

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC
Form 10-K
March 17, 2017

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

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2016

Or

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 or other jurisdiction of incorporation or organization)

71-0675758
(I.R.S. Employer
Identification No.)

914 N Jefferson Street
Springdale, Arkansas 72764
(Address of principal executive offices) (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 No

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

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

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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 (§ 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 No

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.

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 Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

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 \$5,108,689 (for the purposes hereof, directors, executive officers and 10% or greater shareholders have been deemed affiliates).

Number of shares of Class A common stock outstanding at February 28, 2017: Class A — 89,631,162

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our Definitive Proxy Statement for our 2017 annual meeting of stockholders, expected to be filed within 120 days of our fiscal year end, are incorporated by reference into Items 10 through 14 Part III of this Annual Report on Form 10-K.

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PART I

Item 1. Business.

Summary

Advanced Environmental Recycling Technologies, Inc. (the Company, AERT, we, our or us), founded in 1988, develops and commercializes technologies to recycle waste polyethylene plastics and develops, manufactures, and markets value-added, green building products. The majority of our products are composite building materials that are a superior replacement for 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 and waste wood fiber, which have been cleaned, sized and reprocessed utilizing our patented and proprietary technologies. Our products have been extensively tested, and are sold or distributed by leading companies such as Lowe's Companies, Inc. (Lowe's), BlueLinx Corp. (BlueLinx), Cedar Creek LLC (Cedar Creek) and CanWel Building Materials Ltd. (CanWel), our Canadian distributor for Lowe's Canada. 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.

We currently manufacture all of our composite products at extrusion facilities in Springdale, Arkansas. We operate a plastic recycling, blending and storage facility in Lowell, Arkansas, where we also lease a warehouse and land for inventory storage. We also operate a plastic recycling, cleaning, and reformulation facility at Watts, Oklahoma.

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®, MoistureShield® Pro and ChoiceDek® brands,

Exterior door components,

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 decompose like wood.

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.

Since 2006, our products have contained a mildewcide to inhibit the growth of mold.

Our latest generation of products offers colors and textures to more closely resemble the natural look of wood.

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 original equipment manufacturer (OEM) components that represent the most attractive market opportunities at this time. Within these 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, Lowe's, and 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 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 generally due to seasonal climate changes. Reductions in 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 our extrusion operations over the last several years. The aesthetics of our products, which are overwhelmingly composed of recycled materials, have improved with technology advances.

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

Our Brands

ChoiceDek® Decking. We currently sell our ChoiceDek® branded decking and railing products in the home improvement warehouse (HIW) market through Lowe's. Approximately 50% of our revenue in 2016 was from ChoiceDek® products. This market segment primarily focuses on the do-it-yourself (DIY) market in which homeowners buy, build, and install their own decks. The ChoiceDek® brand is sold to consumers exclusively at Lowe's. ChoiceDek® is promoted through in-store displays and an ongoing print and marketing campaign targeting the HIW decking market. We maintain a nationwide sales and customer service group, and Lowe's also conducts national print and television ads for the products it carries, including from time to time, our ChoiceDek® brand of

decking and railing products.

MoistureShield® Decking. Our MoistureShield® brand line (which includes Pro, Vantage, Refine and Vision) of decking products is currently sold to select primary distributors, who re-sell to lumber dealers and contractor yards for sale to local deck builders and home builders. Most of our MoistureShield® customers are 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. As with all of AERT's products, it can be installed on the ground, in the ground or in the water. Approximately 40% of our revenues in 2016 were from MoistureShield® products.

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, Northwest Hardwoods, and JELD-WEN, and door frames for Quanex Building Products. 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 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.

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 initially more expensive 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.

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 in the United States. We therefore view manufacturers and suppliers of wood decking as our principal competitors. 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, AZEK Building Products, Tamko Building Products, and Fiber Composites LLC as our primary competitors. We believe that our MoistureShield® 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.

