

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC
Form 10-Q
August 06, 2014

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

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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
(Address of principal executive offices)

72764
(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES: NO:
Indicate by check mark whether the registrant 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 for such shorter period that the registrant was required to submit and post such files). YES: NO:

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 Exchange Act). Yes
 No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of July 31, 2014, the number of shares outstanding of the Registrant's Class A common stock, which is the class registered under the Securities Exchange Act of 1934, was 89,541,289. As of July 31, 2014, there were 89,873 outstanding shares of the Registrant's Class B Common Stock.

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

FORM 10-Q

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

BALANCE SHEETS

Unaudited
(in thousands)

	June 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash	\$ 117	\$ 124
Trade accounts receivable, net of allowance of \$61 and \$44 at June 30, 2014 and December 31, 2013, respectively	4,685	3,095
Accounts receivable - related party	57	55
Inventories	11,676	13,150
Prepaid expenses	1,890	522
Total current assets	18,425	16,946
Land, buildings and equipment:		
Land	2,220	2,220
Buildings and leasehold improvements	16,972	16,972
Machinery and equipment	48,617	47,479
Construction in progress	3,918	3,962
Total land, buildings and equipment	71,727	70,633
Less accumulated depreciation	43,623	41,808
Net land, buildings and equipment	28,104	28,825
Other assets:		
Debt issuance costs, net of accumulated amortization of \$819 and \$634 at June 30, 2014 and December 31, 2013, respectively	668	853
Other assets	380	380
Total other assets	1,048	1,233
Total assets	\$47,577	\$ 47,004

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

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

BALANCE SHEETS (continued)
Unaudited
(in thousands, except share and per share data)

	June 30, 2014	December 31, 2013
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable – trade	\$5,918	\$ 3,993
Accounts payable – related parties	147	13
Current maturities of long-term debt	2,071	1,209
Accruals related to expected settlement of class action lawsuit	-	133
Other accrued liabilities	3,191	3,859
Working capital line of credit	1,468	5,135
Total current liabilities	12,795	14,342
Long-term debt, less current maturities	35,643	34,972
Commitments and Contingencies (See Note 9)		
Series E cumulative convertible preferred stock, \$0.01 par value; 30,000 shares authorized, 20,524 shares issued and outstanding at June 30, 2014 and December 31, 2013, including accrued unpaid dividends of \$4,441 and \$3,709 at June, 2014 and December 31, 2013, respectively	24,965	24,233
Stockholders' deficit:		
Class A common stock, \$.01 par value; 525,000,000 shares authorized; 89,541,289 shares issued and outstanding at June 30, 2014 and 88,165,632 shares issued and outstanding at December 31, 2013	896	882
Class B convertible common stock, \$.01 par value; 7,500,000 shares authorized; 89,873 shares issued and outstanding at June 30, 2014 and 1,465,530 shares issued and outstanding at December 31, 2013	1	15
Additional paid-in capital	53,660	53,660
Accumulated deficit	(80,383)	(81,100)
Total stockholders' deficit	(25,826)	(26,543)
Total liabilities and stockholders' deficit	\$47,577	\$ 47,004

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

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

STATEMENTS OF OPERATIONS
(unaudited)
(in thousands, except share and per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Net sales	\$24,547	\$ 24,145	\$41,237	\$ 42,883
Cost of goods sold	18,501	18,026	33,043	31,991
Gross margin	6,046	6,119	8,194	10,892
Selling and administrative costs	2,859	3,028	6,010	6,095
Gain from asset disposition	(7)	-	(14)	(1)
Operating income	3,194	3,091	2,198	4,798
Other income and expenses:				
Other income	6	11	10	15
Gain from involuntary conversion of non-monetary assets due to fire	500	-	845	-
Other expense	(11)	-	(11)	-
Net interest expense	(804)	(725)	(1,593)	(1,448)
Net income	2,885	2,377	1,449	3,365
Dividends on preferred stock	(369)	(348)	(732)	(690)
Net income applicable to common stock	\$2,516	\$ 2,029	\$717	\$ 2,675
Income per share of common stock (basic and diluted)	\$0.01	\$ 0.01	\$0.00	\$ 0.01
Weighted average common shares outstanding (basic and diluted)	419,221,626	400,166,099	416,799,684	397,884,184

