

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC

Form 10-Q

May 10, 2007

Table of Contents

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 March 31, 2007

Commission File Number 1-10367

Advanced Environmental Recycling Technologies, Inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

71-0675758

(I.R.S. Employer Identification No.)

914 N Jefferson Street

Post Office Box 1237

Springdale, Arkansas

(Address of principal executive offices)

72765

(Zip Code)

(479) 756-7400

(Registrant's telephone number, including area code)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. (See definition of *accelerated filer and large accelerated filer* in Rule 12b-2 of the Exchange Act). (Check one):
Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of May 7, 2007, the number of shares outstanding of the Registrant's Class A common stock, which is the class registered under the Securities Exchange Act of 1934, was 45,567,990 and the number of shares outstanding of the Registrant's Class B Common Stock was 1,465,530.

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

Form 10-Q Index

PART I FINANCIAL INFORMATION

	Page
Item 1. Financial Statements	
<u>Balance Sheets, March 31, 2007 (unaudited) and December 31, 2006</u>	1-2
<u>Statements of Operations (unaudited) Three Months Ended March 31, 2007 and 2006</u>	3
<u>Statements of Cash Flows (unaudited) Three Months Ended March 31, 2007 and 2006</u>	4
<u>Notes to Financial Statements</u>	5-10
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	11
<u>Item 3. Quantitative and Qualitative Disclosure about Market Risk</u>	18
<u>Item 4. Controls and Procedures</u>	19

PART II OTHER INFORMATION

<u>Item 1. Legal Proceedings</u>	20
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	21
<u>Item 6. Exhibits</u>	21
<u>Signatures</u>	22
<u>Index to Exhibits</u>	23
Certification Pursuant to Section 302	
Certification Pursuant to Section 302	
Certification Pursuant to Section 906	
Certification Pursuant to Section 906	
<u>Certification by the Chief Executive Officer Pursuant to Section 302</u>	
<u>Certification by the Chief Financial Officer Pursuant to Section 302</u>	
<u>Certification by the Chief Executive Officer Pursuant to Section 906</u>	
<u>Certification by the Chief Financial Officer Pursuant to Section 906</u>	

Table of Contents

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
Balance Sheets
ASSETS

	March 31, 2007 (unaudited)	December 31, 2006
Current assets:		
Cash and cash equivalents	\$ 1,607,590	\$ 2,164,532
Restricted cash	1,255,834	787,191
Trade accounts receivable, net of allowance of \$374,894 at March 31, 2007 and December 31, 2006	5,070,929	3,789,302
Other accounts receivable	709,133	760,970
Inventories	14,795,965	14,515,845
Prepaid expenses	398,527	1,018,657
Deferred tax asset	1,475,911	1,163,017
Total current assets	25,313,889	24,199,514
Land, buildings and equipment:		
Land	1,988,638	1,988,638
Buildings and leasehold improvements	6,008,146	5,979,223
Machinery and equipment	39,560,878	39,475,682
Transportation equipment	1,182,794	1,243,556
Office equipment	868,008	801,231
Construction in progress	15,567,227	14,762,153
	65,175,691	64,250,483
Less accumulated depreciation	27,660,524	26,728,540
Net land, buildings, and equipment	37,515,167	37,521,943
Other assets:		
Deferred tax asset	4,681,838	4,293,912
Debt issuance costs, net of accumulated amortization of \$855,884 at March 31, 2007 and \$790,532 at December 31, 2006	2,749,038	2,814,390
Debt service reserve fund	2,040,000	2,040,000
Restricted certificate of deposit	840,009	829,961
Other assets, net of accumulated amortization of \$399,880 at March 31, 2007 and \$392,736 at December 31, 2006	392,657	350,246
Total other assets	10,703,542	10,328,509
Total assets	\$73,532,598	\$72,049,966

The accompanying notes are an integral part of these financial statements.

