TREX CO INC
Form 10-Q
November 01, 2012
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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 September 30, 2012**

**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 x 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 x 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 | x |
| 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 x

The number of shares of the registrant s common stock, par value $.01 per share, outstanding at October 23, 2012 was 16,937,942 shares.

**TREX COMPANY, INC.**

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**PART I**

**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**TREX COMPANY, INC.**

**Condensed Consolidated Balance Sheets**

(In thousands)

| | September 30, 2012 (Unaudited) | December 31, 2011 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 2,500 | $ 4,526 |
| Restricted cash | | 37,000 |
| Accounts receivable, net | 32,813 | 29,192 |
| Inventories | 8,601 | 28,896 |
| Prepaid expenses and other assets | 1,680 | 2,118 |
| Income taxes receivable | 663 | 322 |
| Total current assets | 46,257 | 102,054 |
| Property, plant, and equipment, net | 106,512 | 115,212 |
| Goodwill and other intangibles | 10,552 | 10,558 |
| Other assets | 1,104 | 266 |
| Total assets | $ 164,425 | $ 228,090 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 9,704 | $ 11,892 |
| Accrued expenses | 19,671 | 16,187 |
| Accrued warranty | 7,500 | 6,000 |
| Deferred income taxes | 124 | 124 |
| Line of credit | 2,000 | |
| Current portion of long-term debt | | 86,425 |
| Total current liabilities | 38,999 | 120,628 |
| Deferred income taxes | 2,819 | 2,819 |
| Non-current accrued warranty | 24,080 | 10,345 |
| Other long-term liabilities | 320 | 1,799 |
| Total liabilities | 66,218 | 135,591 |
| 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; 16,932,088 and 15,602,132 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 169 | 156 |

| | | |
|---|---|---|
| Additional paid-in capital | 99,241 | 99,885 |
| Retained deficit | (1,203) | (7,542) |
| Total stockholders equity | 98,207 | 92,499 |
| Total liabilities and stockholders equity | $ 164,425 | $ 228,090 |

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

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**TREX COMPANY, INC.**

**Condensed Consolidated Statements of Comprehensive Income**

(Unaudited)

(In thousands, except share and per share data)

| | Three Months Ended September 30, 2012 | Three Months Ended September 30, 2011 | Nine Months Ended September 30, 2012 | Nine Months Ended September 30, 2011 |
|---|---|---|---|---|
| Net sales | $ 70,819 | $ 67,916 | $ 261,199 | $ 215,328 |
| Cost of sales | 68,673 | 50,644 | 190,043 | 151,484 |
| Gross profit | 2,146 | 17,272 | 71,156 | 63,844 |
| Selling, general and administrative expenses | 15,836 | 12,991 | 55,304 | 47,012 |
| Income (loss) from operations | (13,690) | 4,281 | 15,852 | 16,832 |
| Interest expense, net | 153 | 4,795 | 8,863 | 12,769 |
| Income (loss) before income taxes | (13,843) | (514) | 6,989 | 4,063 |
| Provision (benefit) for income taxes | 469 | (18) | 650 | (2,604) |
| Net income (loss) | $ (14,312) | $ (496) | $ 6,339 | $ 6,667 |
| Basic earnings (loss) per common share | $ (0.86) | $ (0.03) | $ 0.40 | $ 0.43 |
| Basic weighted average common shares outstanding | 16,677,159 | 15,427,437 | 15,910,300 | 15,373,132 |
| Diluted earnings (loss) per common share | $ (0.86) | $ (0.03) | $ 0.37 | $ 0.41 |
| Diluted weighted average common shares outstanding | 16,677,159 | 15,427,437 | 17,011,706 | 16,461,674 |
| Comprehensive income (loss) | $ (14,312) | $ (496) | $ 6,339 | $ 6,851 |

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

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**TREX COMPANY, INC.**

**Condensed Consolidated Statements of Cash Flows**

(Unaudited)