Customer Concentration

We have significant customer concentration, with two customers, Lowe's and BlueLinx representing approximately 45% and 10%, respectively, of our revenue in 2016. A loss of Lowe's, or a major reduction in their business, would cause a significant reduction in our liquidity. We continue to broaden our distribution network by adding new distributors for our MoistureShield® brand which will reduce our customer concentration.

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.

Our patents cover plastic recycling processes, methods, and apparatus or other specially designed equipment as well as the composite product that we manufacture. We have also received patents with regard to our mixed recycled plastic resin identification and reformulation technologies. One of our patents expires in 2018, one in 2021 and the remainder expire in 2028.

We continue to update and refine our recycling processes, procedures, and technologies, and we have included these updates in our most recently issued patents and 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, which includes requiring confidentiality and nondisclosure agreements among our associates.

Expenditures for research and development activities for the years ended December 31, 2016 and 2015 were \$0.7 million and \$0.6 million, respectively.

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 lessens 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 creates 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 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

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 evaluation reports inform the consumer, commercial and residential markets, that the products listed in such reports comply with the UBC and BNBC 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 the UBC and BNBC 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 with applicable building codes.

The Company has also received from ICC-ES a Verification of Attributes Report, also known as 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 customers, the number of permanent employees is adjusted throughout the course of the year. At December 31, 2016 we had 351 full-time employees compared to 401 full-time employees at December 31, 2015.

Proposed Merger

On March 16, 2017, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with Oldcastle Architectural, Inc., a Delaware corporation (Parent), and Oldcastle Ascent Merger Sub, Inc., a Delaware corporation and a wholly-owned subsidiary of Parent (Merger Sub), under which Merger Sub will merge with and into the Company (the Merger) with the Company continuing as the surviving corporation and a wholly-owned subsidiary of Parent. Pursuant to the Merger Agreement, at the effective time of the Merger, each issued and outstanding share of common stock, par value \$0.01 per share, of the Company (the Common Stock) will be converted into the right to receive \$0.135936 in cash, less any required withholding taxes, if any, and each issued and outstanding share of

preferred stock, par value \$0.01 per share, of the Company (the Preferred Stock) will be converted into the right to receive \$2,603,483,278 in cash, less any required withholding taxes, if any, in each case other than any shares of Common Stock and Preferred Stock owned by the Company (which will automatically be canceled with no consideration paid therefor) and those shares of Common Stock with respect to which stockholders properly exercised appraisal rights and have not effectively withdrawn or lost their appraisal rights. Consummation of the Merger is subject to satisfaction or waiver of certain customary closing conditions. The Merger is expected to close during the second quarter of 2017. See Item 9B for more information about the Merger.

Available Information

We post on our website (www.aert.com) our periodic reports filed with the Securities Exchange Commission (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 of 1934, as amended, as soon as reasonably practicable after we electronically file such material with the SEC.

Item 1A. Risk Factors

The ownership of the Company's common stock involves a number of risks and uncertainties. Potential investors should carefully consider the risks and uncertainties described below and the other information in this Annual Report on Form 10-K before deciding whether to invest in the Company's securities. The Company's business, financial condition or results of operations could be materially adversely affected by any of these risks. The risks described below are not the only ones facing the Company. Additional risks that are currently unknown to the Company or that the Company currently considers to be immaterial may also impair its business or adversely affect its financial condition, results of operations, liquidity and/or the market price of the Company's common stock.

Risks Relating to the Proposed Merger

The announcement and pendency of the Merger may have a material adverse effect on our business.

Uncertainty about the effect of the Merger on our employees, suppliers, customers and other parties may have a material adverse effect on our business. Although we intend to take steps designed to reduce any adverse effects, these uncertainties could impair our ability to retain and motivate key personnel and could cause customers, suppliers and others that deal with us to defer entering into contracts, or making other decisions, concerning doing business with us or seek to change existing business relationships with us. The pursuit of the Merger and the preparation for the integration may place a significant burden on our management and resources. In addition, we have diverted, and will continue to divert, significant management resources towards the completion of the Merger. The diversion of management's attention away from day-to-day business concerns and any difficulties encountered in the transition and integration process could adversely affect our financial results. In addition, the Merger Agreement restricts us from taking certain actions without the consent of Parent. These uncertainties and restrictions could disrupt or adversely affect our business and prevent us from pursuing otherwise attractive business opportunities that may arise prior to the completion of the Merger or termination of the Merger Agreement.

