Western District of Michigan. On April 4, 2012, a purported class action was commenced against the Company in Superior Court of New Jersey, Essex County by the lead law firm of Stull, Stull & Brody (the Stull Group) on behalf of Caryn Borger, M.D. and similarly situated plaintiffs in New Jersey. On May 1, 2012, the Company removed the Borger case to the United States District Court, District of New Jersey. The plaintiffs in these purported class actions generally allege certain defects in the Company's products and alleged misrepresentations relating to mold growth.

On April 5, 2013, the Company signed a settlement agreement with Hagens Berman that would settle the case pending in the United States District Court, Northern District of California on a nationwide basis, and the parties filed for preliminary approval of such settlement (the nationwide settlement). The material terms of the nationwide settlement as set forth in the settlement agreement (and as modified as discussed later) are as follows:

Trex will make a one-time cash payment or the opportunity to receive other relief, including a rebate certificate on its newer-generation shelled product (Trex Transcend[®] and Trex Enhance[®]). This relief would be available for any consumer whose first-generation composite decking product has a certain defined level of mold growth, color fading or color variation.

Trex agreed to discontinue the manufacture of non-shelled products (Trex Accents[®]) by December 31, 2013.

Trex agreed to provide a video demonstrating cleaning instructions for non-shelled products on its website, and to distribute warranty pads to retailers.

The cost to Trex will be capped at \$8.25 million plus \$1.45 million in attorneys' fees to be paid to the Plaintiffs' counsel upon final approval of the nationwide settlement by the Court.

The settlement agreement provides that the nationwide settlement would apply to any Trex first-generation non-shelled composite decking product purchased between August 1, 2004 and the date of preliminary approval of the nationwide settlement.

On April 19, 2013, Cohen & Malad and the Stull Group filed respective briefs with the Court objecting to the nationwide settlement. On May 28, 2013, the Court filed an Order requesting the parties to address certain issues raised by the Court with the proposed nationwide settlement. On June 14, 2013, the Company and Hagens Berman filed a joint brief with the Court agreeing to certain modifications of the settlement agreement to address the Court's Order. The hearing for preliminary approval of the nationwide settlement is scheduled for August 23, 2013. The nationwide settlement is not final until the Court approves the settlement agreement. Although the Company agreed with Hagens Berman to modify the settlement agreement, the Court may, in its sole discretion, determine not to accept the nationwide settlement. If the Court does not approve the nationwide settlement, the settlement agreement will not be binding on the parties.

The Company denies all liability with respect to the facts and claims alleged. However, the Company is aware of the substantial burden, expense, inconvenience and distraction of continued litigation, and agreed to settle the litigation to avoid these. As of June 30, 2013, the Company has accrued a \$3.4 million liability related to this litigation. It is reasonably possible that the Company may incur costs in excess of the recorded amounts; however, the Company expects that the total net cost to resolve the lawsuit will not exceed approximately \$10 million.

The Company has other lawsuits, as well as other claims, pending against it which are ordinary routine litigation and claims incidental to the business. Management has evaluated the merits of these other lawsuits and claims, and believes that their ultimate resolution will not have a material effect on the Company's consolidated financial condition, results of operations, liquidity or competitive position.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This management's discussion and analysis contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements regarding our expected financial position and operating results, our business strategy, our financing plans, forecasted demographic and economic trends relating to our industry and similar matters are forward-looking statements. These statements can sometimes be identified by our use of forward-looking words such as may, will, anticipate, estimate, expect, intend or similar expressions. We cannot promise you that our expectations in such forward-looking statements will turn out to be correct. Our actual results could be materially different from our expectations because of various factors, including the factors discussed under Item 1A. Risk Factors in our Annual Report on Form 10-K for fiscal year 2012 filed with the Securities and Exchange Commission. These statements are also subject to risks and uncertainties that could cause the Company's actual operating results to differ materially. Such risks and uncertainties include the extent of market acceptance of the Company's products; the costs associated with the development and launch of new products and the market acceptance of such new products; the sensitivity of the Company's business to general economic conditions; the impact of seasonal and weather-related demand fluctuations on inventory levels in the distribution channel and sales of the Company's products; the Company's ability to obtain raw materials at acceptable prices; the Company's ability to maintain product quality and product performance at an acceptable cost; the level of expenses associated with product replacement and consumer relations expenses related to product quality; and the highly competitive markets in which the Company operates.

Overview

General. Trex Company, Inc. is the world's largest manufacturer of wood-alternative decking and railing products, which are marketed under the brand name Trex®. We offer a comprehensive set of aesthetically durable, low maintenance product offerings and believe that the range and variety of our product offerings allow consumers to design much of their outdoor living space using Trex brand products.

We have four principal decking products: Trex Transcend®, Trex Enhance®, Trex Select®, and Trex Accents®; three principal railing products: Trex Transcend Railing, Trex Select Railing, and Trex Reveal aluminum railing; a porch product, Trex Transcend Porch Flooring and Railing System; a steel deck framing system, Trex Elevations®; a fencing product, Trex Seclusions®; a deck lighting system, Trex DeckLighting; and a cellular PVC outdoor trim product, TrexTrim. In addition, we offer Trex Hideaway®, which is a hidden fastening system for specially grooved boards.