Table of Contents

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
Balance Sheets
LIABILITIES AND STOCKHOLDERS EQUITY

	March 31, 2007 (unaudited)	December 31, 2006
Current liabilities:		
Accounts payable – trade	\$ 12,237,131	\$ 10,861,648
Accounts payable – related parties	425,111	494,831
Current maturities of long-term debt	1,702,139	1,673,612
Litigation loss payable	655,769	655,769
Other accrued liabilities	3,249,043	2,509,603
Working capital line of credit	10,460,000	10,060,000
Notes payable – related parties	750,000	1,000,000
Notes payable – other	40,822	410,181
Total current liabilities	29,520,015	27,665,644
Long-term debt, less current maturities	16,601,443	16,827,717
Commitments and contingencies		
Stockholders' equity:		
Class A common stock, \$.01 par value; 75,000,000 shares authorized; 44,979,184 and 43,041,164 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively	449,792	430,412
Class B convertible common stock, \$.01 par value; 7,500,000 shares authorized; 1,465,530 shares issued and outstanding at March 31, 2007 and December 31, 2006	14,655	14,655
Warrants outstanding; 2,834,340 at March 31, 2007 and 4,606,132 at December 31, 2006	1,377,330	2,519,389
Additional paid-in capital	40,040,147	37,891,274
Accumulated deficit	(14,470,784)	(13,299,125)
Total stockholders' equity	27,411,140	27,556,605
Total liabilities and stockholders' equity	\$ 73,532,598	\$ 72,049,966

The accompanying notes are an integral part of these financial statements.

Table of Contents

**ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
STATEMENTS OF OPERATIONS (UNAUDITED)**

	Three months ended March 31	
	2007	2006
Net sales	\$22,367,040	\$27,665,249
Cost of goods sold	19,528,588	21,710,933
Gross margin	2,838,452	5,954,316
Selling and administrative costs	3,940,869	4,219,243
Operating income (loss)	(1,102,417)	1,735,073
Net interest expense	(770,064)	(572,530)
Income (loss) before income taxes	(1,872,481)	1,162,543
Income tax provision (benefit)	(700,822)	256,601
Net income (loss) applicable to common stock	\$ (1,171,659)	\$ 905,942
Income (loss) per share of common stock (Basic)	\$ (0.03)	\$ 0.02
Income (loss) per share of common stock (Diluted)	\$ (0.03)	\$ 0.02
Weighted average number of common shares outstanding (Basic)	45,184,175	39,423,537
Weighted average number of common shares outstanding (Diluted)	45,184,175	45,790,838

The accompanying notes are an integral part of these financial statements.

Table of Contents

**ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
STATEMENTS OF CASH FLOWS (UNAUDITED)**

	Three months ended March 31	
	2007	2006
Cash flows from operating activities:		
Net income (loss) applicable to common stock	\$(1,171,659)	\$ 905,942
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,022,003	1,026,948
Deferred tax provision (benefit)	(700,822)	168,601
(Increase) decrease in other assets	5,752	(796,563)
Increase in cash restricted for letter of credit and interest costs	(468,643)	(677,070)
Changes in current assets and current liabilities	884,981	307,792
Net cash provided by (used in) operating activities	(428,388)	935,650
Cash flows from investing activities:		
Purchases of land, buildings and equipment	(653,667)	(3,599,428)
Cash flows from financing activities:		
Net borrowings on line of credit	400,000	
Proceeds from issuance of notes	750,000	2,303,225
Payments on notes	(1,568,205)	(652,043)
Increase in cash restricted for payment of long-term debt		(33,055)
Increase in outstanding advances on factored receivables		1,763,812
Proceeds from exercise of stock options and warrants, net	943,318	214,608
Net cash provided by financing activities	525,113	3,596,547
Increase (decrease) in cash and cash equivalents	(556,942)	932,769
Cash and cash equivalents, beginning of period	2,164,532	1,748,023
Cash and cash equivalents, end of period	\$ 1,607,590	\$ 2,680,792

The accompanying notes are an integral part of these financial statements.

Table of Contents**NOTES TO FINANCIAL STATEMENTS****Note 1: Unaudited Information**

Advanced Environmental Recycling Technologies, Inc. (the Company or AERT) has prepared the financial statements included herein without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). However, all adjustments have been made to the accompanying financial statements which are, in the opinion of the Company's management, of a normal recurring nature and necessary for a fair presentation of the Company's operating results. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented herein not misleading. It is recommended that these financial statements be read in conjunction with the financial statements and the notes thereto included in the Company's latest annual report on Form 10-K.