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

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Six months ended	
	June 30, 2014	June 30, 2013
Cash flows from operating activities:		
Net income applicable to common stock	\$717	\$ 2,675
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,023	2,676
Dividends on preferred stock	732	690
Accrued interest converted to long-term debt	1,264	1,154
Gain from asset disposition	(14)	(1)
Increase in accounts receivable allowance	17	8
Gain from involuntary conversion of non-monetary assets due to fire	(845)	-
Decrease in other assets	-	33
Changes in other current assets and current liabilities	1,176	(2,315)
Net cash provided by operating activities	5,070	4,920
Cash flows from investing activities:		
Purchases of land, buildings and equipment	(1,124)	(1,006)
Proceeds from assets disposition	21	8
Insurance proceeds from involuntary conversion of non-monetary assets due to fire	418	-
Net cash used in investing activities	(685)	(998)
Cash flows from financing activities:		
Payments on notes	(725)	(736)
Net payments on line of credit	(3,667)	(2,327)
Debt issuance costs	-	(32)
Net cash used in financing activities	(4,392)	(3,095)
Increase (decrease) in cash	(7)	827
Cash, beginning of period	124	346
Cash, end of period	\$117	\$ 1,173

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

NOTES TO FINANCIAL STATEMENTS
Unaudited

Note 1: Unaudited Information

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

Note 2: Description of the Company

AERT, founded in 1988, recycles polyethylene plastic and develops, manufactures, and markets composite building materials that are used in place of traditional wood or plastic products for exterior applications in building and remodeling homes and for certain other industrial or commercial building purposes. The Company's products are made primarily from approximately equal amounts of waste wood fiber, which have been cleaned, sized and reprocessed, and recycled polyethylene plastics which have been cleaned, processed, and reformulated utilizing our patented and proprietary technologies. Its products have been extensively tested, and are sold by leading national companies such as BlueLinx Corporation (BlueLinx), Lowe's Companies, Inc. (Lowe's) and Therma-Tru Corporation. The Company's products are primarily used in renovation and remodeling by consumers, homebuilders, and contractors as an exterior environmentally responsible building alternative for decking, railing, and trim products.

BlueLinx Corporation is the Company's primary distributor for its ChoiceDek® products, which are sold exclusively by Lowe's.

The Company currently manufactures all of its composite products at extrusion facilities in Springdale, Arkansas. The Company operates a plastic recycling, blending and storage facility in Lowell, Arkansas, where it also leases warehouses and land for inventory storage. AERT also maintains a facility at Watts, Oklahoma where it cleans, reformulates, and recycles polyethylene plastic scrap as a means to reduce the Company's costs of recycled plastics.

Note 3: Statements of Cash Flows

In order to determine net cash provided by operating activities, net income has been adjusted by, among other things, changes in current assets and current liabilities, excluding changes in cash, current maturities of long-term debt and current notes payable. Those changes, shown as an (increase) decrease in current assets and an increase (decrease) in current liabilities, are as follows (in thousands):

	Six Months Ended	
	June 30, 2014	June 30, 2013
Receivables	\$(1,182)	\$ (431)
Inventories	1,087	(828)
Prepaid expenses	13	236
Accounts payable - trade and related parties	2,059	246
Accrued liabilities	(801)	(1,538)
Change in current assets and liabilities	\$1,176	\$ (2,315)
Cash paid for interest	\$324	\$ 292

Supplemental Disclosures of Non-Cash Investing and Financing Activities (in thousands):

	Six Months Ended	
	June 30, 2014	June 30, 2013
Notes payable for financing insurance policies	\$994	\$ 727

Note 4: Significant Accounting Policies

Revenue Recognition Policy

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. Sales are recorded net of discounts, rebates and returns, which were \$1.8 million and \$1.5 million for the six months ended June 30, 2014 and 2013, respectively.

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

Shipping and Handling

The Company records shipping fees billed to customers in net sales and records the related expenses in cost of goods sold.

