

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC

Form 10-K/A

April 13, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K/A**

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

For the fiscal year ended December 31, 2006

Commission file number 1-10367

Advanced Environmental Recycling Technologies, Inc.
(Exact name of Registrant as specified in its charter)

Delaware
(State of Incorporation)

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

**914 N Jefferson Street
Post Office Box 1237
Springdale, Arkansas**
(Address of principal executive offices)

72764
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Class A common stock, \$.01 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

On June 30, 2006, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity of the registrant was \$103,046,769 (for the purposes hereof, directors, executive officers and 10% or greater shareholders have been deemed affiliates).

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Number of shares of common stock outstanding at March 12, 2007: **Class A 44,812,956; Class B 1,465,530**

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our Definitive Proxy Statement for the 2007 Annual Meeting to be held June 14, 2007, and expected to be filed within 120 days of our fiscal year end, are incorporated by reference into Part III.

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Explanatory Note

Purpose of the re-filing is to modify certain certifications made by the officers of the company.

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Item 1. *Business.*

Summary

Advanced Environmental Recycling Technologies, Inc. (AERT) 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. Our products are made primarily from approximately equal amounts of waste wood fiber, which have been cleaned, sized and reprocessed, and recycled polyethylene plastics. Our products have been extensively tested, and are sold by leading national companies such as the Weyerhaeuser Company (Weyerhaeuser), Lowe's Companies, Inc. (Lowe's) and Therma-Tru Corporation. Since our inception in 1989, we have sold over \$454.5 million of products into the North American marketplace. Our composite building materials are marketed as a substitute for wood and plastic filler materials for standard door components, windowsills, brick mould, fascia board, decking and heavy industrial flooring under the trade names LifeCycle®, MoistureShield®, MoistureShield® CornerLoc®, Weyerhaeuser ChoiceDek® Premium, ChoiceDek® Premium Colors, MoistureShield® outdoor decking, and Basics™ outdoor decking. Weyerhaeuser ChoiceDek® products are available exclusively through Lowe's Home Improvement stores. We operate manufacturing facilities in Springdale, Lowell, and Tontitown, Arkansas; Junction, Texas and Alexandria, Louisiana. We also operate a warehouse and reload complex in Lowell, Arkansas. Operations will commence in the second quarter of 2007 at our third composite extrusion plant, which we refer to as Springdale South. Our customers are primarily regional and national door and window manufacturers, Weyerhaeuser our primary decking customer and regional building product distributors.

Products

Using the same basic process and material, we manufacture the following product lines:

Commercial and residential decking planks and accessories such as balusters and handrails (MoistureShield and Weyerhaeuser ChoiceDek),

Exterior door and window components,

Exterior housing trim (MoistureShield), and

Fence boards

The wood fiber content of our products gives them many properties similar to all-wood products, but we believe the plastic content makes our products superior to either all-wood or all-plastic alternatives because:

Unlike wood, our products do not require preservatives or treatment with toxic chemicals nor do they require yearly water sealing or staining.

Our products are less subject to thermal contraction or expansion and have greater dimensional stability than competing all-plastic products.

Our products are engineered for superior moisture-resistance and will not swell or expand like wood.

Our products can be designed and extruded through dies to a desired shape in accordance with customer specifications, which helps the customer to minimize waste.

Our products are less subject to rotting, cracking, warping, and splintering, insect infestation and water absorption than conventional wood materials.

Our products can be aesthetically enhanced to provide a wood-like or grained surface appearance.

When combined with our unique tie coat primer, the life of exterior paint can be greatly enhanced, thus creating a low-maintenance non-wood trim and fascia system designed to enhance and complement fiber cement siding.

Our products can be combined with coloring agents and/or other additives to provide different colors and aesthetics.

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AERT's composites manufacturing process involves proprietary technologies, certain of which are patented. We also use manufacturing equipment that has been custom-built or modified to our specifications. Our composite building material became a patented product in June 1998 under U.S. Patent No. 5,759,680.

Based upon our extensive product testing and successful extended field history of over a decade, we offer a limited lifetime replacement warranty on our products against rot and fungal decay, and termite and insect damage.

