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Hit the deck

Evan Lorenz writes:

As President Biden was saying only the other day, 2021 was a barnburner. The U.S. economy expanded at a real rate of 5.7%, highest since 1984, while earnings per share of the S&P 500 exploded by what may prove to be 45% (if the fourth-quarter estimates are on the beam). But what will we do for an encore?

A gale of fiscal and monetary stimulus was the macroeconomic propellant of 2021. However, while last year's tailwinds are fast becoming this year's headwinds, scores of stocks, in our opinion, remain valued for the year that was. Trex Co., Inc. (TREX on the New York Stock Exchange), the world's largest manufacturer of composite decking, is a member of this mispriced cohort. In preview, we're bearish on it.

You'll recall that 2021 was the year it rained money. Beyond that famous $1.4 trillion bulge in the Federal Reserve's balance sheet, there was the American Rescue Plan Act of 2021. In the first six months, $1,400 in government funds infused most American wallets, subject to income thresholds. Normally, parents can claim the childcare tax credit, which tops out at $3,600 per child, as a deduction against taxes owed. Not last year, when half the credit was paid preemptively in the form of monthly checks, authorized by the same act. But there'll be no more stimmies in 2022.

The dollar deluge helped foment December's 7% pop in the Consumer Price Index, though hourly wages in the same month rose by just 4.7%, the ninth consecutive month of real wage declines. According to a Gallup survey issued last week, 79% of Americans expect inflation to worsen; and half say by "a lot." Per a Jan. 23 NBC News poll, 72% of Americans feel the country is headed in the wrong direction and 61% opine that their incomes are falling behind the CPI.

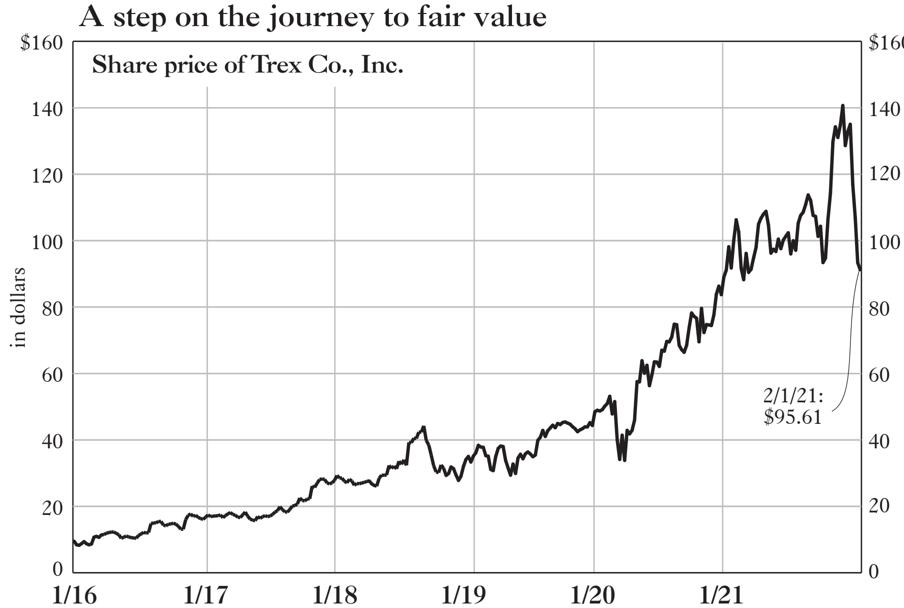
Not surprisingly, observant people are changing their spending habits. The IHS Markit U.S. Manufacturing PMI fell to 55 in January, a 15-month low, from 57.7 in December. "Alongside labor and material shortages, firms noted that customers were keen to reduce spending amid sharp hikes in costs," said the accompanying Jan. 24 press release.

According to the New York Fed's latest Survey of Consumer Expectations, fewer Americans plan to splash out on big-ticket items. The proportion of respondents intending to purchase a vehicle in the next four months, for instance, dropped to 8.6% in December from 9.8% in April. So with home repairs, to 21.2% from 30.1%; furniture, to 11% from 14.3%; and vacations, to 22.4% from 31.9%.

Spending decisions may ratchet still lower once the 2022 tax season begins. The understaffed (and perhaps undermotivated) Internal Revenue Service is starting the year with a backlog of several million unprocessed tax returns. Non-electronic filers may expect delays beyond the customary three weeks, the agency is warning, unless they make a clean breast of their childcare credits.

