ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC
Form 10-K
March 15, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

þ	ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
	For the fiscal year ended December 31, 2012
	Or
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 1-10367

Advanced Environmental Recycling Technologies, Inc.
(Exact name of Registrant as specified in its charter)

Delaware (State of Incorporation)	71-0675758 (I.R.S. Employer Identification No.)
914 N Jefferson Street Springdale, Arkansas (Address of principal executive offices)	72764 (Zip Code)

Registrant's telephone number, including area code:
(479) 756-7400

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:

Class A common stock, $.01 par value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No þ

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 þ No o

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 (Section 232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files). Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer o Smaller reporting company þ

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing stock price of such common equity as of the last business day of the registrant's most recently completed second fiscal quarter was $4,970,219 (for the purposes hereof, directors, executive officers and 10% or greater shareholders have been deemed affiliates).

Number of shares of common stock outstanding at March 15, 2013: Class A — 88,165,632; Class B — 1,465,530

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our Definitive Proxy Statement for our 2013 annual meeting scheduled to be held in June 19, 2013, and expected to be filed within 120 days of our fiscal year end, are incorporated by reference into Part III.

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Part I

Item 1. Business.

Summary

Advanced Environmental Recycling Technologies, Inc. (AERT or the Company), founded in 1988, develops and commercializes technologies to recycle waste polyethylene plastics and develops, manufactures, and markets value-added, green building compounds. Our primary products are 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 recycled polyethylene plastic, which has been cleaned, processed, and reformulated and waste wood fiber, which has been cleaned, sized and reprocessed utilizing our patented and proprietary technologies. Our products have been extensively tested, and are sold by leading national companies such as the BlueLinx Corporation (BlueLinx), Lowe's Companies, Inc. (Lowe's) and Therma-Tru Corporation. Our products are primarily used in renovation and remodeling by consumers, homebuilders, and contractors as an exterior environmentally responsible ("Green") building alternative for decking, railing, and trim products.

The Company currently manufactures all of its composite products at extrusion facilities in Springdale, Arkansas. The Company operates a plastic recycling, blending and storage facility in Lowell, Arkansas, where it also leases warehouses and land for inventory storage. In April 2011, the Company started a new green-age recycling, cleaning and reformulation facility at Watts, Oklahoma. The marketing and sale of recycled plastic and filler resins to third parties commenced in late 2011.

Products

Building on our base process and materials, we manufacture the following product lines:

- Commercial and residential decking planks and accessories such as balusters and handrails under the MoistureShield® and ChoiceDek® brands,
- Exterior door components,
- Exterior housing trim (MoistureShield®), and
- Green recycled plastic resin compounds.

The wood fiber content of our products gives them many properties similar to all-wood products, but we believe that the plastic content renders our products superior to both all-wood or all-plastic alternatives because:

- Unlike wood, our products do not require preservatives or treatment with toxic chemicals or annual sealing or staining.
- Our products are less subject to thermal contraction or expansion and have greater dimensional stability than competing all-plastic products.
- Our products are engineered for superior moisture-resistance and will not swell or expand like wood.
- Our products are designed and extruded through dies to a desired shape in accordance with customer specifications, which helps the customer to minimize waste.
- Our products are less subject to rotting, cracking, warping, splintering, insect infestation and water absorption than conventional wood materials.
- Our products are aesthetically enhanced to provide a wood-like or grained surface appearance.
- Our products are combined with coloring agents and/or other additives to provide various colors and aesthetics.

Our latest generation of products offers colors to more closely resemble the natural look of wood. We also commenced adding a mildew-cide in our products in 2006 to inhibit the growth of mold.

Based upon our extensive product testing and successful extended field history, we offer a 25-year limited replacement warranty on our ChoiceDek® Foundations™ and a limited lifetime replacement warranty on our MoistureShield® products against rot and fungal decay, and termite and insect damage.

Marketing and Sales

General Market Strategy. Our products are designed for applications where we can add the greatest value and address market needs, i.e., for external applications where wood is prone to rot and/or requires substantial annual maintenance in the form of staining or sealing. Though we believe there are many possible applications for our wood/plastic composite technology, we have focused our resources and personnel on outdoor decking and handrail components and door and other OEM components; that represent the most attractive market opportunities at this time. Within our chosen markets, we are constantly working to develop and improve strong customer relationships.