Marketing and Sales

General Market Strategy. We have manufactured wood plastic composite products since 1989. Our products are designed for applications where we can add the greatest value and address market needs, i.e. for external applications where wood is prone to rot and/or requires substantial yearly maintenance in the form of staining or water sealing. Though we believe there are many possible applications for our wood/plastic composite technology, we have focused our resources and personnel on outdoor decking, door and window components, and soon outdoor fencing, which in our view represent the most attractive market opportunities at this time. Within our chosen markets, we are constantly working to develop and improve strong customer relationships.

Outdoor Decking Systems. Beginning in 1995, we sold our decking products exclusively to Weyerhaeuser Building Materials. That changed in 2004 when we entered into a new contract whereby Weyerhaeuser purchased all of our ChoiceDek Premium decking products for resale exclusively to Lowe's Companies under the Weyerhaeuser ChoiceDek brand. The Weyerhaeuser contract required us to produce, and Weyerhaeuser to purchase, a minimum number of truckloads of ChoiceDek Premium decking and accessories, which amount was set by Weyerhaeuser each year subject to a minimum annual quantity of 1,850 truckloads. Terms have recently been reached with Weyerhaeuser on a new contract that will replace the 2004 contract. The new contract, which is substantially similar to the 2004 contract, is currently being circulated for signatures of all parties, including AERT's bondholders, who must approve. Both Weyerhaeuser and independent lumber dealers can also special order MoistureShield decking from the Weyerhaeuser distribution network in certain markets. Weyerhaeuser recently announced a new three year agreement to provide Lowe's the exclusive right to carry the ChoiceDek Premium product line, which Lowe's sells in all of its 1,300+ home improvement stores across the U.S. Weyerhaeuser and AERT were named Lowe's Vendor of the Year for lumber products in 2005. Lowe's promotes ChoiceDek Premium through a national print and advertising campaign and sponsorship of major sporting events such as the NCAA basketball Final Four tournament and NASCAR races. We believe our relationship with Weyerhaeuser strengthens our competitive position in the decking marketplace and gives us the opportunity to develop and sell new products through the same home improvement warehouse channel.

We promote our decking products through displays and presentations at national, regional, and local home, lawn, and garden shows, and through in-store displays. We have an on-going print advertising program that targets the residential decking market. Lowe's is also conducting a national print and television advertising campaign for ChoiceDek Premium.

Weyerhaeuser purchases accounted for about 81% of our 2006 gross sales. If Weyerhaeuser were to cancel the Weyerhaeuser contract, we would have to develop an alternative distribution system for decking products, which could be expensive and time consuming. Though Weyerhaeuser has purchased substantially all of our decking production since 1995, there is no assurance that it will continue to do so (see Item 1A. Risk Factors The loss of one or more of our key customers could cause a substantial reduction in our revenues and profits and Note 2 to the financial statements regarding concentration of risk).

In October 2004, we began production of our new MoistureShield brand line of decking products, which consists of four colors and a wood-like embossed surface pattern. MoistureShield decking is currently sold to select primary

distributors, who re-sell it to lumber dealers and contractor yards for sale to local deck builders and home builders. MoistureShield decking sales represented about 9% of total Company sales in 2006 and 2005, during which we had limited production capacity available to serve that market. In 2007 and beyond, the MoistureShield decking line will allow us to diversify our customer base. It also allows us to diversify the risk inherent in selling such a large portion of our production to one customer, Weyerhaeuser. It is our intent

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to grow the MoistureShield decking program as we identify opportune markets and that, over time, MoistureShield will become a larger portion of our sales.

In February 2007 we began manufacturing our new Basicstm line of outdoor decking. With smaller dimensions and a lower price point, Basics is designed to effectively compete against the largest segment of the outdoor decking market, pressure treated wood. Basics will initially be available through select independent building products distributors.

Total wholesale revenue from outdoor decking products (deck boards and handrail systems) was estimated by an independent industry research organization to be about \$5.1 billion in 2005 (most recent data available). Of that amount, about 19% was spent on wood/plastic composite products such as we manufacture. They estimate that annual unit sales of wood/plastic composite decking products grew about 25% per year from 2000 to 2005 and are expected to continue double digit annual growth for the foreseeable future. Most end-user sales are for remodeling jobs.

