TREX CO INC
Form 10-K
March 17, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2007

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number: 001-14649

Trex Company, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**54-1910453**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
160 Exeter Drive, Winchester, Virginia	**22603-8605**
(Address of principal executive offices)	**(Zip Code)**

(540) 542-6300

Registrant s telephone number, including area code:

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:	**Name of each exchange on which registered:**
Common Stock, par value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act:

None

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

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 þ

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 þ 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. þ

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.

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

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

The aggregate market value of the registrant s common equity held by non-affiliates of the registrant at June 29, 2007, which was the last business day of the registrant s most recently completed second fiscal quarter, was approximately $257.0 million based on the closing price of the common stock as reported on the New York Stock Exchange on such date and assuming, for purposes of this computation only, that the registrant s directors, executive officers and beneficial owners of 10% or more of the registrant s common stock are affiliates.

The number of shares of the registrant s common stock outstanding on March 10, 2008 was 15,179,003.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated by reference in this Form 10-K as indicated herein:

Document	**Part of 10-K into which incorporated**
Proxy Statement relating to Registrant s 2008 Annual Meeting of Stockholders	Part III

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NOTE ON FORWARD-LOOKING STATEMENTS

This report, including the information it incorporates by reference, contains 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. We intend our forward-looking statements to be covered by the safe harbor provisions for forward-looking statements in these sections. All statements regarding our expected financial position and operating results, our business strategy, our financing plans, forecasted demographic and economic trends relating to our industry and similar matters are forward-looking statements. These statements can sometimes be identified by our use of forward-looking words such as believe, may, will, anticipate, estimate, expect or intend. We cannot promise you that our expectations in such forward-looking statements will tu to be correct. Our actual results could be materially different from our expectations because of various factors, including the factors discussed under Risk Factors in this report.

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PART I

Some of the information contained in this report concerning the markets and industry in which we operate is derived from publicly available information and from industry sources. Although we believe that this publicly available information and the information provided by these industry sources are reliable, we have not independently verified the accuracy of any of this information.

Item 1. Business
General

Trex Company, Inc., which we sometimes refer to as the company in this report, is the country s largest manufacturer of wood-alternative decking, railing, fencing and trim products, which are marketed under the brand name Trex®. Our products provide the attractive appearance and the workability of wood without many of wood s on-going maintenance requirements and functional disadvantages. The majority of our products are made using a proprietary manufacturing process supported by patented technology that combines waste wood fibers and reclaimed polyethylene. Our products are used primarily for residential and commercial decking, railing, fencing and trim. We promote Trex products among consumers, homebuilders and contractors as a premium alternative to wood decking, railing, fencing, and trim products.

The large majority of our business is in decking and railing. In 2006, we introduced our first fencing product, Trex Seclusions®, in limited test markets. In 2007, we expanded distribution of this product in additional markets. In 2008, we plan to introduce Trex Escapes , an ultra-low maintenance cellular PVC deck board, and Trex Trim , a cellular PVC outdoor trim product. Our net sales of fencing and trim products were not material to our 2007 operating results.

We seek to achieve sales by converting demand for wood decking and railing products into demand for Trex products. Industry studies estimate that the wood segment of the decking and railing market represented approximately 81% of the market, as measured by linear feet of lumber, and 64% of the market, as measured by wholesale market value, in 2007. We intend to continue to develop and promote Trex as the premium outdoor living brand and to focus on the professionally-installed and do-it-yourself market segments.

At December 31, 2007, we sold our products through 90 wholesale distribution locations, which in turn sold our products to approximately 3,920 retail lumber outlets across the United States and Canada. In 2004, we began selling our products through Home Depot stores. At December 31, 2007, approximately 1,300 Home Depot stores stocked some Trex products, and all of our products were available through special order in all Home Depot stores. In 2007, we began selling our products through Lowe s stores. At December 31, 2007, approximately 1,290 Lowe s stores stocked some Trex products, and all of our products were available through special order in all Lowe s stores.

We are incorporated in Delaware. Our principal executive offices are located at 160 Exeter Drive, Winchester, Virginia 22603, and our telephone number at that address is (540) 542-6300.

Decking and Railing Market Overview

The decking and railing market is part of the substantial home improvement and repair market. According to Harvard University s Joint Center for Housing Studies, expenditures for homeowner remodeling activity totaled approximately $176 billion in 2007 compared to $178 billion in 2006.

Our primary market is residential decking and railing and, to a lesser extent, commercial decking and railing. An industry study estimates that factory sales of all residential decking and railing products for each year in the three-year period ended December 31, 2007 totaled approximately 3.3 billion linear feet of lumber, which represented approximately $4.3 billion of sales in 2007. The estimate includes sales of deck surface and railing products and excludes sales of products used for a deck s substructure, such as joists, stringers, beams and

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columns. For the same three-year period, the study estimates that factory sales of non-wood decking and railing products to the residential market increased by 12% from 555 to 622 million linear feet.

The demand for residential decking reflects the increasing popularity of decks as a means of extending living areas and providing outdoor recreation and entertainment spaces. Residential decking purchases include the installation of new and replacement decks for existing homes, construction of decks for new homes and repair of existing decks. An industry study estimates that approximately 4.1 million residential decks were built in 2007. The study forecasts that deck construction will grow at an annual rate of approximately 1% through 2010. We expect that deck repair, modernization and replacement will increase as existing decks age.

During periods of economic uncertainty, when spending on discretionary items is reduced, many homeowners forego the purchase of new homes and choose to improve their existing residences. Adding a deck has become one of the most popular home improvement projects. Construction of a deck is a relatively low-cost means of adding living space, and industry studies indicate that decking improvements generally return a significant percentage of their cost at the time of resale. We believe that, because residential deck construction is not primarily tied to new home activity, the residential decking and railing market historically has not experienced the high level of cyclicality common to businesses in the new home construction and building materials industries.

Approximately 80% of the lumber used in wood decks and railing is pressure-treated lumber, generally pine and fir, which is treated with chemicals to create resistance to insect infestation and decay. The balance of the wood-decking segment is primarily divided between redwood and cedar products. The 100% plastic decking and railing products segment utilizes polyethylene, fiberglass and polyvinyl chloride, or PVC, as raw materials. Wood/plastic composites are produced from a combination of waste wood fiber and polyethylene, polypropylene or PVC. Growing consumer awareness of the product attributes of non-wood decking alternatives and the decline in lumber quality and quantity have contributed to increased sales of wood/plastic composites and 100% plastic lumber for decking. Manufacturers of pressure-treated decking and railing materials, which are locally produced in hundreds of treating operations, typically sell these materials directly to lumber yards and home centers, which, in turn, supply the materials to homebuilders, contractors and homeowners.

Wood decking and railing products generally do not have consumer brands. The primary softwoods used for decking, which consist of treated southern yellow pine, treated fir, redwood and cedar, are sold as commodities graded according to classifications established by the U.S. Department of Commerce. Pricing is based on species, grade, size and level of chemical treatment, if any. There is generally no pricing differentiation based on brand, although some wood preservers have attempted to brand their treated wood products.

Privacy Fencing Market Overview

The market for our Trex Seclusions product is privacy fencing. The privacy fencing market is part of the $5.5 billion fencing market that includes wood (privacy, post and rail, split rail), chain link, ornamental metal, concrete, block, brick and stone fencing. Industry studies estimate that factory sales of the total fencing market have increased at a compound annual growth rate of approximately 6% over the ten-year period ended December 31, 2007, and that the market for plastic residential fencing materials will grow at a compound annual growth rate of over 6% for the next five years.

Privacy fencing is typically made from wood, vinyl or masonry and, to a lesser extent, metal. Manufacturers of fencing products sell to distributors and/or directly to installers, while lumber yards and home centers carry wood and vinyl fencing products to sell to contractors and homeowners. Homebuilders subcontract the installation of fencing to contractors.

Wood fencing products generally do not have consumer brands, although vinyl-fencing companies have had some success in branding products to the trade. Pricing for wood fencing is similar to that for wood decking, as described above. Vinyl fencing is priced based on color, quality of the profiles, and decorative options.

Exterior Trim Market Overview

The market for our TrexTrim product is primarily residential exterior trim. The North American market for materials used in residential exterior trim, mouldings and millwork was approximately $2.2 billion in 2007, with trim board materials accounting for about 80% of this market. Cellular PVC trim has experienced rapid growth and, due to its low maintenance and workability, has been the fastest growing material in the trim-board segment. In 2007, cellular PVC trim accounted for approximately 8% of the trim board market by volume. Only wood and engineered wood in 2007 had greater penetration of the trim board market, at approximately 74% and 13%, respectively, of the market volume. An industry study forecasts that cellular PVC trim will grow at a compound annual growth rate of 7% from January 2008 through December 2012, climbing to almost 10% of the trim board market on a volume basis.

Trim boards are typically made from wood, engineered wood, fiber cement, cellular PVC, and other plastics, including polypropylene, polyurethane and polystyrene foam. Using the same distribution channels as for decking and railing products, manufacturers of wood alternative trim materials sell the materials to distributors for sale to lumberyards or home centers, who, in turn, sell to home builders or remodelers.

Trim products generally do not have consumer brands, although one company has been successful in establishing its cellular PVC brand within the trade. Pricing for exterior trim products varies greatly and is based on substantially the same factors as pricing of decking, railing and fencing. Wood trim is significantly less expensive than alternative materials, but its life cycle cost is greater due to required maintenance and repair over time.

Growth Strategies

Our long-term goal is to perpetuate our position as the leading producer of branded superior wood-alternative outdoor living products by increasing our market share and expanding into new product categories and geographic markets. To attain these goals, we intend to employ the following long-term strategies:

- *Innovation*: Bring to the market new products, such as Trex Escapes and Trex Trim, that address unmet consumer and trade professional needs. Provide a compelling value proposition through ease of installation, low maintenance, long-term durability and superior aesthetics.

- *Brand*: Continue to build preference and commitment for the Trex brand with both the consumer and trade professional. Deliver on the brand s promise of superior quality, functionality, aesthetics and overall performance in the outdoor living space.

- *Channels*: Achieve comprehensive market segment and geographic coverage for Trex products by increasing the number of stocking dealers and retailers, thereby making our products available wherever our customers choose to purchase their decking, railing, fencing and trim products.

- *Quality*: Continuously advance the quality of all operational and business processes, with the goal of achieving superior product quality and service levels, thereby giving our company a sustainable competitive advantage.

- *Cost*: Through capital investments and process engineering, continuously seek to lower the cost to manufacture Trex products. Investments in plastic recycling capabilities will allow us to expand our ability to use a wider breadth of waste streams and, as a result, lower our raw material costs. We plan to concentrate on improving the productivity of our production process, from raw materials preparation through extrusion into finishing and packaging.

Products

We offer a comprehensive set of aesthetically durable, low maintenance product offerings in the decking, railing, fencing and trim categories. We believe that the range and variety of our product offerings allow consumers to design much of their outdoor living space using Trex brand products.

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The majority of our products are made in a proprietary process that combines waste wood fibers and reclaimed polyethylene. Our decking, railing, fencing and trim products are provided in a wide selection of popular sizes and lengths and are available with several finishes and/or numerous colors.

We have four decking product lines:

- Trex Contours®, which has a deep, wood grain surface;
- Trex Origins , which features a smooth surface;
- Trex Accents®, which offers a smooth surface on one side and subtle wood grain on the other; and
- Trex Brasilia®, which replicates the look of tropical hardwoods with a smooth surface and subtle, random color variations.

In 2008, we plan to introduce Trex Escapes, an ultra-low maintenance cellular PVC deck board; Trex Hideaway , a hidden fastening system for a specially grooved Brasilia board; and a new Trex Accents Fire Defense deck board that meets stringent new fire resistant requirements for certain areas of the Western United States.

Our two railing product lines are Trex Designer Series Railing® and Trex Artisan Series Railing®. Our Designer Series Railing system consists of a decorative top and bottom rail, refined balusters, our Trex RailPost , and post caps and skirts. In addition to its styling benefits for consumers, this railing is fast and easy to construct for contractors that use our TrexExpress assembly tool and system. The Designer railing is available in our smooth Trex Origins finish and color palette, as well as in the Trex Brasilia finish and colors. In 2005, we launched our newest railing line, Trex Artisan Series Railing. The styling and warm, white finish of this railing line make it appropriate for use with Trex decking products as well as other decking materials, which we believe will enhance the sales prospects of our railing business. This railing line is manufactured with Fibrex® material, which is a patented technology that we license from Andersen Corporation. We believe that this technology may enable us to develop other new product lines.

In 2006, we introduced our first fencing product line. Trex Seclusions consists of structural posts, bottom rail, interlocking pickets, top rail and decorative post caps. This system has been well received by fencing installers and provides the homeowner a superior combination of low maintenance, durability and premium aesthetics which are designed to complement the outdoor living experience provided by Trex decking and railing products.

In 2008, we plan to introduce TrexTrim as our initial offering in low maintenance residential exterior trim. TrexTrim is a cellular PVC trim product that offers exceptional workability, durability, visual appeal and a low level of required maintenance.

Trex products offer a number of significant aesthetic advantages over wood while eliminating many of wood s major functional disadvantages, which include warping, splitting and other damage from moisture. Our products require no staining, are resistant to moisture damage, provide a splinter-free surface and need no chemical treatment against rot or insect infestation. These features eliminate most of the on-going maintenance requirements for a wood deck and make Trex products less costly than wood over the life of the deck. Like wood, Trex products are slip-resistant (even when wet), can be painted or stained and are less vulnerable to damage from ultraviolet rays. Special characteristics (including resistance to splitting, the ability to bend, and ease and consistency of machining and finishing) facilitate deck, railing, fencing and trim installation, reduce contractor call-backs and afford customers a wide range of design options. Trex products do not have the tensile strength of wood and, as a result, are not used as primary structural members in posts, beams or columns used in a deck s substructure.

We have received product building code listings from the major U.S. and Canadian building code listing agencies for both our decking and railing systems. Our listings facilitate the acquisition of building permits by deck builders and promote consumer and industry acceptance of our products as an alternative to wood in decking. In addition, Trex Seclusions privacy fencing has passed the Miami/Dade County wind load testing, a widely regarded standard for assessing a fencing product s performance under extreme environmental conditions.

Sales and Marketing

At December 31, 2007, we had a dedicated sales team of approximately 70 professionals that works with all levels of our distribution system in the pull through sales of our products. We expect to expand our sales force as needed to support these efforts.

We have invested $66.4 million during the last three years to develop Trex as a recognized brand name in the residential and commercial decking and railing market. Our sales growth in the decking and railing market will largely depend on our success in converting demand for wood into demand for Trex products and on our long-term success in preserving our market share advantage over our many alternative decking and railing product competitors.

We have implemented a two-pronged marketing program directed at both consumers and trade professionals. We seek to develop brand awareness, preference and commitment among consumers, contractors and project designers to generate demand for Trex products among dealers and distributors. Our branding strategy promotes differentiation of Trex decking, railing and fencing products in markets that are not generally characterized by brand identification. This strategy enables us to command premium prices compared to wood, gain market share from wood and alternative decking, railing and fencing producers, and maintain more price stability for our products.

Our marketing program includes consumer and trade advertising, public relations, trade promotion, association with highly publicized showcase projects, and sales to influential home design groups. We actively invest in market research to monitor consumer brand awareness, preference and usage in the decking and railing market.

Distribution

In 2007, we generated the majority of our net sales through our wholesale distribution network by selling Trex products to 19 wholesale companies operating from 90 distribution locations. Our distributors, in turn, marketed our products to approximately 3,920 retail lumber outlets across the United States and Canada. Although our dealers sell to both homeowners and contractors, they primarily direct their sales at professional contractors, remodelers and homebuilders. We also began selling our products through Home Depot stores in 2004 and through Lowe s stores in 2007.

Wholesale Distributors. We believe that attracting wholesale distributors, who are committed to our products and marketing approach and can effectively sell higher value products to contractor-oriented lumber yards and other retail outlets, is important to our future growth. Our distributors are able to provide value-added service in marketing our products because they sell premium wood decking products and other innovative building materials that typically require product training and personal selling efforts.

Under our agreement with each wholesale distributor, we appoint the distributor on a non-exclusive basis to distribute Trex products within a specified area. The distributor generally purchases our products at prices in effect at the time we ship the product to the distributor. The distributor is required to maintain specified minimum inventories of our products. Upon the expiration of the initial one-year term, the wholesale distributor agreement is automatically renewed for additional one-year terms unless either party provides notice of termination at least 30 days before the expiration of any renewal term. Either party may terminate the agreement at any time upon 30 days notice, while we may also terminate the agreement immediately upon the occurrence of specified events.

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We require our wholesale distributors to devote significant resources to support our products and to demonstrate their ability to promote growth in the market share of Trex products. All wholesale distributors are required to appoint a Trex product specialist, regularly conduct dealer-training sessions, fund demonstration projects and participate in local advertising campaigns and home shows.

Of our 2007 gross sales, approximately 69% were made to the following five wholesale distributors: Boise Cascade Corporation, Parksite Plunkett-Webster, Oregon Pacific Corporation, Capital Lumber Company and Snavely Forest Products. Our gross sales to four of the five foregoing distributors in 2007 and to three of such distributors in 2006 exceeded 10% of our gross sales. Each of the foregoing distributors has multiple locations for the sale of Trex products. Each distributor agreement permits the parties either to add additional locations or remove certain locations without terminating the agreement.

On July 27, 2007, we advised one of our distributors identified above that we were terminating our distributor agreement with the distributor effective August 26, 2007. We took this action because the distributor advised us that it intended to carry a competitive product, which we believe would constitute a violation of the distributor agreement. In 2006, this distributor accounted for approximately 16% of our gross sales. We have retained new distributors to distribute our products in the affected territories previously serviced by the terminated distributor. Although the termination of this distributor may have had a short-term negative effect on sales in the affected service areas while we engaged replacement distributors, we do not believe that the termination will have a long-term negative impact on our net sales or operating performance.