Note 2: Description of the Company

Advanced Environmental Recycling Technologies, Inc. develops, manufactures, and markets composite building materials that are used in place of traditional wood or plastic products for exterior applications in building and remodeling homes and for certain other industrial or commercial building purposes. Our products are made primarily from approximately equal amounts of waste wood fiber and reclaimed polyethylene plastics, which have been extensively tested, and are sold by leading national companies such as the Weyerhaeuser Company (Weyerhaeuser), Lowe's Companies, Inc. (Lowe's) and Therma-Tru Corporation. Our customers are primarily regional and national door and window manufacturers, Weyerhaeuser, our primary decking customer, and various building product distributors. Our composite building materials are marketed as a substitute for wood and plastic filler materials for standard door components, windowsills, brick mould, fascia board, and decking under the trade names LifeCycle®, MoistureShield®, MoistureShield® CornerLoc®, Weyerhaeuser ChoiceDeK® Premium, ChoiceDeK® Premium Colors, MoistureShield® outdoor decking, and Basics® outdoor decking. We operate manufacturing and recycling facilities in Springdale, Lowell, and Tontitown, Arkansas; Junction, Texas and Alexandria, Louisiana. We also operate a warehouse and reload complex in Lowell, Arkansas.

Note 3: Statements of Cash Flows

In order to determine net cash provided by operating activities, net income has been adjusted by, among other things, changes in current assets and current liabilities, excluding changes in cash, current maturities of long-term debt and current notes payable.

Those changes, shown as an (increase) decrease in current assets and an increase (decrease) in current liabilities, are as follows for the three months ended March 31:

	2007	2006
	(unaudited)	(unaudited)
Receivables	\$ (1,229,791)	\$ (2,207,732)
Inventories	(280,120)	596,360
Prepaid expenses and other	620,131	435,185

Table of Contents

	2007 (unaudited)	2006 (unaudited)
Accounts payable Trade and related parties	1,035,321	454,254
Accrued liabilities	739,440	1,029,725
	\$ 884,981	\$ 307,792
Cash paid for interest	\$ 416,304	\$ 555,453
Cash paid for income taxes	\$	\$ 30,000

Supplemental Disclosures of Non-Cash Investing and Financing Activities:

	2007 (unaudited)	2006 (unaudited)
Accounts / notes payable for equipment	\$271,542	\$1,498,659
Accrued premium on preferred stock paid with Class A common stock		235,367

Note 4: Significant Accounting Policies***Revenue Recognition Policy***

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements* (SAB 104). Under SAB 104, revenue is recognized when the title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the sales price is determinable and collectibility is reasonably assured. The Company typically recognizes revenue at the time product is shipped or when segregated and billed under a bill and hold arrangement. Sales are recorded net of discounts, rebates, and returns, which were \$654,236 and \$567,981 for the quarters ended March 31, 2007 and 2006, respectively.

Estimates of expected sales discounts are calculated by applying the appropriate sales discount rate to all unpaid invoices that are eligible for the discount. The Company's sales prices are determinable given that the Company's sales discount rates are fixed and given the predictability with which customers take sales discounts.

Shipping and Handling

In accordance with Emerging Issues Task Force (EITF) Issue 00-10, *Accounting for Shipping and Handling Fees and Costs*, the Company records shipping fees billed to customers in net sales and records the related expenses in cost of goods sold.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market. Inventories consisted of the following:

	March 31, 2007 (unaudited)	December 31, 2006
Parts and supplies	\$ 2,053,948	\$ 2,007,535
Raw materials	5,619,335	5,072,734
Work in process	4,463,266	3,928,442
Finished goods	2,659,416	3,507,134
	\$ 14,795,965	\$ 14,515,845

Table of Contents

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Concentration Risk

The Company's revenues are derived principally from a number of regional and national door and window manufacturers, regional building materials dealers and Weyerhaeuser, the Company's primary decking customer. The Company extends unsecured credit to its customers. The Company's concentration in the building materials industry has the potential to impact its exposure to credit risk because changes in economic or other conditions in the construction industry may similarly affect the customers. Weyerhaeuser is the only customer from which the Company derived more than 10% of its revenue. Gross sales to Weyerhaeuser comprised approximately 76% of total sales for the first quarter of 2007.