Sales and Customer Service. We provide sales support and customer service through our own marketing department, contract marketing through outside commissioned representatives, through BlueLinx, and through training programs for our customers and their sales associates. We also promote our decking products through interactive displays at national, regional, and local home and garden shows, as well as through in-store displays. Our in-house sales and customer support team is focused on serving commercial decking contractors and customers, and supporting the sales professionals at our regional building products distributors, as well as BlueLinx and Lowe’s. Information and customer service are provided through the websites www.choicedek.com and www.moistureshield.com, and through a national toll-free customer assistance telephone number: 1-800-951-5117.

Cyclical Nature of Building Products Industry. Our products are used primarily in home improvement and new home construction. The home improvement and housing construction industries are subject to significant fluctuations in activity and periodic downturns caused by general economic conditions. High fuel prices, reduced disposable income, and economic uncertainty in particular can lead to reduced home improvement activity. Reductions in such activity have an adverse effect on the demand for our products. We have focused a large portion of our business on the remodel and repair market segment, which we believe is less cyclical than the new homebuilding market.

Facility Upgrades/Product Innovation. In our ongoing pursuit to satisfy our customers and to keep up with changing trends in the marketplace, we continuously work to develop new products and improve existing products. We have invested significantly in plastic recycling technology and infrastructure over the last several years, which is also a strategic initiative designed to help insulate our raw materials purchasing from wide price swings associated with the petrochemical markets. The aesthetics of our products, which are overwhelmingly composed of recycled materials, have improved with technology advances. The startup of our next-generation Watts, Oklahoma recycling facility allows us to expand into additional customer-driven opportunities.

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

Innovation

We are committed to becoming the leader in green building products from recycled plastic materials. In addition, we believe plastic recycling technologies could lead to new opportunities in the future. Our Watts, Oklahoma facility, which is designed to recover, utilize, and convert lower grades of waste plastics into usable feed stocks, is an example of our efforts to continually improve our recycling technology. By utilizing technology, we are upgrading the quality and aesthetics of our products made primarily from recycled raw materials to levels comparable to virgin resin based products.

Green Building Products

We have been recycling plastic and manufacturing green building products since our inception in 1988, and we intend to continue building our brands and differentiating AERT as a green building products company. Listed below are the major categories of products we manufacture and markets we supply.

ChoiceDek® Decking. We currently sell our ChoiceDek® branded decking products in the home improvement warehouse (HIW) market through BlueLinx to Lowe’s. We derived most of our revenue (62%) from BlueLinx (our distributor for ChoiceDek® products) in 2012. This market segment primarily focuses on the do-it-yourself (DIY) market in which homeowners buy, build, and install their own decks. The DIY market is also serviced by The Home Depot, as well as several smaller regional chains. Our decking products are not currently carried in The Home Depot, and the ChoiceDek® brand is sold exclusively to Lowe’s. ChoiceDek® is promoted through in-store displays and an ongoing print and marketing campaign targeting the residential decking market. We maintain a nationwide sales and customer service group. Lowe’s also conducts national print and television ads for the products it carries. In 2012, ChoiceDek® introduced its new line, ChoiceDek® Foundations™. This newly engineered product provides better fade performance than our previous product and features a smaller profile, making it more lightweight and easier to handle.

MoistureShield® Decking. Our MoistureShield® brand line of decking products is currently sold to select primary distributors, who re-sell it to lumber dealers and contractor yards for sale to local deck builders and home builders. Our international distributor accounted for 14% of our sales in 2012. Most of our MoistureShield® 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 from competing products to our brands. The MoistureShield® decking line allows us to diversify our customer base.

Door Component Products. We sell our MoistureShield® industrial products to door manufacturers for use as component parts in products. For example, we manufacture door rails built into doors by Therma-Tru Corporation. In marketing these products, we emphasize the value-added feature of the MoistureShield® composite product, which, unlike competing wood products, can be engineered to incorporate certain desired end-product characteristics that save our customers time and expense. Customers also avoid the need for chemical treatments to their final product, which are often otherwise necessary to prevent rot and sustain durability. The durability of our MoistureShield® composite components allows our customers to extend the lifetime or warranties of their products while reducing or eliminating warranty claims costs. We are unable to predict the future size of the markets for MoistureShield® industrial products; however, we believe that the national door and window and commercial and residential trim markets are large and will allow us to diversify our customer base over time as we add production capacity and focus on additional opportunities.

Exterior Trim and Fascia Products. We have marketed an exterior trim and fascia system under the trade names MoistureShield® Trim and MoistureShield® CornerLoc™. Several national homebuilders have been specifying and using the product. We believe this product line has significant growth potential as a green alternative to plastic (i.e., PVC) and wood trims to be distributed and sold in conjunction with our MoistureShield® distributors.

