

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC
Form 10-Q
May 08, 2015

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 March 31, 2015

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

Accelerated filer
Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of March 31, 2015, 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 89,631,162. As of March 31, 2015 there were no 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

(In thousands)

| | March 31, 2015 (unaudited) | December 31, 2014 |
|---|----------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash | \$ 110 | \$ 112 |
| Trade accounts receivable, net of allowance of \$53 and \$48 at March 31, 2015 and December 31, 2014, respectively | 2,996 | 4,346 |
| Accounts receivable - related party | 26 | 26 |
| Inventories | 17,828 | 14,316 |
| Prepaid expenses | 788 | 1,134 |
| Total current assets | 21,748 | 19,934 |
| Land, buildings and equipment: | | |
| Land | 2,220 | 2,220 |
| Buildings and leasehold improvements | 17,019 | 17,019 |
| Machinery and equipment | 52,787 | 52,267 |
| Construction in progress | 1,226 | 662 |
| Total land, buildings and equipment | 73,252 | 72,168 |
| Less accumulated depreciation | 45,879 | 45,080 |
| Net land, buildings and equipment | 27,373 | 27,088 |
| Other assets: | | |
| Debt issuance costs, net of accumulated amortization of \$1,097 and \$1,004 at March 31, 2015 and December 31, 2014, respectively | 390 | 483 |
| Other assets | 464 | 380 |
| Total other assets | 854 | 863 |
| Total assets | \$49,975 | \$47,885 |

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

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

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

| | March 31, 2015 (unaudited) | December 31, 2014 |
|--|----------------------------------|----------------------|
| Liabilities and Stockholders' Deficit | | |
| Current liabilities: | | |
| Accounts payable – trade | \$4,593 | \$4,559 |
| Accounts payable – related parties | 32 | 25 |
| Current maturities of long-term debt | 5,307 | 5,240 |
| Other accrued liabilities | 3,912 | 3,865 |
| Working capital line of credit | 7,159 | 3,625 |
| Total current liabilities | 21,003 | 17,314 |
| Long-term debt, less current maturities | 33,259 | 32,470 |
| 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 March 31, 2015 and December 31, 2014, including accrued unpaid dividends of \$5,605 and \$5,196 at March 31, 2015 and December 31, 2014, respectively | | |
| | 26,106 | 25,720 |
| Stockholders' deficit: | | |
| Class A common stock, \$.01 par value; 525,000,000 shares authorized; 89,631,162 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively | | |
| | 897 | 897 |
| Class B convertible common stock, \$.01 par value; 7,500,000 shares authorized; no shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively | | |
| | - | - |
| Additional paid-in capital | 53,660 | 53,660 |
| Accumulated deficit | (84,950) | (82,176) |
| Total stockholders' deficit | (30,393) | (27,619) |
| Total liabilities and stockholders' deficit | \$49,975 | \$47,885 |

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 | |
|---|--------------------|-------------------|
| | March 31, 2015 | March 31, 2014 |
| Net sales | \$12,194 | \$16,690 |
| Cost of goods sold | 10,711 | 14,542 |
| Gross margin | 1,483 | 2,148 |
| Selling and administrative costs | 3,036 | 3,151 |
| Gain from asset impairment and disposition | (1) | (7) |
| Operating loss | (1,552) | (996) |
| Other income and expenses: | | |
| Other income | 6 | 4 |
| Gain from involuntary conversion of non-monetary assets due to fire | - | 345 |
| Net interest expense | (842) | (789) |
| Net loss | (2,388) | (1,436) |
| Dividends on preferred stock | (386) | (363) |
| Net loss applicable to common stock | \$(2,774) | \$(1,799) |
| Loss per share of common stock (basic and diluted) | \$(0.03) | \$(0.02) |
| Weighted average common shares outstanding (basic and diluted) | 89,631,162 | 89,631,162 |