(In thousands)

| | Nine Months Ended September 30, 2012 | Nine Months Ended September 30, 2011 |
|---|---|---|
| **Operating Activities** | | |
| Net income | $ 6,339 | $ 6,667 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 12,901 | 14,785 |
| Debt discount amortization | 5,450 | 7,133 |
| Loss on extinguishment of debt | | 621 |
| Stock-based compensation | 2,583 | 2,390 |
| Deferred income taxes | | 191 |
| Loss on disposal of property, plant and equipment | 1,909 | 3 |
| Other non-cash adjustments | (314) | (127) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (3,597) | 38,861 |
| Inventories | 20,296 | (3,972) |
| Prepaid expenses and other assets | 86 | (209) |
| Accounts payable | (2,188) | (5,153) |
| Accrued expenses and other liabilities | 16,559 | (19,750) |
| Income taxes receivable/payable | 352 | (277) |
| Net cash provided by operating activities | 60,376 | 41,163 |
| **Investing Activities** | | |
| Expenditures for property, plant and equipment | (5,642) | (6,160) |
| Proceeds from sales of property, plant and equipment | 3 | 28 |
| Purchase of acquired company, net of cash acquired | (11) | (2,010) |
| Notes receivable, net | 87 | 72 |
| Net cash used in investing activities | (5,563) | (8,070) |
| **Financing Activities** | | |
| Financing costs | (750) | |
| Principal payments under mortgages and notes | (91,875) | (2,542) |
| Borrowings under line of credit | 80,700 | |
| Principal payments under line of credit | (78,700) | |
| Repurchases of convertible notes | | (5,882) |
| Change in restricted cash | 37,000 | |
| Repurchases of common stock | (3,785) | (3,068) |
| Proceeds from employee stock purchase and option plans | 571 | 1,345 |
| Net cash used in financing activities | (56,839) | (10,147) |
| Net increase (decrease) in cash and cash equivalents | (2,026) | 22,946 |
| Cash and cash equivalents at beginning of period | 4,526 | 27,270 |

| | | |
|---|---|---|
| Cash and cash equivalents at end of period | $ 2,500 | $ 50,216 |
| | | |
| Supplemental Disclosure: | | |
| Cash paid for interest, net of capitalized interest | $ 5,771 | $ 6,347 |
| Cash paid for income taxes, net | $ 384 | $ 649 |

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

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**TREX COMPANY, INC.**

**Notes to Condensed Consolidated Financial Statements**

**For the Nine Months Ended September 30, 2012 and 2011**

**(Unaudited)**

## 1. BUSINESS AND ORGANIZATION

Trex Company, Inc. (the Company ) is the 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 nine months ended September 30, 2012 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, 2011 and 2010 and for each of the three years in the period ended December 31, 2011 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, 2011.

In 2011, the Company completed the acquisition of substantially all of the assets of Iron Deck Corporation, a manufacturer of steel deck-framing systems located in Denver, Colorado, for approximately $2 million in cash plus the assumption of certain liabilities. As a result of the acquisition, the Company recorded an increase of $3.7 million to Goodwill. The provisions of the purchase agreement allow for future payments contingent upon certain future sales targets. The contingent payments were estimated as purchase consideration at the acquisition date and may be revised if actual sales differ from projected sales. As a result of decreased near-term sales projections of steel deck-framing systems, the Company reduced its provision for future contingent payments and recorded a $1.4 million benefit to selling, general and administrative expenses in the three months ended September 30, 2012.

## 3. NEW ACCOUNTING STANDARDS

### Accounting Pronouncements Recently Adopted

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income.* ASU 2011-05 requires the components of net income and other comprehensive income to be either presented in one continuous statement, referred to as the statement of comprehensive income, or in two separate, but consecutive statements. An entity is also required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. In December 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05,* which defers the effective date for the portion of ASU 2011-05 that pertains to the presentation of reclassification adjustments out of accumulated other comprehensive income. While ASU 2011-05 changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. The Company adopted ASU 2011-05 effective

January 1, 2012. As this guidance only amends the presentation of the components of comprehensive income, the adoption did not have an impact on the Company s consolidated financial position or results of operations.

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**4. INVENTORIES**

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

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Finished goods | $ 16,137 | $ 29,980 |
| Raw materials | 19,275 | 27,134 |
| Total FIFO inventories | 35,412 | 57,114 |
| Reserve to adjust inventories to LIFO value | (26,811) | (28,218) |
| Total LIFO inventories | $ 8,601 | $ 28,896 |

Due to the liquidation of certain inventories, a portion of the Company s cost of sales is based on prior year costs rather than current year costs. As a result, the Company recognized benefits of $0.5 million and $1.4 million during the three and nine months ended September 30, 2012, respectively.