Privacy Fencing Systems. In January 2007, we announced our newest product, LifeCycletm Fencing. We estimate the privacy fence market to be \$5.5 billion annual sales with metal products comprising 63% of the market and wood/other products at 27%. We believe there is a substantial market for an aesthetically pleasing fence product that will serve for twenty years or more, which we expect LifeCycle Fencing to do. In fact, we intend to certify LifeCycle fencing for use in hurricane-prone regions of the U.S. where its strength and durability could give it a clear competitive advantage over other, less durable, fencing products. We plan to begin manufacturing LifeCycle fencing for limited introduction in the second quarter 2007.

Door and Window Products. We sell our MoistureShield industrial products to door and window manufacturers for use as component parts of their products. For example, we manufacture a windowsill that is built into products like Portrait windows by Stock Building Supply and we manufacture door rails built into doors by Therma-Tru Corporation. In marketing, we emphasize the value-added feature of the MoistureShield composite product, which, unlike competing wood products, can be engineered to incorporate certain desired end-product characteristics that save our customers time and expense. Customers also avoid the need for chemical treatments to their final product, which are otherwise often necessary to prevent rot and sustain durability. The durability of our MoistureShield composite components allows our customers to extend the lifetime or warranties of their products while reducing or eliminating warranty claims costs.

Therma-Tru and Stock Building Supply each purchase a large portion of our industrial products. The loss of either customer would negatively impact sales and earnings. We are unable to predict the future size of the markets for MoistureShield industrial products; however, we believe that the national door and window, commercial and residential trim, and residential decking material markets are large and growing and will allow us to diversify our customer base over time as we add production capacity and focus on additional opportunities.

Exterior Trim and Fascia Products. We market an exterior trim and fascia system under the trade names MoistureShield Trim and MoistureShield CornerLoc. Three national homebuilders are now specifying and using the product. With our previous limitations on production capacity and focus to meet the demand for our decking systems, we have limited our Trim and CornerLoc production to date. We believe this product line has significant growth potential, and we are striving to increase production capacity so that we can increase production and initiate a marketing program, in conjunction with our MoistureShield distributors. This product line is currently being redesigned. The timetable of a full product launch is dependent upon our construction and financing timetable and the start-up of our Springdale South manufacturing facility (see Item 2 Properties and Item 7 Liquidity and Capital Resources).

Sales and Customer Service. We provide sales support and customer service through our own marketing department, through outside commissioned representatives with an affiliated entity, through Weyerhaeuser, and through training

programs for our customers and their sales associates. Our in-house sales and customer support team is focused on serving commercial decking contractors and supporting the sales professionals at our regional building products distributor customers as well as Weyerhaeuser and Lowe's. Information and customer service are provided through the websites www.choicedek.com and www.moistureshield.com, and

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through a national toll-free customer assistance telephone number. We also use independent, outside sales representatives in some markets to serve door, window, and decking customers.

Cyclical Nature of Building Products Industry. Our products are used primarily in home improvement and new home construction. The home improvement and housing construction industries are subject to significant fluctuations in activity and periodic downturns caused by general economic conditions. High interest rates and economic uncertainty in particular can lead to reduced homebuilding and/or home improvement activity, such as since mid-2006. Reductions in such activity has an adverse effect on the demand for our products. We have focused a large portion of our business on the remodel and repair market segment, which we believe is less sensitive to interest rate fluctuations than the new homebuilding market.

Product Innovation. In our constant pursuit of satisfying our customers, and to keep up with changing trends in the marketplace, we routinely analyze the need to develop new products and improve existing products.

Raw Materials

Wood Fiber. The wood fiber we use is waste byproduct generated by hardwood furniture, cabinet, and flooring manufacturers. The cost of acquiring the waste wood has primarily been the handling and transportation costs involved in getting the material to our facilities. Costs vary with transportation costs in general, which are related to petroleum prices and the supply and demand for over-the-road trucking services. Our cost of sourcing waste wood fiber has increased over the last three years due to transportation costs, but remains a small proportion of our total costs. The housing slowdown starting in mid-2006 reduced the demand for hardwood building products and has caused some of our suppliers to temporarily close facilities, which has forced us to pay higher costs to source wood elsewhere.