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

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

| | Three Months Ended | |
|---|--------------------|-------------------|
| | March 31, 2015 | March 31, 2014 |
| Cash flows from operating activities: | | |
| Net loss applicable to common stock | \$(2,774 |) \$(1,799 |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,157 | 1,013 |
| Dividends on preferred stock | 386 | 363 |
| Accrued interest converted to long-term debt | 684 | 625 |
| Gain from asset disposition | - | (7 |
| (Increase) decrease in accounts receivable allowance | 5 | (4 |
| Gain from involuntary conversion of non-monetary assets due to fire | - | (345 |
| Change in other assets | 16 | - |
| Changes in other current assets and current liabilities | (1,734 |) 842 |
| Net cash provided by (used in) operating activities | (2,260 |) 688 |
| Cash flows from investing activities: | | |
| Purchases of land, buildings and equipment | (783 |) (793 |
| Proceeds from disposition of assets | - | 11 |
| Insurance proceeds from involuntary conversion of non-monetary assets due to fire | - | 418 |
| Net cash used in investing activities | (783 |) (364 |
| Cash flows from financing activities: | | |
| Payments on notes | (493 |) (322 |
| Net borrowings on line of credit | 3,534 | 481 |
| Net cash provided by financing activities | 3,041 | 159 |
| Increase (decrease) in cash | (2 |) 483 |
| Cash, beginning of period | 112 | 124 |
| Cash, end of period | \$110 | \$607 |

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. Interim reports, however, are not necessarily indicative of results to be obtained for the full year.

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 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 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.

The Company, BlueLinx and Lowe's reached an agreement prior to the end of 2014 whereby AERT would sell, directly to Lowe's, ChoiceDek® product stocked by Lowe's stores and BlueLinx would continue to distribute ChoiceDek® special orders for certain parts of the country.

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. The Company 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):

| | Quarters ended | |
|--|-------------------|-------------------|
| | March 31, 2015 | March 31, 2014 |
| Receivables | \$1,349 | \$95 |
| Inventories | (3,512) | (317) |
| Prepaid expenses | 346 | (254) |
| Accounts payable - trade and related parties | 36 | 871 |
| Accrued liabilities | 47 | 447 |
| Change in current assets and liabilities | \$(1,734) | \$842 |
| Cash paid for interest | \$157 | \$165 |

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

| | Quarters ended | |
|---|----------------------------------|----------------------------------|
| | March 31, 2015 (unaudited) | March 31, 2014 (unaudited) |
| Notes payable for financing manufacturing equipment | 666 | - |

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 except sales to Lowe's, whose revenue is recognized when the product is received. Sales are recorded net of discounts, rebates and returns, which were \$0.8 million for the three months ended March 31, 2015 and March 31, 2014, 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):

| | March 31, 2015 | December 31, 2014 |
|-----------------|-------------------|----------------------|
| Raw materials | \$4,205 | \$5,083 |
| Work in process | 1,778 | 1,827 |
| Finished goods | 11,845 | 7,406 |
| Total inventory | \$17,828 | \$14,316 |

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. 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 has significant customer concentration, with one customer representing approximately 50% of our accounts receivable at March 31, 2015, as compared to another customer who represented approximately 80% at December 31, 2014.

Major Customers

For the three months ended March 31, 2015, Lowe's represented approximately 32% of the Company's revenue compared to 6% for the three months ended March 31, 2014. Our next leading customer, BlueLinx, accounted for 22% of the Company's revenue for the three months ended March 31, 2015 compared to 60% for the three months ended March 31, 2014. While, in prior years, AERT sold ChoiceDek® to its distributor, BlueLinx, under and hold agreement, in late 2014, AERT commenced selling directly to Lowe's. The result of this new arrangement created a customer concentration dilution.

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 March 31, 2015, 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 NOL 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 17 years. The impact of this limitation is approximately \$27.3 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 NOL carryforwards.

As there is insufficient evidence that the Company will be able to generate adequate future taxable income to enable it to realize its NOL 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 Company is no longer subject to income tax examinations by taxing authorities for years before 2011, except in the States of California, Colorado and Texas, for which the 2010 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). 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 or the cumulative effect of an accounting change.

