TREX CO INC
Form 10-Q
July 30, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018

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)

Delaware	**54-1910453**
(State or other jurisdiction of	**(I.R.S. Employer**

incorporation or organization)	**Identification No.)**
160 Exeter Drive	
Winchester, Virginia	**22603-8605**
(Address of principal executive offices)	**(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, a smaller reporting company or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company, and emerging growth company in Rule 12b-2 of the Exchange Act.:

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

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 19, 2018 was 58,726,643 shares.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

TREX COMPANY, INC.

Condensed Consolidated Statements of Comprehensive Income

(Unaudited)

(In thousands, except share and per share data)

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Net sales	$ 206,692	$ 157,941	$ 377,899	$ 302,747
Cost of sales	115,577	85,927	210,071	165,563
Gross profit	91,115	72,014	167,828	137,184
Selling, general and administrative expenses	33,513	27,221	62,472	50,490
Income from operations	57,602	44,793	105,356	86,694
Interest expense, net	369	251	598	456
Income before income taxes	57,233	44,542	104,758	86,238
Provision for income taxes	14,413	15,760	24,828	29,506
Net income	$ 42,820	$ 28,782	$ 79,930	$ 56,732
Basic earnings per common share	$ 0.73	$ 0.49	$ 1.36	$ 0.97
Basic weighted average common shares outstanding	58,760,753	58,778,916	58,807,694	58,752,814
Diluted earnings per common share	$ 0.73	$ 0.49	$ 1.35	$ 0.96
Diluted weighted average common shares outstanding	59,051,413	59,100,836	59,125,258	59,111,970
Comprehensive income	$ 42,820	$ 28,782	$ 79,930	$ 56,732

See Notes to Condensed Consolidated Financial Statements (Unaudited).

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TREX COMPANY, INC.

Condensed Consolidated Balance Sheets

(In thousands)

	June 30, 2018 (Unaudited)	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$ 2,901	$ 30,514
Accounts receivable, net	171,131	66,882
Inventories	36,188	34,524
Prepaid expenses and other assets	18,136	16,878
Total current assets	228,356	148,798
Property, plant and equipment, net	107,652	103,110
Goodwill and other intangibles	75,121	71,319
Other assets	3,316	3,000
Total assets	$ 414,445	$ 326,227
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 24,817	$ 9,953
Accrued expenses and other liabilities	46,101	46,266
Accrued warranty	6,290	6,290
Line of credit	8,500	
Total current liabilities	85,708	62,509
Deferred income taxes	1,286	1,286
Non-current accrued warranty	27,482	28,709
Other long-term liabilities	1,970	2,473
Total liabilities	116,446	94,977
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.01 par value, 3,000,000 shares authorized; none issued and outstanding		
Common stock, $0.01 par value, 120,000,000 shares authorized; 69,959,734 and 69,844,222 shares issued and 58,722,328 and 58,856,860 shares outstanding at June 30, 2018 and December 31, 2017, respectively	700	349
Additional paid-in capital	121,541	122,043
Retained earnings	362,299	282,370

Treasury stock, at cost, 11,237,406 and 10,987,362 shares at June 30, 2018 and December 31, 2017, respectively	(186,541)	(173,512)
Total stockholders equity	297,999	231,250
Total liabilities and stockholders equity	$ 414,445	$ 326,227

See Notes to Condensed Consolidated Financial Statements (Unaudited).

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TREX COMPANY, INC.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)

	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Operating Activities		
Net income	$ 79,930	$ 56,732
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	9,363	7,513
Stock-based compensation	3,645	2,876
(Gain) loss on disposal of property, plant and equipment	(29)	1,343
Other non-cash adjustments	(406)	(405)
Changes in operating assets and liabilities:		
Accounts receivable	(104,250)	(81,842)
Inventories	(1,664)	1,604
Prepaid expenses and other assets	(2,616)	3,701
Accounts payable	14,863	4,370
Accrued expenses and other liabilities	(5,705)	(5,680)
Income taxes receivable/payable	5,195	9,907
Net cash (used in) provided by operating activities	(1,674)	119
Investing Activities		
Expenditures for property, plant and equipment and intangibles	(17,697)	(7,125)
Proceeds from sales of property, plant and equipment	83	
Net cash used in investing activities	(17,614)	(7,125)
Financing Activities		
Borrowings under line of credit	167,750	163,000
Principal payments under line of credit	(159,250)	(163,000)
Repurchases of common stock	(17,230)	(3,271)
Proceeds from employee stock purchase and option plans	405	189
Net cash used in financing activities	(8,325)	(3,082)
Net decrease in cash and cash equivalents	(27,613)	(10,088)
Cash and cash equivalents, beginning of period	30,514	18,664

Cash and cash equivalents, end of period	$	2,901	$	8,576
Supplemental Disclosure:				
Cash paid for interest	$	385	$	364
Cash paid for income taxes, net	$	19,618	$	19,600

See Notes to Condensed Consolidated Financial Statements (Unaudited).