We will add new distributors and increase the number of distributor locations as needed to support our growth in sales and retail dealers.

Retail Lumber Dealers. Of the approximately 25,000 retail outlets in the United States that sell lumber, approximately 5,000 are independent lumber yards that emphasize sales to contractors. Although there is demand for our products from both the do-it-yourself homeowner and contractor, our sales efforts historically have emphasized the contractor-installed market. Contractor-installed decks generally are larger installations with professional craftsmanship. Our retail dealers generally provide sales personnel trained in Trex products, contractor training, inventory commitment and point-of-sale display support.

Retail Building Material Specialty Dealers. Composite decking is increasingly being sold through dealers that specialize in specific product lines instead of general lumber sales. These dealers include roofing and siding supply companies. We are focusing more attention on these distribution channels as we seek to make our products available at any retail location where contractor, builder or homeowner customers choose to purchase their decking.

Home Depot and Lowe s. In 2004, we began selling our products through Home Depot stores. By the end of 2007, some Trex products were stocked in approximately 1,300 Home Depot stores, and all of our products were available through special order at all Home Depot stores. In 2007, we began selling our products through Lowe s stores. At December 31, 2007, approximately 1,290 Lowe s stores stocked some Trex products, and all of our products were available through special order in all Lowe s stores. Although Home Depot and Lowe s serve the contractor market, the largest part of their sales are to do-it-yourself homeowner customers that shop for their materials at Home Depot and Lowe s stores rather than at retail lumber dealers. We believe that brand exposure through Home Depot and Lowe s distribution promotes consumer acceptance and generates sales to contractors that purchase from independent dealers.

National Accounts. We employ a national account strategy to focus on corporate-level selling to retail chains, builders, trade associations and large municipalities. We believe that a focus on corporate-level selling to large organizations can effectively augment our field selling effort and generate additional sales for our existing distributor and dealer networks.

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Contractor/Dealer Locator Service and Web Site. We maintain a toll-free telephone service (1-800-BUY-TREX) for use by consumers and building professionals to locate the closest contractors and dealers offering Trex products and to obtain product information. We use these calls to generate sales leads for contractors, dealers, distributors and Trex sales representatives. We also analyze caller information to assess the effectiveness of our promotional and advertising activities. Our Internet corporate web site (*www.trex.com*) provides an additional source of information to consumers, dealers and distributors.

Contractor Training. We regularly provide training about Trex products to contractors. These contractors, referred to as TrexPros®, receive consumer referrals directly from our toll-free telephone service and are listed on our web site. At December 31, 2007, we had approximately 3,500 TrexPro contractors.

Shipment. We ship Trex products to distributors by truck and rail. Distributors typically pay shipping and delivery charges.

Manufacturing Process

Our products are manufactured at two sites. Our Winchester, Virginia site has floor space of approximately 265,000 square feet and had approximately $296 million of installed revenue-generating capacity at December 31, 2007. Our Fernley, Nevada site has floor space of approximately 250,000 square feet and had approximately $180 million of installed revenue-generating capacity at December 31, 2007. Our Olive Branch, Mississippi site has floor space of approximately 200,000 square feet and had approximately $68 million of installed revenue-generating capacity at December 31, 2007. In September 2007, we suspended operations at our Olive Branch facility for an indeterminate period and consolidated all of our manufacturing operations into our Winchester and Fernley sites.

Our total annual production capacity at December 31, 2007 was approximately $544 million sales value of finished product. At December 31, 2007, our construction in process totaled approximately $3.3 million. The construction in process consisted primarily of funds expended to complete production lines in various stages of construction at our manufacturing sites and to provide process and productivity improvements.

Trex products are primarily manufactured from waste wood fiber and reclaimed polyethylene, which we sometimes refer to as PE material in this report. The composition of Trex is approximately 50% waste wood fiber and 50% PE material. We use waste wood fiber purchased from woodworking factories, mills, and pallet and flooring recyclers. We recover PE material from a variety of sources, including distribution and shopping centers and retail chains.

Our primary manufacturing process involves mixing wood particles with plastic, heating and finally extruding, or forcing, the highly viscous and abrasive material through a profile die. We have many proprietary and skill-based advantages in this process.

Production of a non-wood decking alternative such as ours requires significant capital investment, special process know-how and time to develop. We have continuously invested the capital necessary to expand our manufacturing capacity and improve our manufacturing processes. We have obtained, and continue to seek, patents with respect to our manufacturing process. We have also broadened the range of raw materials that we can use to produce a consistent and high-quality finished product. We have centralized our research and development operations in the Trex Technical Center, a 30,000-square foot building adjacent to our Winchester, Virginia manufacturing facilities. In connection with our building code listings, we maintain a quality control testing program that is monitored by an independent inspection agency.

In 2005, we initiated company-wide training and implementation of Six Sigma practices and in 2006 began implementation of Standard Lean Manufacturing methodology within our plant operations. We have incorporated the use of these tools throughout our company in the planning and execution of those projects that are the most important to our success.

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Suppliers

The production of most of our products requires the supply of waste wood fiber and PE material. We purchased $18.7 million of waste wood fiber and $77.6 million of PE material in 2007, and $15.9 million of waste wood fiber and $103.0 million of PE material in 2006.

We fulfill requirements for raw materials under both purchase orders and supply contracts. In 2007, we purchased approximately one-third of our waste wood fiber requirements and approximately two-thirds of our PE material requirements under purchase orders, which do not involve long-term supply commitments. We also are a party to supply contracts that require us to purchase waste wood fiber and PE material for terms that range from one to eight years. The prices under these contracts are generally reset annually.

Our supply contracts have not had any material adverse effect on our business. In the past three years, the amounts we have been obligated to purchase under our PE material supply contracts and the minimum amounts we have been required to purchase under our wood supply contracts, with the exception of purchases for our Winchester site, generally have been less than the amounts of these materials we have needed for production. In 2007, our total commitments for wood supplies for one of our manufacturing sites exceeded its requirements. We sold the excess material to third parties at a loss which was not material.

Waste Wood Fiber. Woodworking plants or mills are our preferred suppliers of waste wood fiber because the waste wood fiber produced by these operations contains little contamination and is low in moisture. These facilities generate waste wood fiber as a byproduct of their manufacturing operations.

If the waste wood fiber meets our specifications, our waste wood fiber supply contracts generally require us to purchase at least a specified minimum and at most a specified maximum amount of waste wood fiber each year. Depending on our needs, the amount of waste wood fiber that we actually purchase within the specified range under any supply contract may vary significantly from year to year.

One supplier accounted for approximately one-third of our 2007 waste wood fiber purchases. Based on our discussions with waste wood fiber suppliers and our analysis of industry data, we believe that, if our contracts with this or with other current suppliers were terminated, we would be able to obtain adequate supplies of waste wood fiber at an acceptable cost from our other current suppliers or from new suppliers.

PE Material. The PE material we consumed in 2007 was primarily composed of recovered plastic bags and plastic film. Approximately two billion pounds of polyethylene resin are used in the manufacture of plastic bags and stretch film in the United States each year. We will continue to seek to meet our future needs for plastic from the expansion of our existing supply sources and the development of new sources, including post-industrial waste and plastic coatings. We believe our use of multiple sources provides us with a cost advantage and facilitates an environmentally responsible approach to our procurement of PE material.

Our ability to source and use a wide variety of PE material is important to our cost strategy. We maintain this ability through the continued expansion of our plastic reprocessing operations in combination with the advancement of our proprietary material preparation and extrusion processes. In 2007, we upgraded our capabilities in both areas by making significant investments in new processes to clean contaminants from our plastic supplies on a more cost-effective basis, as well as by upgrading our materials preparation and extrusion steps to facilitate the conversion of waste plastic into high-quality finished goods.

We own a 35% equity interest in a joint venture, called Denplax S.A., which operates a plant in El Ejido, Spain. Our joint venture partners are a local Spanish company responsible for public environmental programs in southern Spain and an Italian equipment manufacturer. The plant is designed to recycle waste polyethylene generated primarily from agricultural and post-consumer sources. The plant delivered approximately 7% of the total PE material we purchased during 2007. We have agreed to purchase up to approximately 12,300 metric tons of the plant s production in each year if the production meets material specifications.

To facilitate our PE material processing operations in 2006, we constructed our own plastic reprocessing plant on our manufacturing site in Winchester, Virginia.

One supplier provided approximately 14% of the PE material we purchased in 2007.

Competition

In decking, we compete with wood and other manufacturers of wood alternative decking products. Many of the conventional lumber suppliers with which we compete have established ties to the building and construction industry and have well-accepted products. In railing, we compete with wood and other manufacturers of composite, non-wood and plastic products, as well as with railings using metal, glass, vinyl and other materials. In privacy fencing, we compete with wood, vinyl and other manufacturers of composites. In trim, we compete against wood, engineered wood, fiber cement, and other manufacturers of cellular PVC and similar plastic products.

Our primary competition consists of wood products, which industry sources estimate accounted for approximately 81% of 2007 decking and railing sales, as measured by linear feet of lumber. These sources estimate that approximately 65% of the lumber used in wooden decks is pressure-treated lumber. Southern yellow pine and fir have a porosity that readily allows the chemicals used in the pressure treating process to be absorbed. The same porosity makes southern yellow pine susceptible to taking on moisture, which causes the lumber to warp, crack, splinter and expel fasteners. In addition to pine and fir, other segments of wood material for decking include redwood, cedar and tropical hardwoods, such as ipe, teak and mahogany. These products are often significantly more expensive than pressure-treated lumber, but do not eliminate many of the disadvantages of other wood products.

Industry studies indicate that we have the leading market share of the wood/plastic composite segment of the decking and railing market. We estimate that wood/plastic composites and plastic accounted for approximately 24% of 2007 decking and railing sales, as measured by wholesale market value. Our principal competitors in the wood/plastic composite decking and railing market include Advanced Environmental Recycling Technologies, Inc., Fiber Composites, LLC, Tamko Building Products, Inc., Timbertech Limited, and Universal Forest Products, Inc.

We also compete with decking products made from 100% plastic lumber that utilizes polyethylene, fiberglass and PVC as raw materials. Although there are several companies in the United States that manufacture 100% plastic lumber, industry studies estimate that this segment accounted for only approximately 1% of 2007 decking sales, as measured by wholesale market value. We believe a number of factors have limited the success of 100% plastic lumber manufacturers, including poor product aesthetics and physical properties not considered suitable for decking, such as higher thermal expansion and contraction and poor slip resistance. In 2008, we plan to introduce Trex Escapes, an ultra-low maintenance cellular PVC deck board, which we believe is superior, both in terms of product aesthetics and physical properties, to 100% plastic lumber products available in the market.

Our ability to compete depends, in part, on a number of factors outside our control, including the ability of our competitors to develop new non-wood decking and railing alternatives that are competitive with our products. We believe that the principal competitive factors in the decking and railing market include product quality, price, aesthetics, maintenance cost, distribution and brand strength. We believe we compete favorably with respect to these factors. We believe that our products offer aesthetic and cost advantages over the life of a deck when compared to other types of decking and railing materials. Although a contractor-installed deck built with Trex products in 2007 using a pressure-treated wood substructure generally costs more than a deck made entirely from pressure-treated wood, Trex products eliminate most of the on-going maintenance required for a pressure-treated deck and are, therefore, less costly over the life of the deck. We believe that our manufacturing process and utilization of relatively low-cost raw material sources provide us with a competitive cost advantage relative to other wood/plastic composite and 100% plastic decking products. The scale of our operations also confers cost efficiencies in manufacturing, sales and marketing.

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Government Regulation

We are subject to federal, state and local environmental regulation. The emissions of particulates and other substances from our manufacturing facilities must meet federal and state air quality standards implemented through air permits issued to us by the Department of Environmental Quality of the Commonwealth of Virginia, the Division of Environmental Protection of Nevada s Department of Conservation and Natural Resources and the Mississippi Department of Environmental Quality. Our facilities are regulated by federal and state laws governing the disposal of solid waste and by state and local permits and requirements with respect to wastewater and storm water discharge. Compliance with environmental laws and regulations has not had a material adverse effect on our business, operating results or financial condition.

Our operations also are subject to work place safety regulation by the U.S. Occupational Safety and Health Administration, the Commonwealth of Virginia, the State of Nevada and the State of Mississippi. Our compliance efforts include safety awareness and training programs for our production and maintenance employees.

Intellectual Property

Our success depends, in part, upon our intellectual property rights relating to our products, production processes and other operations. We rely upon a combination of trade secret, nondisclosure and other contractual arrangements, and patent, copyright and trademark laws, to protect our proprietary rights. We have made substantial investments in manufacturing process improvements that have enabled us to increase manufacturing line production rates, facilitated our development of new products, and produced improvements in our existing products dimensional consistency, surface texture and color uniformity.

Intellectual property rights may be challenged by third parties and may not exclude competitors from using the same or similar technologies, brands or works. We seek to secure effective rights for our intellectual property, but cannot provide assurance that third parties will not successfully challenge, or avoid infringing, our intellectual property rights.

We have obtained two patents for complementary methods of preparing the raw materials for the manufacturing phase of production, one patent on an apparatus for implementing one of the methods, and one patent on a tool for use with the installation of the decking board. We intend to maintain our existing patents in effect until they expire, beginning in 2015, as well as to seek additional patents as we consider appropriate. At December 31, 2007, we were pursuing four patent applications directed to an improved product, as well as two patent applications directed to accessories that may be used with the principal product and methods of using those accessories.

We consider our trademarks to be of material importance to our business plans. The U.S. Patent and Trademark Office has granted us federal registrations for many of our trademarks. Federal registration of trademarks is effective for as long as we continue to use the trademarks and renew their registrations. We do not generally register any of our copyrights with the U.S. Copyright Office, but rely on the protection afforded to such copyrights by the U.S. Copyright Act. That law provides protection to authors of original works, whether published or unpublished, and whether registered or unregistered. We enter into confidentiality agreements with our employees and limit access to and distribution of our proprietary information. If it is necessary to disclose proprietary information to third parties for business reasons, we require that such third parties sign a confidentiality agreement prior to any disclosure.

See Legal Proceedings in Item 3 of this report for information about a pending lawsuit involving intellectual property to which we are a party.

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Employees

At December 31, 2007, we had 756 full-time employees, approximately 570 of whom were employed in our manufacturing operations. Our employees are not covered by collective bargaining agreements. We believe that our relationships with our employees are good.

Executive Officers and Directors

The table below sets forth information concerning our executive officers, our CFO-designate and directors as of March 10, 2008. Effective on March 18, 2008, James E. Cline will succeed Anthony J. Cavanna as our Chief Financial Officer.

Name	Age	Positions with Company
Ronald W. Kaplan	56	President and Chief Executive Officer; Director
Anthony J. Cavanna	68	Chief Financial Officer; Director
James E. Cline	56	Vice President and Chief Financial Officer
William R. Gupp	48	Vice President and General Counsel
F. Timothy Reese	55	Vice President, Operations
Andrew U. Ferrari	61	Chairman
William F. Andrews	76	Director
Paul A. Brunner	72	Director
Jay M. Gratz	55	Director
William H. Martin, III	77	Director
Frank H. Merlotti, Jr.	57	Director
Patricia B. Robinson	55	Director

Ronald W. Kaplan has served as a director and President and Chief Executive Officer of the company since January 2008. From February 2006 through December 2007, Mr. Kaplan served as Chief Executive Officer of Continental Global Group, Inc., a manufacturer of bulk material handling systems. From July 2005 to February 2006, Mr. Kaplan was an independent consultant. From 1979 to July 2005, Mr. Kaplan was employed by Harsco Corporation, an international industrial services and products company, at which he served in a number of capacities, including as Senior Vice President-Operations, and, from 1994 through June 2005, as President of Harsco s Gas Technologies Group, which manufactures containment and control equipment for the global gas industry. Mr. Kaplan received a B.A. degree in economics from Alfred University and an M.B.A. degree from the Wharton School of Business, University of Pennsylvania.

Anthony J. Cavanna has served as a director of the company since September 1998 and as a non-employee interim Chief Financial Officer of the company since September 2007. Mr. Cavanna served as Chairman of the company from August 2005 through December 2007 and as Chief Executive Officer of the company from August 2005 through August 2007. From December 2003 through August 2005, Mr. Cavanna was retired. Before his retirement, Mr. Cavanna served as Executive Vice President and Chief Financial Officer of the company from September 1998 through December 2003, and of TREX Company, LLC, which was the company s wholly owned subsidiary until December 31, 2002, from August 1996 through December 2002. From 1962 to August 1996, Mr. Cavanna held a variety of positions with Mobil Chemical, including Group Vice President, Vice President-Planning and Finance, Vice President of Mobil Chemical and General Manager of its Films Division Worldwide, President and General Manager of Mobil Plastics Europe and Vice President-Planning and Supply of the Films Division. Mr. Cavanna currently serves as a director of Ultralife Batteries Co., Inc. and is a member of its Audit and Finance Committee, Acquisition Committee and Compensation Committee. Mr. Cavanna received a B.S. degree in chemical engineering from Villanova University and an M.S. degree in chemical engineering from the Polytechnic Institute of Brooklyn.

James E. Cline will serve as Vice President and Chief Financial Officer of the company effective on March 18, 2008. Mr. Cline served from July 2005 through December 2007 as the President of Harsco GasServ, a

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subsidiary of Harsco Corporation and a manufacturer of containment and control equipment for the global gas industry. From January 2008 through February 2008, in connection with the purchase of Harsco GasServ by Taylor-Wharton International LLC, which is owned by Windpoint Partners Company, Mr. Cline served as a consultant to the buyers by providing transition management and financial services. From April 1994 through June 2005, Mr. Cline served as the Vice President and Controller of Harsco GasServ. Mr. Cline served in various capacities with Huffy Corporation from June 1976 to February 1994, including as the Director of Finance of its True Temper Hardware subsidiary, a manufacturer of lawn care and construction products with nine manufacturing locations in the United States, Canada and Ireland. Mr. Cline received a B.S.B.A. degree in accounting from Bowling Green State University.