Stockholders may file lawsuits challenging the Merger, which may name us and/or our board of directors as defendants. We cannot assure you as to the outcome of such lawsuits, including the amount of costs associated with defending any such claim or any other liabilities that may be incurred in connection with the litigation of any such claim. One of the conditions to the closing of the Merger is the absence of any order, injunction or other legal restraint by a court or other governmental entity of competent jurisdiction that prevents the consummation of the Merger. Accordingly, if any plaintiff in any lawsuit is successful in obtaining an injunction prohibiting the parties from completing the Merger on the agreed-upon terms, such an injunction may delay the consummation of the Merger in the expected time-frame, or may prevent the Merger from being consummated altogether. Whether or not any plaintiff's claim is successful, this type of litigation may result in significant costs and diverts management's attention and resources, which could adversely affect the operation of our business.

There may be unexpected delays in the completion of the Merger, or the Merger may not be completed at all.

The consummation of the Merger is subject to the satisfaction of customary closing conditions. Certain events may delay the completion of the Merger or result in a termination of the Merger Agreement. Some of these events are outside the control of either party. We may incur significant additional costs in connection with any delay in completing the Merger or the termination of the Merger Agreement, in addition to significant transaction costs, including legal, financial advisory, accounting and other costs we have already incurred.

We can neither assure you that the conditions to the completion of the Merger will be satisfied or waived or that any adverse change, effect, event, circumstance, occurrence or state of facts that could give rise to the termination of the Merger Agreement will not occur, and we cannot provide any assurances as to whether or when the Merger will be

completed.

Failure to complete the Merger in a timely manner or at all could negatively affect our stock price and future business and financial results.

Delays in completing the Merger or the failure to complete the Merger at all could negatively affect our future business and financial results, and, in that event, the market price of our common stock may decline significantly. If the Merger is not completed for any reason, we will be subject to several risks, including the diversion of management's attention and resources from operational matters and other strategic opportunities while working to implement the Merger, any of which could materially adversely affect our business, financial condition, results of operations and the value of our stock price. A failed transaction may result in negative publicity and a negative impression of us in the investment community. Further, any disruptions to our business resulting from the announcement and pendency of the Merger, including any adverse changes in our relationships with our customers, suppliers and employees, could continue or accelerate in the event of a failed transaction. In addition, if we do not complete the Merger, we may be required to pay a termination fee of approximately \$4.7 million under certain circumstances set forth in the Merger Agreement.

In addition, we have incurred, and will continue to incur, significant costs, expenses and fees for professional services and other transition costs in connection with the Merger. We will be required to pay such costs relating to the transaction whether or not the Merger is consummated.

We will incur significant transaction and Merger-related transition costs.

We have incurred significant costs in connection with negotiating the Merger and expect that we will continue to incur significant costs in connection with completing the Merger and integrating the operations of the two companies. Some of these costs are payable regardless of whether the transaction is completed. If the Merger is not completed, we will not receive any benefit from these expenditures.

Risks Related to Our Business

The demand for our products is influenced by general economic conditions and may be adversely affected by general economic downturns or declines in construction and/ or home remodeling activity.

Our products are sold in the home improvement and new home construction markets. These markets are subject to significant fluctuations in activity and periodic downturns caused by general economic conditions. Slowdowns in the economy, construction, and/or home remodeling activity may result in a reduction of the demand for our products and adversely affect our profitability. A worsening of the current economic climate, including deterioration of the credit markets and/or consumer confidence, will negatively impact the Company's sales and profitability.