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TREX COMPANY, INC.

Notes to Condensed Consolidated Financial Statements

For the Six Months Ended June 30, 2018 and 2017

(Unaudited)

1. BUSINESS AND ORGANIZATION

Trex Company, Inc. (Company) is the world s largest manufacturer of wood-alternative decking and railing products, with more than 25 years of product experience, which are marketed under the brand name Trex®. The Company manufactures and distributes high-performance, low-maintenance wood/plastic composite outdoor living products and related accessories. A majority of its products are manufactured in a proprietary process that combines reclaimed wood fibers and scrap polyethylene. On July 31, 2017, through its newly-formed, wholly-owned subsidiary, Trex Commercial Products, Inc., the Company acquired certain assets and assumed certain liabilities of Staging Concepts Acquisition, LLC (SC Company) and thus expanded its markets to also become a market leader for the design, engineering and marketing of modular and architectural railing, staging, acoustical and seating systems for the commercial and multi-family market, including sports stadiums and performing arts venues. Additional information on the acquisition of SC Company is presented in Note 5. Subsequent to the acquisition, the Company began operating in two reportable segments, Trex Residential Products and Trex Commercial Products. 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.

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 and, accordingly, the accompanying condensed consolidated financial statements do not include all of the information and notes 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 except as otherwise described herein) considered necessary for a fair presentation have been included in the accompanying condensed consolidated financial statements.

The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Trex Wood-Polymer Espana, S.L. and Trex Commercial Products, Inc. The accounts of Trex Wood-Polymer Espana, S.L. are included in the condensed consolidated financial statements for all periods presented. The Condensed Consolidated Statements of Comprehensive Income and the Condensed Consolidated Statements of Cash Flows of the Company include the operations and cash flows of Trex Commercial Products, Inc. for the three and six months ended June 30, 2018. The Company s Condensed Consolidated Balance Sheet includes the assets and liabilities of Trex Commercial Products, Inc. for all periods presented.

The consolidated results of operations for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2018. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements as of December 31, 2017 and 2016 and for each of the three years in the period ended December 31, 2017 included in the

Annual Report of Trex Company, Inc. on Form 10-K, as filed with the U.S. Securities and Exchange Commission.

3. RECENTLY ADOPTED ACCOUNTING STANDARDS

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-09, *Compensation Stock Compensation (Topic 718), Scope Modification Accounting*. The guidance clarified when to account for a change to the terms or conditions of a share-based payment award as a modification. Under the new guidance, modification accounting is required only if the fair value (or calculated intrinsic value, if those amounts are being used to measure the award under ASC 718), the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. The guidance was effective prospectively for annual periods beginning on or after December 15, 2017. Adoption of the new standard did not have a material impact on the Company s financial condition or results of operations.

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In January 2017, the FASB issued ASU No. 2017-01, *Business Combinations (Topic 805), Clarifying the Definition of a Business.* The guidance requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets: if so, the set of transferred assets and activities is not a business. The guidance was effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Adoption of the new standard did not have a material impact on the Company s financial condition or results of operations.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606),* and issued subsequent amendments to the initial guidance in August 2015 within ASU No. 2015-14, in March 2016 within ASU No. 2016-08, in April 2016 within ASU No. 2016-10, in May 2016 within ASU No. 2016-12, and in December 2016 within ASU No. 2016-20 (collectively, Topic 606). The Company adopted Topic 606 on January 1, 2018 and applied Topic 606 under the full retrospective method. The Company determined the appropriate revenue recognition for its contracts with customers by analyzing the type, terms and conditions of its contracts with its customers. The Company has consistently applied the accounting policies to all periods presented in these Condensed Consolidated Financial Statements. Adoption of Topic 606 did not have an impact on the Company s financial condition or results of operations other than increased disclosures. Refer to Note 13, *Revenue,* for a discussion of the Company s accounting policy related to revenue from contracts with customers.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. The guidance is intended to reduce diversity in practice across all industries in how certain transactions are classified in the statement of cash flows. The guidance was effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Adoption of the new standard did not have a material impact on the Company s consolidated financial statements.