Competition

Our products compete with high-grade western pine, cedar and other premium woods, aluminum, high-performance plastics, and an increasing number of composites and other construction materials. We believe that our products have superior characteristics, which make them a better value for the consumer; however, they are more expensive initially than traditional wood products. Additionally, manufacturers of some competing products have long-established ties to the building and construction industry and have well-accepted products. Some of our competitors are larger and have research and development budgets, marketing staffs, and financial and other resources that surpass our resources.

Sales of non-wood decking products to date represent a small portion of the decking market. Pressure treated pine, cedar, redwood and other traditional woods constitute the vast majority of annual decking sales. We thus view wood decking as our principal competitor. The wood decking industry is highly segmented with many small to medium sized manufacturers. Wood decking is principally a commodity that competes as the low-priced product, whereas the more expensive non-wood products must compete on features and performance.

Among manufacturers of alternative decking materials, we view Trex Company, TimberTech Ltd., Tamko Building Products and Fiber Composites LLC as our primary competitors. The market for door products is highly segmented, with many competitors. We believe that our MoistureShield® industrial products have superior characteristics and are competitively priced. We emphasize durability, which means that manufacturers and homebuilders using our products should see reduced warranty callbacks and higher customer satisfaction. Our product competes not only on durability, but also the ability of the customer to order a product that is custom manufactured to its specifications.

Intellectual Property and Proprietary Technology

Our products are built for hostile external environmental conditions. Our recycling processes focus on intensive cleaning and reformulating of our raw materials prior to extrusion. Our extrusion process is unique and focuses on total encapsulation of the wood fibers. Our composite manufacturing process and our development efforts in connection with waste plastics reclamation technologies involve patents and many trade secrets that we consider to be proprietary. We have also developed certain methods, processes, and equipment designs for which we have sought additional patent protection. We have three new patents that were issued in 2012. Our patents expire between 2013 and 2028.

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Our patents cover plastic recycling processes, methods, and apparatus or specially designed equipment as well as the composite product that we manufacture. The composite product patent was issued in 1998 and expires in 2015. This patent covers the unique properties, formulation and processing parameters of our encapsulated wood/polyethylene plastic composite building material. We have also received patents with regard to our mixed recycled plastic resin identification and reformulation technologies.

We have updated and continue to refine our recycling processes, procedures, and technologies, and included these in later issued patents or pending patent applications. We have taken additional measures to protect our intellectual property and trade secrets by restricting access to our facilities and maintaining a policy of nondisclosure among our associates, which includes requiring confidentiality and nondisclosure agreements.

Raw Materials

Wood Fiber. The wood fiber we use is primarily waste byproduct generated by hardwood furniture, cabinet, and flooring manufacturers. However, we see competition for scrap wood fiber for use as a fuel to replace other fuels for both residential and industrial applications.

Recycled Plastics. We use primarily post-consumer waste polyethylene. The largest portion of the plastic materials we use is mixed with paper and other non-plastic materials, which lessen its value to other plastic recyclers. By principally sourcing these contaminated waste plastics prior to processing; we produce a usable but lower-cost feedstock for our composite extrusion lines. We believe our investments in recycling technology and infrastructure will create a significant raw material cost advantage compared to several of our virgin resin-based competitors while offering a more competitive green building product.

Competition for Raw Materials. As the wood/plastic composites industry grows, we sometimes compete for raw materials with other plastic recyclers or plastic resin producers. We believe that our ability to use more contaminated polyethylene limits the number of competitors. Nonetheless, we expect to continue to encounter new entrants into the plastics reclamation business. We increased our capacity for processing waste plastic in recent years, which reduced our dependence on outside suppliers and gave us more control over our costs.

Industry Standards

Building codes exist to provide for safe and effective structures and consistency of structures and construction practices. Our decking and railing products comply with the International Building Code and the International Residential Code as well as the 1997 Uniform Building Code™ (UBC) and the BOCA® National Building Code/1999 (BNBC). The International Code Council – Evaluation Service (ICC-ES) publishes evaluation reports for building products. These reports tell the consumer, commercial or residential, that the products listed in the report comply with code when they are used in the prescribed application and installed according to the manufacturer’s installation instructions. In 2009, we converted from the legacy evaluation report, NER-596, to ESR-2388 from ICC-ES. In Canada, compliance of our products to code is documented in evaluation report CCMC 13191-R from the Canadian Construction Materials Center. We utilize an independent third-party to ensure continuing compliance of our products to code.