The loss of one or more of our key customers could cause a substantial reduction in our revenues and profits.

We could be materially adversely affected if we were to lose one or more of our large existing customers. Our principal customer for our decking material is Lowe's, which accounted for approximately 45% of our sales in 2016. A loss of any one of our large customers would adversely affect our sales and profitability.

We may be unable to secure an adequate quantity of quality raw materials at economical prices.

Our products are constructed primarily from scrap wood fiber and scrap polyethylene. The markets for such scrap materials are dynamic. The global demand for these materials has increased significantly and we expect demand to continue to increase. The largest component of our raw material costs is scrap polyethylene. Our future profitability is contingent on us being able to manage raw material costs under these circumstances.

Weather

Sales of decking and accessories are subject to weather and seasonality trends associated with outdoor construction and accordingly adverse weather could have a negative impact on sales.

Item 2. Properties.

AERT currently manufactures all of our composite products at extrusion facilities in Springdale, Arkansas, and we operate a plastic recycling, blending and storage facility in Lowell, Arkansas, where we also lease a warehouse and land for inventory storage. We also operate a plastic recycling, cleaning, and reformulation facility in Watts, Oklahoma.

The recycling and extrusion facilities typically operate continuously with occasional shutdowns for holidays and maintenance. We are constantly searching for improvements and efficiencies to our production process and currently

are exploring alternative recycling technology at our Lowell facility.

Our extrusion facility in Springdale, Arkansas and our processing facilities in Lowell, Arkansas and Watts, Oklahoma are currently mortgaged in favor of Webster Business Credit Corporation (WBCC) pursuant to the Credit and Security Agreement dated October 30, 2015 with WBCC. See Notes 4 and 5 of the Notes to Financial Statements included in the financial supplement (the Financial Supplement) at pp. F-1 through F-22, which is attached to this Annual Report on Form 10-K (this Annual Report) and incorporated herein by reference.

Item 3. Legal Proceedings.

AERT is involved from time to time in litigation arising in the normal course of business that is not disclosed in its filings with the SEC. In management's opinion, the Company is not involved in any litigation that we expect to materially impact the Company's results of operations or financial condition.

Item 4. Mine Safety Disclosures.

Not applicable

PART II

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

The Company's Class A common stock is currently quoted on the OTCQB and trades under the symbol "AERT". As of February 28, 2017, there were 1,356 holders of record of our Class A common stock.

We have not previously paid cash dividends on our Class A common stock and there are currently restrictions with our 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 bid information of our Class A common stock for the years ended December 31, 2016 and 2015. These over-the-counter market quotations reflect inter-dealer prices without retail mark-up, mark-down or commission, and may not represent actual transactions.

| Fiscal 2016 | High | Low |
|----------------|--------|--------|
| First Quarter | \$0.10 | \$0.06 |
| Second Quarter | 0.09 | 0.06 |
| Third Quarter | 0.09 | 0.06 |
| Fourth Quarter | 0.15 | 0.07 |

| Fiscal 2015 | High | Low |
|----------------|--------|--------|
| First Quarter | \$0.11 | \$0.07 |
| Second Quarter | 0.11 | 0.07 |
| Third Quarter | 0.09 | 0.02 |
| Fourth Quarter | 0.13 | 0.06 |

No repurchases of Class A common stock took place during 2016 or 2015.

Equity Compensation Plan Information

The following table provides information as of December 31, 2016, regarding shares outstanding and available for issuance under the Company's equity compensation plans. No awards were made in 2016 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 equity compensation plans (excluding securities reflected in the first column of this table) |
|--|---|---|---|
| Equity compensation plans approved by security holders | - | N/A | 40,000,000 |
| Equity compensation plans not approved by security holders | - | N/A | - |
| | - | | 40,000,000 |