William R. Gupp has served as Vice President and General Counsel of the company since May 2001. From March 1993 to May 2001, Mr. Gupp was employed by Harsco Corporation, an international industrial services and products company, most recently as Senior Counsel and Director-Corporate Development. From August 1985 to March 1993, Mr. Gupp was employed by the law firm of Harter, Secrest & Emery. Mr. Gupp received a B.S. degree in accounting from Syracuse University and a J.D. from the University of Pennsylvania Law School.

F. Timothy Reese has served as Vice President, Operations of the company since February 2008. From March 2007 through January 2008, Mr. Reese served as Operations Director for the Americas Region of DuPont Teijin Films, a DuPont Teijin Films U.S. Limited Partnership and producer of polyester films. From 1979 to March 2007, Mr. Reese served in various positions with DuPont, including Global Director, Business and Integrated Operations, DuPont High Performance Films from November 1995 through November 1998; Director/Plant Manager, Global Operations, Cyrel® Packaging Graphics Products, from December 1998 through May 2000; Director, Global Operations and Six Sigma Champion, Cyrel® Packaging Graphics Products, from June 2000 through February 2001; and Director/Plant Manager in multiple assignments from March 2001 through February 2007, including in Corporate Operations, Human Resources and DuPont Chemical Solutions Enterprise. Mr. Reese served in the U.S. Navy and received a B.S. in ocean engineering with an emphasis on mechanical engineering from the U.S. Naval Academy.

Andrew U. Ferrari has served as a director of the company since September 1998 and as Chairman since January 2008. Mr. Ferrari served as Chief Executive Officer of the company from August 2007 through December 2007, and as President and Chief Operating Officer of the company from August 2005 through July 2007. From March 2003 through August 2005, Mr. Ferrari was a marketing and business development consultant. Mr. Ferrari served as Executive Vice President of Marketing and Business Development of the company from October 2001 through March 2003, and of TREX Company, LLC from October 2001 through December 2002. He served as Executive Vice President of Sales and Marketing of the company from September 1998 to October 2001 and of TREX Company, LLC from August 1996 to October 2001. From 1989 to 1996, Mr. Ferrari held various positions with Mobil Chemical, including Director of Sales and Marketing of the Composite Products Division, New Business Manager, and Marketing Director of the Consumer Products Division. Mr. Ferrari received a B.A. degree in economics from Whitman College and an M.B.A. degree from Columbia University.

William F. Andrews has served as a director of the company since April 1999. Mr. Andrews has served as Chairman of Corrections Corporation of America since August 2000, as Chairman of Katy Industries, Inc., a manufacturer of maintenance and electrical products, since October 2001, and as Chairman of the Singer Sewing Company, a manufacturer of sewing machines, since 2004. Mr. Andrews has been a Principal of Kohlberg & Company, a venture capital firm, since 1994, and served as Chairman of Allied Aerospace Company from 2000 to 2006. Prior to 2002, he served in various positions, including Chairman of Scovill Fasteners Inc.; Chairman of Northwestern Steel and Wire Company; Chairman of Schrader-Bridgeport International, Inc.; Chairman, President and Chief Executive Officer of Scovill Manufacturing Co., where he worked for over 28 years; Chairman and Chief Executive Officer of Amdura Corporation; Chairman of Utica Corporation; and Chairman, President and Chief Executive Officer of Singer Sewing Company. Mr. Andrews also serves as a director of Black Box Corporation and O Charley s Restaurants. Mr. Andrews received a B.S. degree in business administration from the University of Maryland and an M.B.A degree in marketing from Seton Hall University.

Paul A. Brunner has served as a director of the company since February 2003. Mr. Brunner is President and Chief Executive Officer of Spring Capital Inc., a merchant bank, which he founded in 1985. From 1982 to 1985, Mr. Brunner served as President and Chief Executive Officer of U.S. Operations of Asea-Brown Boveri, a multi-national Swiss manufacturer of high technology products. In 1967, he joined Crouse Hinds Company, a manufacturer of electronics and electronic equipment, and through 1982 held various positions with that company, including President and Chief Operating Officer, Executive Vice President of Operations, Vice President of Finance and Treasurer, and Director of Mergers and Acquisitions. From 1959 to 1967, he worked for Coopers & Lybrand, an international accounting firm, as an audit supervisor. Mr. Brunner is a Certified Public Accountant. He received a B.S. degree in accounting from the University of Buenos Aires and an M.B.A. degree in management from Syracuse University.

Jay M. Gratz has served as a director of the company since February 2007. Mr. Gratz is retired. From 1999 through October 2007, Mr. Gratz served as Executive Vice President and Chief Financial Officer of Ryerson Inc., a metals processor and distributor, and as President of Ryerson Coil Processing Division from November 2001 through October 2007. Mr. Gratz served as Vice President and Chief Financial Officer of Inland Steel Industries from 1994 through 1998 and served in various other positions, including Vice President of Finance, at that company since 1975. Mr. Gratz is a Certified Public Accountant. He received a B.A. degree in economics from the State University of New York in Buffalo and a Masters degree in management from Northwestern University Kellogg Graduate School of Management.

William H. Martin, III has served as a director of the company since April 1999. Mr. Martin served as Chairman of Martin Industries, Inc., a manufacturer and producer of gas space heaters, gas logs and pre-engineered fireplaces, from 1994 through 2003 and as a director of Martin Industries from 1974 to 1994. From 1987 to 1993, Mr. Martin served as Executive Assistant to the Rector of Trinity Church in New York City. From 1971 to 1987, he served as President and Chief Executive Officer of Martin Industries. Since 1993, Mr. Martin has been managing private investments and serving as a director of Aluma-Form, Inc., a manufacturer of components for electric utilities, and on the boards of several not-for-profit organizations. Mr. Martin is a graduate of Vanderbilt University.

Frank H. Merlotti, Jr. has served as a director of the company since February 2006. Since October 2006, Mr. Merlotti has served as President of Steelcase Design Group, the North American business unit of Steelcase, Inc., a manufacturer of office furniture and furniture systems, and served as President of Steelcase North America from September 2002 through September 2006. Mr. Merlotti served as President and Chief Executive Officer of G&T Industries, a manufacturer and distributor of fabricated foam and soft-surface materials for the marine, office furniture and commercial building industries, from August 1999 to September 2002. From 1991 through 1999, Mr. Merlotti served as President and Chief Executive Officer of Metropolitan Furniture Company, a Steelcase Design Partnership company. From 1985 through 1999, Mr. Merlotti served as General Manager of the Business Furniture Division of G&T Industries.

Patricia B. Robinson has served as a director of the company since November 2000. Ms. Robinson has been an independent consultant since 1999. From 1977 to 1998, Ms. Robinson served in a variety of positions with Mead Corporation, a forest products company, including President of Mead School and Office Products, Vice President of Corporate Strategy and Planning, President of Gilbert Paper, Plant Manager of a specialty machinery facility and Product Manager for new packaging product introductions. Ms. Robinson received a B.A. degree in economics from Duke University and an M.B.A. degree from the Darden School at the University of Virginia.

Web Sites and Additional Information

The SEC maintains an Internet web site at *www.sec.gov* that contains reports, proxy statements, and other information regarding our company. In addition, we maintain an Internet corporate web site at *www.trex.com*. We make available through our web site our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports, as soon as reasonably practicable after we electronically file or furnish such material with or to the SEC. We do not charge any fees to view, print or access these reports on our web site. The contents of our web site are not a part of this report.

Item 1A. Risk Factors

Our business is subject to a number of risks, including the following:

We will not be able to grow unless we increase market acceptance of our products and develop new products and applications.

Our ability to grow will depend largely on our success in converting the current demand for wood in decking, railing, fencing, and trim applications into a demand for Trex products. Industry studies estimate that wood products accounted for approximately 81% of the 2007 decking and railing market, as measured by linear feet of lumber. To increase our market share, we must overcome:

- the low consumer awareness of non-wood decking, railing, fencing and trim alternatives in general and Trex brand products in particular;
- the resistance of many consumers and contractors to change from well-established wood products;
- the greater initial expense of installing Trex decking, railing, fencing and trim;
- the established relationships existing between suppliers of wood decking, railing, fencing and trim products and contractors and homebuilders; and
- the increased competition from wood/plastic composite manufacturers.

Our business could suffer from a lack of product diversification.

In 2008, we will derive substantially all of our revenues from sales of Trex Wood-Polymer® lumber. Although we have developed new products and applications since beginning operation in 1996, and intend to continue this development, our product line is currently based almost exclusively on the composite formula and manufacturing process for Trex Wood-Polymer lumber. If we should experience any problems, real or perceived, with product quality or acceptance of Trex Wood-Polymer lumber, our lack of product diversification could have a significant adverse impact on our net sales levels.

Our prospects for sales growth and profitability will be adversely affected if we fail to maintain product quality and product performance at an acceptable cost.

We will be able to expand our net sales and to sustain and enhance profitable operations only if we succeed in maintaining the quality and performance of our products. If we should not be able to produce high-quality products at standard manufacturing rates and yields, unit costs may be higher. A lack of product performance would negatively affect our profitability by impeding acceptance of our products in the marketplace and by leading to higher product replacement and consumer relations expenses. In recent periods, we have experienced significant increases in product replacement and consumer relations expenses related to product quality and have increased our warranty reserve accordingly. Because the establishment of reserves is an inherently uncertain process involving estimates of the number of future claims and the cost to settle claims, our ultimate losses may exceed our warranty reserve. Future increases to the warranty reserve would have an adverse effect on our profitability in the periods in which we make such increases. The warranty reserve we established in the third quarter of 2007 and increased in the following quarter had a material adverse impact on our 2007 operating results.

Our dependence on three manufacturing sites to meet the demand for Trex products could limit our ability to meet customer demand.

We are able to produce our products at three manufacturing sites, although we do not currently utilize our Olive Branch, Mississippi facility. Any interruption in the operations or decrease in the production capacity at any of these sites, whether because of equipment failure, fire, natural disaster, labor difficulties or otherwise, would limit our ability to meet existing and future customer demand for our products.

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Our business is subject to risks in obtaining the raw materials we use.

The production of Trex Wood-Polymer requires substantial amounts of waste wood fiber and PE material. Our business could suffer from the termination of significant sources of raw materials, the payment of higher prices for raw materials or the failure to obtain sufficient additional raw materials to meet planned increases in production capacity. In 2007, one supplier accounted for approximately one-third of our waste wood fiber purchases. Our ability to obtain adequate supplies of PE material depends on our success in developing new sources that meet the minimum quality requirements, entering into long-term arrangements with suppliers and managing the collection of supplies from geographically dispersed distribution centers and off-shore resources. We generally obtain our raw materials under supply contracts at prices established annually based on then-current market prices or under purchase orders based on market rates in effect when the orders become effective. These supply arrangements subject us to risks associated with fluctuations in raw materials prices.

We have limited ability to control or project inventory build-ups in our distribution channel that can negatively affect our sales in subsequent periods.

The dynamic nature of our industry can result in substantial fluctuations in inventory levels of Trex products carried in our two-step distribution channel. We have limited ability to control or precisely project inventory build-ups, which can adversely affect our net sales levels in subsequent periods. We make the substantial majority of our sales to wholesale distributors, who, in turn, sell our products to local lumber yards. Because of the seasonal nature of the demand for decking, railing and fencing, our distribution channel partners must forecast demand for our products, place orders for the products, and maintain Trex product inventories in advance of the prime deck-building season, which generally occurs in our second and third fiscal quarters. Accordingly, our results for the second and third fiscal quarters are difficult to predict and past performance will not necessarily indicate future performance. Inventory levels respond to a number of changing conditions in our industry, including product price increases resulting from escalating raw materials costs, increases in the number of competitive producers and in the production capacity of those competitors, the rapid pace of product introduction and innovation, changes in the levels of home-building and remodeling expenditures, and weather-related demand fluctuations.

Our strategy of using recycled plastic and waste wood to create a competitive cost advantage involves significant risks.

Our business strategy is to create a substantial cost advantage over our competitors. To achieve such a cost advantage, we must recycle plastic and process waste wood on a cost-effective basis and efficiently convert these materials into high-quality finished goods. This strategy involves significant risks, including the risks that:

- Our profitability may be materially diminished. The intrinsic variability of our raw material sources can result in considerable reduction in our operating rates and yields, which may more than offset any savings we realize from the low purchase price of the materials.

- We may not produce a sustainable return on investment. Because our production model requires backward integration in plastic recycling operations, as well as customized solutions for material preparation, compounding and extrusion, our model is significantly more capital intensive on a per-unit-basis than the models of our typical competitors. Our plants must convert our raw materials at high rates and high net yields to generate the profit margins and cash flows necessary to sustain our business.

- We may be limited in the markets in which we can effectively compete. Successfully expanding our business beyond decking and railing requires applying our formulation and process technology to increasingly more challenging applications, such as fencing products. The greater complexity and tighter design tolerances of such profiles requires a level of process control than is more stringent than the level involved in deck and rail board production. Our raw materials and process technology may not permit us to develop new applications on a cost-effective basis.

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The demand for our products is influenced by general economic conditions and could be adversely affected by economic downturns.

The demand for our products is correlated to changes in the level of activity in home improvements and, to a lesser extent, new home construction. These activity levels, in turn, are affected by such factors as home equity values, home equity withdrawals, consumer spending habits, employment, interest rates and inflation. Market conditions in the housing industry have slowed significantly in recent periods, particularly in new home construction. Economic trends indicate that home equity values in many markets have softened and that home equity withdrawals have decreased, which may result in decreased home improvement spending. We cannot predict whether this trend will continue or worsen. Any economic downturn could reduce consumer income or equity capital available for spending on discretionary items such as decking, railing, fencing or trim, which could adversely affect the demand for our products.

Our performance will suffer if we do not compete effectively in the highly competitive decking, railing, fencing and trim markets.

We must compete with an increasing number of companies in the wood/plastic composites segment of the decking, railing, fencing and trim markets and with wood producers that currently have more production capacity than is required to meet the demand for such products. Our failure to compete successfully in such markets could have a material adverse effect on our ability to replace wood or increase the market share of wood/plastic composites compared to wood. Many of the conventional lumber suppliers with which we compete have established ties to the building and construction industry and have well-accepted products. Many of our competitors in the decking, railing, fencing and trim markets that sell wood products have significantly greater financial, technical and marketing resources than we do. Our ability to compete depends, in part, upon a number of factors outside our control, including the ability of our competitors to develop new non-wood alternatives that are competitive with Trex products.

We face risks in increasing our production levels to meet customer demand.

To support sales growth and improve customer service, we will face risks:

- recruiting and training additions to our workforce;
- installing and operating new production equipment;
- purchasing raw materials for increased production requirements; and
- maintaining product quality.

These risks could result in substantial unanticipated delays or expense, which could adversely affect our operating performance.

Past seasonal fluctuations in our net sales and quarterly operating results may not be a reliable indicator of future seasonal fluctuations.

Our historical seasonality may not be a reliable indicator of our future seasonality. Quarterly variations in our net sales and income from operations are principally attributable to seasonal trends in the demand for our products. We generally experience lower net sales levels during the fourth quarter, in which holidays and adverse weather conditions in some regions usually reduce the level of home improvement and new construction activity. Income from operations and net income tend to be lower in quarters with lower net sales, which are not fully offset by a corresponding reduction in expenses.

We have significant capital invested in property, plant and equipment that may become obsolete or impaired and result in a charge to our earnings.

At December 31, 2007, we had $193.9 million of net property, plant and equipment. The improvement we seek to make to our manufacturing processes sometimes involves the implementation of new technology and

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replacement of equipment at our manufacturing facilities, which may result in charges to our earnings if the existing equipment is not fully depreciated. Of our net property, plant and equipment at December 31, 2007, approximately $46.1 million is located at our Olive Branch, Mississippi manufacturing facility. We suspended manufacturing operations at the Olive Branch facility in the third quarter of 2007 for an indeterminate period. Changes in our plans regarding the future operation of the facility or the expected cash flows generated by the facility may result in impairment charges and reduce earnings.

Our substantial level of indebtedness could adversely affect our financial health and ability to compete.

As of December 31, 2007, we had $134.0 million of total indebtedness. Our substantial level of indebtedness could have important consequences. For example, it may:

- increase our vulnerability to general adverse economic and industry conditions, including interest rate fluctuations, because a significant portion of our borrowings will continue to be at variable rates of interest;
- require us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures and other general corporate purposes;
- limit our ability to borrow additional funds to alleviate liquidity constraints, as a result of financial and other restrictive covenants in our indebtedness;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- place us at a competitive disadvantage relative to companies that have less indebtedness; and
- limit our ability to refinance our principal secured indebtedness.

In addition, our senior secured credit facility and bond reimbursement agreement impose operating and financial restrictions that limit our discretion on some business matters, which could make it more difficult for us to expand, finance our operations and engage in other business activities that may be in our interest. These restrictions limit our ability to:

- incur additional indebtedness and additional liens on our assets;
- engage in mergers or acquisitions or dispose of assets;
- enter into sale-leaseback transactions;
- pay dividends or make other distributions;
- voluntarily prepay other indebtedness;

- enter into transactions with affiliated persons;
- make investments; and
- change the nature of our business.

We may incur indebtedness in addition to our current indebtedness. Any additional indebtedness we may incur in the future could subject us to similar or even more restrictive conditions.

Our ability to refinance our indebtedness will depend on our ability in the future to generate cash flows from operations and to raise additional funds, including through the offering of equity or debt securities. We may not be able to generate sufficient cash flows from operations or to raise additional funds in amounts necessary for us to repay our indebtedness when such indebtedness becomes due and to meet our other cash needs.

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We will have to generate substantial operating cash flow to meet our obligations and maintain compliance under our debt obligations.