The Company has also received from ICC-ES a Verification of Attributes Report (VAR-1015) that verifies the content of recycled materials in our decking, railing and OEM products.

Employees

Due to the seasonality of our business and timing of orders received from our largest customer, the numbers of permanent employees is adjusted throughout the course of the year. At December 31, 2011 and 2012 we had 427 and 371 employees, respectively, reflecting, in part, process efficiencies identified and implemented during 2012.

Available Information

We post on our website (www.aert.com) our periodic reports filed with the SEC on Forms 10-K, 10-Q, and 8-K and amendments to these reports filed pursuant to Section 13(a) of the Securities Exchange Act as soon as reasonably practicable after we electronically file such material with the SEC.

Item 2. Properties.

We currently manufacture all of our composite products at extrusion facilities in Springdale, Arkansas where we also lease our corporate office space.

We suspended extrusion operations at our Junction, Texas facility in October 2007. In 2012, we transferred all of the remaining extrusion and other equipment from the Texas facility to our Arkansas and Oklahoma facilities for additional surge capacity and new product development work. The land and buildings located at Junction are being offered for sale.

We operate a facility in Lowell, Arkansas that is used for plastic recycling, blending, and storage. Additionally, we lease warehouses and land in Lowell for inventory storage.

In December 2007, we entered into a related party lease for the use of 60 acres in Watts, Oklahoma where we constructed an additional plastics recycling facility that commenced operations in February 2010.

We lease a warehouse in Westville, Oklahoma for inventory storage.

Item 3. Legal Proceedings. – See Note 11: Commitments and Contingencies

Item 4. Mine Safety Disclosure. – Not applicable

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

The Company's stock is currently listed with the OTC Bulletin Board and trades under the symbol of AERT. As of December 31, 2012, there were approximately 1,414 holders of record of our Class A common stock and 5 holders of record of our Class B common stock. The closing price of our common stock was $0.09 on December 30, 2012. We have not previously paid cash dividends on our common stock and there are currently restrictions under various debt obligations and our Series E preferred stock designation that would prevent the payment of such dividends for the foreseeable future. The following table sets forth the range of high and low quarterly sales prices of our Class A common stock for the years ended December 31, 2011 and 2012.

Sales Price Range of Class A Common Stock

Fiscal 2011	High	Low
First Quarter	0.24	0.16
Second Quarter	0.25	0.10
Third Quarter	0.18	0.10
Fourth Quarter	0.17	0.06
Fiscal 2012		
First Quarter	0.09	0.07
Second Quarter	0.10	0.06
Third Quarter	0.15	0.05
Fourth Quarter	0.12	0.08

No repurchases of common stock took place during 2011 or 2012.

Equity Compensation Plan Information

The following table provides information as of December 31, 2012, regarding shares outstanding and available for issuance under the Company's equity compensation plans. With the H.I.G. recapitalization in 2011 (See Note 5), the remaining 1,540,673 shares that were authorized to be issued were withdrawn from the 1997 plan. No awards were made in 2012 pursuant to the Company's 2012 Stock Incentive Plan, which was approved by security holders at the Company's annual shareholders' meeting on June 27, 2012.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under compensation plans (excluding securities reflected in the first column of this table)*
1997 Equity compensation plans approved by security holders	350,000	$ 1.17	-
2012 Equity compensation plans approved by security holders	-	N/A	40,000,000
	-	N/A	-

Equity compensation plans not approved by security holders			
Total	350,000	$ 1.17	40,000,000

* The amount in this column represents the sum of restricted stock units available for grant or available to be issued.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

2012 Summary

Results of Operations
Two Year Comparison (in thousands)

	2011	2012	% Change
Net sales	$59,259	$74,611	25.9 %
Cost of goods sold	55,331	61,328	10.8 %
% of net sales	93.4 %	82.2 %	
Gross margin	3,928	13,283	238.2 %
% of net sales	6.6 %	17.8 %	
Gain (loss) from asset disposition	(195)	38	(119.5 %)
Selling and administrative costs	10,733	11,070	3.1 %
% of net sales	18.1 %	14.8 %	
Operating income (loss)	(7,000)	2,251	(132.2 %)
% of net sales	(11.8 %)	3.0 %	
Other Income:			
Other Income	40	52	30 %
Gain on Recapitalization	3,029	-	*
Other expenses:			
Net interest expense	(2,996)	(2,972)	(0.8 %)
Loss before dividends	(6,927)	(669)	90.3 %
% of net sales	(11.7 %)	(0.9 %)	
Dividends on preferred stock	(1,119)	(1,320)	18.0 %
Net loss applicable to common stock	$(8,046)	$(1,989)	75.3 %
% of net sales	(13.6 %)	(2.7 %)	