Inventories

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

	June 30, 2014	December 31, 2013
Raw materials	\$ 5,377	\$ 5,100
Work in process	1,706	2,337
Finished goods	4,593	5,713
Total inventory	\$ 11,676	\$ 13,150

Accounts Receivable

Accounts receivable are uncollateralized customer obligations due under normal trade terms generally requiring payment within thirty days from the invoice date. Trade accounts are stated at the amount management expects to collect from outstanding balances. Payments of accounts receivable are allocated to the specific invoices identified on the customers' remittance advice.

Accounts receivable are carried at original invoice amounts less an estimated reserve provided for returns and discounts based on a review of historical rates of returns and expected discounts. The carrying amount of accounts receivable is reduced, if needed, by a valuation allowance that reflects management's best estimate of the amounts that will not be collected. Management individually reviews all overdue accounts receivable balances and, based on an assessment of current creditworthiness, estimates the portion, if any, of the balance that will not be collected. Management provides for probable uncollectible amounts through a charge to earnings and a credit to an allowance account based on its assessment of the current status of the individual accounts. Balances which remain outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to trade accounts receivable. Recoveries of trade receivables previously written off are recorded when received.

Use of Estimates

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

Concentration Risk

Credit Risk

The Company's revenues are derived principally from national and regional building products distributors and BlueLinX, the Company's primary decking customer. The ChoiceDek® brand of decking products sold to BlueLinX are in turn sold exclusively to Lowe's. BlueLinX is also one of the Company's MoistureShield® decking customers. The Company extends unsecured credit to its customers. The Company's concentration in the building materials industry has the potential to impact its exposure to credit risk because changes in economic or other conditions in the construction industry may similarly affect the Company's customers. The Company derived most of its revenue from BlueLinX, its distributor of ChoiceDek® products.

Major Customers

The Company's revenues are derived principally from national and regional building products distributors. BlueLinx is the Company's largest single customer, distributing both the ChoiceDek® brand of decking products sold exclusively at Lowe's as well as the Company's MoistureShield® decking products in select geographies. For the six months ended June 30, 2014, BlueLinx represented more than 62% of the Company's revenue as compared to 70% for the same period in 2013. A loss of this customer, or a major reduction in their business, could cause a significant reduction in our liquidity. We are currently working to increase our distribution network that will reduce this customer's concentration.

The Company has significant customer concentration, with one customer representing more than 50% of our accounts receivable for the six months ended June 30, 2014 as compared to approximately 80% at December 31, 2013. A loss of this customer, or a major reduction in their business, could cause a significant reduction in our liquidity. We are currently working to expand our distribution network, which will reduce this customer's concentration.

Cash

The Company maintains bank accounts that are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. At times, cash balances may be in excess of the FDIC limit. The Company believes no significant concentrations of risk exist with respect to its cash.

Note 5: Income Taxes

As of June 30, 2014, the Company had net operating loss (NOL) carryforwards for federal income tax purposes, which are available to reduce future taxable income. If not utilized, the NOL carryforwards will expire between 2017 and 2031. In March 2011, H.I.G. AERT, LLC acquired a controlling interest in the Company, which resulted in a significant restriction on the utilization of the Company's net operating loss carryforwards. It is estimated that the utilization of future NOL carryforwards will be limited (per IRC 382) to approximately \$0.8 million per year for the next 18 years. The impact of this limitation is approximately \$27.0 million in NOL's, which will expire before the Company can use them. The estimated annual effective income tax rate for 2014 is 0% due to the use of net operating loss carryforwards.

As there is insufficient evidence that the Company will be able to generate adequate future taxable income to enable it to realize its net operating loss carryforwards prior to expiration, the Company maintains a valuation allowance to recognize its deferred tax assets only to the extent of its deferred tax liabilities.

Based upon a review of its income tax filing positions, the Company believes that its positions would be sustained upon an audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded. The Company recognizes interest related to income taxes as interest expense and recognizes penalties as operating expense.

The Company is subject to routine audits by various taxing jurisdictions. The examination by the Internal Revenue Service (the Service) of the Company's 2010 federal tax return yielded changes that did not affect the tax that was reported on the return; therefore, the Service has accepted the return. The Company is no longer subject to income tax examinations by taxing authorities for years before 2010, except in the States of California and Texas, for which the 2009 tax year is still subject to examination.