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

Proposed Merger

On March 16, 2017, the Company entered into an Agreement and Plan of Merger with Parent and Merger Sub, under which Merger Sub will merge with and into the Company, with the Company continuing as the surviving corporation and a wholly-owned subsidiary of Parent. Pursuant to the Merger Agreement, at the effective time of the Merger, each issued and outstanding share of Common Stock will be converted into the right to receive \$0.135936 in cash, less any required withholding taxes, if any, and each issued and outstanding share of Preferred Stock will be converted into the right to receive \$2,603.483278 in cash, less any required withholding taxes, if any, in each case other than any shares of Common Stock and Preferred Stock owned by the Company (which will automatically be canceled with no consideration paid therefor) and those shares of Common Stock with respect to which stockholders properly exercised appraisal rights and have not effectively withdrawn or lost their appraisal rights. Consummation of the Merger is subject to satisfaction or waiver of certain customary closing conditions. The Merger is expected to close during the second quarter of 2017. See Item 9B for more information about the Merger. For the year ended December 31, 2016, the Company recognized approximately \$0.4 million of transaction-related expenses, primarily for legal and financial advisory services.

2016 Summary

Results of Operations

Two-Year Comparison

(Dollars in thousands, except share and per share data)

| | December 31, | | |
|------------------------------------|--------------|----------|----------|
| | 2016 | 2015 | % Change |
| Net sales | \$85,347 | \$82,671 | 3.2% |
| Cost of goods sold | 62,910 | 65,595 | (4.1%) |
| % of net sales | 73.7% | 79.3% | |
| Gross margin | 22,437 | 17,076 | 31.4% |
| % of net sales | 26.3% | 20.7% | |
| Selling and administrative costs | 13,448 | 13,012 | 3.4% |
| % of net sales | 15.8% | 15.7% | |
| Loss on impairment of building | 2,834 | - | * |
| (Gain) Loss from asset disposition | 72 | (1) | * |
| Operating income | 6,083 | 4,065 | 49.6% |
| % of net sales | 7.1% | 4.9% | |
| Other income and expense: | | | |
| Other income | 1,112 | 13 | * |
| Other expense | (356) | - | * |
| Net interest expense | (2,870) | (3,356) | (14.5%) |
| Net income before income tax | 3,969 | 722 | 449.7% |
| % of net sales | 4.7% | 0.9% | |

| | | | |
|--|---------|---------|--------|
| Income tax provision | (105) | - | * |
| Net income | 3,864 | 722 | 435.2% |
| Dividends on preferred stock | (1,675) | (1,578) | 6.1% |
| Net income (loss) applicable to common stock | \$2,189 | \$(856) | 355.7% |
| % of net sales | 2.6% | (1.0%) | |

*Not meaningful as a percentage change.

Sales

Net sales for the year ended December 31, 2016 were up \$2.7 million, or 3.2% from the year ended December 31, 2015. This increase was primarily due to increased ChoiceDek sales to Lowe's and an increase in Original Equipment Manufacturer (OEM) sales.

Cost of Goods Sold and Gross Margin

Cost of goods sold decreased \$2.7 million, or 4.1% for the year ended December 31, 2016 as compared to 2015. As a percentage of sales, cost of goods sold decreased 5.6 percentage points, reflecting lower labor and overhead costs resulting from new cost saving capital projects, improved manufacturing efficiencies resulting in higher yields, along with process enhancements and lower raw material and freight costs.

Selling and Administrative Costs

Selling and administrative costs for the year ended December 31, 2016 were up \$0.4 million, or 3.4%, as compared to 2015. This increase resulted from increased salaries and wages, and advertising and promotional costs.

As a percentage of sales, selling and administrative costs for the year ended December 31, 2016 were 15.8% compared to 15.7% for 2015. The major components of selling and administrative costs were employee compensation, advertising and promotion, professional fees, and commissions.