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

**5. PROPERTY, PLANT AND EQUIPMENT**

During the three months ended September 30, 2012, the Company determined that certain manufacturing equipment rendered obsolete due to improvements in technology would not be employed in its manufacturing process in the future. As a result, the Company recorded a $1.9 million pre-tax charge related to the disposal of the assets.

**6. ACCRUED EXPENSES**

Accrued expenses consist of the following (in thousands):

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Accrued compensation and benefits | $ 9,069 | $ 2,116 |
| Accrued sales and marketing | 4,473 | 5,831 |
| Accrued rent obligations | 2,035 | 1,821 |
| Accrued interest | 26 | 2,807 |
| Other | 4,068 | 3,612 |
| Total accrued expenses | $ 19,671 | $ 16,187 |

**7. DEBT**

Long-term debt consists of the following (in thousands):

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Convertible notes | $ | $ 91,875 |
| Less unamortized debt discount | | (5,450) |
| | | 86,425 |
| Less current portion | | (86,425) |
| Total long-term 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 Revolving Credit Facility ) with BB&T, Wells Fargo Capital Finance, LLC and BB&T Capital Markets (the Lenders ). Under the Amended Credit Agreement, the Lenders agreed to provide the Company with one or more revolving loans in a collective maximum principal amount of $100,000,000. The Revolving Credit Facility replaces the previous revolving credit facility in its entirety. Amounts drawn under the Revolving Credit Facility are subject to a borrowing base consisting of certain accounts receivables, inventories, machinery and equipment and real estate.

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At September 30, 2012, the Company had $2.0 million of outstanding borrowings under its revolving credit facility and additional available borrowing capacity of approximately $59.3 million.

*Convertible Notes Offering*. On July 2, 2012 the Company repaid the $91.9 million principal balance on the notes and, in accordance with the conversion feature of the notes, issued 1,061,745 shares of common stock to the note-holders.

Interest expense relating to the Company s convertible notes for the three and nine months ended September 30, 2012 and 2011 is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Interest expense at coupon rate (6.0%) | $ | $ 1,422 | $ 2,756 | $ 4,347 |
| Non-cash interest in accordance with ASC 470 | | 2,488 | 5,450 | 7,133 |
| Total interest expense recognized on convertible debt instruments | $ | $ 3,910 | $ 8,206 | $ 11,480 |

*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 September 30, 2012, 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.

**8. FINANCIAL INSTRUMENTS**

The Company considers the recorded value of its financial assets and liabilities, consisting primarily of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses and other current liabilities to approximate the fair value of the respective assets and liabilities at September 30, 2012 and December 31, 2011.

**9. 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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Numerator: | | | | |
| Net income (loss) available to common shareholders | $ (14,312) | $ (496) | $ 6,339 | $ 6,667 |
| Denominator: | | | | |
| Basic weighted average shares outstanding | 16,677,159 | 15,427,437 | 15,910,300 | 15,373,132 |
| Effect of dilutive securities: | | | | |
| SARs and options | | | 421,539 | 480,297 |

| | | | | |
|---|---|---|---|---|
| Convertible notes | | | 643,978 | 562,139 |
| Restricted stock | | | 35,889 | 46,106 |
| Diluted weighted average shares outstanding | 16,677,159 | 15,427,437 | 17,011,706 | 16,461,674 |
| Basic earnings (loss) per share | $ (0.86) | $ (0.03) | $ 0.40 | $ 0.43 |
| Diluted earnings (loss) per share | $ (0.86) | $ (0.03) | $ 0.37 | $ 0.41 |

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. For the three months ended September 30, 2012 and 2011, 342,342 and 308,037 shares of restricted stock and stock options, respectively, and 941,914 and 1,172,011 stock appreciation rights, respectively, were excluded from the computation of diluted earnings per share because the effect would be anti-dilutive. For the nine months ended September 30, 2012 and 2011, 201,626 and 219,071 shares of restricted stock and stock options, respectively, and 418,694 and 434,719 stock appreciation rights, respectively, were excluded from the computation of diluted earnings per share because the effect would be anti-dilutive.