Tax refunds can be a meaningful part of a working American's income stream. Last year, according to the Taxpayer

A step on the journey to fair value



source: The Bloomberg

Trex at a glance
all figures in USD millions except per share data

	TTM*	2020	2019	2018	2017
sales	$1,121.3	$880.8	$745.3	$684.3	$565.2
operating income	303.1	233.6	188.2	176.9	142.4
net income	227.0	175.6	144.7	134.6	95.1
earnings per share	1.96	1.51	1.24	1.14	0.81
shares	115.6	116.3	117.3	118.1	118.3
cash	54.0	121.7	148.8	105.7	30.5
debt	0	0	0	0	0
total assets	953.5	770.5	592.2	465.1	326.2

* The 12 months ended Sept. 30, 2021.

source: company reports

Advocate Service, a division of the IRS, about 7 out of 10 filers received money back from the government, in the average sum of $2,827. Consumer lenders, especially the ones that service lower-income borrowers, may register the fact of late-arriving refunds in the form of the credit metrics they present to their investors. Interestingly, signs of decay are already surfacing in January delinquency data of the online lender Upstart Holdings, Inc., whose loan officers are algorithms.

The recent crash in cryptos and meme stocks could throw another monkey wrench into consumers' spending plans. The retail masses that drove dogecoin and AMC Entertainment Holdings, Inc. to the moon last year are likely sitting on short-term realized capital gains for the 2021 tax year, even as they nurse trading losses from early 2022. The bitter combination seems unlikely to spur heavy St. Valentine's Day spending.

Among the many things that the virus has scrambled are shopping lists. Thus, between the fourth quarters of 2019 and 2021, goods as a proportion of personal-consumption expenditures rose to 34.6% from 31% while services fell to 65.4% from 69%.

On the one hand, sales of durable merchandise climbed 33.4%, led by categories such as furnishings and household equipment, which grew by 29.8%. On the other, services nudged higher by just 5.8% over the past two years, restrained by outlays on travel and recreation, which declined by 6.2%.

That could be changing, to judge from the stock market's rough handling of a pair of famous former Covid beneficiaries. However, despite the corrections in Netflix, Inc. and Peloton Interactive, Inc., investors are still wont to capitalize the gains of the Covid outperformers as if the plague has come to stay. Beware, then, more reopenings, better health, herd immunity—and a reversion to pre-virus shopping patterns.

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The idea for outdoor decks fashioned from composite materials, rather than wood, came to Roger Wittenberg in 1988 as he combined plastic waste and sawdust to make planks for a park bench. In 1992, Wittenberg, an organic chemist, sold the technology to Mobil Oil Corp., one half of the predecessor to Exxon Mobil Corp. In 1996, Trex came into being through a management buyout of Mobil's composite-products division. Early customers included the Mount Rushmore National Memorial and Disney World, happy auguries of future success.

Besides the legacy composite decking boards, Trex produces rails, fences, outdoor lighting systems and staging equipment (portable platforms, orchestral shells, camera platforms, etc.). Twelve-month trailing revenues summed to $1.1 billion.

If composite decking is a must-have product, it's not because of its price tag. Trex's Enhance line, the entry-level product, starts at $1.90 per square foot, almost double the price of wood. The premium Transcend line, featuring patterns with names like "Tiki Torch," "Havana Gold" and "Spiced Rum," starts at $5.75 a square foot. Then, again, since composite doesn't stain, splinter, warp or fade over time, one could make the case that it's the cheaper option in the long run.

Greener, too, given that all but 5% of these rails, fences and decks are made from what used to be known as waste material. "From reclaimed wood, plastic film and sawdust, we create durable, low-maintenance, high-performance materials that withstand the harshest outdoor conditions—not to mention the most demanding designers, builders and homeowners," the company website proclaims.

Though it exports to 42 countries, Trex keeps mum about the split between its domestic and foreign sales. Nor does management choose to identify the three customers that, in 2020, accounted for 56% of overall sales.

What we do know is that Covid proved a boon to the composite-manufacturing industry. Locked-down workers, flush with stimulus payments and absent from offices, turned to home-improvement projects. Adding a deck to a home (most new builds lack one) or refurbishing an existing deck typically costs no more than $10,000. Nor does it require workmen to enter the home, no small selling point in the current anxious era.

Standard decks are made of pressure-treated lumber, the price of which rose last year on the back of supply-chain problems and Canadian trade imbroglios. No surprise, then, that Trex was able to push through a 5% price increase across its various product lines.