4. NEW ACCOUNTING STANDARDS NOT YET ADOPTED

In June 2018, the FASB issued ASU No. 2018-07, *Compensation Stock Compensation (Topic 718)*. The ASU expands the scope of Topic 718, which currently only includes share-based payments issued to employees, to also include share-based payments issued to nonemployees for goods or services. The ASU supersedes Subtopic 505-50, *Equity Equity-Based Payment to Non-Employees*. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially aligned. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. Early adoption is permitted. The Company intends to adopt the guidance on January 1, 2019 and does not believe adoption will have a material impact on its financial condition or results of operations.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment*. The guidance removes Step 2 of the goodwill impairment test and eliminates the need to determine the fair value of individual assets and liabilities to measure goodwill impairment. A goodwill impairment will now be the amount by which a reporting unit s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. Entities will continue to have the option to perform a qualitative assessment to determine if a quantitative impairment test is necessary. The guidance will be applied prospectively, and is effective for annual and interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for any impairment tests performed on testing dates after January 1, 2017. The Company intends to adopt the guidance on January 1, 2020 and does not believe adoption will have a material impact on its financial condition or results of operations.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842),* and issued a subsequent amendment to the initial guidance in January 2018 within ASU No. 2018-01. The standard requires lessees to recognize leases on the balance sheet as a right-of-use asset and a lease liability, other than leases that meet the definition of a short-term lease. The liability will be equal to the present value of the lease payments. The asset will be based on the liability, subject to adjustment. Currently, under existing U.S. generally accepted accounting principles, the Company does not recognize on the balance sheet a right-of-use asset or lease liability related to its operating leases. For income statement purposes, the leases will continue to be classified as either operating or finance. Operating leases will result in straight-line expense (similar to current operating leases) and finance leases will result in a front-loaded expense pattern (similar to current capital leases). The standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The standard must be adopted using the modified retrospective transition method and provides for the option to elect a package of practical expedients upon adoption. The Company intends to adopt the standard in the first quarter of fiscal 2019 and has begun the process of assessing its lease population and the impact of adoption of the standard on its consolidated financial statements and related note disclosures. The Company has not made any decision on the option to elect adoption of the practical expedients.

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5. ACQUISITION

On July 31, 2017, through its newly-formed, wholly-owned subsidiary, Trex Commercial Products, Inc., the Company acquired certain assets and assumed certain liabilities of SC Company for $71.8 million. The Company used cash on hand and $30.0 million of funding from its existing revolving credit facility, which was fully paid on August 17, 2017, to acquire the assets. The acquired business designs, engineers and markets modular architectural railing, staging, acoustical and seating systems for the commercial and multi-family market, including sports stadiums and performing arts venues. As a result of the purchase, the Company gained access to growing commercial markets, expanded its custom design and engineering capabilities, and added the contract architect and specifier communities as new channels for its products.

The acquisition was accounted for using the acquisition method of accounting under accounting principles generally accepted in the United States, which requires, among other things, that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The fair values of consideration transferred and net assets acquired were determined using a combination of Level 2 and Level 3 inputs as specified in the fair value hierarchy in Accounting Standards Codification 820, *Fair Value Measurements and Disclosures*. The Company believes that the fair values assigned to the assets acquired and liabilities assumed are based on reasonable assumptions. The Company s Condensed Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2018 includes the results of operations of Trex Commercial Products, Inc. The Company s Condensed Consolidated Balance Sheets include the assets and liabilities of Trex Commercial Products, Inc. for all periods presented.

Total consideration of $71.8 million was allocated to the assets acquired and liabilities assumed, as follows (in thousands):

Accounts receivable, net	$ 8,357
Contract retainage	1,948
Inventories, net	2,344
Prepaid expenses and other assets	1,223
Revenues in excess of billings	3,463
Fixed assets, net	1,264
Intangible assets	4,900
Goodwill	57,938
Accounts payable	(3,990)
Accrued liabilities and other expenses	(2,329)
Billings in excess of revenues	(1,752)
Customer Deposits	(1,562)
Total estimated consideration	$ 71,804

Goodwill of $57.9 million is primarily attributable to the potential opportunity for the Company to offer full service railing systems in the growing commercial and multi-family market, access to a complementary product category with a track record of substantial revenue growth, the ability to achieve economies of scale around raw material procurement, an increase in the range of products the Company may offer its core customers, and intangible assets that do not qualify for separable or legal criterion, such as an assembled workforce. The amount of goodwill that is expected to be amortized and deductible for tax purposes in 2018 is $3.9 million. All of the goodwill was recorded to the Trex Commercial Products reportable segment. The fair value attributed to intangible assets, which consists of production backlog and trade names and trademarks, is being amortized straight line over 12 months and is based on the estimated economics of the assets. The fair value attributed to the intangible assets acquired and goodwill was based on assumptions and other information compiled by management, including independent valuations that utilized established valuation techniques.