Two suppliers accounted individually for about 40% and collectively for approximately 80% of our 2006 waste wood fiber purchases. Based on our discussions with other waste wood fiber suppliers, we believe that if the arrangements with one or both of these suppliers were terminated we would be able to obtain adequate supplies of waste wood fiber at an acceptable price from new suppliers. We are currently evaluating the feasibility of establishing an in-house wood fiber reclamation and cleaning system in northwest Arkansas.

Recycled Plastics. We use the following classes of industrial and consumer waste polyethylene:

Low density polyethylene (LDPE) poly coatings or linings from recycled bleached food-board, which are generated from the hydro-pulping process;

High density polyethylene (HDPE) and linear low density polyethylene (LLDPE) mixed plastic grocery bags from supermarket and store collection programs;

HDPE ground container material;

LLDPE stretch film from warehouses and packing waste; and

Virgin HDPE and LDPE pellets.

The largest portion of the materials we use is highly contaminated with paper and other non-plastic materials, which lessen its value to other plastic recyclers. Our proprietary recycling process does not require the purity, extensive cleaning, additional washing, and melt filtration required for conventional plastics manufacturing, and can be conducted faster and more economically. By using primarily these contaminated waste plastics, we produce a usable,

but lower cost, feedstock for our composite extrusion lines. We also purchase plastic raw materials from outside sources, including virgin resin producers. These materials are more expensive and more sensitive to price swings related to the petrochemical industry. We also are subject to various quality and consistency problems when dealing with third party scrap suppliers, which increases our costs.

One supplier accounted for about 34% of our 2006 polyethylene scrap purchases by weight. No other of our more than 100 polyethylene suppliers accounted for more than 10% of our purchases by weight.

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Over the last several years, we believe three factors have caused an increase in the demand for scrap polyethylene and, consequently, the cost to us of acquiring raw materials for our manufacturing process.

As world political events conspired to raise the price of petroleum there was a related rise in the price of virgin plastic, which is a petroleum and natural gas derivative. This in turn increased the demand for scrap plastics since scrap can be substituted for virgin plastics in many manufacturing applications. We thus began competing with scrap plastic consumers that had not previously been in the market.

The relative decline in the value of the dollar versus major Asian currencies has made it economical for Asian manufactures to source scrap plastic in the U.S. for use in their countries. We have thus encountered significant competition for scrap plastics from foreign consumers that had not previously been a factor in the market. Demand for petrochemical products from China, India and other rapidly expanding economies is expected to increase.

As annual sales of wood composite decking products have grown, we and other composite decking manufacturers have become relatively large consumers of scrap plastics, which has created increasing competition for raw materials and driven up prices.

On the other hand, we believe that the economics of recycling are now such that more private and public entities will find it attractive to undertake removing plastic scrap from the waste stream and make it available to consumers like us.

Supply Contracts. We purchase raw materials under both supply contracts and purchase orders. In 2006, we purchased 45% of our polyethylene scrap and all of our waste wood via purchase orders. Purchase order acquisitions are one-time transactions that involve no long-term obligation. We also have both polyethylene and wood supply contracts, with terms that range from one to three years, which obligate us to purchase materials. The prices under these contracts are renegotiated semi-annually or annually. In the past three years, the amounts we have been obligated to purchase under the supply contracts have been significantly less than the amounts of these materials we have needed for production.

Competition for Raw Materials. As the wood/plastic composites industry grows, we sometimes compete for raw materials with other plastic recyclers or plastic resin producers. We believe that our ability to use highly contaminated polyethylene limits the number of competitors because most recycling processes require cleaner waste plastic sources. Nonetheless, we expect to continue to encounter new entrants into the plastics reclamation business. These new entrants may have greater financial and other resources than we do, and may include domestic and foreign beverage bottlers, manufacturers, distributors and retailers, forestry product producers, petrochemical and other companies. We increased our capacity for processing waste plastic in 2006, which reduced our dependence on outside suppliers and reduces our overall costs but it is still not to desired levels. There is no assurance that we will be able to control the effect that increasing waste plastic costs has on our profitability. (see Item 7. Management's Discussion and Analysis Liquidity and Capital Resources.)