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* Not meaningful as a percentage change

Sales

Net sales for the year ended December 31, 2012 were up 25.9% from the year ended December 31, 2011 due primarily to increased MoistureShield® sales, attributed to the increase in international sales and the additions of new MoistureShield® customers. ChoiceDek® sales also increased in 2012 over 2011. In 2011, sales were reduced by a $4.6 million inventory refresh that entailed the replacement of ChoiceDek® product at Lowe’s stores with a newly designed ChoiceDek® Foundations™ product.

Cost of Goods Sold and Gross Margin

Cost of goods sold increased by 10.8% for the year ended December 31, 2012 compared to 2011. As a percentage of sales, 2012 cost of goods sold decreased 11.2 percentage points from 2011. Gross margin increased reflecting increased manufacturing efficiencies primarily associated with economies of scale relating to increased production.

Selling and Administrative Costs

Selling and administrative costs were up 3.1% in 2012 compared to 2011. The increase is primarily due to an increase in advertising, promotions, and commissions related to increased sales. As a percentage of sales, selling and administrative costs were down 3.3% from 2011. The primary components of selling and administrative costs are compensation and benefits, advertising and promotion, travel, professional fees, and commissions.

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Asset Impairment, Disposition and Other Expenses

During 2012, AERT disposed of fully depreciated assets, which were no longer of service to the Company. These assets were once located in the Company's Junction, Texas facility.

Infrequent charges recorded during 2011 include the following:

- Gain on restructure due to H.I.G. recapitalization of $3.0 million
- Accrual for returns of product from Lowe's relating to an inventory refresh of $4.6 million
- Equity compensation expense of $0.5 million relating to shares becoming fully vested as a result of change of control.

Net Income (Loss)

AERT generated operating income of $2.3 million for 2012 versus an operating loss of $7.0 million for 2011. After the gain on recapitalization in 2011 and the deduction for interest and dividends, the Company had a net loss of $2.0 million, an improvement of $6.0 million in net income over the 2011 $8.0 million net loss.

Liquidity and Capital Resources

Liquidity refers to the liquid financial assets available to fund our business operations and pay for near-term obligations as well as unused borrowing capacity under our revolving credit facility. Our cash requirements have historically been satisfied through a combination of cash flows from operations and debt financings.

On November 15, 2012, AERT entered into a $15.0 million Loan and Security Agreement (the Agreement) with AloStar Bank of Commerce (AloStar), a state banking institution organized under the laws of the State of Alabama; $8 million as a Revolver Loan and $7.0 million as an asset-based loan (Term Loan).

Upon execution of the Agreement, AloStar advanced funds from the Term Loan in full payment of the Liberty Bank Revolving Line of Credit and the Mortgage, Security Agreement. The Revolver Loan will be used to cover operating expenses as needed. At December 31, 2012, $2.5 million was available for drawdown.

The Term Loan requires that AloStar hold first security interest to the majority of AERT's plant, property, and equipment; as well as, real estate. Payments on the principal portion of the loan commenced on December 1, 2012 and will be made in 36 equal monthly installments of $0.08 million plus interest. The final installment $4.1 million shall be due and payable on the commitment termination date. Interest is calculated at 4.5% plus the greater of (a) 1.0% and (b) the LIBOR Rate as shown in the Wall Street Journal on such day for United States dollar deposits for the one month delivery of funds in amounts approximately equal to the principal amount of the Loan for which such rate is being determined or, if such day is not a Business Day on the immediately preceding Business Day. Interest accrued on the principal balance of the Term Loan shall be due and payable on the first day of each month, computed through the last day of the preceding month. Interest, expressed in simple interest terms as of December 31, 2012, is 5.5%.

The Revolver Loan is subject to a reserve of $1.0 million plus a maximum reserve of $1.0 million for class action claims. Interest is assessed at the greater of (a) 1.0% and (b) the LIBOR rate as shown in the Wall Street Journal on such day for United States dollar deposits for the one month delivery of funds in an amount approximately equal to the principal amount of the Loan for which such rate is being determined plus 4% as of December 31, 2012. If the LIBOR cannot be determined, the interest will be calculated using the prime lending rate plus 2%. The Revolver Loan is secured by 85% of accounts receivable after a reduction for amounts owed by international customers. The Revolver Loan is also secured by 60% of the eligible inventory or 85% of the net orderly liquidation value of the inventory. The line of credit at AloStar had a balance of $2.3 million at December 31, 2012.