**10. STOCK-BASED COMPENSATION**

The Company has one stock-based compensation plan, the 2005 Stock Incentive Plan (the 2005 Plan ), which was amended by its shareholders on May 7, 2008. The 2005 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 2005 Plan. The 2005 Plan provides for grants of stock options, stock appreciation rights ( SARs ), restricted stock and performance share awards. As of September 30, 2012, the total aggregate number of shares of the Company s common stock that may be issued under the 2005 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 nine months ended September 30, 2012 and 2011, respectively, the assumptions shown in the following table were used:

| | Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|
| Weighted-average fair value of grants | $ 14.11 | $ 14.33 |
| Dividend yield | 0% | 0% |
| Average risk-free interest rate | 0.8% | 2.0% |
| Expected term (years) | 5 | 5 |
| Expected volatility | 66% | 65% |

The following table summarizes the Company s stock-based compensation grants for the nine months ended September 30, 2012:

| | Stock Awards Granted | Weighted-Average Grant Price Per Share |
|---|---|---|
| Stock appreciation rights | 100,740 | $ 25.73 |
| Restricted stock | 156,832 | $ 27.18 |

The following table summarizes the Company s stock-based compensation expense for the three and nine months ended September 30, 2012 and 2011 (in thousands):

| | Three Months Ended September 30, 2012 | 2011 | Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|---|---|
| Stock appreciation rights | $ 369 | $ 408 | $ 1,089 | $ 1,146 |
| Restricted stock | 508 | 391 | 1,442 | 1,198 |
| Employee stock purchase plan | 13 | 10 | 52 | 46 |
| Total stock-based compensation | $ 890 | $ 809 | $ 2,583 | $ 2,390 |

Total unrecognized compensation cost related to unvested awards as of September 30, 2012 was $6.2 million. The cost of these unvested awards is being recognized over the requisite vesting period of each award.

**11. INCOME TAXES**

The Company s effective tax rate for the nine months ended September 30, 2012 and 2011 was 9.3% and (64.1%) respectively, which resulted in an expense of $0.7 million and a benefit of $2.6 million, respectively. During the first quarter of 2011, the Company recognized an income tax benefit of approximately $2.6 million related to the favorable resolution of uncertain tax positions.

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. Accordingly, the Company s effective tax rate for the nine months ended September 30, 2012 and 2011, excluding the impact from the aforementioned one-time benefit, was 9.3% and 0.1% respectively. 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 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 September 30, 2012, tax years 2009 through 2012 remain subject to examination by federal and certain state tax jurisdictions.

The Company has taken tax positions in certain taxing jurisdictions for which it is reasonably possible that the total amounts of unrecognized tax benefits may decrease within the next 12 months. The Company does not expect any material change to the total amount of unrecognized tax benefits within the next 12 months.

**12. 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.

**13. 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. The Company has executed subleases for the entire 55,047 square feet it currently leases. The terms of the existing subleases expire in years 2013 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. Accordingly, the Company accounts for the expected shortfall as contract termination costs and has recorded a liability in accordance with FASB ASC Topic 420, *Exit or Disposal Cost Obligations*.

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 delivery of a significant amount of new office space or poor economic conditions could have a negative effect on vacancy rates and rental rates in the area. 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 September 30, 2012, the minimum payments remaining under the Company s lease relating to its reconsidered corporate relocation over the years ending December 31, 2012, 2013, 2014, 2015 and 2016 are $0.4 million, $1.7 million, $1.7 million, $1.7 million and $1.8 million, respectively, and $4.5 million thereafter. The minimum receipts remaining under the Company s existing subleases over the years ending December 31, 2012, 2013, 2014, 2015 and 2016 are $0.4 million, $1.5 million, $1.2 million, $0.3 million and $0.3 million, respectively, and $0.9 million thereafter. As a result of new leases executed with subtenants, the Company recognized an increase in estimated contract termination costs of $0.1 million during the nine months ended September 30, 2012.

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

| | 2012 | 2011 |
|---|---|---|
| Balance as of January 1 | $ 452 | $ 567 |
| Net rental receipts (payments) | 30 | (107) |
| Accretion of discount | 28 | 34 |
| Increase in estimated contract termination costs | 127 | |
| Balance as of September 30 | $ 637 | $ 494 |

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*Product Warranty*

The Company warrants that its products will be free from material defects in workmanship and material and will not check, split, splinter, rot or suffer structural damage from termites or fungal decay. This warranty extends for a period of 25 years for residential use and 10 years for commercial use. With respect to the Company s Transcend and Enhance 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 of the Transcend product, 20 years for residential use of the Enhance product, and 10 years for commercial use of either product. If there is a breach of such warranties, the Company has an obligation either to replace the defective product or refund the purchase price.