Our ability to make scheduled principal and interest payments on our real estate loans, convertible notes and bond loan agreement, borrow and repay amounts under our revolving credit facility and continue to comply with our loan covenants will depend primarily on our ability to generate substantial cash flow from operations. Our failure to comply with our loan covenants might cause our lenders to accelerate our repayment obligations under our credit facility or bond reimbursement agreement, which may be declared payable immediately based on a default and which could result in a cross-default under our $97.5 million principal amount of outstanding convertible notes. Our ability to borrow under our revolving credit facility is tied to a borrowing base that consists of specified receivables and inventory. To remain in compliance with our credit facility, real estate loans and bond reimbursement agreement, we must maintain specified financial ratios based on our levels of debt, capital, net worth, fixed charges, and earnings (excluding extraordinary gains and extraordinary non-cash losses) before interest, taxes, depreciation and amortization, all of which are subject to the risks of our business.

Our dependence on a small number of significant distributors makes us vulnerable to business interruptions involving these distributors.

Our total gross sales to our five largest wholesale distributors accounted for approximately 69% of our gross sales in 2007. Our contracts with these distributors are terminable by the distributors upon 30 days notice at any time during the contract term. A contract termination or significant decrease or interruption in business from any of our five largest distributors or any other significant distributor could cause a short-term disruption of our operations and adversely affect our operating results.

Environmental regulation exposes us to potential liability for response costs and damages to natural resources.

We are subject to federal, state and local environmental laws and regulations. The environmental laws and regulations applicable to our operations establish air quality standards for emissions from our manufacturing operations, govern the disposal of solid waste, and regulate wastewater and storm water discharge. As is the case with manufacturers in general, we may be held liable for response costs and damages to natural resources if a release or threat of release of hazardous materials occurs on or from our properties or any associated offsite disposal location, or if contamination from prior activities is discovered at any properties we own or operate.

We may not have adequate protection for the intellectual property rights on which our business depends.

Our success depends, in part, on our ability to protect our important intellectual property rights. The steps we have taken may not be adequate to deter misappropriation or unauthorized use of our proprietary information or to enable us to detect unauthorized use and take appropriate steps to enforce our intellectual property rights. We have obtained and continue to seek patents with respect to our manufacturing process and products. We or our predecessor company have been required in lawsuits to establish that our production processes and products do not infringe the patents of others. We also rely on a combination of trade secret, nondisclosure and other contractual arrangements, and copyright and trademark laws to protect our proprietary rights. We enter into confidentiality agreements with our employees and limit access to and distribution of our proprietary information, and if it is necessary to disclose proprietary information to third parties for business reasons, we require that such third parties sign a confidentiality agreement prior to any disclosure. However, these confidentiality agreements cannot guarantee there will not be disclosure or misappropriation of such proprietary information.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

We lease our corporate headquarters in Winchester, Virginia, which consists of approximately 40,000 square feet of office space, under a lease that expires in May 2011. In anticipation of relocating our corporate headquarters to Dulles, Virginia, we entered into a lease agreement in 2005, which expires in 2019. The Dulles lease agreement provides for our initial occupancy of 55,047 square feet of office space, which will increase during the lease term to 80,071 square feet. We reconsidered our decision to relocate our corporate headquarters in 2005 and decided not to move. As of January 10, 2008, we had executed subleases for the entire space we currently lease. The duration of the subleases, all of which include options to renew, vary from five to seven years. For a description of our financial reporting in connection with the Dulles lease agreement, see note 12 to our consolidated financial statements appearing elsewhere in this report.

We own approximately 74 contiguous acres of land in Winchester, Virginia and the buildings on this land. The site includes our original manufacturing facility, which contains approximately 115,000 square feet of space, our research and development technical facility, which contains approximately 30,000 square feet of space, a mixed-use building, which contains approximately 173,000 square feet of space, and an additional manufacturing facility, which contains approximately 150,000 square feet of space. We own the land and the manufacturing facility on the Fernley, Nevada site, which contains approximately 250,000 square feet of manufacturing space. Our Fernley site is located on approximately 37 acres, which includes outside open storage. We own approximately 102 acres of land in Olive Branch, Mississippi and the buildings on this land. The site contains four buildings with approximately 200,000 square feet for manufacturing and raw material handling operations. In September 2007, we suspended operations at our manufacturing facility in Olive Branch, Mississippi for an indeterminate period and consolidated all of our manufacturing operations into our other two sites.

We lease a total of approximately 875,000 square feet of storage warehouse space under leases with expiration dates ranging from 2008 to 2015. For information about these leases, see note 9 to our consolidated financial statements appearing elsewhere in this report.

The equipment and machinery we use in our operations consist principally of plastic and wood conveying and processing equipment. We own all of our manufacturing equipment. At December 31, 2007, we operated approximately 46 wood trailers and approximately 95 forklift trucks under operating leases. We also owned an additional 95 wood trailers and approximately eight forklift trucks.

We regularly evaluate the capacity of our various facilities and equipment and make capital investments to expand capacity where necessary. In 2007, we spent a total of $24.0 million on capital expenditures, primarily to make process and productivity improvements. We estimate that our capital expenditures in 2008 will be in the range of $10 to $15 million. We expect to use these expenditures principally to make process and productivity improvements.

Item 3. Legal Proceedings

On December 5, 2001, Ron Nystrom commenced an action against Trex Company in the United States District Court for the Eastern District of Virginia, Norfolk Division, alleging that the company s decking products infringed his patent. The company denied any liability and filed a counterclaim against the plaintiff for declaratory judgment and antitrust violations based upon patent misuse. The company sought a ruling that the plaintiff s patent is invalid, that the company does not infringe the patent, and that the company is entitled to monetary damages against the plaintiff. On October 17, 2002, the District Court issued a final judgment finding that the company does not infringe any of the plaintiff s patent claims and holding that certain of the plaintiff s patent claims are invalid. On October 4, 2006, the Court of Appeals affirmed the District Court s judgment dismissing the plaintiff s action against the company.

In connection with the foregoing patent litigation, on April 12, 2002, the company filed suit in the United States District Court, Eastern District of Virginia, Alexandria Division, against ExxonMobil Corporation. The

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suit sought to enforce an indemnity provision in the company s 1996 purchase agreement with Mobil Oil Corporation, pursuant to which the company acquired substantially all of the assets and assumed some of the liabilities of the Composite Products Division of Mobil Oil Corporation, the predecessor of ExxonMobil Corporation. In that agreement, Mobil agreed to indemnify the company for any losses, including reasonable legal fees, incurred by the company as a result of a patent infringement claim by Mr. Nystrom. ExxonMobil denied liability to indemnify the company for such losses. On December 10, 2002, the District Court entered summary judgment in favor of the company and ordered ExxonMobil to indemnify the company for all losses, including reasonable legal fees, arising out of the patent infringement claim by Mr. Nystrom and the company s lawsuit against ExxonMobil. On March 22, 2007, the company and ExxonMobil signed a settlement agreement settling the lawsuit pursuant to which ExxonMobil agreed to reimburse the company in the amount of $3.25 million, which represented a portion of the attorneys fees incurred by the company in connection with the Nystrom litigation and the lawsuit against ExxonMobil.

On October 16, 2006, Ron Nystrom commenced another lawsuit against the company, which also named Home Depot, Inc. and Snavely Forest Products, Inc. as defendants. Mr. Nystrom alleges that the company s Accents® product and other new products introduced after the commencement of the first action infringe his patent referred to above. On April 10, 2007, Mr. Nystrom made a motion to amend his complaint to allege also that the company s Contours® product infringes a second patent owned by him. The company believes that the claims in the original complaint and the amended complaint are without merit, and, in addition, are barred by the judgment and patent claim construction in the preceding action. The company has also asserted against Exxon-Mobil Corporation in connection with the second Nystrom lawsuit an indemnity claim pursuant to the 1996 purchase agreement referred to above. As part of their settlement agreement, the company and ExxonMobil have agreed that each party will bear a certain proportion of the cost of defense of the new Nystrom lawsuit.

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

There were no matters submitted to our security holders in the fourth quarter of 2007.

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PART II

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

Market for Common Stock

Our common stock has been listed on the New York Stock Exchange, or NYSE, under the symbol TWP since April 8, 1999. The table below shows the reported high and low sale prices of our common stock for each quarter during 2006 and 2007 as reported by the New York Stock Exchange:

2007		High	Low
First Quarter	...	$ 27.70	$ 21.13
Second Quarter		22.40	18.00
Third Quarter	...	20.91	10.36
Fourth Quarter	.	12.48	5.34

2006		High	Low
First Quarter		$ 32.10	$ 24.17
Second Quarter		31.41	24.79
Third Quarter	...	28.35	23.64
Fourth Quarter	.	26.42	20.52

Dividend Policy

We have never paid cash dividends on our common stock. We intend to retain future earnings, if any, to finance the development and expansion of our business and, therefore, do not anticipate paying any cash dividends on the common stock in the foreseeable future. Under the terms of our senior credit facility agreement, we may not pay cash dividends in any fiscal year in an amount that exceeds 50% of our consolidated net income, as calculated in accordance with our credit agreement, reported for the preceding fiscal year.

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Stockholder Return Performance Graph

The following graph and table show the cumulative total stockholder return on Trex Company s common stock for the last five fiscal years compared to the Russell 2000 Index and the Standard and Poor s 600 Building Products Index. The graph assumes $100 was invested on December 31, 2002 in (1) Trex Company common stock, (2) the Russell 2000 Index and (3) the S&P 600 Building Products Index, and assumes reinvestment of dividends and market capitalization weighting as of December 31, 2003, 2004, 2005, 2006 and 2007.

Comparison of Cumulative Total Return

Among Trex Company, Inc., Russell 2000 Index, and S&P 600 Building Products Index

	December 31, 2002	December 31, 2003	December 31, 2004	December 31, 2005	December 31, 2006	December 31, 2007
Trex Company	$ 100.00	$ 107.59	$ 148.56	$ 79.46	$ 64.84	$ 24.11
Russell 2000	$ 100.00	$ 147.25	$ 174.24	$ 182.18	$ 215.64	$ 212.26
S&P 600 BPI	$ 100.00	$ 147.01	$ 193.29	$ 221.13	$ 233.09	$ 204.16

Other Stockholder Matters

As of March 10, 2008, there were approximately 242 holders of record of our common stock.

In 2007, we submitted to the NYSE in a timely manner the annual certification that our Chief Executive Officer was not aware of any violation by us of the NYSE corporate governance listing standards.

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Item 6. Selected Financial Data

The following table presents selected financial data as of December 31, 2003, 2004, 2005, 2006 and 2007 and for each of the years in the five-year period ended December 31, 2007.

The selected financial data as of December 31, 2006 and 2007 and for each of the years in the three-year period ended December 31, 2007 are derived from our audited consolidated financial statements appearing elsewhere in this report.

The selected financial data as of December 31, 2003, 2004 and 2005 and for the years ended December 31, 2003 and 2004 are derived from our financial statements which have been audited.

The selected financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes thereto appearing elsewhere in this report.

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	Year Ended December 31, 2003	2004	2005	2006	2007
	(In thousands, except share and per share data)				
Statement of Operations Data:					
Net sales	$ 191,008	$ 253,628	$ 294,133	$ 336,956	$ 328,952
Cost of sales	107,110	150,793	213,897	257,671	289,529
Gross profit	83,898	102,835	80,236	79,285	39,423
Selling, general and administrative expenses	46,829	56,351	77,378	73,223	119,439
Income (loss) from operations	37,069	46,484	2,858	6,062	(80,016)
Interest expense, net	3,560	3,064	2,626	3,011	8,995
Income (loss) before income taxes	33,509	43,420	232	3,051	(89,011)
Provision (benefit) for income taxes	12,429	15,933	(2,019)	708	(13,099)
Net income (loss)	$ 21,080	$ 27,487	$ 2,251	$ 2,343	$ (75,912)
Basic earnings (loss) per share	$ 1.45	$ 1.88	$ 0.15	$ 0.16	$ (5.10)
Basic weighted average shares outstanding	14,522,092	14,636,959	14,769,799	14,829,832	14,884,174
Diluted earnings (loss) per share	$ 1.43	$ 1.85	$ 0.15	$ 0.16	$ (5.10)
Diluted weighted average shares outstanding	14,727,838	14,834,718	14,879,661	14,892,966	14,884,174
Cash Flow Data:					
Cash provided by (used in) operating activities	$ 5,617	$ 45,265	$ 11,234	$ (4,038)	$ (1,163)
Cash used in investing activities	(17,727)	(56,319)	(29,374)	(27,743)	(24,035)
Cash provided by (used in) financing activities	5,379	26,859	(4,432)	31,058	24,592
Other Data (unaudited):					
EBITDA (1)	$ 49,608	$ 60,197	$ 18,997	$ 26,324	$ (57,525)
Balance Sheet Data:					
Cash and cash equivalents and restricted cash	$ 8,162	$ 44,926	$ 1,395	$ 672	$ 66
Working capital	49,728	78,910	40,061	29,559	56,582
Total assets	210,391	286,772	285,714	352,317	328,726
Total debt	54,376	78,497	73,606	104,637	133,972
Total stockholder s equity	$ 127,297	$ 159,937	$ 164,708	$ 169,415	$ 94,027

(1) EBITDA represents net income before interest, income taxes, depreciation and amortization. EBITDA is not a measurement of financial performance under accounting principles generally accepted in the United States, or GAAP. The company has included data with respect to EBITDA because management evaluates and projects the performance of the company s business using several measures, including EBITDA. Management considers EBITDA to be an important supplemental indicator of the company s operating performance, particularly as compared to the operating performance of the company s competitors, because this measure eliminates many differences among companies in capitalization and tax structures, capital investment cycles and ages of related assets, as well as some recurring non-cash and non-operating charges to net income or loss. For these reasons, management believes that EBITDA provides important supplemental information to investors regarding the operating performance of the company and facilitates

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comparisons by investors between the operating performance of the company and the operating performance of its competitors. Management believes that consideration of EBITDA should be supplemental, because EBITDA has limitations as an analytical financial measure. These limitations include the following:

- EBITDA does not reflect the company s cash expenditures, or future requirements for capital expenditures, or contractual commitments;

- EBITDA does not reflect the interest expense, or the cash requirements necessary to service interest or principal payments, on the company s indebtedness;

- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and EBITDA does not reflect any cash requirements for such replacements;

- EBITDA does not reflect the effect of earnings or charges resulting from matters the company considers not to be indicative of its ongoing operations; and

- not all of the companies in the company s industry may calculate EBITDA in the same manner in which the company calculates EBITDA, which limits its usefulness as a comparative measure.

The company compensates for these limitations by relying primarily on its GAAP results to evaluate its operating performance and by considering independently the economic effects of the foregoing items that are not reflected in EBITDA. As a result of these limitations, EBITDA should not be considered as an alternative to net income (loss), as calculated in accordance with GAAP, as a measure of operating performance, nor should it be considered as an alternative to cash flows as a measure of liquidity. The following table sets forth, for the years indicated, a reconciliation of EBITDA to net income (loss):

	Year Ended December 31,				
	2003	2004	2005	2006	2007
			(In thousands)		
Net income (loss)	$ 21,080	$ 27,487	$ 2,251	$ 2,343	$ (75,912)
Plus interest expense, net	3,560	3,064	2,626	3,011	8,995
Plus income tax provision (benefit)	12,429	15,933	(2,019)	708	(13,099)
Plus depreciation and amortization	12,539	13,713	16,139	20,262	22,491
EBITDA	$ 49,608	$ 60,197	$ 18,997	$ 26,324	$ (57,525)

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

General. Management considers growth in net sales, gross margin, selling, general and administrative expenses, and net income as key indicators of our operating performance. Growth in net sales reflects consumer acceptance of composite decking, railing and fencing, the demand for Trex over competing products, the success of our branding strategy, the effectiveness of our distributors, and the strength of our dealer network and contractor franchise. Management emphasizes gross margin as a key measure of performance because it reflects the company s ability to price its products accurately and to manage effectively its manufacturing unit costs. Managing selling, general and administrative expenses is important to support profitable growth. The company s investment in research and development activities, which is included in selling, general and administrative expenses, enables it to enhance manufacturing operations, develop new products and analyze new technologies. Management considers net income to be a measure of the company s overall financial performance.

In recent years, the company has expanded its product offerings by introducing the Trex Accents, Trex Brasilia and Trex Contours decking product lines and the new Trex Designer Series Railing and Trex Artisan Series Railing products. Sales of the Trex Accents and Trex Contours products accounted for approximately 70% of total gross sales in 2007. Sales of Trex Brasilia and Trex railing products accounted for approximately 20% of total gross sales in 2007. Because Trex Brasilia and Trex railing products have a higher sales price per unit than our other products, the introduction of the new products into the sales mix has had a positive effect on our total net sales. The company expects that the demand for the Trex Brasilia, Trex Designer Series Railing and Trex Artisan Series Railing products will grow as a result of expanded marketing and merchandising efforts.

In 2006, the company introduced a fencing product, Trex Seclusions, in limited test markets. The company expects that the demand for Trex Seclusions will grow as fencing wholesalers and installers become more familiar with the product. In 2008, the company plans to introduce Trex Escapes, which is an ultra low-maintenance cellular PVC deck board, and Trex Trim, which is a cellular PVC outdoor trim product. Both of these products will be manufactured for the company by third-party manufacturers. Our net sales of fencing and trim products were not material to our 2007 operating results.

The management of raw material costs, the improvement of manufacturing performance and the enhancement of product quality constitute some of the company s principal operating objectives. During 2005 and 2006, manufacturing unit costs increased primarily because of higher costs for reclaimed polyethylene, or PE material, lower manufacturing plant utilization and incremental costs associated with the company s quality initiatives. During 2006 and 2007, the company applied a significant portion of its capital investments to the purchase and installation of PE material processing equipment. These investments have enabled the company to enhance the management of its cost of PE material and to improve its manufacturing performance. The new equipment has resulted in incremental monthly improvements in manufacturing efficiencies during the later part of 2007, a trend the company expects to continue into 2008.