The Company continues to improve on liquidity by increasing plant efficiencies, decreasing our overhead costs, negotiating longer payment terms with vendors and increasing profitability within our product sector. Our Junction, Texas facility, which is currently unused, is available for sale.

On October 20, 2011, AERT and H.I.G. amended their Credit Agreement on the Series B Senior Term Note with H.I.G. With the addition of PIK interest, as of December, 2012, the Company had $0.4 million available to be drawn, as needed.

Cash Flows

Cash Flows from Operations

Cash provided by operations in 2012 was $0.8 million compared to cash used in operations of $8.0 million in 2011. The $8.0 million used in operations in 2011 was primarily due to the changes relating to the recapitalization (See Note 3) offset by increased accrued liabilities for the inventory refresh.

The changes in our revenue and cost of raw materials significantly impact the Company's liquidity. We are in the remodeling industry that has been depressed as a result of the reduction in home prices in recent years. While improvements in the Company's sales improved, our business is still dependent upon the economy and we cannot accurately predict cyclical economic changes or the impact on consumer buying.

The Company has significant customer concentration, with one customer representing approximately 62% of our revenue. A loss of this customer, or a major reduction in their business, would cause a significant reduction in our liquidity. We are currently working to increase our distribution network, which will reduce this customer's concentration.

The change in current assets and current liabilities was primarily due to the reduction of $4.6 million accrued product returns at 2011 year end for the Lowe's inventory refresh. The process of refreshing the inventory at over 2,000 Lowe's locations proved to be very successful and resulted in increased sales of the new ChoiceDek® Foundations™ product.

Cash Flows from Investing Activities

Cash used in investing activities in 2012 increased only slightly from 2011, by $0.7 million. This increase in cash used resulted from additional capital expenditures at our Watts, Oklahoma plastic recycling facility and increased capital expenditures to improve our extrusion operations in Springdale, Arkansas.

Cash Flows from Financing Activities

Cash provided by financing activities was $1.5 million in 2012 compared to cash provided by financing activities of $9.8 million in 2011, which was primarily proceeds from the issuance of notes associated with the H.I.G. recapitalization. In 2012, the proceeds from the Term Loan from AloStar were used to pay the outstanding loans with Liberty Bank.

Working Capital

At December 31, 2012, the Company had working capital of $0.2 million compared to a working capital deficit of $9.9 million at December 31, 2011. The increase in working capital for 2012 was primarily due to the completion of the inventory refresh in the Lowe's stores, which reduced the $4.6 million accrual recorded in 2011; and, the new loan with AloStar that paid the Liberty line of credit and real estate loan. An increase in international sales and sales to new customers in new markets increased accounts receivable. Components of working capital that fluctuated significantly include accounts receivable, inventory, accruals related to class action, accrued product returns and current maturities of long term debt.

Property, Plant and Equipment

The changes in our property, plant and equipment for 2012 are due primarily to fixed asset additions to our Watts, Oklahoma plastic recycling facility and at our extrusion facilities in Springdale, Arkansas. The depreciation of buildings and equipment is provided on a straight-line basis over the estimated useful lives of the assets. Gains or losses on sales, or other dispositions of property, are credited or charged to income in the period incurred. Repairs and maintenance costs are charged to income in the period incurred, unless it is determined that the useful life of the respective asset has been extended.

Arkansas Loan Program

On March 30, 2010, the Company entered into a grant agreement with the City of Springdale and the Arkansas Economic Development Commission (AEDC) in the amount of $170,000. Part of the grant funds have been used to pay for a new packaging line in the Springdale North plant. On June 4, 2010, the Company accepted an offer of additional grant funding in the amount of $150,000 that would be combined with and become a part of the initial grant provided by AEDC, bringing the total amount of that grant to $320,000. In 2011, $70,000 of the grant fund was used to purchase a hammermill for the Springdale South location. The remainder of the grant funding was used when we removed and relocated equipment from AERT's plant at Junction, Texas to the Springdale South Plant. AERT expects to create 84 jobs in its operations in Arkansas as a result of the grant funding from AEDC.

Debt

In addition to the H.I.G. transaction on March 18, 2011, as discussed in Note 5, and the recent obligations pledged to AloStar on November 15, 2012, also discussed in Note 5, the Company continues to explore financing options, including various financial assistance programs sponsored by state and federal governments.