Earnings

Net income was up \$3.1 million for the year ended December 31, 2016 compared to the year ended December 31, 2015. This increase was primarily due to higher gross margins for the year and a net insurance recovery in 2016 of \$1.1 million from the final settlement of all claims related to the 2013 fire at the Springdale plant. Offsetting this increase was a \$2.8 million loss on impairment of fixed assets at our Watts, Oklahoma facility, (as discussed below under Buildings and Equipment), a \$0.4 million increase in selling and administrative costs as described above, and a \$0.4 million increase in other professional expenses.

Interest expense decreased \$0.5 million, or 14.5%, for the year ended December 31, 2016 compared to the year ended December 31, 2015, in part due to decreased borrowing on the WBCC revolver loan, lower PIK (payment-in-kind) interest on the H.I.G. AERT, LLC Series B note due to a payment of principal in 2015, and lower interest rates resulting from the financing agreement with WBCC.

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 October 30, 2015, we signed a Credit and Security Agreement (the WBCC Agreement) with Webster Business Credit Corporation (WBCC), a state banking institution organized under the laws of the State of Connecticut. The WBCC Agreement provides us with access to working capital to fund business operations, and gives the Company access to a line of credit with limits of \$15.0 million between January 1 and May 31, and \$8.5 million for the remainder of the year. The Company had no outstanding borrowing under the WBCC line of credit as of December 31, 2016.

For further information regarding the WBCC Agreement, see Notes 4 and 5 of the Notes to Financial Statements included in the financial supplement (the Financial Supplement), which is attached to this Annual Report on Form 10-K (this Annual Report) and incorporated herein by reference.

We believe that our internally generated cash from operations together with the WBCC Agreement will be sufficient to meet our cash and liquidity requirements for at least the next twelve months.

Cash Flows

Cash Flows from Operations

Cash provided by operations for the year ended December 31, 2016 was \$14.7 million, an increase of \$10.4 million from the year ended December 31, 2015. This increase was primarily due to a change in net income applicable to

common stock of \$3.0 million, a change in current assets and liabilities of \$5.0 million, that was due in part to a decrease in inventory of \$2.5 million compared to an increase in inventory for the year ended December 31, 2015, and asset impairment of \$2.9 million.

Changes to our revenue and cost of raw materials significantly impact the Company's liquidity. We are in the remodeling industry, which is influenced by consumer confidence and changes in housing values. Our business is subject to general economic conditions, and we cannot accurately predict cyclical economic changes or the impact on consumer buying.

We have significant customer concentration, with two customers, Lowe's and BlueLinx representing approximately 45% and 10%, respectively, of our revenue in 2016. A loss of Lowe's, or a major reduction in their business, would cause a significant reduction in our liquidity. We are currently working to broaden our distribution network by adding new distributors for our MoistureShield® and MoistureShield® Pro brands, which would reduce our customer concentration.

Cash Flows from Investing Activities

Cash used in investing activities during the year ended December 31, 2016 was \$3.5 million compared to cash used in investing activities of \$2.7 million during the year ended December 31, 2015. This change was primarily due to purchases of capital assets for a new product line and continuous improvements to air quality in our production facilities.

Cash Flows from Financing Activities

Cash used in financing activities was \$9.7 million for the year ended December 31, 2016 compared to \$1.6 million of cash used in financing activities for the year ended December 31, 2015. The increase was due to the repayment of the WBCC revolver loan of \$7.5 million and net debt payments of \$2.2 million.

Working Capital

The Company had working capital of \$15.1 million at December 31, 2016, compared to working capital of \$6.8 million at December 31, 2015. Although current assets decreased \$0.2 million from the previous year-end, current liabilities decreased by \$8.6 million from December 31, 2015. This change is primarily due to a \$7.5 million decrease in outstanding borrowings under the WBCC line of credit during 2016, and a \$0.8 million decrease in accrued liabilities due to the payment of employee incentives in December 2016.

Property, Plant and Equipment

The changes in our property, plant, and equipment for the year ended December 31, 2016 were due primarily to the following:

Construction in progress was \$2.7 million in 2016 compared to \$1.8 million in 2015 due to the addition of a liquid polymer coating line.