The company continues to focus on product quality initiatives to enhance the appearance of the entire product line. These initiatives emphasize color consistency and other product specifications. Each manufacturing plant has added personnel to its inspection functions, and finished goods packaging has been redesigned to minimize damage to the product in transit. These quality initiatives have contributed to higher manufacturing costs by reducing manufacturing efficiencies as well as increasing labor and raw material costs.

In addition to the continued focus on manufacturing performance and product quality, management took several actions in 2007 to streamline the company s operations, reduce costs and improve liquidity. On September 10, 2007, the company s board of directors approved a plan intended to reduce operating costs and improve the efficiency of the company s manufacturing operations. Under the plan, the company suspended operations at its manufacturing facility in Olive Branch, Mississippi, for an indeterminate period and consolidated all of its manufacturing operations into its other two plants, located in Winchester, Virginia and

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Fernley, Nevada. As a result, the company recorded a charge of $3.3 million to income in 2007. Management also decided to reclaim certain finished goods inventories for use in the company s manufacturing process, thereby reducing the future planned purchases of certain raw materials. As a result, the company recorded a $9.4 million charge to write down the affected inventory to reclaim value. The company also renewed its focus on more effectively managing raw material and finished goods inventory levels, which resulted in an $18.9 million reduction of inventory.

Nevada Facility Product Replacement and Warranty Reserve. The company continues to experience increased costs, which adversely affect profitability, related to the replacement of Trex product that exhibited surface defects and which the company has determined was produced at the Nevada manufacturing facility beginning in 2003. The costs related to the replacement of this product are reflected in net sales as product replacement costs, thereby reducing net sales, while the costs related to installation labor are reflected in selling, general and administrative expenses as consumer relations expenses. The company maintains a warranty reserve for expected future product replacement and consumer relations expenses and reviews and adjusts the reserve on a quarterly basis.

During 2005, the company began receiving claims related to the replacement of Trex product that exhibited surface defects. Initial analysis of the available data indicated that the product failure was confined to material produced in 2003 at the Nevada manufacturing facility and that the incubation period, or the period between deck installation and appearance of the defect and related submission of a claim, was approximately two years. Based on these factors, the company concluded that substantially all of the costs related to the defective material had been recognized and estimated that the future costs related to the defect were immaterial. During late 2006 and into mid-2007, the company began receiving claims that indicated that the product failure was not limited to 2003 production. Throughout this period, management initiated efforts to investigate the source of the problem and identify the affected production, and implemented progressive improvements to the manufacturing process at the Nevada facility to stem the continued production of defective material. During the quarter ended June 30, 2007, the company concluded that product failures extended to include 2004 production from the Nevada facility and increased its warranty reserve accordingly.

During the quarter ended September 30, 2007, the company experienced a significant increase in the number of customer claims related to the defect that indicated that product failures extended beyond 2004 production from the Nevada facility and that the rate of failure was greater than previously estimated. Following a detailed analysis of the additional claims data, production samples, operating data and the incubation period after deck installation and other factors, the company believes that only a small percentage of the product manufactured from 2003 to mid-2006 at the Nevada plant was affected, and that products manufactured at other Trex facilities are not affected. The decks affected by the defects are subject to deterioration between two and three years after installation. The company believes that changes made to its manufacturing process and quality control procedures have prevented any additional product with this type of defect from reaching the market after mid-2006.

Based on the available data, the company revised its estimate of expected future product replacement and consumer relations expenses related to the defect and increased its warranty reserve by recording a charge to earnings of $45.2 million in the quarter ended September 30, 2007. In addition, during the quarter ended December 31, 2007, the company elected to alter its handling of future customer claims. As a result of the effect of this change on the estimated cost to settle claims, the company recorded an additional $1.5 million increase to its warranty reserve. To estimate the reserve, the company primarily relies on information obtained from consumers through the claims process to determine the volume of product susceptible to defect and the rate of failure. Management also continually reevaluates its practices regarding discretionary payments made to consumers for installation labor costs for which the company is not obligated to pay under the provisions of the company s limited warranty. Although the company adjusted the warranty reserve accordingly by recording the best estimate of the expected costs, due to the inherent subjectivity of estimating future claims, it is possible that the ultimate settlement of the claims may exceed the amount recorded and may result in future charges against earnings.

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Net Sales. Net sales consist of sales and freight, net of returns, discounts, sales incentives and changes in the warranty reserve. The level of net sales is principally affected by sales volume and the prices paid for Trex. The company s branding and product differentiation strategy enables it to command premium prices over wood and to maintain price stability for Trex. To ensure adequate availability of product to meet anticipated seasonal consumer demand, the company has historically provided its distributors and dealers incentives to build inventory levels before the start of the prime deck-building season. These incentives include prompt payment discounts or extended payment terms. In addition, the company from time to time may offer price discounts on specified products and other incentives based on increases in distributor purchases as part of specific promotional programs.

On July 27, 2007, the company advised one of its distributors that it was terminating the company s distributor agreement with the distributor effective August 26, 2007. The company took this action because the distributor advised the company that it intended to carry a competitive product, which the company believes would constitute a violation of the distributor agreement. In 2006, this distributor accounted for approximately 16% of the company s gross sales. The company has retained new distributors to distribute its products in the affected territories previously serviced by the terminated distributor. Although the termination of this distributor may have had a short-term negative effect on sales in the affected service areas while the company engaged replacement distributors, the company does not believe that the termination will have a long-term negative impact on its net sales or operating performance.

There is no product return right granted to the company s distributors except those granted pursuant to the warranty provisions of the company s agreement with its distributors. Under such warranty provisions, the company warrants that its products will be free from defects in workmanship and materials and will conform to the company s standard specifications for its products in effect at the time of the shipment. If there is such a defect in any of its products, the company has an obligation under its warranty to replace the products. On some occasions, the company will voluntarily replace products for distributors as a matter of distributor relations, even though the company does not have a legal obligation to do so.

As a result of the introduction of newer-generation Trex Accents products in 2007, the company voluntarily accepted returns of older-generation Trex Accents products from distributors, which resulted in a reduction of $9.0 million to 2007 net sales. The company anticipates that it will sell the older-generation products at or above its carrying cost to alternative markets not currently served by Trex distributors.

Under the company s limited warranty with consumers, the company warrants that its products will be free from material defects in workmanship and material and will not check, split, splinter, rot or suffer structural damage from termites or fungal decay. If there is such a defect in any of its products, the company has an obligation either to replace the defective product or refund the purchase price, in either case without any payment for labor to replace the defective product or freight. The company may voluntarily replace a product or refund a portion of the purchase price to consumers as a matter of consumer relations, even though the company does not have a legal obligation to do so. During 2007, the company experienced an increase in product replacement expenses resulting from an increase in the warranty reserve.

Gross Profit. Gross profit represents the difference between net sales and cost of sales. Cost of sales consists of raw materials costs, direct labor costs, manufacturing costs and freight. Raw materials costs generally include the costs to purchase and transport waste wood fiber, PE material and pigmentation for coloring Trex products. Direct labor costs include wages and benefits of personnel engaged in the manufacturing process. Manufacturing costs consist of costs of depreciation, utilities, maintenance supplies and repairs, indirect labor (including wages and benefits), and warehouse and equipment rental activities.

Selling, General and Administrative Expenses. The largest components of selling, general and administrative expenses are branding and other sales and marketing costs. Sales and marketing costs consist primarily of salaries, commissions and benefits paid to sales and marketing personnel, consumer relations, advertising expenses and other promotional costs. General and administrative expenses include salaries and benefits of personnel engaged in research and development, procurement, accounting and other business functions, office occupancy costs attributable to these functions, and professional fees. As a percentage of net sales, selling, general and administrative expenses have varied from quarter to quarter due, in part, to the seasonality of the company s business. During 2007, the company experienced an increase in consumer relations expenses resulting from an increase in the warranty reserve described above.

Critical Accounting Policies, Estimates and Risks and Uncertainties

Our significant accounting policies are described in note 2 to our consolidated financial statements appearing elsewhere in this report. Critical accounting policies include the areas where we have made what we consider to be particularly difficult, subjective or complex judgments in making estimates, and where these estimates can significantly affect our financial results under different assumptions and conditions. We prepare our financial statements in conformity with accounting principles generally accepted in the United States. As a result, we are required to make estimates, judgments and assumptions that we believe are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods presented. Actual results could be different from these estimates.

Inventories. The company accounts for its inventories at the lower of cost (last-in, first-out, or LIFO) or market value. The company believes that its current inventory of finished goods will be saleable in the ordinary course of business and, accordingly, has not established significant reserves for estimated slow moving products or obsolescence. The company has written down to its estimated market value the estimated portion of PE material and other raw materials that are not consumable. At December 31, 2007, the excess of the replacement cost of inventory over the LIFO value of inventory was approximately $28.3 million. The company cannot estimate at this time the effect of future reductions, if any, in inventory levels on its future operating results. The company currently anticipates that inventory levels in 2008 will be consistent with inventory levels in 2007.

Long-Lived Assets. In accordance with the Statement of Financial Accounting Standards, or SFAS, No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* the company reviews its long-lived assets, including property, plant and equipment, whenever events or changes in circumstances indicate that the carrying amount of the assets may not be fully recoverable. To determine the recoverability of its long-lived assets, the company evaluates the probability that future estimated undiscounted net cash flows will be less than the carrying amount of the long-lived assets. If such cash flows are more likely than not to be less than the carrying amount of the long-lived assets, such assets are written down to their fair value. The company s estimates of anticipated cash flows and the remaining estimated useful lives of long-lived assets could be reduced in the future. As a result, the carrying amount of long-lived assets could be reduced in the future.

Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets. The depreciable lives of these assets range from five to 40 years. We make estimates of the useful lives, in part, based upon historical performance of similar assets. We periodically review the remaining estimated useful lives of our property, plant and equipment to determine if any revisions to our estimates are necessary. Changes to our estimate of the useful lives of our property, plant and equipment could have a material effect on our financial position or results of operations.

Product Warranty. Under the company s limited warranty with consumers, the company warrants that its products will be free from material defects in workmanship and material and will not check, split, splinter, rot or suffer structural damage from termites or fungal decay. If there is such a defect in any of its products, the company has an obligation either to replace the defective product or refund the purchase price, in either case without any payment for labor to replace the defective product or freight. The company establishes warranty reserves to provide for estimated future expenses as a result of product defects that result in claims. Reserve estimates are based on management s judgment, considering such factors as historical experience and other available information. Management reviews and adjusts these estimates on a quarterly basis based on the differences between actual experience and historical estimates.

During 2005, the company began receiving claims related to the replacement of Trex product that exhibited surface defects. Initial analysis of the available data indicated that the product failure was confined to material produced in 2003 at the Nevada manufacturing facility and that the incubation period, or the period between deck installation and appearance of the defect and related submission of a claim, was approximately two years. Based on these factors, the company concluded that substantially all of the costs related to the defective material had been recognized and estimated that the future costs related to the defect were immaterial.

During 2007, the company experienced a significant increase in the number of customer claims related to the defect that indicated that product failures extended beyond 2004 production from the Nevada facility and that the rate of failure was greater than previously estimated. Following a detailed analysis of the additional claims data, production samples, operating data and the incubation period after deck installation and other factors, the company believes that only a small percentage of the product manufactured from 2003 to mid-2006 at the Nevada plant was affected, and that products manufactured at its other facilities are not affected. The decks affected by the defects are subject to deterioration between two and three years after installation. The company believes that changes made to its manufacturing process and quality control procedures have prevented any additional product with this type of defect from reaching the market after mid-2006.

Based on the available data, the company revised its estimate of expected future product replacement and consumer relations expenses related to the defect and increased its warranty reserve. To estimate the reserve, the company primarily relies on information obtained from consumers through the claims process to determine the volume of product susceptible to defect and the rate of failure. Although the company adjusted the warranty reserve accordingly by recording the best estimate of the expected costs, due to the inherent subjectivity of estimating future claims, it is possible that the ultimate settlement of the claims may exceed the amount recorded and may result in future charges against income. For additional information about product warranties, see notes 2 and 12 to the consolidated financial statements appearing elsewhere in this report.

Contract Termination Costs. In anticipation of relocating the company s corporate headquarters, the company entered into a lease agreement in July 2005. The company reconsidered and decided not to move its headquarters. The lease, which began on January 1, 2006 and extends through June 30, 2019, currently obligates the company to lease 55,047 square feet and increases to 80,071 square feet during 2012 through the end of the lease term. As of January 10, 2008, the company had executed subleases for the entire 55,047 square feet it currently leases. The duration of the subleases, all of which include options to renew, vary from five to seven years. The company estimates that the present value of the estimated future sublease rental receipts, net of transaction costs, will be less than the company s remaining minimum lease payment obligations under its lease for the office space. Accordingly, the company accounts for the costs associated with the lease as contract termination costs in accordance with SFAS No. 146*, Accounting for Costs Associated with Exit or Disposal Activities.*

To estimate future sublease receipts for the periods beyond the term of the existing subleases and for the additional space the company is obligated to lease, the company has assumed that the existing subleases will be renewed or new subleases will be executed at rates consistent with rental rates in the current subleases. However, management cannot be certain that the timing of future subleases or the rental rates contained in future subleases will not differ from current estimates. Factors such as the delivery of a significant amount of new office space or poor economic conditions could have a negative effect on vacancy rates and rental rates in the area. The inability to sublet the office space in the future or unfavorable changes to key management assumptions used in the estimate of the future sublease receipts may result in additional charges to selling, general and administrative expenses in future periods.

Contingencies and Other Liabilities. The company is subject, from time to time, to various lawsuits and other claims related to patent infringement, product liability and other matters. The company is required to assess the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. The company makes a determination of the amount of reserves required, if any, for these contingencies

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after an analysis of each lawsuit and claim. The required reserves may change in the future as a result of new developments in any such matter or changes in approach, such as a change in settlement strategy in dealing with a particular matter. In the opinion of management, adequate provision has been made for any probable losses as of December 31, 2007.

Revenue Recognition. The company recognizes revenue when title is transferred to customers, which is generally upon shipment of the product to the customer. Pursuant to Emerging Issues Task Force, or EITF, Issue 00-10, *Accounting for Shipping and Handling Fees and Costs,* the company records all shipping and handling fees in net sales and records all of the related costs in cost of sales. The company offers several programs to dealers and distributors, including cash rebates, sales incentives and cooperative advertising. The company accounts for these programs as either reductions to sales or as selling, general and administrative expenses in accordance with EITF Issue 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).* The company classifies cash rebates as a reduction in revenue. Cash rebates are recorded in the period in which the related revenue is recognized. Sales incentives are accrued based upon estimates of the amounts that will be earned by customers. Cooperative advertising costs are classified in selling, general and administrative expenses and are accrued as the related advertising expenditures are incurred.

Valuation of Deferred Tax Assets. The company provides for valuation allowances against its deferred tax assets in accordance with the requirements of SFAS No. 109, *Accounting for Income Taxes.* At December 31, 2007, the company had a valuation allowance of $21.6 million related primarily to the realization of its excess deferred tax assets. The company has considered all available evidence, including its historical levels of cumulative losses, the future reversal of existing taxable temporary differences, estimated future taxable income for each applicable state, and the expiration period of tax credit carry-forwards in determining the need for a valuation allowance. Based upon this analysis, management determined that it is more likely than not that its deferred tax assets will not be realized.

Income Taxes FIN 48. On January 1, 2007, the company adopted the provisions for Financial Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48), and recorded a $2.7 million reduction in retained earnings on January 1, 2007, as discussed in note 11 to the consolidated financial statements appearing elsewhere in this report.

Stock-Based Compensation. Effective January 1, 2006, the company adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment,* using the modified prospective transition method. Under that transition method, compensation cost includes (1) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R).

Under the provisions of FAS 123(R), we calculate the grant date fair value of share-based awards using the Black-Scholes valuation model for grants subsequent to the adoption of FAS 123(R). Determining the fair value of share-based awards is judgmental in nature and involves the use of significant estimates and assumptions, including the term of the share-based awards, risk-free interest rates over the vesting period, expected dividend rates, the price volatility of our shares and forfeiture rates of the awards. Prior to adopting FAS 123(R), we recognized forfeitures only as they occurred. We base our fair value estimates on assumptions we believe to be reasonable but that are inherently uncertain. Actual future results may differ from those estimates.

As mandated by FAS 123(R), beginning in the first quarter of 2006, we also report the benefits of tax deductions in excess of recognized compensation expense as a financing cash inflow in the consolidated statements of cash flows. Prior to the adoption of FAS 123(R), we reported these tax benefits as an operating cash flow. Results for prior periods have not been restated.

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Results of Operations

The following table shows, for the last three years, selected statement of operations data as a percentage of net sales:

	Year Ended December 31, 2005	2006	2007
Net sales	100.0%	100.0%	100.0%
Cost of sales	72.7	76.5	88.0
Gross profit	27.3	23.5	12.0
Selling, general and administrative expenses	26.3	21.7	36.3
Income (loss) from operations	1.0	1.8	(24.3)
Interest expense, net	0.9	0.9	2.7
Income (loss) before taxes and extraordinary item	0.1	0.9	(27.1)
Provision (benefit) for income taxes	(0.7)	0.2	(4.0)
Net income (loss)	0.8%	0.7%	(23.1%)

2007 Compared to 2006

Net Sales. Net sales in 2007 decreased 2.4% to $329.0 million from $337.0 million in 2006. Net sales in 2007 were adversely affected by charges of $26.8 million. The company recorded a $17.8 million charge against net sales as a result of an increase to the warranty reserve, which was related to Trex product produced at the Nevada manufacturing facility, as described under Overview, and a $9.0 million charge against net sales for distributor credits related to our decision to voluntarily take back older-generation Trex Accents products. Before giving effect to these charges, net sales in 2007 totaled $355.8 million, which represented a 5.6% increase over net sales in 2006. The increase in net sales, before the increased warranty reserve and distributor credits, was primarily attributable to an increase in revenue per product unit and lower sales discounts. The increase in revenue per product unit resulted from a price increase of 7% on all products effective in May 2006. Lower sales discounts resulted from lower costs under the company s early buy sales program and the extension of fewer incentives to distributors in the company s annual sales discount programs. The positive impact on net sales of higher revenue per product unit and lower sales discounts was offset, in part, by an increase in product replacement expenses incurred during 2007, which were in addition to the warranty reserve increase, substantially all of which related to Trex product produced at the Nevada manufacturing facility. Product replacement expenses were $12.2 million, or 3.3% of gross sales, in 2007 compared to $9.8 million, or 2.8% of gross sales, in 2006.

