

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC
Form 10-K
March 30, 2012

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, 2011

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 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 No

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 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

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 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 Smaller reporting company

(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 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 \$12,809,362 (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 30, 2012: Class A — 88,165,632; Class B — 1,465,530

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our Definitive Proxy Statement for our 2012 annual meeting scheduled to be held in June 27, 2012, 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), 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 waste wood fiber that has been cleaned, sized and reprocessed, and recycled polyethylene plastics that have been cleaned, processed, and reformulated 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 green (environmentally responsible) building alternative for decking, railing, and trim products. We have recently started a new Green Age plastic recycling, cleaning and reformulation facility at Watts, OK. The marketing and sale of recycled plastic and filler resins to third parties commenced in late 2011 and is expected to increase in 2012. It is our intent to have recycled plastic sales become a significant part of our business in the future.

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 can be 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 can be aesthetically enhanced to provide a wood-like or grained surface appearance.
- Our products can be combined with coloring agents and/or other additives to provide various colors and aesthetics.

Our latest generation of products offers multidimensional color levels to more closely resemble the natural look of wood. We also commenced adding a mildewcide 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 feedstocks, 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.

As manufacturing technology and aesthetics of composite decking improve, market trends are also shifting. Consumers are demanding more variety and selection compared to prior periods as demand for a wider selection of decking colors appears to be increasing. Also, the evolution toward a more natural wood look appears to be increasing on the higher end of the market, while decreasing wood prices have widened the price differential between composites and wood on the lower end. In addition, we are working with a company to develop and commercialize a new generation of surface coatings. We will continue to work toward more selection combined with innovation and new products in conjunction with our customers.

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 from BlueLinx (our distributor for ChoiceDek® products) in 2011. No other customers accounted for more than 10% of sales in 2010 or 2011. 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. Lowe's started carrying a higher priced composite decking brand in 2007, which could limit ChoiceDek's® growth. 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® will introduce 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. 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 currently have six new patents — five have been issued and one, which involves mixed polyethylene plastic identification measurement and reformulation processes, is still pending in the U.S. 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.

One of our patents expired in March 2011. This patent related to an early stage plastic recycling process. We believe the plastic waste stream has diversified and become more complex since the issuance of that patent. 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. Our patents expire between 2012 and 2021. We recently received patents in regard to our mixed recycled plastic resin identification and reformulation technologies. There is one patent currently pending. There can be no assurance, however, that additional patents will be issued or if issued, will be defensible in court.

Raw Materials

Wood Fiber. The wood fiber we use is waste byproduct generated by hardwood furniture, pallet, cabinet, and flooring manufacturers. Until recently, the cost of acquiring the waste wood has primarily been the handling and transportation costs involved in getting the material to our facilities. Costs vary with transportation costs in general, which are related to petroleum prices and the supply and demand for over-the-road trucking services. Our cost of sourcing waste wood fiber has increased over the last three years due to increases in transportation costs, but remains a small proportion of our total costs. The housing slowdown starting in mid-2006 reduced the demand for hardwood building products and has caused some of our suppliers to temporarily close facilities, which has forced us to pay higher costs to source wood elsewhere. In addition, we now increasingly see competition for scrap wood fiber for use as a fuel to replace natural gas or oil burners for both residential and industrial applications.

Recycled Plastics. We use both post-industrial and 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 primarily 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. We also purchase plastic raw materials from outside sources, including virgin resin producers. These materials are more expensive and more sensitive to price swings related to the petrochemical industry. We also are subject to various quality and consistency problems when dealing with third party scrap suppliers, which increase our costs.

Our Watts, Oklahoma plastic recycling facility is designed to allow us to use the less desirable, but lower cost, forms of waste polyethylene, which should greatly assist us in regaining a competitive advantage and maintaining a low cost structure. The recycling facility is based on a successful joint development project involving polyethylene film recovery with the Dow Chemical Company earlier in our history. We believe that further refinement of this

technology could lead to additional revenue opportunities beyond composite decking and building materials. The recycling facility commenced operations in February 2010.

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 auditor 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

During 2011, we temporarily increased our workforce by approximately 126. We then reduced our workforce by 102, leaving a net increase of 24 as we continued to restructure our operations to improve efficiencies and lower costs. At December 31, 2011, we employed 427 associates.

Available Information

We make available and free of charge 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 or furnished pursuant to Section 13(a) of the Securities Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Item 2. Properties.

We currently manufacture all of our composite products at extrusion facilities in Springdale, Arkansas. We also lease office space in Springdale, which is used as our corporate offices.

We suspended extrusion operations at our Junction, Texas facility in October 2007. We are currently evaluating the movement and transfer of the 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 commenced construction of an additional plastics recycling facility in September 2008. This facility commenced operations in February 2010, and is used to recycle lower grades of polyethylene plastic scrap in an effort to reduce our costs of recycled plastics and value added compounds. The facility also allows for potential sales of recycled plastics to third parties.

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

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PART II

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

The Company's shares ceased to be listed on the Nasdaq Capital Market on December 29, 2009, at which time the OTC Bulletin Board commenced providing quotes for the Company's shares, which continue to trade under the symbol AERT. As of December 31, 2011, there were approximately 1,417 holders of record of our Class A common stock and 4 holders of record of our Class B common stock. The closing price of our common stock was \$0.07 on December 30, 2011. 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, 2010 and 2011.

	High	Low
Fiscal 2010		
First Quarter	\$0.45	\$0.28
Second Quarter	0.49	0.36
Third Quarter	0.40	0.25
Fourth Quarter	0.37	0.15
Fiscal 2011		
First Quarter	0.24	0.16
Second Quarter	0.25	0.10
Third Quarter	0.18	0.10
Fourth Quarter	0.17	0.06

No repurchases of common stock took place during 2010 or 2011.

Equity Compensation Plan Information

The following table provides information as of December 31, 2011, regarding shares outstanding and available for issuance under our existing equity compensation plans.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average 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	525,000	\$ 1.62	1,540,673
Equity compensation plans not approved by security holders	-	-	-

Total	525,000	\$ 1.62	1,540,673
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* The amount in this column represents the sum of restricted stock units available for grant or available to be issued.

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

2011 Summary

2011 continued to be a challenging year for the building materials industry and for AERT, marked by lower sales of our ChoiceDek® brand to BlueLinx due to a reduction in inventory carried by BlueLinx for Lowe’s.

Results of Operations

Two Year Comparison (in thousands)

	2010	2011	% Change
Net sales	\$ 69,819	\$59,259	(15.1 %)
Cost of goods sold	58,922	55,331	(6.1 %)
% of net sales			