Patented and Proprietary Technology

Our composite manufacturing process and our development efforts in connection with waste plastics reclamation technologies involve patents and many trade secrets that we consider to be proprietary. We have also developed certain methods, processes, and equipment designs for which we have sought additional patent protection. We have taken measures to safeguard our trade secrets by, among other things, entering into confidentiality and nondisclosure agreements, and restricting access to our facilities. We also have installed advanced security systems, including limited access and cameras, at all facilities including on-site security personnel. Should our trade secrets be disclosed

notwithstanding these efforts, our business and prospects could be materially and adversely affected.

We have filed nineteen patent applications and have received issuance from the United States Patent and Trademark Office for fourteen patents, five of which relate to our composite materials manufacturing operations and product, and nine of which relate to waste plastics reclamation technologies. The patents cover our composite product, extrusion process and apparatus, our continuous down-stream cooling and forming

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conveyor system and our plastic reclamation process and equipment. The cost of patent protection and, in particular, patent litigation is extremely high. It can also strain resources and inhibit growth.

Industry Standards

Local building codes often require that building materials meet strength and safety standards developed by the International Code Commission and that, in order to qualify, the materials be evaluated by an independent testing organization. Our decking, handrails and stair applications are covered in a National Evaluation Report (NER) under NER-596, which provides local building inspectors and code officials with independent testing and installation information regarding our products. We believe that the NER listing has helped to increase sales and market acceptance of our decking products. We have recently renewed our building code listing and are currently in the process of upgrading and increasing the number of products covered for additional building code approval.

Regulation

AERT is subject to federal, state, and local environmental regulations. Environmental discharges and impacts from our manufacturing facilities including air, solid waste, and wastewater discharges must meet the standards set by environmental regulatory authorities in Texas, Arkansas, and Louisiana. Compliance with environmental laws has not had a material effect on our operating results or financial condition.

Our operations are also subject to workplace safety regulation by the U.S. Occupational Safety and Health Administration, and the states of Arkansas, Texas, and Louisiana. We provide safety awareness and training programs for all associates who work in a manufacturing environment.

Competition

Competition for Sales. Our products compete with high-grade western pine, cedar and other premium woods, aluminum, high-performance plastics, and an increasing number of composites and other construction materials. We believe that our products have superior physical characteristics, which make them a better value for the consumer. Manufacturers of some competing products, however, have long-established ties to the building and construction industry and have well-accepted products. Many of our competitors are larger and have research and development budgets, marketing staffs, and financial and other resources that surpass our resources.

Sales of non-wood decking products to date represent a small portion of the decking market. According to an independent research report the wood-alternative market share was 19% in 2005 and continues to grow. Pressure treated pine, cedar, redwood and other traditional woods constitute the vast majority of annual decking sales. We thus view wood decking as our principal competitor. The wood decking industry is highly segmented with many small to medium sized manufacturers. Wood decking is principally a commodity that competes as the low-priced product, whereas the more-expensive non-wood products must compete on features and performance.

Among manufacturers of alternative decking materials, we view Trex Company, TimberTech Ltd., Louisiana-Pacific Corporation, Tamko Building Products and Fiber Composites LLC as our primary competitors.

The market for door, windowsill, and trim products is highly segmented, with many competitors. We believe that our MoistureShield industrial products have superior characteristics and are competitively priced. We emphasize durability, which means that manufacturers and homebuilders using our products should see reduced warranty callbacks and higher customer satisfaction. Our product competes on durability and the ability of the customer to order a product that is custom manufactured to its specifications.

Employees

On December 31, 2006, we employed 664 people on a full-time basis. We had 60 associates at the Texas facility, of which four were executive and/or office personnel and 56 were full-time factory personnel. The

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Arkansas facilities, including our corporate office and field sales team, employed 578 full-time associates, of which 110 were executives and/or sales or office personnel and 468 were full-time factory personnel. We had 26 full-time associates at our Louisiana facility. From time-to-time, we hire part-time employees to supplement our workforce.