The following presents the two-class method for the three months ended March 31, 2015 and 2014:

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

| | Quarters ended | |
|---|-------------------|-------------------|
| | March 31, 2015 | March 31, 2014 |
| Net loss applicable to common stock | \$(2,774) | \$(1,799) |
| Preferred stock dividend | 386 | 363 |
| Loss before dividends | \$(2,388) | \$(1,436) |
| Per share information: | | |
| Basic earnings per common and participating share: | | |
| Distributed losses per share: | | |
| Common | \$0.00 | \$0.00 |
| Preferred | \$0.00 | \$0.00 |
| Earned, unpaid dividends per share: | | |
| Preferred | \$18.80 | \$17.71 |
| Undistributed losses per share: | | |
| Common | \$(0.03) | \$(0.02) |
| Preferred | \$- | - |
| Total basic earnings (losses) per common and participating share: | | |
| Common | \$(0.03) | \$(0.02) |
| Preferred | \$18.80 | \$17.71 |
| Basic weighted average common shares: | | |
| Common weighted average number of shares | 89,631,162 | 89,631,162 |
| Participating preferred shares - if converted | - | - |
| Total weighted average number of shares | 89,631,162 | 89,631,162 |
| Total weighted average number of preferred shares | 20,524 | 20,524 |

Although not included in the basic earnings per share calculation under the two-class method, due to a period of loss, the Company had participating securities outstanding at March 31, 2015 and 2014. The following schedule presents these securities for the quarters ended March 31, 2015 and 2014.

| | 2015 | 2014 |
|--------------------------|-------------|-------------|
| Series E preferred stock | 348,074,930 | 327,950,710 |

Although these financial instruments were not included due to a period of loss for the three months ended March 31, 2015 and 2014, such financial instruments would need to be included with future calculations of basic EPS under the two-class method in periods of income.

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 March 31, 2015, the interest rate was determined to be 5%. The Revolver is secured by 85% of domestic and Canadian accounts receivable and by 60% of the eligible inventory or 85% of the net orderly liquidation value of the inventory.

On March 25, 2015, AloStar and AERT amended the terms of the Revolver Agreement to remove, for a 90-day period, the \$1.0 million reserve to the line of credit.

There were \$7.2 million outstanding borrowings on the Revolver at March 31, 2015. The proceeds available to draw down on the Revolver at March 31, 2015 were \$0.8 million.

Lowe's receivables are not included in the Borrowing Base Report effective March 20, 2015, as AERT will participate in the Lowe's Companies, Inc. Supply Chain Financing Program.

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.

Financing Agreement

Banc of America Leasing & Capital, LLC

In 2007, AERT entered into an operating lease with the LaSalle National Leasing Company (presently Banc of America Leasing & Capital, LLC). The equipment leased was identified as "Schedule 1 Equipment" and "Schedule 2 Equipment". The operating lease contained a provision for a fair market value buy out at the end of the lease. The lease for the "Schedule 1 Equipment" expired on December 31, 2014. On January 22, 2015, AERT entered into a new financing agreement with Banc of America Leasing & Capital, LLC (BOA). This agreement will finance the equipment buy out for the Schedule 1 Equipment. The terms of the new financing agreement are 18 monthly payments of \$39 thousand. Payments began on February 1, 2015 and will continue until July 1, 2016. The stated interest rate is 6%.

The Company's lease obligation for the Schedule 2 Equipment expired on March 31, 2015, at which time AERT entered into another financing agreement for the buyout of this equipment, the terms of which will be 16 equal installments of \$46 thousand beginning on April 1, 2015 and will continue until July 1, 2016. The stated interest rate is 6%.

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 transition method we will utilize upon adoption of the standard in 2017.