Note 6: Earnings Per Share

The Company utilizes the two-class method for computing and presenting earnings per share. The Company currently has two classes of common stock (the Common Stock) and one class of cumulative participating preferred stock, Series E (the Preferred Stock). Pursuant to the Series E Designation, holders of the Series E Preferred Stock are entitled to receive per share dividends equal to 6% per annum of the stated value of \$1,000 per share of Series E Preferred Stock when declared by the Company's Board of Directors. In addition, holders of the Series E Preferred Stock are entitled to participate in any dividends declared on shares of the Company's Common Stock on an as-converted basis. Therefore, the Preferred Stock is considered a participating security requiring the two-class method for the computation and presentation of net income per share – basic.

The two-class computation method for each period segregates basic earnings per common and participating share into two categories: distributed earnings per share (i.e., the Preferred Stock stated dividend) and undistributed earnings per share, which allocates earnings after subtracting the Preferred Stock dividend to the total of weighted average common shares outstanding plus equivalent converted common shares related to the Preferred Stock. Basic earnings per common and participating share exclude the effect of Common Stock equivalents, and are computed using the two-class computation method.

In computing diluted EPS, only potential common shares that are dilutive—those that reduce earnings per share or increase loss per share—are included. The exercise of options or conversion of convertible securities is not assumed if the result would be antidilutive, such as when a loss from continuing operations is reported. As a result, if there is a loss from continuing operations, diluted EPS would be computed in the same manner as basic EPS is computed, even if an entity has net income after adjusting for discontinued operations, an extraordinary item or the cumulative effect of an accounting change.

The following presents the two-class method for the three and six months ended June 30, 2014 and 2013:

BASIC AND DILUTED EARNINGS PER SHARE
(in thousands, except share and per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Net income applicable to common stock	2,516	2,029	717	2,675
Preferred stock dividend	369	348	732	690
Income before dividends	2,885	2,377	1,449	3,365
Per share information:				
Basic earnings per common and participating share:				
Distributed earnings per share:				
Common	\$0.00	\$0.00	\$0.00	\$0.00
Preferred	\$0.00	\$0.00	\$0.00	\$0.00
Earned, unpaid dividends per share:				
Preferred	\$17.98	\$16.94	\$35.69	\$33.62
Undistributed earnings per share:				
Common	\$0.01	\$0.01	\$0.00	\$0.01
Preferred	\$96.38	\$76.75	\$27.41	\$100.99
Total basic earnings per common and participating share:				
Common	\$0.01	\$0.01	\$0.00	\$0.01
Preferred	\$114.36	\$93.69	\$63.10	\$134.61
Basic weighted average common shares:				
Common weighted average number of shares	89,631,162	89,631,162	89,631,162	89,631,162
Participating preferred shares - if converted	329,590,464	310,534,937	327,168,522	308,253,022
Total weighted average number of shares	419,221,626	400,166,099	416,799,684	397,884,184
Total weighted average number of preferred shares	20,524	20,524	20,524	20,524

Note 7: Line of Credit

The Company has an \$8.0 million line of credit (Revolver) loan with the AloStar Bank of Commerce, subject to a reserve of \$1.0 million. Interest is assessed at the greater of (a) 1.0% (minimum) plus 4%, or (b) the LIBOR rate as shown in the Wall Street Journal on such day for United States dollar deposits for the one month delivery of funds in an amount approximately equal to the principal amount of the Revolver. If the LIBOR cannot be determined, the interest will be calculated using the prime lending rate plus 2%. Because LIBOR was less than 1% on June 30, 2014, the interest rate was determined to be 5%. The Revolver is secured by 85% of accounts receivable after a reduction for amounts owed by international customers. The Revolver is also secured by 60% of the eligible inventory or 85% of the net orderly liquidation value of the inventory. The Revolver at AloStar had a balance of \$1.5 million at June 30, 2014. The proceeds available to draw down on the Revolver at June 30, 2014 were \$5.5 million.