Highlights related to the second quarter of 2013 include:

During the quarter, we repaid in full the outstanding balance under our revolving credit facility, and at June 30, 2013, had no outstanding indebtedness.

We experienced an increase in net sales of 4.5% during the quarter compared to the second quarter of 2012. Year-to-date 2013 net sales were 8.4% higher than in the comparable 2012 period.

We achieved gross margins of 37.5% during the quarter compared to 35.6% during the second quarter of 2012.

Net Sales. Net sales consists of sales and freight, net of returns and discounts. The level of net sales is principally affected by sales volume and the prices paid for Trex products. Our branding and product differentiation strategy enables us to command premium prices over wood products. Our operating results have historically varied from quarter to quarter, in part due to seasonal trends in the demand for Trex. We have historically experienced lower net sales during the fourth quarter because holidays and adverse weather conditions in certain regions reduce the level of home improvement and construction activity.

Sales Incentives / Early Buy Program: As part of our normal business practice and consistent with industry practices, we have historically provided our distributors and dealers incentives to build inventory levels before the start of the prime deck-building season to ensure adequate availability of product to meet anticipated seasonal consumer demand and to enable production planning. These incentives, which together we reference as our early buy program, include payment discounts and favorable payment terms. In addition, from time to time we may offer price discounts or volume rebates on specified products and other incentives based on increases in purchases as part of specific promotional programs.

We launched our early buy program for the 2013 decking season in December 2012. The timing and terms of the 2013 program were generally consistent with the timing and terms of the 2012 program launched in December 2011. To qualify for early buy program incentives, customers must commit to the terms of the program which specify eligible products and quantities, order deadlines and available terms, discounts and

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rebates. Early Buy shipments in December 2012 were lower than in December 2011 due, in part, to the introduction of new product offerings which were not available for shipment until January 2013. There are no product return rights granted to our distributors except those granted pursuant to the warranty provisions of our agreements with distributors. In addition, our products are not susceptible to rapid changes in technology that may cause them to become obsolete. The early buy program can have a significant impact on our sales, receivables and inventory levels. We have provided further discussion of our receivables and inventory in the liquidity and capital resources section.

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Gross Profit. Gross profit represents the difference between net sales and cost of sales. Cost of sales consists of raw materials costs, direct labor costs, manufacturing costs and freight. Raw materials costs generally include the costs to purchase and transport waste wood fiber, reclaimed polyethylene, or PE material, and pigmentation for coloring Trex products. Direct labor costs include wages and benefits of personnel engaged in the manufacturing process. Manufacturing costs consist of costs of depreciation, utilities, maintenance supplies and repairs, indirect labor, including wages and benefits, and warehouse and equipment rental activities.

Product Warranty. We continue to receive and settle claims related to material produced at our Nevada facility prior to 2007 that exhibits surface flaking and maintain a warranty reserve to provide for the settlement of these claims. Due to extensive use of decks during the summer outdoor season, variance to annual claims expectations is typically observed during the latter part of our fiscal year. During the third quarter of 2012, based on an analysis of additional claims activity, we observed that the actual rate of decline in claims received in 2012 would fall short of our anticipated rate of decline. As a result, we revised our estimate of the future claims to be received to reflect a rate of decline that incorporated levels experienced in 2012. Although the number of claims received continues to decline each year, the effect of reducing the anticipated rate of decline increases the number of claims expected in future years. As a result of these changes in estimate, we recorded an increase to the warranty reserve of \$20 million during the three months ended September 30, 2012.

We monitor surface flaking claims activity each quarter for indications that our estimate of the number of claims expected requires revision. Through the six months ended June 30, 2013, both the number of claims received and the cost per claim are unfavorable, while the number of claims settled with payment against the reserve is favorable. At June 30, 2013 we believe that claims information received to date provides evidence that our warranty reserve is sufficient to cover future surface flaking payment obligations.

Selling, General and Administrative Expenses. The largest component of selling, general and administrative expenses is personnel related costs, which include salaries, commissions, incentive compensation, and benefits of personnel engaged in sales and marketing, accounting, information technology, corporate operations, research and development, and other business functions. Another component of selling, general and administrative expenses is branding and other sales and marketing costs, which are used to build brand awareness of Trex. These costs consist primarily of advertising, merchandising, and other promotional costs. Other general and administrative expenses include professional fees, office occupancy costs attributable to the business functions previously referenced, and consumer relations expenses. As a percentage of net sales, selling, general and administrative expenses have varied from quarter to quarter due, in part, to the seasonality of our business.

Provision for Income Taxes. In recent periods our effective tax rate has been substantially lower than the statutory rate due to the effect of the valuation allowance we maintain against our net deferred tax assets which substantially offsets statutory income tax. Management is continuing to monitor this matter, and to the extent it is determined that the valuation allowance should be reduced, it could have a significant impact on our effective income tax rate in the future.

Results of Operations