The Company continues to receive and settle claims related to material produced at its Nevada facility prior to 2007 that exhibits surface flaking and maintains a warranty reserve to provide for the settlement of these claims. Projecting future surface flaking settlement costs requires management to estimate the number of claims to be received, the number of claims that will ultimately result in payment and the average cost to settle each claim, all of which are subject to variables that are difficult to predict.

The average cost per claim may vary due to a number of factors, including the average size of affected decks, the type of replacement material used, changes in the cost of production and the method of claim settlement. Although the cost per claim varies over time, it is less volatile and more predictable than the number of claims to be received, which is inherently uncertain. The Company is not aware of any analogous industry data that might be referenced in predicting future claims to be received. The Company evaluates its historical surface flaking claims activity in developing its estimate of future claims. The Company anticipated that the effects of a previously settled class action lawsuit would subside and the number of claims received would substantially diminish. Payments for surface flaking claims decreased from $28 million in 2007 to $8 million in 2011. While the number of claims received continues to decline, recent claims activity indicates that the rate of acceleration in the decline has not improved as anticipated.

During the three months ended September 30, 2012, the Company concluded, based on an analysis of recent claims activity, that the payments for surface flaking claims and the rate of decline in claims in 2012 will approximate the levels experienced in 2011, falling short of the Company s estimated decline. As a result, the Company revised its estimate of the future claims to be received to reflect a rate of decline consistent with the trend now emerging from the claims activity. The effect of reducing the anticipated rate of decline both increases the number of claims expected in future years and extends the number of years in which claims will be received. As a result of these changes in estimate, the Company recorded an increase of $20 million to the warranty reserve at September 30, 2012.

The Company s analysis is based on currently known facts and a number of assumptions. However, projecting future events such as new claims to be received each year and the average cost of resolving each claim could cause the actual warranty liabilities to be higher or lower than those projected which could materially affect our 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 does not diminish consistent with the Company s expectations, 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 or the expected cost to settle claims may result in approximately a $3.2 million change in the warranty reserve.

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

| | 2012 | 2011 |
|---|---|---|
| Beginning balance, January 1 | $ 16,345 | $ 14,472 |
| Provision for estimated warranties | 21,487 | |
| Settlements made during the period | (6,252) | (5,949) |
| Ending balance, September 30 | $ 31,580 | $ 8,523 |

*Legal Matters*

As reported in the Company s Annual Report on Form 10-K for the year ended December 31, 2011, 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 Lieff, Cabraser, Heimann & Bernstein, LLP and certain other law firms (the Lieff 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 (the Hagens Berman Firm ) 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 Lieff 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 Lieff Cabraser Group involving surface flaking of the Company s product, and on March 15, 2010, it granted final approval of the settlement. On April 14, 2010, the Hagens Berman Firm filed a notice to appeal the District Court s ruling to the United States Court of Appeals for the Ninth Circuit. On July 9, 2010, the Hagens Berman Firm dismissed their appeal, effectively making the settlement final.

On March 25, 2010, the Lieff Cabraser Group amended its complaint to add claims relating to alleged defects in the Company s products and alleged misrepresentations relating to mold growth. The Hagens Berman firm 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 the Hagens Berman Firm as lead counsel in this case. The Company believes that these claims are without merit, and will vigorously defend this lawsuit.

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 the lead law firm of Cohen & Malad, LLP ( Cohen & Malad ) on behalf of Richard Levin and similarly situated plaintiffs, and on June 13, 2011, a purported class action was commenced against the Company in the Marion Circuit/Superior Court of Indiana by Cohen & Malad on behalf of Ellen Kopetsky and similarly situated plaintiffs. 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 50$^{th}$ Circuit Court for the County of Chippewa, Michigan on behalf of Joel and Lori Peffers and similarly situated plaintiffs. 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 on behalf of Caryn Borger, M.D. and similarly situated plaintiffs. 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. The Company believes that these claims are without merit, and will vigorously defend these lawsuits.

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.

Table of Contents

**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 2011 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 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 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 Accents®, and Trex Escapes®; two railing products: Trex Designer Series Railing® and Trex Transcend Railing; a porch product, Trex Transcend Porch Flooring and Railing System; a steel deck framing system, Trex Elevations ; two fencing products: Trex Seclusions® and Trex Surroundings®; 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 third quarter of 2012 include:*