Note 8: Related Party Transactions

Advisory Services

The Company entered into an Advisory Services Agreement between H.I.G. Capital, L.L.C. and the Company (the Advisory Services Agreement) on March 18, 2011 that provides for an annual monitoring fee between \$250,000 and \$500,000 (the Monitoring Fee) and reimbursement of all other out of pocket fees and expenses incurred by H.I.G. Capital, L.L.C.

Note 9: Commitments and Contingencies

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

Class Action Lawsuits

The U.S. District Court, Western District of Washington (Seattle Division) approved a class action settlement in January 2009 related to a purported class action lawsuit seeking to recover on behalf of purchasers of ChoiceDek® composite decking for damages allegedly caused by mold and mildew stains on their decks. The settlement includes decking material purchased from January 1, 2004 through December 31, 2007, along with decking material purchased after December 31, 2007 that was manufactured before October 1, 2006, the date a mold inhibitor was introduced into the manufacturing process.

In 2008, the Company accrued an estimated \$2.9 million for resolving claims. In the third quarter of 2009, the Company increased its estimate of costs to be incurred in resolving claims under the settlement by \$5.1 million. The estimate was revised due to events that occurred and information that became available after the second quarter of 2009 concerning primarily the number of claims received. The deadline for submitting new claims has now passed. The claim resolution process had an annual net cost limitation to the Company of \$2.0 million. The claims resolution process is now completed.

Note 10: New Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP.

The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our financial statements and have not yet determined the method we will adopt the standard in 2017.

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

Three Months Ended June 30, 2014 Compared to Three Months Ended June 30, 2013

The following table sets forth selected information from our statements of operations (in thousands):

	Three Months Ended			% Change	%
	June 30, 2014	June 30, 2013			
Net sales	\$24,547	\$ 24,145		1.7	%
Cost of goods sold	18,501	18,026		2.6	%
% of net sales	75.4	74.7	%		
Gross margin	6,046	6,119		(1.2)	%
% of net sales	24.6	25.3	%		
Gain from asset disposition	(7)	-		*	
Selling and administrative costs	2,859	3,028		(5.6)	%
% of net sales	11.6	12.5	%		
Operating income	3,194	3,091		3.3	%
% of net sales	13.0	12.8	%		
Other income:					
Other income	6	11		(45.5)	%
Gain on involuntary conversion of non-monetary assets due to fire	500	-		*	
Other expense	(11)	-		*	
Net interest expense	(804)	(725)		10.9	%
Net income	2,885	2,377		21.4	%
% of net sales	11.8	9.8	%		
Dividends on preferred stock	(369)	(348)		6.0	%
Net income applicable to common stock	\$2,516	\$ 2,029		24.0	%
% of net sales	10.2	8.4	%		

*not meaningful as a percentage change

Net Sales

Second quarter 2014 sales were up \$0.4 million or 1.7% from second quarter 2013 due to increased sales of Original Equipment Manufacturers (OEM) and other non-decking products.

Cost of Goods Sold and Gross Margin

The total cost of goods sold for the second quarter of 2014 increased 2.6% from the second quarter of 2013, reflecting increased sales. As a percent of net sales, gross margin declined due to changes in the mix of products sold as OEM and other non-decking products generate lower gross margins.

Selling and Administrative Costs

Selling and administrative costs decreased 5.6% for the second quarter of 2014 as compared to the second quarter of 2013. The decrease was due primarily to lower payroll and related expenses.

Earnings

Operating income improved to \$3.2 million in the second quarter of 2014 from \$3.1 million in the second quarter of 2013 due to lower selling and administrative costs. A gain of \$0.5 million from involuntary conversion of non-monetary assets due to the July 2013 Springdale fire was recorded to recognize insurance proceeds. Interest costs increased 10.9% compared to the second quarter of 2013 largely due to increased borrowing on the line of credit.