Line of Credit

On November 15, 2012, the Revolving Line of Credit with the Liberty Bank was paid in full using funds provided by a new term loan (Term Loan) with AloStar Bank of Commerce (AloStar). A new Revolver Loan (Revolver) was established with AloStar as well. The Revolver Loan with AloStar does not require a guarantee.

Oklahoma Energy Program Loan

On July 14, 2010, the Company entered into a loan agreement with the Oklahoma Department of Commerce (ODOC) whereby ODOC agreed to a 15-year, $3.0 million loan to AERT at a fixed interest rate of 3.0%. The loan is being made pursuant to the American Recovery and Reinvestment Act State Energy Program for the State of Oklahoma, and is funding the second phase of AERT's new recycling facility in Watts, Oklahoma. Payments on the loan commenced on May 1, 2012. The balance on the loan at December 31, 2012 was $2.9 million.

ODOC, under award number 14215 SSEP09, advanced $3.0 million to AERT between 2010 and 2012. As of December 31, 2012, a total of $3.0 million was spent on contract labor, contract materials, and equipment. In addition, as of December 31, 2012, matching funds of $9.2 million have been contributed (in-kind) to the project by AERT.

Debt Covenants

Our debt covenants per the Company's agreements with AloStar Bank of Commerce and H.I.G. are as follows:

	For the period of November 16, 2012 through December 31, 2012		Compliance
	Actual	Required	
AloStar Bank of Commerce Debt Covenants			
Capital Expenditures	$ 0	<$0.5 million	Yes
Fixed Charge Coverage Ratio	2.9	> 1.10:1.00	Yes
Adjusted Consolidated EBITDA / Consolidated Fixed Charges			
Adjusted EBITDA	$8.3 million	= >$5.25 million	Yes

	Year Ended December 31, 2012		Compliance
H.I.G. Debt Covenants	Actual	Required	
Leverage Ratio	4.2	= < 4.0:1.00	No, Waived
Consolidated Indebtedness / Consolidated EBITDA			
Fixed Charge Coverage Ratio	3.4	> 1.25:1.00	Yes
Adjusted Consolidated EBITDA / Consolidated Fixed Charges			
Consolidated EBITDA	$8.9 million	=>$6.5 million	Yes

On January 25, 2013, H.I.G. AERT LLC, the holder of all of the issued and outstanding shares of Series E Convertible Preferred Stock, waived the Specified Events of Default as a result of AERT failing to have a Leverage Ratio (as defined in that certain Credit Agreement, dated as of March 18, 2011, as amended by that certain First Amendment to Credit Agreement, dated as of May 12, 2011, and as further amended by that certain Second Amendment to Credit Agreement, dated as of October 20, 2011 and as further amended, restated, supplemented or otherwise modified from time to time, the Credit Agreement, by and among AERT, the lenders from time to time parties thereto and H.I.G. AERT, LLC) of below 4.0 to 1.0 for four Fiscal Quarters (as defined in the Credit Agreement) ending December 31, 2012 and (collectively, the Specified Events of Default). On February 20, 2013, H.I.G. AERT LLC, waived its right to deliver a Triggering Event Redemption Notice solely as a result of the Specified Events of Default.

H.I.G. Long Term Debt

On March 18, 2011, the Company consummated related recapitalization transactions (the Transactions) with H.I.G. AERT, L.L.C., an affiliate of H.I.G. Capital L.L.C. (H.I.G.) and with other existing preferred stockholders, pursuant to which, among other things, H.I.G. exchanged $32,620,816 of its secured debt in the Company, including interest accrued through March 17, 2011, for a combination of new debt and equity. (See Note 5 for further discussion.)

Critical Accounting Policies and 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 amounts reported on our financial statements. The estimates made in applying the accounting policies described below are material to the financial statements and notes thereto due to the level of judgment involved in arriving at those estimates.

Accounts Receivable

Trade accounts receivable are stated at the amount management expects to collect from outstanding balances. Payments of accounts receivable are allocated to the specific invoices identified on the customers' remittance advice. Accounts receivable are carried at the original invoice amount less an estimated reserve. Management reviews all overdue accounts receivable balances and estimates the portion, if any, of the balance that may not be collected and provides an allowance. Balances that remain outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a reduction in trade accounts receivable. Recoveries of trade receivables previously written off are recorded when received.

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Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market. Material, labor, and factory overhead necessary to produce the inventories are included in their cost.