The company offered various sales incentives to its distributor customers during both 2006 and 2007. The company has historically utilized an annual early buy sales program to create an incentive for distributors and dealers to commit to purchase Trex products before the start of the decking season. The company s early buy program in 2006 and 2007 for purchases in the first four months of each year consisted of an option of extended terms or an early payment discount and a cash rebate for shipments that are sent directly to the dealer locations. The expense, which the company recognized in 2007 for the early payment discount, was comparable to the expense it recognized in 2006. The payment options provided in the 2006 early buy program included prompt payment discounts from 0.5% to 2.0% or extended payment terms from 30 to 90 days. The payment options provided in the 2007 early buy program included prompt payment discounts from 0.5% to 3.0% or extended payment terms from 30 to 90 days. The company recognized an expense of $1.2 million for direct-to-dealer shipments in 2007 during the early buy sales program compared to an expense of $2.3 million for direct-to-dealer shipments in 2006, as a lower percentage of shipments during the early buy sales program went direct-to-dealer in 2007. In addition, the company offers certain annual sales incentives to dealers, which vary based on the level of sales activity from those dealers. The company reduced the annual incentive program during 2007. The expenses recognized through the annual dealer incentive program in 2007 was $1.8 million compared to $3.8 million in 2006.

Gross Profit. Gross profit decreased 50.3% to $39.4 million in 2007 from $79.3 million in 2006. The decrease was primarily attributable to charges of $37.5 million. Such charges included the $26.8 million reduction in net sales described above resulting from the increase in the warranty reserve and the distributor credits, as well as charges of $10.7 million to cost of goods sold for inventory adjustments. The $10.7 million charges included the effect of a $9.4 million inventory valuation adjustment for certain inventories reclaimed for use in the company s manufacturing process. Before giving effect to the increase in the warranty reserve, distributor credits and inventory valuation adjustments, gross profit in 2007 was $76.9 million, which represented a decrease of 3.0% from gross profit in 2006. The decrease, before the increased warranty reserve, distributor credits and inventory valuation adjustments, was primarily attributable to higher unit manufacturing costs, which resulted principally from production inefficiencies and lower manufacturing utilization. Before the increased warranty reserve, distributor credits and inventory valuation adjustments, gross profit as a percentage of net sales, or gross profit margin, decreased to 21.6% in 2007 from 23.5% in 2006. Such decrease in gross margin in 2007, resulted from a decrease in production rates and yields, higher raw materials costs and higher labor and manufacturing costs due to product quality initiatives and lower manufacturing utilization, which accounted for a 5.5% decrease in gross margin. The negative effect of these factors in 2007 was offset in part by higher sales prices and an improved product mix, which accounted for a 3.8% increase in gross margin.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 63.1% to $119.4 million in 2007 from $73.2 million in 2006. Selling, general and administrative expenses in 2007 were adversely affected by charges of $35.9 million, which included a $29.7 million charge as a result of the increase to the warranty reserve and a charge of $6.1 million for losses on disposal of fixed assets. Before giving effect to the increase in the warranty reserve and the loss on disposal, selling, general and administrative expenses in 2007 were $83.6 million, which represented a 14.2% increase over selling, general and administrative expenses in 2006. The higher selling, general and administrative expenses, before the increased warranty reserve and loss on disposal, resulted from $4.6 million of expense related to the suspension of operation of the company s Olive Branch, Mississippi manufacturing facility, a $4.4 million increase in personnel-related costs, an increase of $3.3 million in consumer relations expenses (substantially all of which related to Trex product produced at the Nevada manufacturing facility), and an increase of $3.3 million in branding expenses. Consumer relations expenses were $12.2 million, or 3.3% of gross sales, in 2007 compared to $8.9 million, or 2.5% of gross sales, in 2006. As a result of the suspension of operations at the Olive Branch facility, all costs related to the facility are recognized in selling, general and administrative expenses until such time as the facility is placed back into service. The $4.6 million of expense recognized in 2007 in selling, general and administrative expenses related to the Olive Branch facility consisted of $3.3 million of costs specifically related to the suspension of operations and $1.3 million of ongoing costs, which primarily reflected depreciation charges of $1.0 million. The $3.3 million of incremental costs specifically related to the suspension of operations included personnel costs and raw material storage costs under contractual commitments, including a $0.4 million contract termination charge on a leased facility for raw material storage and inventory management costs associated with transfers of raw material and finished goods inventory to the company s Winchester, Virginia and Fernley, Nevada manufacturing plants. The effect of these factors was offset in part by the company s receipt of $3.25 million in reimbursement of previously paid attorneys fees under a previously reported settlement with ExxonMobil and a $2.0 million decrease in expenses associated with the lease for office space the company is subletting. Before the increased warranty reserve and loss on disposal, selling, general and administrative expenses as a percentage of reported net sales increased to 25.4% in 2007 from 21.7% in 2006.

Interest Expense. Net interest expense increased to $9.0 million in 2007 from $3.0 million in 2006. The increase in net interest expense resulted primarily from an increase in average debt balances under the company s revolving credit facility and from an increase in total debt as a result of the company s combined issuance of $97.5 million principal amount of convertible senior subordinated notes in June and July 2007. The company retired the $24.0 million outstanding principal amount of senior secured notes with the net proceeds of the convertible notes offering and, in connection with the retirement, paid a $0.6 million prepayment penalty. The higher average debt balances under the company s revolving credit facility during 2007 were required to fund the higher levels of inventories at each manufacturing location. The company capitalized $1.0 million and $1.8 million of interest on construction in process in 2007 and 2006, respectively.

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Provision for Income Taxes. The company recorded a benefit for income taxes of $13.1 million in 2007 compared to a provision for income taxes of $0.7 million in 2006. The related effective tax rates were a benefit of 14.7% in 2007 and a provision of 23.2% in 2006. The lower effective tax rate in 2007 resulted from a valuation allowance of $19.4 million recorded with respect to the excess net deferred tax asset. The company recorded the allowance with reference to the future realization of the excess deferred tax asset, which is dependent on the company s ability to generate taxable income.

2006 Compared to 2005

Net Sales. Net sales in 2006 increased 14.6% to $337.0 million from $294.1 million in 2005. The increase in net sales was primarily attributable to an increase in price per unit and, to a lesser extent, a 5.3% growth in sales volume as a result of an increase in demand from dealers and distributors. The increase in price per unit resulted from a price increase, effective January 2006, of 4% and a price increase, effective May 2006, of 7%, as well as from increased sales of the higher unit priced products. The effect of the price increases was partially offset by a 4% sales price discount offered on certain products in the 2006 third quarter.

The company offered various sales incentives to its distributor customers during both 2005 and 2006. The company s early buy program in 2005 and 2006 included extended payment terms for purchases in the first four months of each year. The payment options provided in the 2005 early buy program included prompt payment discounts from 1.0% to 2.0% or extended payment terms from 45 to 90 days. The payment options provided in the 2006 early buy program included prompt payment discounts from 0.5% to 2.0% or extended payment terms from 30 to 90 days. In addition, in the fourth quarter of 2006, the company granted extended payment terms of up to 150 days on shipments in the fourth quarter to encourage distributors to start stocking inventory for the upcoming decking season. Similar incentives were not offered in the fourth quarter of 2005.

Gross Profit. Gross profit decreased 1.2% to $79.3 million in 2006 from $80.2 million in 2005. The decrease was primarily attributable to the higher unit manufacturing costs, which resulted from a 19% increase in the cost per pound of PE material, an additional $11.7 million in labor and packaging expenses incurred as a result of product quality initiatives, an increase in freight costs and lower production yields. The negative effect of these factors was offset in part by higher average sales prices of 8.8% per unit. Gross profit as a percentage of net sales decreased to 23.5% in 2006 from 27.3% in 2005. The overall reduction in gross margin was primarily attributable to the negative 9.2% effect of the forgoing factors, which was partially offset by the positive 5.8% effect of increased sales prices and sales of higher margin products.

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased 5.4% to $73.2 million in 2006 from $77.4 million in 2005. The lower selling, general and administrative expenses resulted principally from a decrease of $6.4 million in branding expenses, a decrease of $1.0 million in professional fees and a decrease of $0.8 million in personnel-related expenses, including salaries, benefit and hiring costs. Selling, general and administrative expenses in 2005 also included the write-off of $1.0 million in equipment which the company disposed of during 2005 in connection with its retooling of some of its production lines. The effect of these factors was offset in part by a $2.5 million increase in expenses related to the lease for unused office space the company was attempting to sublet, a $2.3 million increase in consumer relations expenses and a $0.3 million increase in market research expenses. For additional information regarding the lease, see note 12 to the consolidated financial statements appearing elsewhere in this report. As a percentage of net sales, selling, general and administrative expenses decreased to 21.7% in 2006 from 26.3% in 2005.

Interest Expense. Net interest expense increased to $3.0 million in 2006 from $2.6 million in 2005. The increase in net interest expense resulted primarily from a decrease in interest capitalized on construction in process. The company capitalized $1.8 million and $2.5 million of interest on construction in process in 2006 and 2005, respectively.

Provision for Income Taxes. The provision for income taxes increased to $0.7 million in 2006 from a benefit of $2.0 million in 2005. The effective rate was approximately 23.2% in 2006 compared to a benefit of approximately 870.3% in 2005. The effective rate for 2006 differed from the expected statutory rates due primarily to the recognition of certain federal and state tax credits and incentives. The 2005 income tax benefit differed from the expected tax provision determined by applying the expected statutory rates due primarily to the recognition of certain federal and state tax credits and incentives for which the company determined that it qualified in 2005. The state tax benefit resulted from the expansion of the company s operations into Mississippi as well as the recognition of other state tax credits and incentives for which the company filed amended tax returns for prior years.

Liquidity and Capital Resources

The company finances its operations and growth primarily with cash flow from operations, borrowings under its credit facility and other loans, operating leases and normal trade credit terms from operating activities.

S*ources and Uses of Cash.* Net cash used in operating activities totaled $1.2 million in 2007 compared to $4.0 million in 2006. The effects of the net loss of $75.9 million recorded in 2007, compared with net income of $2.3 million in 2006, and the net decrease of $2.8 million in non-cash items was offset by improved net working capital of $84.6 million. The increase in cash flow related to working capital resulted primarily from decreases in inventories and accounts receivable. In 2007, inventories decreased $18.9 million compared to an increase of $54.5 million in 2006. In 2007, accounts receivable decreased $11.6 million compared to an increase of $5.8 million in 2006. Net cash used in operations increased $15.2 million in 2006 over 2005 as a result of increased working capital usage.

Net cash used in investing activities totaled $24.0 million in 2007 compared to cash used in investing activities of $27.7 million in 2006. Capital expenditures in 2007 were applied primarily to the purchase of plastic reprocessing equipment and other equipment to improve product quality and reduce costs. In 2006, net cash used in investing activities totaled $27.7 million compared to $29.4 million in 2005.

Net cash provided by financing activities was $24.6 million in 2007 compared to cash provided for financing activities of $31.1 million in 2006. In 2007, the $94.2 million of net proceeds received by the company from its sale of $97.5 million principal amount of convertible senior subordinated notes was offset in part by net debt reductions of $45.7 million under its revolving credit facility and $24.0 million under its outstanding senior secured notes, which were repaid with such net proceeds. Net cash provided by financing activities was $31.1 million in 2006, compared to net cash used in financing activities of $4.4 million in 2005. At December 31, 2006, there were $44.1 million of borrowings outstanding under the company s revolving credit facility compared to $4.1 million at December 31, 2005.

Indebtedness. At December 31, 2007, the company s indebtedness totaled $134.0 million and the annualized overall weighted average interest rate of such indebtedness, including the effect of the company s interest rate swaps, was approximately 5.76%.

On March 16, 2007, the company secured its obligations under its credit agreement with Branch Banking and Trust Company, or BB&T, with a lien on the company s accounts receivable and inventory. BB&T has extended a senior secured revolving credit facility and some real estate loans to the company under the credit agreement.

Sale of Convertible Notes and Related Debt Agreement Amendments. On June 18, 2007, the company issued $85.0 million principal amount of its 6.00% convertible senior subordinated notes due 2012, or convertible notes, through an underwritten public offering. The company used a portion of net proceeds of $82.1 million from the sale of the convertible notes to repay in full $24.0 million principal amount of its 8.32% senior secured notes due July 19, 2009 and $45.7 million principal amount of borrowings outstanding under its revolving credit facility. The company paid a prepayment penalty of $0.6 million in connection with the retirement of the senior secured notes. On July 12, 2007, the underwriters of the convertible notes offering exercised their over-allotment option to purchase an additional $12.5 million principal amount of convertible notes. The company received net proceeds of $12.1 million from the sale of the additional convertible notes, which it issued on July 17, 2007. For information about the convertible notes, see note 6 to the consolidated financial statements appearing elsewhere in this report.

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Effective on June 18, 2007, in connection with its offering of the convertible notes, the company entered into amendments to its credit agreement with BB&T and its reimbursement and credit agreement, or reimbursement agreement, with JPMorgan Chase Bank, N.A., or JPMorgan, relating to the outstanding bonds issued in December 2004 by a Mississippi public corporation to finance specified costs relating to solid waste disposal facilities used in connection with the company s manufacturing plant in Olive Branch, Mississippi. Among other things, the amendments to the agreements:

- extended the maturity of the revolving credit facility to June 30, 2010;
- reset the maximum revolving commitment amount under the revolving credit facility to be (a) $70 million for the period commencing December 1 of each calendar year to and including May 31 of the immediately succeeding calendar year, and (b) $40 million for the period commencing June 1 to and including November 30 of each calendar year;
- amended the financial covenants the company is required to observe under the agreements, to provide the company with additional operating flexibility;
- amended the applicable real estate term loan margin, the applicable revolving loan margin and the unused commitment fee percentage definitions in the credit agreement so that such loan margins and fee percentage will be determined with reference to the company s ratio of funded net senior debt to EBITDA, as defined for purposes of the reimbursement agreement; and
- revised the annual facility fee payable by the company under the reimbursement agreement, which will be calculated based on the company s ratio of funded net senior debt to EBITDA, as defined for purposes of the reimbursement agreement.

On June 18, 2007, concurrently with the effectiveness of the foregoing amendments to the credit agreement and the reimbursement agreement, the company executed three promissory notes to BB&T under the credit agreement secured by real property of the company in the aggregate principal amount of approximately $6.7 million. The three promissory notes, which replaced previously outstanding promissory notes, extended the maturity of the underlying indebtedness to June 30, 2011.

After June 18, 2007, the company entered into additional amendments to its debt agreements, including the credit agreement and the reimbursement agreement, as discussed below under Compliance with Debt Covenants.

Amounts drawn under the revolving credit facility are subject to a borrowing base consisting of accounts receivable and finished goods inventories. As of December 31, 2007, no amount was outstanding under the revolving credit facility and the borrowing base totaled approximately $52.6 million.

Consistent with generally accepted accounting principles, the company capitalized $4.0 million of financing-related expenses as deferred financing costs in 2007 relating to the refinancing of the company s revolving credit facility and issuance of the convertible notes and the foregoing real estate notes. The deferred financing costs will be amortized over the terms of the various debt instruments for periods that will vary between three to five years.

Compliance With Debt Covenants. The company s ability to make scheduled principal and interest payments on its real estate loans, convertible notes and bond loan agreement, borrow and repay amounts under its revolving credit facility, and continue to comply with its loan covenants will depend primarily on its ability to generate substantial cash flow from operations. To remain in compliance with its credit facility, real estate loans and reimbursement agreement, the company must maintain specified financial ratios based on its levels of debt, capital, net worth, fixed charges, and earnings (excluding extraordinary gains and extraordinary non-cash losses) before interest, taxes, depreciation and amortization, all of which are subject to the risks of its business, some of which are discussed in this report under Risk Factors.

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As of September 30, 2007, as a result of adverse operating results in the third quarter of 2007, including the significant increase to its warranty reserve as of September 30, 2007, as discussed above under Overview, the company was not in compliance with covenants under the credit agreement and the reimbursement agreement requiring the company not to exceed a maximum prescribed ratio of consolidated debt to consolidated EBITDA and to maintain a minimum ratio of consolidated EBITDA to fixed charges, as those ratios are defined for purposes of the agreements. Such noncompliance constituted an event of default under each agreement. On November 5, 2007, effective as of September 30, 2007, BB&T and JPMorgan waived the company s noncompliance with these covenants solely in respect of its noncompliance as of the September 30, 2007 measurement date. As a condition of the limited waivers, the company agreed that, to secure the company s obligations under the reimbursement agreement, it would grant to JPMorgan (1) a second-priority lien on the company s accounts receivable and inventory that currently secure the company s obligations under the credit agreement and (2) a first-priority lien on all fixtures and personality (including machinery and equipment, but excluding inventory) at the company s Olive Branch, Mississippi facility which were not then subject to liens. On November 20, 2007, effective as of September 30, 2007, the company entered into amendments to its agreements with BB&T and JPMorgan giving effect to the new security arrangements. As of September 30, 2007, the company also was not in compliance with the covenant in its real estate loan agreement with Bank of America, N.A. with respect to its fixed charge coverage ratio (as defined for purposes of that agreement). Such noncompliance constituted a default under the agreement. On November 6, 2007, Bank of America, N.A. waived the exercise of its rights and remedies arising as a result of the company s noncompliance with this covenant for the measurement period ended September 30, 2007.