Research and Development

Expenditures relating to the development of new products and processes, including significant improvements to existing products, are expensed as incurred.

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (SFAS 123R). SFAS 123R is a revision of SFAS 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. This statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions) and requires that cost to be recognized in the financial statements. In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, which includes interpretations that express views of the SEC staff regarding the interaction between SFAS 123R and certain SEC rules and regulations and provide the staff's views regarding the valuation of share-based payment arrangements for public companies. The Company adopted the provisions of this statement effective January 1, 2006, using the modified prospective method of transition provided in SFAS 123R. Under modified prospective application, this statement applies to new awards and to awards modified, repurchased, or cancelled after the effective date. Compensation cost for the unvested portion of awards at the effective date is to be recognized as the awards vest. The grant-date fair value of those awards is to be used to calculate compensation cost under SFAS 123R. The adoption of SFAS 123R did not have a material effect on the Company's financial statements and related disclosures. In 2005, the Company modified its employee/director equity compensation policies to generally provide restricted stock awards rather than stock options. Restricted stock awards are expensed as earned as a portion of compensation costs.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* (FIN 48). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted the provisions of this interpretation effective January 1, 2007. The adoption of FIN 48 did not have a material effect on the Company's financial statements and related disclosures (see Note 5: Income Taxes).

Table of Contents

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. The issuance of this standard is meant to increase consistency and comparability in fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company does not expect the adoption of SFAS 157 to have a material effect on its financial statements and related disclosures.

In February 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value, and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company does not expect the adoption of SFAS 159 to have a material effect on its financial statements and related disclosures.

Note 5: Income Taxes

The Company had no current income tax provision for the quarter ended March 31, 2007 due to its net loss for the quarter. The effective income tax rate for the quarter ended March 31, 2007 of 37% differs from the U.S. federal statutory rate of 34% due primarily to state income taxes. The effective income tax rate for the quarter ended March 31, 2006 was 22%.

The Company adopted the provisions of FIN 48 (see Note 4: Significant Accounting Policies - Recent Accounting Pronouncements) on January 1, 2007. Based upon a review of its income tax filing positions, the Company believes that its positions would be sustained upon an audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. At January 1, 2007, we had no unrecognized tax benefits. In addition, we did not record a cumulative effect adjustment related to the adoption of FIN 48. The Company recognizes interest related to income taxes as interest expense and penalties as operating expenses.

Note 6: Earnings Per Share

The Company calculates and discloses earnings per share (EPS) in accordance with Statement of Financial Accounting Standards No. 128, *Earnings Per Share* (SFAS 128). SFAS 128 requires dual presentation of Basic and Diluted EPS on the face of the statements of operations and requires a reconciliation of the numerator and denominator of the Basic EPS computation to the numerator and denominator of the Diluted EPS computation. Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company.

In computing Diluted EPS, only potential common shares that are dilutive those that reduce earnings per share or increase loss per share are included. Exercise of options and warrants or conversion of convertible securities is not assumed if the result would be antidilutive, such as when a loss from continuing operations is reported. The control number for determining whether including potential common shares in the diluted EPS computation would be antidilutive is income from continuing operations. As a result, if there were a loss from continuing operations, Diluted EPS would be computed in the same manner as Basic EPS is computed, even if an entity has net income after adjusting for discontinued operations, an extraordinary item or the cumulative effect of an accounting change. Therefore, basic and diluted EPS are calculated in the same manner for the quarter ended March 31, 2007, as there was a loss from continuing operations for that period.