During the three and six months ended June 30, 2018 Trex Commercial Products, Inc. generated $17.4 million and $33.3 million of net sales, respectively, and $0.7 million and $0.2 million of net income, respectively.

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The following pro forma results of Trex Company, Inc. are prepared for comparative purposes only and do not necessarily reflect the results that would have occurred had the acquisition occurred at the beginning of the periods presented or the results which may occur in the future. The following unaudited pro forma results of operations assumes the acquisition occurred on January 1, 2017 (in thousands, except per share amounts):

	Three Months Ended June 30, 2017		Six Months Ended June 30, 2017	
	Actual	**Pro Forma**	**Actual**	**Pro Forma**
Net sales	$ 157,941	$ 172,063	$ 302,747	$ 330,485
Net income	$ 28,782	$ 28,633	$ 56,732	$ 56,082
Basic earnings per common share	$ 0.49	$ 0.49	$ 0.97	$ 0.95
Diluted earnings per common share	$ 0.49	$ 0.48	$ 0.96	$ 0.95

Significant pro forma adjustments included in the above pro forma information include an adjustment to amortization expense for the intangible assets acquired, elimination of transaction costs related to the acquisition as such costs are considered to be non-recurring in nature, an adjustment to compensation expense related to restricted stock units granted in connection with the acquisition, and the income tax effects of the adjustments.

6. INVENTORIES

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

	June 30, 2018	December 31, 2017
Finished goods	$ 33,006	$ 32,986
Raw materials	21,438	19,432
Total FIFO (first-in, first-out) inventories	54,444	52,418
Reserve to adjust inventories to LIFO value	(20,070)	(20,070)
Total LIFO inventories	$ 34,374	$ 32,348

The Company utilizes the LIFO method of accounting related to its wood-alternative decking and residential railing products, which generally provides for the matching of current costs with current revenues. However, under the LIFO method, reductions in annual inventory balances cause a portion of the Company s cost of sales to be based on historical costs rather than current year costs (LIFO liquidation). Reductions in interim inventory balances expected to be replenished by year-end do not result in a LIFO liquidation. Accordingly, interim LIFO calculations are based, in part, on management s estimates of expected year-end inventory levels and costs which may differ from actual results. Since inventory levels and costs are subject to factors beyond management s control, interim results are subject to the final year-end LIFO inventory valuation. There were no LIFO inventory liquidations or related impact on cost of sales in the six months ended June 30, 2018 or 2017.

Inventories valued at lower of cost (FIFO method) and net realizable value consist of $1.8 million and $2.2 million consist of raw materials at June 30, 2018 and December 31, 2017, respectively. The Company utilizes the FIFO method of accounting related to its architectural railing, staging, acoustical and seating systems for the commercial and multi-family market.

7. PREPAID EXPENSES AND OTHER ASSETS

Prepaid expenses and other assets consist of the following (in thousands):

	June 30, 2018	December 31, 2017
Revenues in excess of billings	$ 8,517	$ 4,841
Prepaid expenses	5,466	7,494
Contract retainage	2,502	1,449
Income tax receivable	845	2,230
Other	806	864
Total prepaid expenses and other assets	$ 18,136	$ 16,878

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8. GOODWILL AND OTHER INTANGIBLE ASSETS

Intangible assets consist of the following (in thousands):

Intangible assets:	June 30, 2018	December 31, 2017
Customer backlog	$ 4,000	$ 4,000
Trade names and trademarks	900	900
Domain names	6,287	
Total intangible assets	11,187	4,900
Accumulated amortization:		
Customer backlog	(3,667)	(1,666)
Trade name and trademarks	(825)	(376)
Domain names	(75)	
Total accumulated amortization	(4,567)	(2,042)
Intantible assets, net	$ 6,620	$ 2,858

Intangible asset amounts were determined based on the estimated economics of the asset and are amortized over the estimated useful lives on a straight-line basis over 12 months for customer backlog and trade names and trademarks and 15 years for domain names, which approximates the pattern in which the economic benefits are expected to be received. In May 2018, the Company purchased certain domain names for $6.3 million. We evaluate the recoverability of intangible assets periodically and consider events or circumstances that may warrant revised estimates of useful lives or that may indicate an impairment. Intangible asset amortization expense for the six months ended June 30, 2018 was $2.5 million. As of June 30, 2018, the Company had goodwill of $68.5 million.

9. ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities consist of the following (in thousands):

	June 30, 2018	December 31, 2017
Sales and marketing	$ 20,888	$ 21,964
Compensation and benefits	10,278	14,818
Income taxes	3,810	
Customer deposits	2,100	1,230
Manufacturing costs	2,076	1,979
Billings in excess of revenues	1,213	1,842
Rent obligations	967	779
Other	4,769	3,654

Total accrued expenses and other liabilities	$ 46,101	$ 46,266

10. DEBT

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

Revolving Credit Facility

On January 12, 2016, the Company entered into a Third Amended and Restated Credit Agreement, as amended, with Bank of America, N.A. as Lender, Administrative Agent, Swing Line Lender and Letter of Credit Issuer, and certain other lenders including Citibank, N.A., Capital One, N.A., and SunTrust. The Third Amended Credit Agreement, as amended, provides the Company with one or more revolving loans in a collective maximum principal amount of $250 million from January 1 through June 30 of each year, and a maximum principal amount of $200 million from July 1 through December 31 of each year throughout the term, which ends January 12, 2021.

The Company had $8.5 million of outstanding borrowings under its revolving credit facility and remaining available borrowing capacity of $241.5 million at June 30, 2018.

Compliance with Debt Covenants and Restrictions

The Company s ability to make scheduled principal and interest payments, 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, 2018, 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.

11. 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, other current liabilities, and debt to approximate the fair value of the respective assets and liabilities on the Condensed Consolidated Balance Sheets at June 30, 2018 and December 31, 2017.

12. STOCKHOLDERS EQUITY

Amendment of Restated Certificate of Incorporation

The Company s Board of Directors unanimously approved an amendment to the Company s Restated Certificate of Incorporation (Amendment) on February 14, 2018, subject to stockholder approval. At the annual meeting of stockholders of the Company held on May 2, 2018, the Company s stockholders approved the Amendment, effective as of May 2, 2018. The Amendment increased the number of shares of common stock, par value $.01 per share, that the Company is authorized to issue from 80,000,000 shares to 120,000,000 shares. The Amendment was filed with the Delaware Secretary of State on May 2, 2018.

Stock Split

On May 2, 2018, the Board of Directors of the Company approved a two-for-one stock split of the Company s common stock, par value $0.01. The stock split was in the form of a stock dividend distributed on June 18, 2018, to stockholders of record at the close of business on May 23, 2018. The stock split entitled each stockholder to receive one additional share of common stock, par value $0.01, for each share they held as of the record date. All common stock share and per share data for all periods presented in the accompanying unaudited condensed consolidated financial statements and notes thereto have been retroactively adjusted to reflect the stock split.

Earnings Per Share

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,			
	2018		2017		2018		2017	
Numerator:								
Net income available to common shareholders	$	42,820	$	28,782	$	79,930	$	56,732
Denominator:								
Basic weighted average shares outstanding		58,760,753		58,778,916		58,807,694		58,752,814
Effect of dilutive securities:								
Stock appreciation rights and options		173,571		197,626		183,814		199,398
Restricted stock		117,089		124,294		133,750		159,758
Diluted weighted average shares outstanding		59,051,413		59,100,836		59,125,258		59,111,970
Basic earnings per share	$	0.73	$	0.49	$	1.36	$	0.97
Diluted earnings per share	$	0.73	$	0.49	$	1.35	$	0.96

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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,	
	2018	2017	2018	2017
Stock appreciation rights	21,260	32,680	16,063	24,510
Performance-based restricted stock units	854		427	

Stock Repurchase Programs

On February 16, 2017, the Board of Directors authorized a common stock repurchase program of up to 5.92 million shares of the Company s outstanding common stock (February 2017 Stock Repurchase Program). The Company made no repurchases under the February 2017 Stock Repurchase Program. On February 16, 2018, the Board of Directors terminated the February 2017 Stock Repurchase Program and adopted a new stock repurchase program of up to 5.8 million shares of the Company s outstanding common stock (February 2018 Stock Repurchase Program). As of the date of this report, the Company has repurchased 250,044 shares of the Company s outstanding common stock under the February 2018 Stock Repurchase Program.