Six Months Ended June 30, 2014 Compared to Six Months Ended June 30, 2013

The following table sets forth selected information from our statements of operations (in thousands):

	Six Months Ended		
	June 30, 2014	June 30, 2013	% Change
Net sales	\$41,237	\$ 42,883	(3.8 %)
Cost of goods sold	33,043	31,991	3.3 %
% of net sales	80.1 %	74.6 %	
Gross margin	8,194	10,892	(24.8 %)
% of net sales	19.9 %	25.4 %	
Gain from asset disposition	(14)	(1)	*
Selling and administrative costs	6,010	6,095	(1.4 %)
% of net sales	14.6 %	14.2 %	2.5 %
Operating income	2,198	4,798	(54.2 %)
% of net sales	5.3 %	11.2 %	
Other income:			
Other income	10	15	(33.3 %)
Gain on involuntary conversion of non-monetary assets due to fire	845	-	*
Other expense	(11)	-	*
Net interest expense	(1,593)	(1,448)	10.0 %
Net income	1,449	3,365	(56.9 %)
% of net sales	3.5 %	7.8 %	
Dividends on preferred stock	(732)	(690)	6.1 %
Net income applicable to common stock	\$717	\$ 2,675	(73.2 %)
% of net sales	1.7 %	6.2 %	

*not meaningful as a percentage change

Net Sales

Sales for the six months ended June 30, 2014 were down \$1.6 million or 3.8% from the same period in 2013. This was primarily due to decreased sales of ChoiceDek® caused by distributor inventory level reductions in the first quarter exacerbated by a late spring and inclement weather that depressed sales of both the MoistureShield® and ChoiceDek® lines offset by sales increases in the second quarter of OEM and other non-decking products.

Cost of Goods Sold and Gross Margin

Total cost of goods sold for the first six months of 2014 increased 3.3% over the same period in 2013. As a percent of sales, the cost of goods sold increased by 5.5 percentage points. While labor and overhead costs were up year-over-year, the primary cause of the cost increase and gross margin decline was a change in the relative customer and product mix.

Selling and Administrative Costs

Selling and administrative costs were down \$0.1 million in the first six months of 2014 compared to the first six months of 2013. The decrease was primarily due to reduced commissions and travel due to reduced sales.

Earnings

Operating income was down \$2.6 million for the six months ended June 30, 2014 as compared to the same period in 2013. The first quarter operating income was \$2.7 million below the 2013 first quarter because of increased labor and overhead. A gain of \$0.8 million from involuntary conversion of non-monetary assets was recorded due to the fires at the Springdale and Lowell plants in July 2013.

Interest costs were up 10.0% as a result of increased borrowing on the line of credit.

Liquidity and Capital Resources

AERT maintains a close working relationship with AloStar Bank of Commerce. The Revolver Loan is used to cover operating expenses as needed. At June 30, 2014, \$5.5 million was available for drawdown.

The Company plans to structure its operations to grow its business, improve its margins and generate net income for 2014 in order to maximize shareholder value. The Company is currently working to improve its liquidity by:

- Streamlining operations to increase efficiencies: The Company expects to make changes to certain operational processes in order to increase production.
- Seeking additional sources of revenue: The Company is pursuing additional distribution of its current product line and is introducing new products in order to increase its sales.

Cash Flows

Cash Flows from Operations

Cash provided by operations for the first six months of 2014 was \$5.1 million, an increase of \$0.1 million from the first six months of 2013. This change is primarily due to a net income reduction of \$2.0 million and a change in current assets and liabilities of \$3.5 million due to the following:

- Accounts receivable increased \$1.2 million in the first six months of 2014 as compared to an increase of \$0.4 million in the first six months of 2013. Increased insurance proceeds receivable and a change in customer mix accounted for this increase.
- First six months 2014 inventory levels decreased \$1.0 million compared to an increase of \$.8 million in the first six months of 2013. Due to production problems relating to the fire, production was down for the first six months of 2014.
-

Accounts payable increased \$2.0 million in 2014 compared to an increase of \$0.2 million in the first six months of 2013 due to increased purchases and better payment terms with vendors.

- Accrued liabilities decreased \$0.8 million the first six months of 2014 compared to a decrease of \$1.5 million in the first six months of 2013 due to the settlement of the remaining class action claims in 2013.

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

The Company has significant customer concentration, with one customer representing approximately 60% of our revenue. A loss of this customer, or a major reduction in their business, would cause a significant reduction in our liquidity. We are currently working to increase our distribution network, which will reduce this customer's concentration.