Item 1A. Risk Factors.

Our business is subject to a number of risks, including but not limited to the following:

We have a working capital deficit

At December 31, 2006, we had a working capital deficit of \$3,466,129 and at December 31, 2005, we had a working capital deficit of \$687,039. The working capital deficit is the result of losses from operations, our decision to finance capital projects with cash generated from operations, and our need to fund rapid growth in sales.

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

The largest component of our raw material costs is scrap polyethylene. The price that we must pay for these materials is related to the market prices of natural gas and petroleum, which have been rising and volatile in recent years. Our future profitability is contingent on us being able to manage raw material costs under these circumstances.

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

We could be materially adversely affected if we were to lose one or more of our large existing customers. Our principal customer for our decking material is Weyerhaeuser, which accounted for 81% and 77% of our sales in 2006 and 2005, respectively. A few large door and window construction companies have historically purchased substantially all of our industrial component products. A loss of any one of our large customers would adversely affect our sales and profitability.

If we are unable to comply with certain debt covenants, our financial position and operations could be adversely affected

The bond agreement contains financial covenants, which include a current ratio of not less than 1.00 to 1.00 and a requirement that not more than 10% of accounts payable be in excess of 75 days past the invoice date. We were not in compliance with these two covenants at December 31, 2006; however, these covenants were waived by the bondholder as of December 31, 2006 through, and including, December 31, 2007. There is no assurance that we will be able to comply with these debt covenants in the future, or that the bondholder will waive or modify the covenants in the future. If we are unable to comply with the covenants or obtain a waiver or modification of the covenants in the future, then the bond debt, currently in the amount of \$14.7 million, could immediately become due and payable, the bondholder could foreclose on the property used to secure the debt, and the bondholder could claim our revenues pledged as part of the bond agreement.

Restrictions regarding increased manufacturing capabilities could restrain our business growth

We increased our sales by \$10.5 million in 2006, \$23.7 million in 2005 and \$20.1 million in 2004. Our products have seen significant growth, and our customers have significant established expansion plans. Our primary customers and markets are large, and continued sales growth will require significant capital expenditures for additional production equipment and manufacturing facilities. Although our goal is to become the number one composite producer in North America, there is no assurance that we will be able to secure the necessary financing, attain the necessary operational execution, or that the equipment and facilities will become operational in a timely manner to meet that goal.

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Our growth is limited by the availability of human capital resources

Future profitable growth will require us to recruit and retain qualified associates. We compete with many larger companies in the labor market, many of whom offer more attractive compensation packages than we are able to economically provide. Though we have adopted equity compensation plans to aid in our efforts to recruit and retain qualified associates, the accounting treatment for those plans results in a reduction in our earnings.

Declines in construction activity may adversely affect our business

Our products are sold in the home improvement and new home construction markets. These markets are subject to significant fluctuations in activity and periodic downturns caused by general economic conditions, as has been the case since mid-2006. Slowdowns in construction activity have an adverse effect on the demand for our products.

Fire disruptions may adversely affect our business

Our raw materials and manufacturing processes involve a greater than average risk of fire loss or disruption. Through the Company's history, we have experienced several fires, some of which severely disrupted our manufacturing operations. There was an accidental fire at our Junction, Texas facility in March 2003, which caused substantial damage and temporarily shut down plant operations. Although we have increased security and increased fire protection equipment at our facilities, another major fire could occur and materially adversely affect our operations.

Covenants in our bond agreements could restrict our ability to borrow, which could impair the improvement and expansion of our operations

Certain covenants in our bond agreements restrict the types and amounts of additional indebtedness that we may incur, including a requirement that, with certain exceptions, we may only incur additional indebtedness to the extent it would satisfy a debt incurrence coverage ratio of 250% of income before interest, taxes, depreciation and amortization to debt service. Those restrictions could inhibit our ability to improve and expand our current operations. Additionally, our ability to secure adequate working capital to support our day-to-day operations as we grow could be limited by the covenants in our bond agreements.