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

Three Months Ended March 31, 2015 Compared to Three Months Ended March 31, 2014

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

| | Three Months Ended | | | |
|---|--------------------|------------|----------|----|
| | March 31, | March 31, | % Change | |
| | 2015 | 2014 | | |
| Net sales | \$12,194 | \$16,690 | (26.9 | %) |
| Cost of goods sold | 10,711 | 14,542 | (26.3 | %) |
| % of net sales | 87.8 | % 87.1 | % | |
| Gross margin | 1,483 | 2,148 | (31.0 | %) |
| % of net sales | 12.2 | % 12.9 | % | |
| Gain from asset disposition | (1 |) (7 |) (85.7 | %) |
| Selling and administrative costs | 3,036 | 3,151 | (3.6 | %) |
| % of net sales | 24.9 | % 18.9 | % | |
| Operating loss | (1,552 |) (996 |) (55.8 | %) |
| % of net sales | (12.7 | %) (6.0 | %) | |
| Other income or (expense): | | | | |
| Other income | 6 | 4 | 50.0 | % |
| Gain on involuntary conversion of non-monetary assets due to fire | - | 345 | * | |
| Net interest expense | (842 |) (789 |) 6.7 | %) |
| Net loss | (2,388 |) (1,436 |) (66.3 | %) |
| % of net sales | (19.6 | %) (8.6 | %) | |
| Dividends on preferred stock | (386 |) (363 |) 6.3 | %) |
| Net loss applicable to common stock | \$(2,774 |) \$(1,799 |) (54.2 | %) |
| % of net sales | (22.7 | %) (10.8 | %) | |

*not meaningful as a percentage change

Net Sales

First quarter 2015 sales were down from 2014 as a result of the agreement reached prior to the end of 2014 whereby AERT commenced selling ChoiceDek® directly to Lowe's. While, in prior years AERT sold ChoiceDek® to its distributor, BlueLinx under a bill and hold agreement, in 2015, AERT built ChoiceDek® inventory in order to service Lowe's during the peak deck-building season.

Cost of Goods Sold and Gross Margin

The total cost of goods sold for the first quarter of 2015 decreased 26.3% from the first quarter of 2014 due to reduced sales. First quarter 2015 cost of goods sold as a percentage of net sales was slightly higher than the first quarter 2014 reflecting increased depreciation expense, repair and maintenance expense and property insurance costs. As a percentage of net sales, gross margin decreased 0.7 percentage points reflecting these cost increases not offset by price increases.

Selling and Administrative Costs

Selling and administrative costs decreased 3.6% for the first quarter of 2015 as compared to the first quarter of 2014. The decrease was due primarily to lower salaries and fringe benefits and lower selling expenses associated with a decrease in sales.

Earnings

Net loss increased by \$1.0 million for the first quarter of 2015 compared to first quarter 2014. This increase is primarily due to the timing of sales directly to Lowe's rather than scheduled sales to BlueLinx under the bill and hold agreement.

Interest costs increased 6.7% compared to the first quarter of 2014 largely due to increased payment in kind (PIK) interest on the H.I.G. Series A and Series B notes.

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.

The Revolver Loan with AloStar Bank of Commerce is used to cover operating expenses as needed. At March 31, 2015, \$0.8 million was available for drawdown.

The Company plans to structure its operations to grow its business, improve its margins and generate net income for 2015 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 productivity. These changes include the installation of equipment to reduce process material handling costs and manufacturing equipment that will improve yields. The Company is evaluating its existing recycling processes and new technology.
- Seeking additional sources of revenue: The Company is pursuing additional distribution of its current product lines with new distributors and is introducing new products, including deck lighting and aluminum railing systems, in order to increase its sales.

Cash Flows

Cash Flows from Operations

Cash used in operations for the first three months of 2015 was \$2.3 million, compared to cash provided by operating activities the first three months of 2014 of \$0.7 million. This change is primarily due to a change in current assets and liabilities. Accounts receivable decreased \$1.3 million primarily due to lower ChoiceDek® sales. Inventory increased \$3.5 million in anticipation of direct sales to Lowe's.

Changes to our revenue and cost of raw materials significantly impact the Company's liquidity. We are in the remodeling industry that may be cyclical and dependent on home prices. Our business is dependent upon the economy and we cannot accurately predict cyclical economic changes or the impact on consumer buying.

Cash Flows from Investing Activities

Cash used in investing activities in the first three months of 2015 was \$0.8 million compared to cash used in investing activities of \$0.4 million for the same period in 2014. This change was primarily due to the recording of insurance proceeds from involuntary conversion of assets due to the 2013 fire.