13. REVENUE

Topic 606 provides a single, comprehensive model for revenue recognition arising from contracts with customers. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer and is the unit of account in Topic 606. A contract s transaction price is allocated to each distinct performance obligation and revenue is recognized when or as the Company satisfies the performance obligation. Revenue is recognized at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring control of the goods or services to a customer.

Trex Residential Products

Trex Residential Products principally generates revenue from the manufacture and sale of its high performance, low maintenance composite decking and residential railing products and accessories. Substantially all of its revenues are from contracts with customers, which are purchase orders of short-term duration of less than one year. Its customers, in turn, sell primarily to the residential market, which includes replacement, remodeling and new construction related to outdoor living products. Trex Residential Products satisfies its performance obligations at a point in time. The shipment of each product is a separate performance obligation as the customer is able to derive benefit from each product shipped and no performance obligation remains after shipment. Upon shipment of the product, the customer obtains control over the distinct product and Trex Residential satisfies its performance obligation. Any performance obligation that remains unsatisfied at the end of a reporting period is part of a contract that has an original expected duration of one year or less. Any variable consideration related to the unsatisfied performance obligation is allocated wholly to the unsatisfied performance obligation and recognized when the product ships and the performance obligation is satisfied.

For each product shipped, the transaction price by product is specified in the purchase order. The Company recognizes revenue on the transaction price less any amount offered under a sales incentive program. The Company recognizes an account receivable (contract asset) for the amount of revenue recognized as it has an unconditional right to consideration at the time of shipment and payment from the customer is due based solely on the passage of time. The Company receives payments from its customers based on the payment terms applicable to each individual contract and the customer pays in accordance with the billing terms specified in the purchase order, which is less than one year. The related accounts receivables are included in *Accounts receivable, net* in the Condensed Consolidated Balance Sheets.

Trex Residential Products may offer various sales incentive programs throughout the year. It estimates the amount of sales incentive to allocate to each performance obligation, or product shipped, using the most-likely-amount method of estimation based on direct sales to the customer. The estimate is updated each reporting period and any changes are allocated to the performance obligations on the same basis as at inception. Changes in estimate allocated to a previously satisfied performance obligation are recognized as a reduction of revenue in the period in which the change occurs under the cumulative catch-up method. In addition to sales incentive programs, Trex Residential Products may offer a payment discount. It estimates the payment discount that it believes will be taken by the customer based on prior history and using the most-likely-amount method of estimation. The Company believes the most-likely-amount method best predicts the amount of consideration to which it will be entitled.

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Trex Residential Products pays commissions to certain employees. However, the sales commissions are not directly attributable to identifiable contracts, are discretionary in nature and are based on other factors not related to obtaining a contract, such as individual performance, profitability of the entity, annual sales targets, etc. These costs are included in selling, general and administrative expenses as incurred. Trex Residential Products does not grant contractual product return rights to customers other than pursuant to its assurance product warranty (see related disclosure on product warranties in Note 18, *Commitments and Contingencies*). Trex Residential Products accounts for all shipping and handling fees invoiced to the customer in net sales and the related costs in cost of sales.

Trex Commercial Products

Trex Commercial Products generates revenue from the manufacture and sale of its modular and architectural railing, staging, acoustical and seating systems. All of its revenues are from fixed-price contracts with customers. Trex Commercial Products contracts have a single performance obligation as the promise to transfer the individual goods or services is not separately identifiable from other promises in the contract and is, therefore, not distinct.

Trex Commercial Products satisfies its performance obligation over time as work progresses because control is transferred continuously to its customers. Revenue and estimated profit is recognized over time based on the proportion of costs incurred to date relative to total estimated costs at completion to measure progress toward satisfying the performance obligation. Incurred costs represent work performed, which corresponds with, and thereby best depicts, the transfer of control to the customer. Incurred costs include all direct material, labor, subcontract and certain indirect costs. The Company reviews and updates its estimates regularly and recognizes adjustments in estimated profit on contracts under the cumulative catch-up method. Under this method, the impact of the adjustment on revenue and estimated profit to date on a contract is recognized in the period the adjustment is identified. Revenues and profits in future periods are recognized using the adjusted estimate. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, the Company recognizes the total loss in the period it is identified. During the six months ended June 30, 2018, no adjustment to any one contract was material to the Company s Condensed Consolidated Financial Statements. In accordance with ASC 606-10-50-15, the Company discloses only the transaction price allocated to its remaining performance obligations on contracts with an original duration greater than one year, which was $42.0 million as of June 30, 2018. The Company will recognize this revenue as contracts are completed, which is expected to occur within the next 18 months.