Future sales of shares could be dilutive and impair our ability to raise capital

The conversion of a significant number of our outstanding derivative securities into Class A common stock could adversely affect the market price of the stock. At December 31, 2006, there were warrants outstanding for 4,606,132 shares of Class A common stock at an average exercise price of \$1.21, and options outstanding for 2,872,130 shares of Class A common stock at an average exercise price of \$1.09. The exercise or conversion of a material amount of such securities will result in a dilution in interest for our other security holders. The convertible securities, whether converted into stock or not, could impair our ability to obtain additional capital because of the potential for dilution. Also, the holders of such securities may be expected to exercise their rights at a time when we would in all likelihood be able to obtain needed capital through a new offering of our securities on terms more favorable than those provided by the outstanding securities.

Item 1B. *Unresolved Staff Comments.*

None.

Item 2. *Properties.*

We operate the following manufacturing and recycling facilities:

We manufacture our MoistureShield and Weyerhaeuser ChoiceDek brand lines of decking products at our Springdale, Arkansas extrusion plant. That facility also produces door, window, and housing trim components. Springdale had four extrusion lines and a plastic recycling facility throughout 2006. The Springdale plant

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consists of 103,000 square feet and is located on ten-acres with a rail siding in the Springdale industrial district. Since 1999, we have added 30,440 square feet of shed storage space and installed a dual sprinkler system.

We lease an office, storage building, and parking lot adjacent to the Springdale facility. The lease is renewable yearly. The office and storage facility is comprised of 10,000 square feet on 2.36 acres and houses our corporate offices.

Our Junction, Texas facility manufactures primarily Weyerhaeuser ChoiceDek and Basics decking products. A fire in March 2003 reduced production capacity for the rest of 2003, but production increased through 2003 and 2004 as fire damage was repaired. Full restoration was slowed by litigation with one of the insurance carriers responsible for paying for fire damage (see Item 3. Legal Proceedings). The Junction plant consists of a 49,000 square foot manufacturing and storage facility on a seven-acre site. We believe that the Junction facility is currently suitable for composite materials manufacturing requirements on a regional basis.

Our industrial products paint system and finishing operations are in a 50,000 square foot facility near Tontitown, Arkansas.

We operate a 45,000 square foot facility at Lowell, Arkansas, which is used for plastic recycling, blending, and storage, and includes a railroad loading/unloading spur, truck scale, receiving station, and finished goods storage.

We operate two 100,000 square foot warehouses in Lowell, Arkansas that are connected by rail spurs and are used for raw materials storage. We also operate a 125,000 square foot warehouse in the same complex, which is used for finished goods processing and distribution. We have signed a lease for a 150,000 square foot warehouse, also in the Lowell complex, which will be used for both raw material and finished goods handling. We also lease ten acres of land adjacent to our Lowell plastic plant for storage and load-out of finished goods; this operation is designed to load up to five railcars and ten trucks at a time.

We lease a 30,000 square foot raw materials warehouse in Springdale, about a mile from our main factory. That facility will be abandoned when the new warehouse at Lowell becomes available.

We lease plastic recycling equipment and factory space in Alexandria, Louisiana, which commenced operations in June 2003. The lease is for five years from June 2003 through June 2008. We have made improvements and installed additional equipment to increase the facility's throughput. The upgrades provide flexibility to economically process different types of scrap plastic and to provide plastic feedstock of a quality and consistency necessary to efficiently operate our extrusion facilities.

We have constructed a new extrusion factory just to the south of our existing Springdale plant. Startup has been delayed twice by faulty equipment supplied by vendors. We believe we can begin operating the first of Springdale South's planned four production lines in the second quarter of 2007, but there is no assurance that we will be able to meet our current schedule. We anticipate installing the other three lines over the course of the next two years, subject to continued growth in demand for our products, availability of financing or adequate cash flow.