Cash Flows from Investing Activities

Cash used in investing activities in the first six months of 2014 was \$0.7 million compared to cash used in investing activities of \$1.0 million for the same period in 2013. This change was primarily due to insurance proceeds from the Lowell fire recovered in 2014.

Cash Flows from Financing Activities

Cash used in financing activities was \$4.4 million for the first six months of 2014 compared to cash used in financing activities of \$3.1 million in 2013. The change was primarily due to paying down the credit line \$3.7 million in the first six months of 2014 compared to paying down the credit line \$2.3 million the first six months of 2013.

Working Capital

At June 30, 2014, the Company had working capital of \$5.6 million compared to working capital of \$2.6 million at December 31, 2013. The increase in working capital was primarily due to a decrease in borrowing on the line of credit and a reduction of the accrual for the class action law suit.

Buildings and Equipment

Property additions and betterments include construction costs 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.

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.

For the six months ended June 30, 2014, the Company has determined that there were no events or circumstances indicating the carrying value may not be recoverable.

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.

Debt

Oklahoma Energy Program Loan

On July 14, 2010, the Company entered into a loan agreement with the Oklahoma Department of Commerce (ODOC) under award number 14215 SSEP09, whereby ODOC agreed to a 15-year, \$3.0 million loan to AERT at a fixed interest rate of 3.0%. The balance on the loan at June 30, 2014 was \$2.6 million.

H.I.G. Long Term Debt

In 2011, the Company consummated related recapitalization transactions (the Transactions) with H.I.G. AERT, LLC, an affiliate of H.I.G. Capital L.L.C. (H.I.G.). H.I.G. exchanged secured debt in the Company for a combination of new debt and equity. In exchange for \$6.9 million of additional new capital available to the Company, H.I.G. was issued:

1. a Series A Term Note in the aggregate principal amount of \$10,000,000,
2. a Series B Senior Term Note in the aggregate principal amount of \$9,000,000 (or such lesser amount as is actually borrowed thereunder), and
3. 20,524,149 shares of Series E Convertible Preferred Stock, par value \$0.01 per share, of the Company (the Series E Preferred Stock).

As a result, H.I.G. owns approximately 80% of the outstanding common equity securities of the Company on a fully diluted, as converted basis.

The Series A Note matures on March 17, 2017 and, at the Company's option, either (i) bears cash interest at 8.0% per annum or (ii) bears cash interest at 4.0% per annum, plus a rate of interest equal to 4.0% per annum payable in kind and added to the outstanding principal amount of the Series A Note (with the latter option only being available until March 17, 2013, after which time, the Series A Note will bear cash interest at 8.0% per annum). Payment of cash interest has been waived until January 1, 2015.

The Series B Note matures on March 17, 2017 and, at the Company's option, either (i) bears cash interest at 10.0% per annum or (ii) bears cash interest at 4.0% per annum, plus a rate of interest equal 6.0% per annum payable in kind and added to the outstanding principal amount of the Series B Term Note. The Series B Note ranks equally to the Series A Note. Payment of cash interest has been waived until January 1, 2015.

The Credit Agreement contains provisions requiring mandatory payments upon the Notes equal to 50% of the Company's "Excess Cash Flow" 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.

Debt Covenants

The Company's Revolver Loan with AloStar and the Company's Credit Agreement with H.I.G. contain covenant restrictions, as defined in the respective agreements.

	June 30, 2014	Covenant	Compliance
AloStar			
Adjusted EBITDA	= \$6.2M	=>\$6.0M	Yes
Fixed Charge Coverage Ratio	= 1.9	> 1.10:1.00	Yes
Adjusted Consolidated EBITDA / Consolidated Fixed Charges			
Capital Expenditures	= \$1.1M	< \$4.5M*	Yes

HIG:

Adjusted EBITDA	= \$6.2M	=>\$9.0M	No, Waived
Fixed Charge Coverage Ratio	= 2.9	> 1.50:1.00	Yes
Adjusted Consolidated EBITDA / Consolidated Fixed Charges			
Leverage Ratio	= 6.35	= < 3.1:1.00	No, Waived
Consolidated Indebtedness / Consolidated EBITDA			
Capital Expenditures	= \$1.1M	< \$2.5M*	Yes