	Three Months Ended	
	March 31, 2007	March 31, 2006
Net income (loss) applicable to common stock (A)	\$ (1,171,659)	\$ 905,942

Assumed exercise of stock options and warrants	10,892,203
Application of assumed proceeds toward repurchase of stock at average market price	(4,524,902)

Table of Contents

	Three Months Ended	
	March 31, 2007	March 31, 2006
Net additional shares issuable		6,367,301
Adjustment of shares outstanding:		
Weighted average common shares outstanding...	45,184,175	39,423,537
Net additional shares issuable		6,367,301
Adjusted shares outstanding (B)	45,184,175	45,790,838
Net income (loss) per common share Diluted (A) divided by (B)	\$ (0.03)	\$ 0.02
Antidilutive and/or non-exercisable options	2,695,936	557,500
Antidilutive and/or non-exercisable warrants	2,834,340	1,021,269

The Company has additional options and warrants that were not included in the calculation of diluted earnings per share for the quarters ended March 31, 2007 and 2006, as indicated in the table above. Those options and warrants were antidilutive and/or not exercisable at March 31, 2007 and 2006. Although the above financial instruments were not included due to being antidilutive and/or not exercisable, such financial instruments may become dilutive and would then need to be included in future calculations of Diluted EPS.

Note 7: Debt

In January 2007, the Company renewed its \$15.0 million bank line of credit. The line is a revolving credit facility maturing June 30, 2007, secured by the Company's inventory, accounts receivable, chattel paper, general intangibles and other current assets, as well as by fixtures and equipment, and is provided by Liberty Bank of Arkansas at a variable interest rate of prime plus one hundred basis points, which was 9.25% at March 31, 2007. The full amount of the line is guaranteed as to payment by our largest stockholder, Marjorie S. Brooks, who also guarantees \$4 million on our 2003 industrial development bond owned by Allstate Investments. When the line of credit matures, the Company intends to seek a line of credit that does not require a personal guarantee. Approximately \$550,000 was available to borrow on the line of credit at March 31, 2007.

Note 8: Commitments and Contingencies**Lloyd's of London**

We have been sued by certain underwriters at Lloyd's of London (Lloyd's) in connection with a pending final settlement of our Junction, Texas fire claim. Lloyd's filed suit January 19, 2005 in the Circuit Court of Washington County, Arkansas initially claiming we had committed fraud in the submission of our claim for damages and seeking a court order declaring the Lloyd's policy void from the inception. Following extensive discovery and depositions, Lloyd's amended the lawsuit and dropped the allegations of fraud and their request for an order declaring the policy void and filed an amended claim alleging we did not rebuild the facility exactly as it had existed prior to the March 2003 fire and also asking the court to decide what assets are part of the building and what assets are business property and to make certain declarations of coverage. The filing was unexpected by us because we cooperated fully with the claims underwriting process and believed that negotiations toward a final settlement of the claim were progressing.

We believe the Lloyd's lawsuit is without merit. We filed our initial counterclaim on January 24, 2005 denying all of Lloyd's allegations and seeking immediate and full reimbursement for rebuilding of the Junction plant. The counterclaim was subsequently amended and we were seeking not only to recover at least \$2.4 million in actual damages, including additional business disruption damages, but also punitive damages for acts of bad faith committed by Lloyd's in their initial handling of the claim.

Table of Contents

The parties participated in an unsuccessful court-ordered mediation on March 13, 2006. A Summary Judgment hearing was conducted on June 27, 2006, following which the Court ruled our business disruption loss is limited to \$1.0 million, which reduces our current claim to \$1.4 million; however, the Court ordered we could present the Bad Faith claim we filed against Lloyd's to the jury and if we are successful the jury can award punitive damages over and above the \$1.4 million in actual damages. Trial has been set for August 6, 2007.

Advanced Control Solutions

On March 3, 2006, a Benton County Circuit Court jury found AERT liable for \$655,769 in damages to Advanced Control Solutions (ACS) for future business opportunities that ACS alleges it lost when AERT discontinued using ACS programming and electrical contractor services and for missing equipment. The jury found that AERT also interfered with certain non-compete provisions of an employment agreement between ACS and an employee by hiring the employee after he had been terminated by ACS in December 2003. The jury also awarded AERT judgment against ACS for approximately \$45,000 for ACS's failure to complete a programming contract. AERT has begun the appeal process at the Arkansas Supreme Court of Appeals, which we expect to take up to two years to resolve.