Item 3. *Legal Proceedings.*

Lloyd's of London

We have been sued by certain underwriters at Lloyd's of London (Lloyd's) in connection with a settlement of our Junction, Texas fire claim. Lloyd's filed suit January 19, 2005 in the Circuit Court of Washington County, Arkansas initially claiming we had committed fraud in the submission of our claim for damages and seeking a court order declaring the Lloyd's policy void from the inception. Following extensive discovery and depositions, Lloyd's amended

the lawsuit and dropped the allegations of fraud and their request for an order declaring the policy void and filed an amended claim alleging we did not rebuild the facility exactly as it had existed prior to the March 2003 fire and also asking the court to decide what assets are part of the building and what assets are business property and to make certain declarations of coverage. The filing

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was unexpected by us because we cooperated fully with the claims underwriting process and believed that negotiations toward a final settlement of the claim were progressing.

We believe the Lloyd's lawsuit is without merit. We filed our initial counterclaim on January 24, 2005 denying all of Lloyd's allegations and seeking immediate and full reimbursement for rebuilding of the Junction plant. The counterclaim was subsequently amended and we were seeking not only to recover at least \$2.4 million in actual damages, including additional business disruption damages, but also punitive damages for acts of bad faith committed by Lloyd's in their initial handling of the claim.

The parties participated in an unsuccessful court-ordered mediation on March 13, 2006. A summary judgment hearing was conducted on June 27, 2006, following which the Court ruled our business disruption loss is limited to \$1.0 million, which reduces our current claim to \$1.5 million; however, the Court ordered we could present the bad faith claim we filed against Lloyd's to the jury and if we are successful the jury can award punitive damages over and above the \$1.5 million in actual damages. Trial has been set for August 6, 2007.

Advanced Control Solutions

On March 3, 2006, a Benton County Circuit Court jury found AERT liable for \$655,769 in damages to Advanced Control Solutions (ACS) for future business opportunities that ACS alleges it lost when AERT discontinued using ACS programming and electrical contractor services and for missing equipment. The jury found that AERT also interfered with certain non-compete provisions of an employment agreement between ACS and an employee by hiring the employee after he had been terminated by ACS in December 2003. The jury also awarded AERT judgment against ACS for approximately \$45,000 for ACS's failure to complete a programming contract. AERT has begun the appeal process at the Arkansas Supreme Court of Appeals, which we expect to take up to two years to resolve.

Other Matters

AERT is involved in other litigation arising from the normal course of business. In management's opinion, this litigation is not expected to materially impact the Company's results of operations or financial condition.

Item 4. *Submission of Matters to a Vote of Security Holders.*

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2006.

Table of Contents**PART II****Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***

Our Class A common stock is traded on the NASDAQ Capital Market System under the symbol **AERT**. As of March 12, 2007, there were approximately 1,600 holders of record of Class A common stock and 11 holders of record of Class B common stock. The price of our common stock was \$2.02 on December 31, 2006. We have not previously paid cash dividends on the common stock and there are currently restrictions under various debt obligations that would prevent the payment of such dividends for the foreseeable future. The following table sets forth the range of high and low quarterly sales prices (as reported by NASDAQ) of our Class A common stock for the years ended December 31, 2006 and 2005.

	High	Low
Sales Price Range of Class A Common Stock		
Fiscal 2005		
First Quarter	\$ 1.85	\$ 1.25
Second Quarter	1.59	1.21
Third Quarter	1.74	1.19
Fourth Quarter	1.79	1.25
Fiscal 2006		
First Quarter	2.56	1.58
Second Quarter	3.71	1.95
Third Quarter	3.32	2.10
Fourth Quarter	2.37	1.48

No repurchases of common stock took place during 2006.

Table of Contents**Item 6. Selected Financial Data.**

The following tables set forth selected historical data for the years ended December 31, 2002 through 2006, derived from our audited financial statements for each such year and should be read in conjunction with such financial statements and the footnotes attached thereto as well as the discussion contained herein in *Management's Discussion and Analysis of Financial Condition and Results of Operations*. Certain prior period amounts have been reclassified to conform to the current period presentation.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
Statements of Operations					
Data:					
Net sales	\$ 97,840,126	\$ 87,312,560	\$ 63,637,285	\$ 43,520,563	\$ 41,415,466
Income (loss) before extraordinary gain, accrued premium on preferred stock and income taxes					