Not that Covid should be seen as a lifeline to a struggling industry. Innovation was in the works before the bug bit. "Trex and Azek, the big two deck makers, introduced their sub-$2 boards in 2019," Kurt Yinger, who rates Trex a hold for D.A. Davidson & Co., tells me. New products were already in place prior to the 2020 lockdowns.

Trex's sales growth doubled, to 18%, in 2020 from 2019, and will nearly double again in 2021, up by 35%, the Street reckons. On the Nov. 8 earnings call, CEO Bryan Fairbanks predicted that such momentum would persist beyond the pandemic: "[O]ur analysis suggests an acceleration in market share gains from wood. It is estimated that gains from wood are now approximately two percentage points in market share per year, up from one percentage point, with composites accounting for approximately 24% to 25% of the overall decking market volume in North America." Longer term, Fairbanks told listeners, composite could claim 45%–50% of the market.

Trex's unleveraged finances round out the bull case. As of Sept. 30, 2021, the balance sheet showed $54 million in cash, no debt and an operating lease liability of $29.7 million. For a sense of proportion, trailing 12-month Ebitda summed to $341.5 million.

There's more to the bear case than three short figures, but "12.8, 113 and 95" capture the essence of the argument.

Thus, in the two years through 2021, it appears that Trex will have compounded its revenue growth at a rate 12.8 percentage points higher than in the five years ended 2019 (26.5% versus 13.7%).

It's likely that this spurt reflected not merely the asserted superiority of composites over wood but also—perhaps, predominantly—the pulling forward of future consumer demand. We'll know soon enough. One of these days, perhaps, American homeowners will put down their hammers, pack up their suitcases and return to life as they knew it in 2019.

The price of a share of TREX, however, despite a recent spill, continues to suggest the conviction that nothing much will change (or so we read Mr. Market's mind). Since Dec. 31, 2019, the Trex market cap has jumped by 113%, or 53 percentage points more than the cumulative increase in estimated sales, producing a ratio of enterprise value to Ebitda of no less than 32.1 times. In the five years through 2019, the stock changed hands at an average of 18.7 times Ebitda.

To accommodate the ostensible new normal, Trex has boosted its manufacturing capacity by 95%, not counting a new plant in Little Rock, Ark., that's slated for completion by 2024. In total, management projects that it will employ 500 people in this, its third facility, versus a grand total of 1,719 at year-end 2020.

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Nor was Trex the only composite-board manufacturer to capitalize on the recent surge in demand. Azek Co., Inc., whose top line approximates Trex's, has doubled its manufacturing capacity from the 2019 level, while smaller competitors, such as Fiberon, LLC, Oldcastle APG, Inc. and Barrette Outdoor Living, Inc.'s DuraLife unit, have likewise added substantial capacity. If, indeed, the lockdowns pulled forward demand, the supply response may be coming online at just the wrong time.

During last year's spike in the price of lumber, composites almost sold themselves, but apparently no longer. On the Nov. 8 earnings call, Fairbanks told analysts to expect higher advertising expenses in 2022.

Longer-term, Trex's durable, low-maintenance products may prove their own impediment to sales growth. Decks made of pressure-treated wood start to break down after 10–15 years, whereas Trex products come with a 25-year limited warranty. As more consumers opt for environmentally friendly composites, the replacement cycle will likely extend.

Out of 17 Wall Street analysts on the Trex case, seven say buy and one says sell. The bearish story has attracted a short interest amounting to 5.4% of the float. Over the past 12 months, insiders have sold 114,352 shares for proceeds of $12 million; not one officer or director has bought a share.

For any who are bullish on composite decking but concerned about Trex's elevated multiple, Azek may serve as the long end of a pair trade. Trex and Azek are much alike in their product lines, through Azek is more exposed to the cyclical commercial end of the market than Trex (11% to 5%). However, Azek trades at 22.8 times enterprise value to trailing Ebitda versus Trex's 32.1 multiple.

"Azek is a great business," Yinger tells me. "So far, management has executed well. They've under-promised and overdelivered, but it is still a relatively new company and there is still an element of track record that they need to build."

Azek, which came public in 2020, lacks the two decades of public-company history that Trex boasts. And Ares Management, LLC and the Ontario Teachers' Pension Plan, which own a combined 24.6% of shares outstanding, will one day presumably choose to lighten their stakes. Perhaps those facts and others are amply discounted in a valuation disparity through which one could drive a truck.

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