Buildings and Equipment

Property additions and betterments include capitalized interest and acquisition, construction and administrative costs allocable to construction projects and property purchases. The depreciation of buildings and equipment is provided on a straight-line basis over the estimated useful lives of the assets. Gains or losses on sales or other dispositions of property are credited or charged to income in the period incurred. Repairs and maintenance costs are charged to income in the period incurred, unless it is determined that the useful life of the respective asset has been extended.

We assess the impairment of long-lived assets, consisting of property, plant, and equipment, whenever events or circumstances indicate that the carrying value may not be recoverable.

Examples of such events or circumstances include:

- an asset group's inability to continue to generate income from operations and positive cash flow in future periods;
- loss of legal ownership or title to an asset;
- significant changes in our strategic business objectives and utilization of the asset(s); and
- the impact of significant negative industry or economic trends.

We evaluate our assets on a quarterly basis during periods when we suffer operating losses. The last evaluation was prepared as of December 31, 2011. For the year ending December 31, 2012, the Company had operating profit of $2.3 million.

For purposes of testing impairment, we group our long-lived assets at the same level for which there are identifiable cash flows independent of other asset groups. Currently, there is only one level of aggregation for our assets. We assess the impairment of long-lived assets, primarily consisting of property, plant, and equipment related to the extrusion and rendering of plastic materials, whenever events or circumstances indicate that the carrying value may not be recoverable. The Company believes the assets which most significantly drive the cash-flow-generating capacity at our facilities are the assets resulting in property, plant and equipment.

Recoverability of assets to be held and used in operations is measured by a comparison of the carrying amount of our assets to the undiscounted future net cash flows expected to be generated by the assets. The factors used to evaluate the future net cash flows, while reasonable, require a high degree of judgment and the results could vary if the actual results are materially different than the forecasts. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs.

As stated in Note 2, buildings and equipment are stated at cost and depreciated over the estimated useful life of each asset using the straight-line method. Estimated useful lives are: buildings — 15 to 30 years, leasehold improvements — 2 to 6 years, office equipment — 3 to 6 years, and machinery and equipment — 3 to 10 years. We also periodically review the lives assigned to our assets to ensure that our initial estimates do not exceed any revised estimated periods from which we expect to realize cash flows from the asset.

Revenue Recognition

The Company recognizes revenue 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 collectability is reasonably assured. The Company typically recognizes revenue at the time product is shipped or when segregated and billed under a bill and hold agreement. Sales are recorded net of discounts, rebates, and returns.

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.

Uncertainties, Issues and Risks

There are many factors that could adversely affect our business and results of operations. These factors include, but are not limited to, general economic conditions, decline in demand for our products, business or industry changes, critical accounting policies, government rules and regulations, environmental concerns, litigation, new products / product transition, product obsolescence, competition, acts of war, terrorism, public health issues, concentration of customer base, loss of a significant customer, availability of raw material (plastic) at a reasonable price, management’s failure to execute effectively, manufacturing inefficiencies, high scrap rates, inability to obtain adequate financing (i.e. working capital), equipment breakdowns, low stock price, and fluctuations in quarterly performance.

The Company voluntarily reported several wastewater exceedances in the summer of 2012 during a period of plant expansion and was fined seventeen thousand dollars by the Oklahoma Department of Environmental Quality relating to wastewater issues at its Watts, OK facility and is currently operating under an agreed consent agreement. If the Company fails to correct and resolve these issues it could incur further fines and or harsher penalties.

Forward-looking Information

An investment in our securities involves a high degree of risk. Prior to making an investment, prospective investors should carefully consider the following factors, among others, and seek professional advice. In addition, this Form 10-K contains certain “forward-looking statements” within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Such forward-looking statements, which are often identified by words such as “believes”, “anticipates”, “expects”, “estimates”, “should”, “may”, “will” and similar expressions, represent our expectations o beliefs concerning future events. Numerous assumptions, risks, and uncertainties could cause actual results to differ materially from the results discussed in the forward-looking statements. Prospective purchasers of our securities should carefully consider the information contained herein or in the documents incorporated herein by reference.

The foregoing discussion contains certain estimates, predictions, projections and other 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) that involve various risks and uncertainties. While these forward-looking statements, and any assumptions upon which they are based, are made in good faith and reflect management’s current judgment regarding the direction of the business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, or other future performance suggested herein. Some important factors (but not necessarily all factors) that could affect the sales volumes, growth strategies, future profitability and operating results, or th