Based on its anticipated operating results, the company determined that it would need to obtain amendments to some of the financial covenants under the credit agreement and reimbursement agreement to achieve compliance with those covenants as of December 31, 2007 and as of quarterly measurement dates in 2008. The company entered into amendments to these agreements effective as of December 21, 2007. Among other things, the amendments amended the following financial covenants the company was required to observe under agreements, so that:

- the company s senior debt ratio, or ratio of consolidated senior debt to consolidated EBITDA (as defined for purposes of the agreements), could not be greater than (a) 9.0 to 1 for the period commencing October 1, 2007 to and including December 31, 2007, (b) 11.0 to 1 for the period commencing on January 1, 2008 to and including March 31, 2008, and (c) thereafter (A) 2.5 to 1 for any measurement period ending June 30 or September 30, and (B) 3.0 to 1 for any measurement period ending December 31 or March 31; and

- the company s fixed charge coverage ratio, or ratio of consolidated EBITDA to fixed charges (as defined for purposes of the agreements), could not be less than (a) 1.0 to 1 for any measurement period through March 31, 2008, and (b) 1.4 to 1 for any measurement period thereafter.

The amendments also increased the highest potential interest rate margin on credit facility loans by 75 basis points (or up to 3.75% in the case of real estate term loans and 3.5% in the case of revolving loans) for so long as the company s senior debt ratio was equal to or greater than 4.0 to 1. To obtain the foregoing amendments, the company paid fees of $95,500 to BB&T and $5,000 to JPMorgan.

As of December 31, 2007, as a result of the foregoing operating developments in the third quarter of 2007, as well as additional charges recorded by the company for the fourth quarter, the company was not in compliance with the amended fixed charge coverage ratio covenant under the credit agreement and the reimbursement agreement and with covenants under the agreements requiring the company not to exceed a prescribed ratio of total consolidated debt to total consolidated capitalization, and to maintain a minimum consolidated tangible net worth, as those financial measures are defined for purposes of the agreements. For the December 31, 2007 measurement period, the company s fixed charge coverage ratio was 0.37 compared to the minimum permitted ratio of 1.0, the company s total consolidated debt to total consolidated capitalization ratio was 60.6% compared to the maximum permitted ratio of 60.0%, and the company s consolidated tangible net worth was $87.2 million compared to the minimum required level of $124.0 million. Such noncompliance constituted an event of default

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under each agreement. On March 6, 2008, effective as of December 31, 2007, BB&T and JPMorgan waived the company s noncompliance with these covenants as of the December 31, 2007 measurement date and entered into amendments to the credit agreement and the reimbursement agreement. Among other things, the amendments amended the following financial covenants the company is required to observe under agreements, so that:

the company s ratio of total consolidated debt to total consolidated capitalization (as defined for purposes of the agreements) may not be greater than (a) 70% for the period commencing January 1, 2008 to and including March 31, 2008, (b) 62.5% for the period commencing April 1, 2008 to and including June 30, 2008, (c) 60% for the period commencing July 1, 2008 to and including September 30, 2008, (d) 65% for the period commencing October 1, 2008 to and including December 31, 2008, (e) 60% for the period commencing January 1, 2009 to and including March 31, 2009, and (c) thereafter (A) 50% for each period commencing April 1 of a calendar year to and including September 30 of such calendar year, and (B) 60% for each period commencing October 1 of a calendar year to and including March 31 of the immediately succeeding calendar year;

the company s fixed charge coverage ratio may not be less than (a) 0.75 to 1 for the one-quarter period ending on March 31, 2008, (b) 0.85 to 1 for the two-quarter period ending on June 30, 2008, (c) 1.0 to 1 for the three-quarter period ending on September 30, 2008, (d) 0.60 to 1 for the four-quarter period ending on December 31, 2008, and (e) 1.40 to 1 for the four-quarter period ending on each fiscal quarter thereafter;

the company s consolidated tangible net worth (as defined for purposes of the agreements) may not be less than the sum of (a) $85 million, (b) 100% of the net proceeds of all stock issued after January 1, 2008, plus (c) 50% of consolidated net income after December 31, 2007 (taken as one accounting period), but excluding from such calculation of consolidated net income for purposes of (c) any quarter in which consolidated net income is negative; and

the company will not be required to comply with the senior debt ratio covenant for any measurement period during 2008, and, effective January 1, 2009, the senior debt ratio may not be greater than (a) 2.5 to 1 for any measurement period ending June 30 or September 30, and (b) 3.0 to 1 for any measurement period ending December 31 or March 31.

The amendment to the reimbursement agreement increased the letter of credit facility fee from a range of 65 to 100 basis points, which was based on the ratio of consolidated senior debt to consolidated EBITDA, to 150 basis points of the stated amount of the letter of credit. To obtain the foregoing amendments, the company paid fees of $94,500 to BB&T and $25,000 to JP Morgan.

As of December 31, 2007, the company was not in compliance with the fixed charge coverage ratio covenant under its real estate loan agreement with Bank of America, N.A. Such noncompliance constituted an event of default under the agreement. On March 14, 2008, effective as of December 31, 2007, the company entered into an amendment to the agreement under which:

the company was granted a waiver with respect to its noncompliance with the applicable financial covenants, as of the December 31, 2007 measurement date;

effective as of January 1, 2008, the company will not be required to meet a ratio of total consolidated debt to total consolidated capitalization; and

the company s fixed charge coverage ratio (as defined for purposes of the agreement) may not be less than 2.50 to 1 for the one-quarter period ending on March 31, 2008, the two-quarter period ending on June 30, 2008, the three-quarter period ending on September 30, 2008, and the four-quarter period ending on December 31, 2008 and at the end of each fiscal quarter thereafter.

The amendment to the agreement increased the interest rate margin on the real estate note by 100 basis points from LIBOR plus 100 basis points to LIBOR plus 200 basis points. To obtain the foregoing amendments, the company paid Bank of America, N.A. a fee of $40,000.

If the company is unable to maintain compliance with the foregoing financial covenants and other provisions of its debt agreements, whether in accordance with their existing terms or as they may be amended, the company s lenders would have the right to enforce their claims against the company to the extent provided by the agreements and applicable law. In such an event, the lenders could accelerate the maturity of the company s indebtedness under the agreements, which could cause an acceleration of the maturity of the convertible notes under cross-default provisions. Upon any such acceleration, if the company were unable to restructure or refinance such indebtedness or to negotiate forbearance or other arrangements with its lenders restricting the enforcement of remedies, the lenders would have the right to proceed against any collateral securing the indebtedness, as well as against other assets of the company.

Contractual Obligations. The following tables show, as of December 31, 2007, the company s contractual obligations and commercial commitments, which consist primarily of long-term debt, operating leases and letters of credit (in thousands):

Contractual Obligations

Payments Due by Period

	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Long-term debt	$ 132,928	$ 1,198	$ 2,698	$ 102,719	$ 26,313
Operating leases	44,517	6,304	10,192	8,054	19,967
Total contractual cash obligations	$ 177,445	$ 7,502	$ 12,890	$ 110,773	$ 46,280

The company uses interest rate swap contracts to manage its exposure to fluctuations in the interest rates under its variable-rate real estate loans. At December 31, 2007, the fair value of the debt-related derivatives was $1.0 million and was classified as a long-term liability.

The company does not have off-balance sheet financing arrangements other than its operating leases.

Capital and Other Cash Requirements. The company made capital expenditures of $49.9 million in 2005, $27.7 million in 2006 and $24.0 million in 2007, primarily to make process and productivity improvements. The company currently estimates that its capital expenditures in 2008 will be in the range of $10 to $15 million. Capital expenditures in 2008 are expected to be used primarily to make process and productivity improvements at the company s two operating manufacturing sites.

The company believes that cash on hand, cash flow from operations and borrowings expected to be available under the company s existing revolving credit facility will provide sufficient funds to enable the company to fund its planned capital expenditures, make scheduled principal and interest payments, fund the warranty reserve, meet its other cash requirements and maintain compliance with terms of its debt agreements for at least the next 12 months. Thereafter, significant capital expenditures may be required to provide increased capacity to meet the expected growth in demand for the company s products. The company currently expects that it will fund its future capital expenditures from operations and borrowings under its revolving credit facility. The actual amount and timing of the company s future capital requirements may differ materially from the company s estimate depending on the demand for Trex and new market developments and opportunities. The company s ability to meet its cash needs during the next 12 months and thereafter could be adversely affected by various circumstances, including increases in raw materials and product replacement costs, quality control problems, higher than expected product warranty claims, service disruptions and lower than expected collections of accounts receivable. In addition, any failure by the company to negotiate amendments to its existing debt agreements to resolve any future noncompliance with financial covenants could adversely affect the company s liquidity by reducing its access to revolving credit borrowings needed primarily to fund its seasonal borrowing needs. The company may determine that it is necessary or desirable to obtain financing through bank borrowings or the issuance of debt or equity securities to address such contingencies or changes to its business plan. Debt

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financing would increase the company s level of indebtedness, while equity financing would dilute the ownership of the company s stockholders. There can be no assurance as to whether, or as to the terms on which, the company would be able to obtain such financing, which would be restricted by covenants contained in its existing debt agreements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The company s major market risk exposure is to changing interest rates. The company s policy is to manage interest rates through the use of a combination of fixed-rate and variable-rate debt. The company uses interest rate swap contracts to manage its exposure to fluctuations in the interest rates on its LIBOR-based variable-rate real estate debt and its $25.0 million variable-rate promissory note. The interest on the variable-rate promissory note is based on auction rates and is reset every seven days. At December 31, 2007, the company had limited its interest rate exposure on all of its $10.4 million variable-rate real estate loans to an annual effective rate of approximately 9.00%. In addition, the company had limited its interest rate exposure to an annual effective rate of approximately 3.12% through January 2012 on $10.0 million of the principal amount of its $25.0 million promissory note, and to an annual effective rate of approximately 2.95% through January 2010 on an additional $10.0 million of the principal amount of such promissory note.

Changes in interest rates affect the fair value of the company s fixed-rate debt. The fair value of the company s long-term fixed-rate debt at December 31, 2007, consisting of the company s convertible notes, was approximately $97.5 million. Based on balances outstanding at December 31, 2007, a 1% change in interest rates would change the fair value of the company s long-term fixed-rate debt by approximately $3.7 million at December 31, 2007.

The foregoing sensitivity analysis provides only a limited view as of a specific date regarding the sensitivity of some of the company s financial instruments to market risk. The actual impact of changes in market interest rates on the financial instruments may differ significantly from the impact shown in this sensitivity analysis.

The company has a purchase agreement for PE material under which it has market risk related to foreign currency fluctuations between the U.S. dollar and the euro. At current purchase levels, such exposure is not material. In addition, the company had a euro-denominated note receivable of 1.4 million euros at December 31, 2007.

Item 8. Financial Statements and Supplementary Data

The financial statements listed in Item 15 and appearing on pages F-2 through F-29 are incorporated by reference in this Item 8 and are filed as part of this report.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer, who is our principal executive officer, and our Chief Financial Officer, who is our principal financial officer, has 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 of December 31, 2007. Based upon this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2007.

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Management s Report on Internal Control Over Financial Reporting

We, as members of management of Trex Company, Inc. (the Company), are responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

We assessed the Company s internal control over financial reporting as of December 31, 2007, based on criteria for effective internal control over financial reporting established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Framework). Based on this assessment, we concluded that, as of December 31, 2007, our internal control over financial reporting was effective, based on the COSO Framework.

The effectiveness of our internal control over financial reporting as of December 31, 2007, has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report, which follows hereafter.

		TREX COMPANY, INC.
March 17, 2008	By:	/s/ RONALD W. KAPLAN **Ronald W. Kaplan** **President and Chief Executive Officer** **(Principal Executive Officer)**
March 17, 2008	By:	/s/ ANTHONY J. CAVANNA **Anthony J. Cavanna** **Chief Financial Officer** **(Principal Financial Officer)**

Remediation of Material Weaknesses in Internal Control Over Financial Reporting

In our annual report on Form 10-K for our 2006 fiscal year, we identified the following material weaknesses in our internal control over financial reporting as of December 31, 2006:

The company lacked a sufficient complement of personnel with knowledge of the company s financial reporting processes and adequate technical expertise in the application of U.S. generally accepted accounting principles and experience in resolving non-routine or complex accounting matters. As a result, errors occurred in the accounting for certain transactions. Management s review of these transactions and the related account analyses and reconciliations were not sufficient to detect the errors. The errors related to the company s inventory, property, plant and equipment, accounts payable, cost of sales, selling, general and administrative expenses and income taxes. These errors resulted in a number of post-closing adjustments that were recorded during the preparation of the 2006 consolidated financial statements.

The company did not have appropriate controls to properly account for activity related to the purchase and receipt of goods and services and the related liabilities. In addition, the company s related monitoring process was not sufficient to identify the resulting errors on a timely basis. The errors were primarily due to the recording of inventory, property, plant and equipment, cost of sales and selling, general and administrative expenses at the time of receipt of the goods or services and again at the time the related invoices were received, resulting in an overstatement of assets, liabilities and expenses. These errors resulted in a number of post-closing adjustments that were recorded during the preparation of the 2006 consolidated financial statements.

As corrective actions to address the material weaknesses noted above, we have:

hired additional technical accounting and finance personnel at our headquarters and plant locations with the requisite knowledge to address complex accounting and financial reporting requirements and to assess the technical accounting capabilities of the staff to ensure the right complement of knowledge, skills and training;

improved the design of period-end closing procedures to ensure completeness and accuracy of period-end transactions;

implemented controls to ensure that account reconciliations and analyses for significant financial statement accounts are maintained and reviewed for completeness and accuracy by qualified accounting personnel;

improved communications between accounting and business personnel to facilitate adequate identification, resolution and conclusions on accounting treatment of business transactions;

utilized external technical accounting resources and subject matter experts in areas in which additional technical expertise was needed such as procure-to-pay processes and accounting for income taxes and stock-based compensation;

identified internal control enhancements to the purchasing, receiving and accounts payable processes and developed a plan to implement the enhancements and train appropriate company personnel responsible for processing transactions; and

developed improved monitoring controls in corporate accounting.

The additional personnel and foregoing enhancements contributed to the discovery in late 2006 and early 2007 of additional errors related to prior interim periods in 2006 that resulted in management s determination that restatement of those prior periods financial statements was warranted. We believe that the foregoing corrective actions have resolved the material weaknesses that existed as of December 31, 2006 and that as of December 31, 2007 it was no longer reasonably possible that our financial statements will be materially misstated. Accordingly, as stated in management s report above, we have concluded that our internal control over financial reporting was effective as of December 31, 2007.

Changes in Internal Control Over Financial Reporting

Other than the actions described in this Item 9A under Remediation of Material Weaknesses in Internal Control Over Financial Reporting, during the fiscal quarter ended December 31, 2007, there have been no changes in our internal control over financial reporting that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

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Report of Independent Registered Public Accounting Firm

On Internal Control Over Financial Reporting

The Board of Directors and Shareholders of Trex Company, Inc.

We have audited Trex Company, Inc. s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Trex Company, Inc. s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on Trex Company, Inc. s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Trex Company, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria**.**

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Trex Company, Inc. as of December 31, 2007 and 2006, and the related consolidated statements of operations, stosp;

Property, plant and equipment, net
17,738 17,973
Trademarks
21,663 21,663
Goodwill
38,061 37,924
Other intangible assets, net
1,896 2,072
Other non-current assets
1,192 1,579
Notes payable current
3,604 4,770
Other current liabilities
20,539 16,977
Notes payable long term
49,744 54,422
Other long-term liabilities
2,985 4,941

Members equity	33,145	21,462

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues	$ 96,282	$ 90,167	$ 178,075	$ 161,569
Costs and expenses	84,935	79,437	160,432	145,762
Depreciation expense.	1,242	1,202	2,463	2,328
Amortization expense.	103	183	205	367
Interest expense, net	1,654	1,526	2,934	3,074
Income tax expense	217	193	337	374
Net income	$ 8,131	$ 7,626	$ 11,704	$ 9,664

Hawaiian Hotel. New Valley recorded income of $0 and a loss of $1,802 for the three months ended June 30, 2006 and 2005, respectively, and income of $1,154 and a loss of $3,442 for the six months ended June 30, 2006 and 2005, respectively, associated with Koa Investors. The income in the 2006 period related to the receipt of a tax credit of $1,154 from the State of Hawaii, which was received in the first quarter of 2006. Summarized financial information for the three and six months ended June 30, 2006 and 2005 and as of June 30, 2006 and December 31, 2005 for Koa Investors is presented below.

	June 30, 2006	December 31, 2005
Cash	$ 1,220	$ 1,375
Restricted assets	3,252	3,135
Other current assets	1,970	1,543
Property, plant and equipment, net	70,331	72,836
Deferred financing costs, net	1,632	2,018
Accounts payable and other current liabilities	9,425	8,539
Notes payable	83,175	82,000
Members deficit	(14,195)	(9,632)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues	$ 6,658	$ 5,223	$ 15,218	$ 10,753
Costs and operating expenses	6,234	5,461	13,584	11,215
Management fees	30	304	60	334
Depreciation and amortization expense	1,380	1,543	2,925	3,070
Interest expense, net	1,747	1,519	3,212	3,018
Net loss	$ (2,733)	$ (3,604)	$ (4,563)	$ (6,884)

In August 2005, a wholly-owned subsidiary of Koa Investors borrowed $82,000 at an interest rate of LIBOR plus 2.45%. Koa Investors used the proceeds of the loan to repay its $57,000 construction loan and distributed a portion of the proceeds to its members, including $5,500 to New Valley. As a result of the refinancing, New Valley suspended its recognition of equity losses in Koa Investors to the extent such losses exceed its basis plus any commitment to make additional investments, which

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totaled $600 at June 30, 2006. Accordingly, the Company s consolidated statements of operations do not include any equity losses of Koa Investors for the three and six months ended June 30, 2006.