*2014 annual covenant

On July 15, 2014, H.I.G. AERT LLC, the holder of all of the issued and outstanding shares of Series E Convertible Preferred Stock, waived the Specified Events of Default as a result of AERT failing to have achieved a Leverage Ratio of below 3.1 to 1.0 for the four Fiscal Quarters ending June 30, 2014. H.I.G. AERT, LLC also waived the Specified Events of Default as a result of AERT having failed to attain required EBITDA of \$9.0 million. In addition, on July 15, 2014, H.I.G. AERT LLC waived its right to deliver a Triggering Event Redemption Notice on the Series E stock solely as a result of the Specified Events of Default.

Uncertainties, Issues and Risks

There are many factors that could adversely affect AERT's 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, 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, inability to obtain adequate financing (i.e. working capital), equipment breakdowns, low stock price, and fluctuations in quarterly performance.

Forward-Looking Information

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

The foregoing discussion contains certain estimates, predictions, projections and other forward-looking statements (within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934) that involve various risks and uncertainties. While these forward-looking statements, and any assumptions upon which they are based, are made in good faith and reflect management's current judgment regarding the direction of the business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, or other future performance suggested herein. Some important factors (but not necessarily all factors) that could affect the sales volumes, growth strategies, future profitability and operating results, or that otherwise could cause actual results to differ materially from those expressed in any forward-looking statement include the following: market, political or other forces affecting the pricing and availability of plastics and other raw materials; accidents or other unscheduled shutdowns affecting us, our suppliers' or our customers' plants, machinery, or equipment; competition from products and services offered by other enterprises; our ability to refinance short-term indebtedness; state and federal environmental, economic, safety and other policies and regulations, any changes therein, and any legal or regulatory delays or other factors beyond our control; execution of planned capital projects; weather conditions affecting our operations or the areas in which our products are marketed; adverse rulings, judgments, or settlements in litigation or other legal matters. We undertake no obligation to publicly release the result of any revisions to any such forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Item 4. Controls and Procedures.

Our Chief Executive Officer, Timothy D. Morrison, who is our principal executive officer, and our Chief Financial Officer, J. R. Brian Hanna, who is our principal financial and accounting officer, have reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of June 30, 2014. Based upon this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, as of June 30, 2014, the end of the period covered by this report, AERT's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by AERT in the reports that it files or submits under the Exchange Act and are effective in ensuring that information required to be disclosed by AERT in the reports that it files or submits under the Exchange Act is accumulated and communicated to AERT's management, including AERT's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

During the six months ended June 30, 2014, there have been no changes in our internal controls over financial reporting that have materially affected, or that are reasonably likely to materially affect, our internal controls over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings – (See Note 9: Commitments and Contingencies)

Item 6. Exhibits.

The exhibits listed in the accompanying Index to Exhibits are filed and incorporated by reference as part of this report.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ADVANCED ENVIRONMENTAL
RECYCLING TECHNOLOGIES, INC.

By: /s/ TIMOTHY D. MORRISON
Timothy D. Morrison,
Chief Executive Officer and Director
(principal executive officer)

/s/ J. R. BRIAN HANNA
J. R. Brian Hanna,
Chief Financial Officer & Principal
Accounting Officer

Date: August 6, 2014

INDEX TO EXHIBITS

- 10.1 Waiver of Default - H.I.G. Credit Agreement dated July 15, 2014**
- 10.2 Waiver of "Special Events Default" per Series A Term Loan Interest dated July 15, 2014**
- 10.3 Waiver of "Special Events Default" per Series E Convertible Preferred Stock Rights dated July 15, 2014**
- 31.1 Certification per Sarbanes-Oxley Act of 2002 (Section 302) by the Company's chief executive and principal executive officer**
- 31.2 Certification per Sarbanes-Oxley Act of 2002 (Section 302) by the Company's chief financial and principal accounting officer **
- 32.1 Certification per Sarbanes-Oxley Act of 2002 (Section 906) by the Company's chief executive and principal executive officer**
- 32.2 Certification per Sarbanes-Oxley Act of 2002 (Section 906) by the Company's chief financial and principal accounting officer**
- 101.IN XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document