Cash Flows from Financing Activities

Cash provided by financing activities was \$3.0 million for the first three months of 2015 compared to cash provided by financing activities of \$0.2 million at March 31, 2014. The change was primarily due to increased borrowing on the line of credit to finance the inventory production in anticipation of seasonal sales to Lowe's.

Working Capital

In past years our ChoiceDek® distributors purchased product during the winter in order to be able to meet demand during the spring and summer deck-building season. The change from BlueLinx as distributor for ChoiceDek® product stocked by Lowe's resulted in a reduction of ChoiceDek® sales and an increase in AERT's ChoiceDek® inventory. This change is reflected in the working capital reduction by reduced trade receivables, increased inventory and increased borrowing.

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 quarter ended March 31, 2015, 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.

We are constantly searching for improvements and efficiencies to our production process and are exploring alternative recycling technology at the Lowell facility. Although no changes have been made or approved, any significant modifications to the process could potentially result in a future impairment of assets currently used in operations if the new technology is successfully implemented.

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 March 31, 2015 was \$2.5 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 April 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 to 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 April 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.

| | March 31, 2015 | Covenant | Compliance |
|---|----------------|-------------|------------|
| AloStar | | | |
| Adjusted EBITDA | = \$7.3M | =>\$6.0M | Yes |
| Fixed Charge Coverage Ratio | = 1.8 | > 1.10:1.00 | Yes |
| Adjusted Consolidated EBITDA / Consolidated Fixed Charges | | | |
| Capital Expenditures*,** | = \$0.8M | < \$2.7M | Yes |

HIG:

| | | | |
|---|----------|--------------|------------|
| Consolidated EBITDA | = \$7.3M | =>\$10.0M | No, Waived |
| Fixed Charge Coverage Ratio | = 1.8 | > 1.50:1.00 | Yes |
| Adjusted Consolidated EBITDA / Consolidated Fixed Charges | | | |
| Leverage Ratio | = 6.25 | = < 3.1:1.00 | No, Waived |
| Consolidated Indebtedness / Consolidated EBITDA | | | |
| Capital Expenditures** | = \$1.4M | < \$2.5M | Yes |

*Adjusted for financed capital expenditures

**Annual covenant for 2015

On April 13, 2015, 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 March 31, 2015. H.I.G. AERT, LLC also waived the Specified Events of Default as a result of AERT having failed to attain required EBITDA of \$10.0 million. In addition, on April 13, 2015, 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 o

beliefs concerning future events. Numerous assumptions, risks, and uncertainties could cause actual results to differ materially from the results discussed in the forward-looking statements. Prospective purchasers of our securities should carefully consider the information contained herein or in the documents incorporated herein by reference.

The foregoing discussion contains certain estimates, predictions, projections and other forward-looking statements (within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934) that involve various risks and uncertainties. While these forward-looking statements, and any assumptions upon which they are based, are made in good faith and reflect management's current judgment regarding the direction of the business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, or other future performance suggested herein. Some important factors (but not necessarily all factors) that could affect the sales volumes, growth strategies, future profitability and operating results, or 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 March 31, 2015. Based upon this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, as of March 31, 2015, 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 three months ended March 31, 2015, 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: May 8, 2015

INDEX TO EXHIBITS

| | |
|---------|---|
| 10.1 | Waiver of Default - H.I.G. Credit Agreement dated April 13, 2015** |
| 10.2 | Waiver of "Special Events Default" per Series A & B Term Loan Interest dated April 13, 2015** |
| 10.3 | Waiver of "Special Events Default" per Series E Convertible Preferred Stock Rights dated April 13, 2015** |
| 10.4 | Loan Agreement between AloStar Bank of Commerce and AERT dated November 15, 2012 (a) |
| 10.5 | Loan Modification Agreement between AloStar Bank of Commerce and AERT dated March 25, 2015** |
| 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 |

** Filed herewith

(a) Incorporated by reference to exhibits filed with Form 10-K for December 31, 2012 filed on March 13, 2013