Other Matters

AERT is involved in other litigation arising from the normal course of business. In management's opinion, this litigation is not expected to materially impact the Company's results of operations or financial condition.

Lease Commitment

In February 2006, AERT entered into an operating lease contract whereby it has agreed to lease up to \$3 million of equipment for seven years. In July 2006 the amount of the lease line was increased to \$6 million. Lease payments are expected to begin in the second quarter of 2007. Until that time, interim interest payments are being made on the amount of equipment subject to the lease that has been purchased by the leasing company, which totaled approximately \$5.1 million at March 31, 2007.

In January 2007, AERT entered into a lease contract whereby it will lease a computer system and associated equipment in the approximate amount of \$1 million. Until lease payments begin, interim interest payments will be made on the amounts paid by the leasing company, which totaled approximately \$357,000 at March 31, 2007.

Table of Contents

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

Overview

The quarter ended March 31, 2007 was marked by extremely cold and icy weather conditions, which negatively affected manufacturing operations, combined with slower sales as our largest customer rebalanced their inventory of our product following the slowdown in the building materials industry last fall. Sales by end users, however, remain healthy and above last year's levels in all but our OEM segment. Reduced throughputs of existing products combined with the start-up of several new products is costly, as overhead expenses of running the business must be absorbed by fewer sales dollars. The manufacturing infrastructure required to produce our products is intensive and volume sensitive.

First Quarter 2007 Operations

Sales

End user purchases of AERT decking products are meeting or exceeding last year's sales. The abrupt slowdown in the new home construction and building materials markets, however, left Weyerhaeuser, our biggest customer, with more ChoiceDek inventory of our existing products than needed, which is limiting our sales as they rebalance their inventory. Several new ChoiceDek products, the Eden (tropical exotic) series in particular, were only recently introduced into the marketplace. We believe that over the course of this year, assuming no further deterioration in the building materials industry, our sales of Weyerhaeuser ChoiceDek will resume healthy growth based upon broader in-store selections combined with the introduction of new products.

Our marketing initiative to expand MoistureShield decking sales is proving successful, and MoistureShield sales are running far ahead of first quarter 2006. We will continue to add distribution and markets over the year with the goal of having nationwide distribution by the first quarter of 2008. We look for continued growth of this product line, which serves a market that is far larger than the do-it-yourself home improvement segment—professional contractors and deck builders. We believe the green building certification of the MoistureShield decking line also addresses a growing niche in the market.

Sales of our OEM parts like door rails and window sills were down significantly in the first quarter because of the slowdown in new home construction. We are uncertain when and at what pace this business segment will recover.

We further delayed some sales opportunity in first quarter 2007 as engineering delays continued to plague the startup of our new Springdale South extrusion plant. This caused delays in rolling out our new exotic tropical hardwood line of decking products, which we expect to be well received by consumers. Exotic decking went into production in March and we expect to see a sales impact in second quarter. The construction delays also forced us to postpone the rollout of our new fencing and our new line of decking.

Margins

Our gross, operating, and net margins fell in first quarter 2007 versus first quarter 2006. Slowing sales left us with some idle manufacturing and administrative capacity, which increased overhead costs relative to sales and reduced profit margins. While we constantly work to reduce our direct labor costs, we have been adding administrative infrastructure over the last three years to support our rapid growth and increase our product mix. This also caused under-absorption of fixed costs in the first quarter. However, we have also added substantial plastic processing and blending capacity which we believe will help reduce raw material costs and improve margins during the second quarter 2007.

Table of Contents

Current Business Environment

As the composite decking business continues to evolve, here are the factors we believe will drive AERT's business in 2007.

Sales

The 2006 second half slowdown, which was more pronounced in the fourth quarter, left building products dealers and distributors with more inventory of existing product lines than they wanted at year end. Whereas industry-wide manufacturer sales of decking products to distributors appears to have exceeded end user sales in 2006, high beginning dealer inventories may very well reverse that market dynamic later in 2007. If the housing and decking business gets back on track, inventories clear by the end of the year and we successfully launch new market introductions of our decking products, we believe we can resume double digit growth in 2008.