Buildings and leasehold improvements were \$14.4 million at the end of 2016 compared to \$17.1 at the end of 2015. The decrease was due to an impairment recorded for the Watts, Oklahoma facility. (See Buildings and Equipment, below).

Machinery and equipment increased \$1.8 million for the year ended December 31, 2016, of which \$0.9 million was spent on fiber storage facilities and \$0.4 million was spent on dust collection equipment.

Debt

In addition to transactions with H.I.G. AERT LLC on March 18, 2011, and the obligations pledged to the WBCC Agreement, as discussed in Note 5 of the Notes to Financial Statements included in the Financial Supplement, we continue to explore financing options, including various financial assistance programs sponsored by state and federal governments.

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 ODOC Loan). The ODOC Loan was made pursuant to the American Recovery and Reinvestment Act State Energy Program for the

State of Oklahoma award number 14215 SSEP09, and funded the second phase of AERT's recycling facility in Watts, Oklahoma. The balance on the ODOC Loan at December 31, 2016 was \$2.2 million.

Webster Business Credit Corporation

On October 30, 2015, AERT entered into the WBCC Agreement, which includes the WBCC revolver loan, a \$5.5 million machinery and equipment loan (WBCC M&E Loan), a \$7.2 million real estate loan (WBCC RE Loan), a \$1.5 million asset-based loan (WBCC Term Loan) and a prospective \$1.2 million capital expenditure loan (WBCC CAPEX Loan).

The purpose of the WBCC Agreement was to refinance a portion of the Company's senior and subordinated debt, to cover the costs and expenses associated with the loan transactions and to provide working capital to fund business operations. The WBCC Agreement expires on October 30, 2020. The WBCC Agreement requires that WBCC hold a senior security interest on the majority of AERT's property, plant, equipment and real estate.

Payments on the principal portion of the WBCC M&E Loan, WBCC RE Loan and WBCC Term Loan commenced on December 1, 2015 and will be made in 60 equal monthly installments of \$0.12 million plus interest. The final installment of \$7.0 million is due and payable on October 30, 2020.

AERT borrows under the WBCC Agreement at the domestic base rate, which at December 31, 2016 was 3.75% plus an applicable margin. At its option, the Company may convert any of the loans under the WBCC Agreement to a LIBOR rate plus an applicable margin loan. Domestic base rate conversions to LIBOR rate loans must be made in minimum increments of \$250,000. For further information, See Note 4 and 5 of the Notes to the Financial Statements included in the Financial Supplement.

H.I.G. Long Term Debt

In 2011, we consummated related recapitalization transactions with H.I.G. AERT, LLC (H.I.G.), an affiliate of H.I.G. Capital L.L.C. H.I.G. exchanged secured debt in us for a combination of new debt (Series A Note and Series B Note issued pursuant to that certain Credit Agreement dated March 18, 2011, between us, H.I.G. Capital L.L.C., the lending party and H.I.G. as administrative agent (Credit Agreement), and equity. As a result, H.I.G. owns approximately 85% of our outstanding common equity securities on a fully diluted, as converted basis.

The Credit Agreement contains provisions requiring mandatory payments upon the Series A Note and Series B Note equal to 50% of our “Excess Cash Flow” (as defined in the Credit Agreement) and equal to 100% of proceeds from most non-ordinary course asset dispositions, additional debt issuances or equity issuances (subject to certain exceptions in each case or as H.I.G. otherwise agrees), and contains covenant restrictions on the incurrence of additional debt, liens, leases or equity issuances.

The Series A Note matures on April 30, 2021 (as amended by the Fourth Amendment to the Credit Agreement), and currently bears cash interest at 4.0% per annum and payment in kind (PIK) interest of 3.25% per annum. Payment of cash interest, however, has been waived until March 31, 2017, and, in lieu of such cash interest, PIK interest is accrued and added to the principal of the Series A Note quarterly.