The Company recognizes an account receivable (contract asset) for satisfied performance obligations as it has an unconditional right to consideration and payment from the customer is due based solely on the passage of time. The Company receives payments from its customers on the accounts receivable based on the payment terms applicable to each individual contract and the customer pays in less than one year. Accounts receivables are included in *Accounts receivable, net* in the Condensed Consolidated Balance Sheets.

In addition, the timing of revenue recognition, billings and cash collections may result in revenues in excess of billings and contract retainage (contract assets), and billings in excess of revenues and customer deposits (contract liabilities) on the Condensed Consolidated Balance Sheet. These assets and liabilities are reported on a contract-by-contract basis at the end of each reporting period in prepaid expenses and other assets (contract assets), and accrued expenses and other liabilities (contract liabilities). These assets and liabilities and changes in these assets and liabilities, respectively, were not material as of and for the six months ended June 30, 2018.

Trex Commercial Products pays sales commissions that are directly attributable to identifiable contracts to certain of its employees. If the amortization period of the commission is one year or less then the Company recognizes the commission expense as incurred. Otherwise, the Company capitalizes the commission and amortizes it on a straight-line basis over the life of the contract. Trex Commercial Products does not grant contractual product return rights to customers other than pursuant to its assurance product warranty. All shipping and handling fees invoiced to the customer are included in net sales and the related costs are included in cost of sales. For the three and six months ended June 30, 2018, revenue is disaggregated in the

following tables by (1) market, (2) timing of revenue recognition, and (3) type of contract. The tables also include a reconciliation of the respective disaggregated revenue with the Company s reportable segments (in thousands).

Three Months Ended June 30, 2018	**Reportable Segment**		
	Residential	***Commercial***	***Total***
Timing of Revenue Recognition and Type of Contract			
Products transferred at a point in time and variable consideration contracts	$ 189,201	$	$ 189,201
Products transferred over time and fixed price contracts		17,491	17,491
	$189,201	$17,491	$206,692

Six Months Ended June 30, 2018	**Reportable Segment**		
	Residential	***Commercial***	***Total***
Timing of Revenue Recognition and Type of Contract			
Products transferred at a point in time and variable consideration contracts	$ 344,401	$	$ 344,401
Products transferred over time and fixed price contracts		33,498	33,498
	$344,401	$33,498	$377,899

14. STOCK-BASED COMPENSATION

The Company has one stock-based compensation plan, the 2014 Stock Incentive Plan (Plan), approved by the Company s stockholders in April 2014. The Plan amended and restated in its entirety the Trex Company, Inc. 2005 Stock Incentive Plan. The Plan was subsequently amended and restated by the Company s Board of Directors in May 2014 and May 2018. 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, restricted stock, restricted stock units, stock appreciation rights (SARs), and unrestricted stock. The total aggregate number of shares of the Company s common stock that may be issued under the Plan is 12,840,000 and as of June 30, 2018, the total number of shares available for future issuance are 5,207,006.

The following table summarizes the Company s stock-based compensation grants for the six months ended June 30, 2018:

	Stock Awards Granted	Weighted-Average Grant Price Per Share
Time-based restricted stock units	79,712	$ 53.69
Performance-based restricted stock units (a)	79,022	$ 35.21
Stock appreciation rights	21,260	$ 56.21

(a) Includes 29,702 of target performance-based restricted stock unit awards granted during the six months ended June 30, 2018, and adjustments of 10,792, 27,166 and 11,362 grants due to the actual performance level achieved for restricted stock and restricted stock units awarded in 2015, 2016, and 2017, respectively.