As manufacturing technology and aesthetics of composite decking improve, market trends are also shifting. Consumers are demanding more variety and selection compared to prior periods as construction of multi-color decks appears to be increasing. Also, the evolution toward a more natural wood look appears to be increasing on the higher end of the market, while decreasing wood prices have widened the price differential on the lower end. We are thus introducing a smaller profile deck board this year, under the Basics™ brand, targeted to a wood upgrade segment for light residential construction. This is being addressed with the introduction of two additional color selections. We believe this will allow us to broaden our customer base and appeal to a wider market segment than in prior periods. The MoistureShield decking introduction is targeted toward the commercial contractor lumberyard, which provides service to large repeat customers. Most of these large customers are regularly purchasing, or have been exposed to, competing brands of composite decking. On this higher end segment, we believe success will require converting customers away from competing products to our brands such as MoistureShield or ChoiceDek. Thus, a significant marketing effort was initiated during the fourth quarter of 2006, and will continue throughout 2007. The marketing program is aimed at converting high end customers to our products.

With difficult conditions facing the decking market, AERT is differentiating its products through a combination of green building products, quality, and outstanding customer service at a low price point. We believe we are in a favorable position to increase market share, but maintaining our low cost model could restrict our ability to grow profit margins over the next year.

We have invested significantly in plastic recycling infrastructure over the last several years. As technology has improved so has the aesthetics of our products, which are overwhelmingly comprised of recycled materials. Green building is an ever increasing trend and we intend to capitalize on that trend with a new slogan: AERT Forest of the Future.

In fact, AERT launched into 2007 with an aggressive customer service campaign focused on the quality and value of our products, their positive, unmatched field histories, and the fact that AERT is truly a Green Building Company. The Leadership in Energy and Environmental Design (LEED®) Green Building System developed by the U.S. Green Building Council is the national benchmark for high performance green buildings. The LEED® for Homes standard specifies environmentally preferable products, such as landscape decking made with a minimum of 25% post consumer recycled content. AERT is one of the few companies that manufacture decking products that meet or exceed the LEED® standards. Developers and builders can earn points and have their projects certified under the LEED® standards by making them more energy efficient and choosing building materials that are environmentally responsible. As a member of the U.S. Green

Table of Contents

Building Council, AERT proudly supports the sustainable green building practices promoted by LEED. In fact, conservation, recycling and better resource management have been the focus of AERT's culture since inception.

The composite decking business is continuously evolving. The technology used to manufacture wood/plastic boards has advanced significantly over the last four years and many contemporary products have much improved aesthetics. Going forward, it will be important for AERT to continue to innovate and keep in close touch with consumer trends.

Since 2001, Lowe's Home Improvement stores have carried our Weyerhaeuser ChoiceDek products exclusively in the composite decking category. During 2007, a second color selection is being introduced into the ChoiceDek set in all of the Lowe's home improvement warehouses. Approximately 400 Lowe's stores carried two color selections in 2006. In addition, 150 new stores will be opened by Lowe's in 2007, which will also carry Weyerhaeuser ChoiceDek. Along with additional in-store selection, two new tropical hardwood products, Driftwood and Spice, are available in ChoiceDek for Lowe's. Lowe's will be aggressively marketing ChoiceDek in print and television advertising. Also, the ChoiceDek website, www.choicedek.com, is being upgraded in 2007. Lowe's will start carrying another, though higher priced, composite decking brand beginning this year, which could limit the strong growth that ChoiceDek has enjoyed the last three years. On the other hand, increased store traffic to the decking aisle could be good for ChoiceDek. Lowe's is broadening the decking category and adding more accessories and products as it attempts to broaden its customer base and attract more customers into its stores.

Three new regional building products distributors have begun carrying MoistureShield decking this year and sales through the first quarter are exceeding our expectations. There has also been strong interest in our new LifeCycle Basics decking and LifeCycle fencing products. Lifecycle Basics is now in production and LifeCycle Fencing will begin production late in 2007 for the 2008 building season. Our new exotic or tropical decking lines will also begin production during the second quarter of 2007. We expect that these factors will continue to drive AERT sales at favorable growth rates. The MoistureShield website, www.moistureshield.com, has also been updated and features a deck design tool.