The Series B Note matures on April 30, 2021 (as amended by the Fourth Amendment to the Credit Agreement), and, at our option, either (i) currently bears cash interest at 10.0% per annum or (ii) bears cash interest at 4.0% per annum and PIK interest equal to 5.25% per annum and added to the outstanding principal amount of the Series B Note. The Series B Note ranks equally to the Series A Note. Payment of cash interest has been waived until March 31, 2017, and, in lieu of such cash interest, PIK interest is accrued and added to the principal of the Series B Note quarterly. On October 30, 2015, we used some of the proceeds received from the loans under the WBCC Agreement to make an \$11.0 million payment on the Series B Note. For further information, see Note 5 of the Notes to the Financial Statements included in the Financial Supplement.

Debt Covenants

The Company is subject to customary covenants included in the credit agreements with H.I.G. AERT LLC (the Credit Agreement) and the WBCC Agreement. Both agreements provide for a fixed charge coverage ratio (FCCR), and an annual limitation on capital expenditures. The H.I.G. AERT LLC agreement provides for a leverage ratio and a minimum consolidated EBITDA (earnings before interest, taxes, depreciation and amortization). As of December 31, 2016, we were in compliance with all of the covenants under both Credit Agreements.

On December 31, 2016, H.I.G. AERT LLC, the holder of all of the issued and outstanding shares of our Series E preferred stock, waived the events of default under the Credit Agreement resulting from AERT failing to pay the required cash interest on the Series A and B notes, as discussed above. In addition, on December 31, 2016, H.I.G.

AERT LLC waived its right to deliver a triggering event redemption notice on the Series E preferred stock solely as a result of the specified events of default.

Pursuant to the terms of the Merger Agreement, all of the Company's outstanding indebtedness under the ODOC Loan, the WBCC Agreement and the Credit Agreement (including the indebtedness under the Series A Note and the Series B Note) will be repaid in connection with the consummation of the Merger.

Off Balance-Sheet Arrangements

As of the date of this Annual Report, we do not have any off-balance sheet arrangements.

Critical Accounting Policies and Estimates

The preparation of financial statements prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) 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 customer's 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.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market, which provides reasonable assurance that inventory values are presented at their current utility. Material, labor, and factory overhead necessary to produce the inventories are included in 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.

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 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. If a change were to occur in any of the above-mentioned factors or estimates, the likelihood of a material change in our reported results would increase. 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. 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, and machinery and equipment — 3 to 10 years.

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.

During 2016, management evaluated the economics of increasing the recycling capacity at the Lowell plant as a means of consolidating all plastic recycling operations at the facility. This evaluation, consisting of a series of tests, was completed in the fourth quarter of 2016. We evaluated the results and management decided to move production from our Watts, Oklahoma facility to the Lowell facility in 2017. As of the filing date for this Form 10-K, there have been no changes to our manufacturing process as it relates to the Watts facility.

However, future plans involve temporarily idling the Watts facility, at which time we will segregate the land and building on the balance sheet. Should we determine the period of idleness to be more than temporary, we will transfer the land and building to other assets and cease depreciation in accordance with ASC 320. In addition, the significant change in operations at Watts may impact compliance with covenants on the associated debt obtained in the construction of the facility, which may render that debt due and payable upon the facility becoming idle. Such debt is expected to be repaid in full pursuant to the terms of the Merger Agreement.

As a result of the anticipated change in usage of the Watts land and buildings, management determined it necessary to assess the associated assets for impairment. We performed a recoverability test for those assets and determined that impairment of the building was necessary. We estimated the current fair value of the facility using the cost approach which resulted in a charge of \$2.8 million being recognized during the fourth quarter of 2016.

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, shipment 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 arrangement. For sales to Lowe's, we recognize revenue when the product is delivered to Lowe's in accordance with their agreement.

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

An investment in our securities involves a high degree of risk. Prior to making an investment, prospective investors should carefully consider the following factors that could adversely affect our business and results of operations, among others, and seek professional advice. 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.