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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, 2018 and 2017 the data and assumptions shown in the following table were used:

	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Weighted-average fair value of grants	$ 22.09	$ 13.91
Dividend yield	0%	0%
Average risk-free interest rate	2.7%	2.01%
Expected term (years)	5	5
Expected volatility	40.4%	42.4%

The Company recognizes stock-based compensation expense ratably over the period from the grant date to the earlier of: (1) the vesting date of the award, or (2) the date the grantee is eligible to retire without forfeiting the award. For performance-based restricted stock and performance-based restricted stock units, expense is recognized ratably over the performance and vesting period of each tranche based on management s judgment of the ultimate award that is likely to be paid out based on the achievement of the predetermined performance measures. The following table summarizes the Company s stock-based compensation expense (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Stock appreciation rights	$ 56	$ 25	$ 259	$ 192
Time-based restricted stock and restricted stock units	578	403	1,400	1,139
Performance-based restricted stock and restricted stock units	666	468	1,919	1,507
Employee stock purchase plan	45	16	67	38
Total stock-based compensation	$ 1,345	$ 912	$ 3,645	$ 2,876

Total unrecognized compensation cost related to unvested awards as of June 30, 2018 was $8.2 million. The cost of these unvested awards is being recognized over the requisite vesting period of each award.

15. INCOME TAXES

The Company s effective tax rate for the six months ended June 30, 2018 and 2017 was 23.7% and 34.2%, respectively, which resulted in expense of $24.8 million and $29.5 million, respectively. The decrease of 10.5% in the effective tax rate was primarily due to the enactment on December 22, 2017 of tax legislation H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, known as the Tax Cuts and Jobs Act (Act), which lowered the Federal statutory rate to 21%. The Company has finalized its analysis of the Act, which did not give rise to new deferred tax amounts.

During the six months ended June 30, 2018 and 2017, the Company realized $2.0 million and $1.0 million, respectively, of excess tax benefits from stock-based awards and recorded a corresponding benefit to income tax expense.

The Company analyzes its deferred tax assets each reporting period, considering all available positive and negative evidence in determining the expected realization of those deferred tax assets. As of June 30, 2018, the Company maintains a valuation allowance of $2.8 million against deferred tax assets primarily related to state tax credits it estimates will expire before they are realized.

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 accrues 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, 2018, for certain tax jurisdictions tax years 2014 through 2017 remain subject to examination. Sales made to foreign distributors are not taxable in any foreign jurisdiction as the Company does not have a taxable presence in any foreign jurisdiction.

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16. SEGMENT INFORMATION

Prior to July 31, 2017, the Company operated in one reportable segment. Subsequent to the acquisition of certain assets and assumption of certain liabilities of SC Company on July 31, 2017, the Company operates in two reportable segments:

Trex Residential Products manufactures wood-alternative decking and residential railing and related products marketed under the brand name Trex®. The products are sold to its distributors and national retailers who, in turn, sell primarily to the residential market, which includes replacement, remodeling and new construction related to outdoor living products. Net sales of Trex Residential Products were $344.4 million and $302.7 million in the six months ended June 30, 2018 and 2017, respectively.

Trex Commercial Products designs, engineers, and markets modular and architectural railing, staging, acoustical and seating systems for the commercial and multi-family market, including sports stadiums and performing arts venues. The segment s products are marketed to architects, specifiers, contractors, and others doing business within the segment s commercial and multi-family market. Net sales of Trex Commercial products were $33.5 million in the six months ended June 30, 2018.

The Company s operating segments have been determined in accordance with its internal management structure, which is organized based on residential and commercial sales activities. The Company evaluates performance of each segment primarily based on net sales and earnings before interest, taxes, depreciation and amortization (EBITDA). The Company uses net sales to assess performance and allocate resources as this measure represents the amount of business the segment engaged in during a given period of time, is an indicator of market growth and acceptance of segment products, and represents the segment s customers spending habits along with the amount of product the segment sells relative to its competitors. The Company uses EBITDA to assess performance and allocate resources because it believes that EBITDA facilitates performance comparison between the segments by eliminating interest, taxes, and depreciation and amortization charges to income. The below segment data for the three and six months ended June 30, 2018, includes data for Trex Residential Products and Trex Commercial Product (in thousands):

	Three Months Ended June 30, 2018		
	Residential	**Commercial**	**Total**
Net sales	$ 189,201	$ 17,491	$ 206,692
Net income	$ 42,115	$ 705	$ 42,820
EBITDA	$ 59,939	$ 2,229	$ 62,168
Depreciation and amortization	$ 3,277	$ 1,289	$ 4,566
Income tax expense	$ 14,178	$ 235	$ 14,413
Capital expenditures	$ 11,825	$ 438	$ 12,263
Total assets	$ 334,289	$ 80,156	$ 414,445

Reconciliation of net income to EBITDA (in thousands):

	Three Months Ended June 30, 2018		
	Residential	**Commercial**	**Total**
Net income	$ 42,115	$ 705	$ 42,820

Interest	369	369
Taxes	14,178 &n	