Costs

The cost of recycled plastic increased in the first quarter 2007 as natural gas and petroleum prices appear to resume their upward march. Our materials cost is also higher compared to prior years as we have begun using expensive additives designed to increase color and improve aesthetics, texture and environmental resistance on decking boards.

Over the last year, AERT has invested substantially in laboratory, analytical, processing and blending equipment at its Lowell, Arkansas facilities aimed at increasing our utilization of lower grades and cheaper polyethylene feedstocks. These systems are coming online during the second quarter 2007, and are intended to reduce costs and improve yield and margins. We believe that with the implementation of these new systems, we can shortly reduce costs and bring our margins back into line.

The slowdown in the building products industry has dealt a harsh blow to cabinet and hardwood flooring manufacturers, from whom we acquire scrap wood fiber. The use of wood pellets as an alternative fuel source has also grown in the last few years. These two forces are acting to raise the cost of our wood raw materials.

When Springdale South starts up, which is expected in early second quarter 2007, we will begin depreciating our investment in that facility, which will add approximately \$1.2 million to our annual manufacturing costs versus 2006.

Table of Contents

Longer Term Factors Driving Our Business

AERT's core competency is extracting value from America's waste stream. As the market matures for our current slate of products made from recycled plastics, AERT will pursue new products and new markets. Given the many commercial uses of polyethylene, we believe that AERT has abundant growth opportunities.

Because of competition from overseas, prevailing prices of easy to access recyclable plastics have risen to the point that we must increase our efficiencies and find new, lower cost sources of raw materials. Initial permitting for the new Oklahoma recycling facility has been cleared and we are now in the financing process. The new facility is designed to allow us to use the less desirable, but low cost, forms of waste polyethylene and additional sources of waste wood fiber, which will ensure our ability to regain a competitive advantage and maintain a low cost structure. The initial phase of the Oklahoma project is currently estimated to cost \$15 million and take one year to build. We are currently exploring financing options for this facility, including incentives and tax exempt waste minimization bonds through the state of Oklahoma.

While the startup of the first line at the Springdale South plant suffered from numerous construction delays and engineering challenges, the installation of the next three lines will be relatively fast and we should be able to increase production capacity relatively quickly as demand picks up or new markets are opened.

As the decking market matures, some of our competitors with high cost processes are falling by the wayside. We are monitoring the activities of our competitors and moving into markets where our competitors are failing.

Management Focus for 2007

Introduce three new ChoiceDek products and work with individual stores to stock a minimum of two colors in all stores.

Introduce our expanded MoistureShield decking product line into nationwide distribution by the end of the first quarter of 2008.

Introduce LifeCycle Basics deck board and fencing products.

Decrease operating costs relative to sales revenue:

- o Complete modifications to our plastic reclamation and blending processes to reduce raw material costs, increase throughput and increase yield at extrusion factories
 - o Increase our ability to use more low cost raw materials
 - o More aggressive raw materials purchasing strategies
 - o Improve training and associate development
 - o Increase automation to improve yield and lower labor costs
 - o Streamline logistics and manufacturing operations
 - o Install new enterprise resource planning system to improve management information
 - o Balance sales, general and administrative overhead expenses to match growth rate
- Reduce leverage and strengthen the balance sheet.

We believe the selected sales data, the percentage relationship between net sales and major categories in the Statements of Operations and the percentage change in the dollar amounts of each of the items presented

Table of Contents

below is important in evaluating the performance of our business operations. We operate in one business segment and believe the information presented in our Management's Discussion and Analysis of Results of Operations and Financial Condition provides an understanding of our business segment, our operations and our financial condition.

Results of Operations

Three Months Ended March 31, 2007 Compared to Three Months Ended March 31, 2006

The following table sets forth selected information from our statements of operations.

Quarterly Comparison

Three Months Ended March 31:		
2007	% Change	2006