St. Regis Hotel, Washington, D.C. In June 2005, affiliates of New Valley and Brickman Associates formed 16th & K Holdings LLC (Hotel LLC), which acquired the St. Regis Hotel, a 193 room luxury hotel in Washington, D.C., for $47,000 in August 2005. In connection with the closing of the purchase of the hotel, a subsidiary of Hotel LLC entered into agreements to borrow up to $50,000 of senior and subordinated debt. The members of Hotel LLC currently plan to renovate the hotel commencing in 2006. In April 2006, Hotel LLC purchased for approximately $3,000 a building adjacent to the hotel to house various administrative and sales functions. New Valley, which holds a 50% interest in Hotel LLC, had invested $9,625 in the project at June 30, 2006 and had committed to make additional investments of up to $325 at June 30, 2006.

New Valley accounts for its interest in Hotel LLC under the equity method and recorded a loss of $290 and $299 for the three and six months ended June 30, 2006, respectively. Hotel LLC will capitalize all costs related to the renovation of the property during the renovation phase.

Holiday Isle. During the fourth quarter of 2005, New Valley advanced a total of $2,750 to Ceebraid Acquisition Corporation (Ceebraid), an entity which entered into an agreement to acquire the Holiday Isle Resort in Islamorada, Florida. In February 2006, Ceebraid filed for Chapter 11 bankruptcy after it was unable to consummate financing arrangements for the acquisition. Although Ceebraid continued to seek to obtain financing for the transaction and to close the acquisition pursuant to the purchase agreement, the Company determined that a reserve for uncollectibility should be established against these advances at December 31, 2005. In April 2006, an affiliate of Ceebraid completed the acquisition of the property for $98,000, and New Valley increased its investment in the project to a total of $5,800 and indirectly holds an approximate 22.22% equity interest. New Valley had committed to make additional investments of up to $200 in Holiday Isle at June 30, 2006. The investors intend to build a condominium hotel resort and marina, with approximately 150 hotel units. In connection with the closing of the purchase, an affiliate of Ceebraid borrowed $98,000 of mezzanine and senior debt to finance a portion of the purchase price and anticipated development costs. In April 2006, Vector agreed, under certain circumstances, to guarantee up to $2,000 of the debt. The Company believes the fair value of its guarantee was negligible at June 30, 2006. New Valley accounts for its interest in Holiday Isle under the equity method and recorded a loss of $290 for the three and six months ended June 30, 2006. Holiday Isle will capitalize all costs related to the renovation of the property during the renovation phase.

Long-Term Investments. New Valley owns long-term investments, which have a $7,869 carrying value at June 30, 2006. The principal business of the limited partnerships is investing in investment securities and real estate. New Valley believes the fair value of the limited partnerships exceeds their carrying amount by approximately $9,195. The estimated fair market value of the limited partnerships was provided by the partnerships based on the indicated market values of the underlying assets or investment portfolio. New Valley s estimates of the fair value of its long-term investments are subject to judgment and are not necessarily indicative of the amounts that could be realized in the current market. The Company is required to make additional investments in one of its limited partnerships of up to an aggregate of $423 at June 30, 2006. In addition, the investments in limited partnerships are illiquid, and the ultimate realization of these investments is subject to the performance of the underlying partnership and its management by the general partners.

LTS. In March 2005, New Valley converted approximately $9,938 of principal amount and accrued interest of the convertible notes of Ladenburg Thalmann Financial Services Inc. (LTS) into 19,876,358 shares of LTS common stock. In the first quarter of 2005, New Valley recorded a gain of

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$9,461 which represented the fair value of the converted shares as determined by an independent appraisal firm. In connection with the debt conversion, New Valley purchased 11,111,111 shares of LTS common stock for $5,000 ($0.45 per share).

On March 30, 2005, New Valley distributed the 19,876,358 shares of LTS common stock it acquired from the conversion of the note to holders of New Valley common shares through a special distribution. On the same date, the Company distributed the 10,947,448 shares of LTS common stock that it received from New Valley to the holders of its common stock as a special distribution. In the first quarter of 2005, the Company recognized equity loss in operations of LTS of $299.

Following the distribution, New Valley continued to hold the 11,111,111 shares of LTS common stock (approximately 7.4% of the outstanding shares), $5,000 of LTS s notes due December 31, 2006 and a warrant expiring August 31, 2006 to purchase 100,000 shares of its common stock at $1.00 per share. The shares of LTS common stock held by New Valley have been accounted for as investment securities available for sale and are carried at $11,111 on the Company s consolidated balance sheet at June 30, 2006.

12. NEW VALLEY EXCHANGE OFFER

In December 2005, the Company completed an exchange offer and subsequent short-form merger whereby it acquired the remaining 42.3% of the common shares of New Valley Corporation that it did not already own. As result of these transactions, New Valley Corporation became a wholly-owned subsidiary of the Company and each outstanding New Valley Corporation common share was exchanged for 0.54 shares of the Company s common stock. The surviving corporation in the short-form merger was subsequently merged into a new Delaware limited liability company named New Valley LLC, which conducts the business of the former New Valley Corporation.

New Valley LLC is engaged in the real estate business and is seeking to acquire additional operating companies and real estate properties. (See Note 11.)

Purchase Accounting. Approximately 5,044,359 shares of Vector common stock were issued in connection with the transactions. The aggregate purchase price amounted to $106,900, which included $101,039 in the Company s common stock, $758 of accrued purchase price obligation, $4,130 in acquisition related costs and $973 of exchanged options, which represents the fair value on the acquisition date of the Vector options issued in exchange for the outstanding New Valley options. The transactions were accounted for under the provisions of SFAS No. 141, Business Combinations. The purchase price has been allocated based upon the estimated fair value of net assets acquired at the date of acquisition.

The purchase price reflects the fair value of Vector common stock issued in connection with the transactions based on the average closing price of the Vector common stock for the five trading days including November 16, 2005, which was $20.03 per share. The purchase price for New Valley was primarily determined on the basis of management s assessment of the value of New Valley s assets (including deferred tax assets and net operating losses) and its expectations of future earnings and cash flows, including synergies.

In connection with the acquisition of the remaining interests in New Valley, Vector estimated the fair value of the assets acquired and the liabilities assumed at the date of acquisition, December 9, 2005. The Company s analysis indicated that the fair value of net assets acquired, net of Vector s stock ownership of New Valley prior to December 9, 2005, totaled $150,543, compared to a fair value of

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liabilities assumed of $21,018, yielding net assets acquired of $129,525 which were then compared to the New Valley purchase price of $106,900 resulting in a reduction of non-current assets acquired of $14,775 and negative goodwill of $7,850, which was reduced to $6,860 in accordance with the adoption of EITF Issue No. 05-8.

Generally accepted accounting principles require that negative goodwill be reported as an extraordinary item on the Company s statement of operations.

Prior to December 9, 2005, New Valley s operating results were included in the accompanying consolidated financial statements of the Company and had been reduced by the minority interests in New Valley. The unaudited pro forma results of operations for the three and six months ended June 30, 2005 of the Company and New Valley, prepared based on the purchase price allocation for New Valley described above and as if the New Valley acquisition had occurred at January 1, 2005, would have been as follows:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Pro forma total net revenues	$ 113,113	$ 217,286
Pro forma net income from continuing operations	$ 10,401	$ 19,502
Pro forma net income	$ 10,401	$ 28,023
Pro forma basic weighted average shares outstanding	49,031,243	48,979,758
Pro forma income from continuing operations per basic common share	$ 0.21	$ 0.40
Pro forma net income per basic common share	$ 0.21	$ 0.57
Pro forma diluted weighted average shares outstanding	51,053,383	50,936,052
Pro forma income from continuing operations per diluted common share	$ 0.20	$ 0.38
Pro forma net income per diluted common share	$ 0.20	$ 0.55

The pro forma financial information above is not necessarily indicative of what the Company s consolidated results of operations actually would have been if the New Valley acquisition had been completed on January 1, 2005. In addition, the pro forma information above does not attempt to project the Company s future results of operations.

Related Litigation. On or about September 29, 2005, an individual stockholder of New Valley filed a complaint in the Delaware Court of Chancery purporting to commence a class action lawsuit against Vector, New Valley and each of the individual directors of New Valley. The complaint was styled as *Pill v. New Valley Corporation, et al*. (C.A. No. 1678-N). A similar action was also filed in state court in Miami-Dade County, Florida, on September 29, 2005 by another individual stockholder of New Valley. This action has been stayed, pending final resolution of the *Pill* action, by agreement of the

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parties. On or about October 28, 2005, a separate action was filed in the Delaware Court of Chancery purporting to commence a class action lawsuit against Vector, New Valley and each of the individual directors of New Valley. The complaint was styled as *Lindstrom v. LeBow, et al*. (Civil Action No. 1745-N). On November 9, 2005, the Delaware Court of Chancery entered an order of consolidation providing that the *Pill* action and the *Lindstrom* action be consolidated for all purposes. On November 15, 2005, the Delaware Chancery Court entered an order certifying the *Pill* action as a class action comprised of all persons who owned common shares of New Valley on October 20, 2005. On November 16, 2005, Vector and the plaintiff class in the *Pill* action reached an agreement in principle to settle the litigation, which was memorialized in a memorandum of understanding entered into on November 22, 2005. The memorandum of understanding provided, among other things, that (i) the consideration being offered be raised from 0.461 shares of Vector common stock per common share of New Valley to 0.54 shares of Vector common stock per common share of New Valley; (ii) the plaintiff acknowledged that 0.54 shares of Vector common stock per common share of New Valley was adequate and fair consideration; (iii) Vector agreed to make supplemental disclosures in the Prospectus with respect to the offer to address claims raised in the *Pill* action; (iv) the plaintiff shall have the right to comment upon and suggest additional disclosures to be made to the public stockholders by New Valley prior to the filing of its amended Schedule 14D-9 with the SEC and such suggested additional disclosures will be considered in good faith for inclusion in such filing by New Valley; and (v) all claims, whether known or unknown, of the plaintiff shall be released as against all of the defendants in the *Pill* matter and the *Lindstrom* matter. On January 20, 2006, the parties executed a Stipulation of Settlement providing for, among other things, payment by the Company of up to $860 in legal fees and costs. The settlement received court approval on April 10, 2006. The Company recorded a charge to operating, selling, administrative and general expense of $860 related to the settlement for the year ended December 31, 2005.

13. DISCONTINUED OPERATIONS

Real Estate Leasing. As discussed in Note 11, in February 2005, New Valley completed the sale for $71,500 of its two office buildings in Princeton, N.J. As a result of the sale, the consolidated financial statements of the Company reflect New Valley s real estate leasing operations as discontinued operations for the three months ended March 31, 2005. Accordingly, revenues, costs and expenses of the discontinued operations have been excluded from the respective captions in the consolidated statements of operations. The net operating results of the discontinued operations have been reported, net of applicable income taxes and minority interests, as Income from discontinued operations . Summarized operating results of the discontinued real estate leasing operations for the three and six months ended June 30, 2005 are as follows:

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VECTOR GROUP LTD.
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	Three and Six Months Ended June 30, 2005
Revenues	$ 924
Expenses	515
Income from discontinued operations before income taxes and minority interests	409
Income tax expense from discontinued operations	223
Minority interests	104
Income from discontinued operations	$ 82

Gain on Disposal of Discontinued Operations. New Valley recorded a gain on disposal of discontinued operations of $2,952 (net of minority interests and taxes) for the three and six months ended June 30, 2005 in connection with the sale of the office buildings.

14. SEGMENT INFORMATION

The Company s significant business segments for the three and six months ended June 30, 2006 and 2005 were Liggett and Vector Tobacco. The Liggett segment consists of the manufacture and sale of conventional cigarettes and, for segment reporting purposes, includes the operations of Medallion acquired on April 1, 2002 (which operations are held for legal purposes as part of Vector Tobacco). The Vector Tobacco segment includes the development and marketing of the low nicotine and nicotine-free cigarette products as well as the development of reduced risk cigarette products and, for segment reporting purposes, excludes the operations of Medallion. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Financial information for the Company s continuing operations before taxes and minority interests for the three and six months ended June 30, 2006 and 2005 follows:

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VECTOR GROUP LTD.
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	Liggett	Vector Tobacco	Real Estate	Corporate and Other	Total
Three Months Ended June 30, 2006:					
Revenues	$ 111,628	$ 1,727	$	$	$ 113,355
Operating income (loss)	30,850	(2,742)		(5,648)	22,460
Depreciation and amortization	1,848	85		585	2,518
Three Months Ended June 30, 2005:					
Revenues	$ 110,229	$ 2,884	$	$	$ 113,113
Operating income (loss)	34,345	(2,749)		(7,234)	24,362
Depreciation and amortization	2,160	168		550	2,878
Six Months Ended June 30, 2006:					
Revenues	$ 227,367	$ 3,692	$	$	$ 231,059
Operating income (loss)	61,271	(6,290)		(12,294)	42,687
Identifiable assets	271,761	6,588	29,226	276,112	583,687
Depreciation and amortization	3,662	142		1,187	4,991
Capital expenditures	2,618	47		10	2,675
Six Months Ended June 30, 2005:					
Revenues	$ 211,864	$ 5,422	$	$	$ 217,286
Operating income (loss)	66,215	(7,180)		(16,025)	43,010
Identifiable assets	267,492	8,350	29,515	222,117	527,474
Depreciation and amortization	3,977	396		1,113	5,486
Capital expenditures	4,083	12		410	4,505

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in Thousands, Except Per Share Amounts)

Overview

We are a holding company for a number of businesses. We are engaged principally in:

the manufacture and sale of cigarettes in the United States through our subsidiary Liggett Group LLC,

the development and marketing of the low nicotine and nicotine-free QUEST cigarette products and the development of reduced risk cigarette products through our subsidiary Vector Tobacco Inc., and

the real estate business through our subsidiary, New Valley LLC, which is seeking to acquire additional operating companies and real estate properties. New Valley owns 50% of Douglas Elliman Realty, LLC, which operates the largest residential brokerage company in the New York metropolitan area.

In recent years, we have undertaken a number of initiatives to streamline the cost structure of our tobacco business and improve operating efficiency and long-term earnings. During 2002, the sales and marketing functions, along with certain support functions, of our Liggett and Vector Tobacco subsidiaries were combined into a new entity, Liggett Vector Brands Inc. This company coordinates and executes the sales and marketing efforts for our tobacco operations.

Effective year-end 2003, we closed Vector Tobacco s Timberlake, North Carolina cigarette manufacturing facility in order to reduce excess cigarette production capacity and improve operating efficiencies company-wide. Production of QUEST and Vector Tobacco s other cigarette brands was transferred to Liggett s manufacturing facility in Mebane, North Carolina. In July 2004, we completed the sale of the Timberlake facility and equipment.

In April 2004, we eliminated a number of positions in our tobacco operations and subleased excess office space. In October 2004, we announced a plan to restructure the operations of Liggett Vector Brands. Liggett Vector Brands has realigned its sales force and adjusted its business model to more efficiently serve its chain and independent customers nationwide. In connection with the restructuring, we eliminated approximately 330 full-time positions and 135 part-time positions as of December 15, 2004.

We may consider various additional opportunities to further improve efficiencies and reduce costs. These prior and current initiatives have involved material restructuring and impairment charges, and any further actions taken are likely to involve material charges as well. Although management may estimate that substantial cost savings will be associated with these restructuring actions, there is a risk that these actions could have a serious negative impact on our tobacco operations and that any estimated increases in profitability cannot be achieved.

In December 2005, we completed an exchange offer and a subsequent short-form merger whereby we acquired the remaining 42.3% of the common shares of New Valley that we did not already own. As a result of these transactions, New Valley became our wholly-owned subsidiary and each outstanding New Valley common share was exchanged for 0.54 shares of our common stock. A total of approximately 5.05 million of our common shares were issued to the New Valley shareholders in the transactions.

All of Liggett s unit sales volume in 2005 and the first half of 2006 was in the discount segment, which Liggett s management believes has been the primary growth segment in the

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industry for over a decade. The significant discounting of premium cigarettes in recent years has led to brands, such as EVE, that were traditionally considered premium brands to become more appropriately categorized as discount, following list price reductions.

Liggett s cigarettes are produced in approximately 270 combinations of length, style and packaging. Liggett s current brand portfolio includes:

- LIGGETT SELECT the third largest brand in the deep discount category,
- GRAND PRIX a rapidly growing brand in the deep discount segment,
- EVE a leading brand of 120 millimeter cigarettes in the branded discount category,
- PYRAMID the industry s first deep discount product with a brand identity, and
- USA and various Partner Brands and private label brands.

In 1999, Liggett introduced LIGGETT SELECT, one of the leading brands in the deep discount category. LIGGETT SELECT is now the largest seller in Liggett s family of brands, comprising 40.0% of Liggett s unit volume in the first six months of 2006 and 48.9% of Liggett s volume in 2005. In September 2005, Liggett repositioned GRAND PRIX to distributors and retailers nationwide. GRAND PRIX is marketed as the lowest price fighter to specifically compete with brands which are priced at the lowest level of the deep discount segment.

We believe that Liggett has gained a sustainable cost advantage over its competitors through its various settlement agreements. Under the Master Settlement Agreement reached in November 1998 with 46 states and various territories, the three largest cigarette manufacturers must make settlement payments to the states and territories based on how many cigarettes they sell annually. Liggett, however, is not required to make any payments unless its market share exceeds approximately 1.65% of the U.S. cigarette market. Additionally, as a result of the Medallion acquisition, Vector Tobacco likewise has no payment obligation unless its market share exceeds approximately 0.28% of the U.S. market.

The discount segment is highly competitive, with consumers having less brand loyalty and placing greater emphasis on price. While the three major manufacturers all compete with Liggett in the discount segment of the market, the strongest competition for market share has recently come from a group of small manufacturers and importers, most of which sell low quality, deep discount cigarettes.

In January 2003, Vector Tobacco introduced QUEST, its brand of low nicotine and nicotine-free cigarette products. QUEST is designed for adult smokers who are interested in reducing their levels of nicotine intake and is available in both menthol and non-menthol styles. Each QUEST style (regular and menthol) offers three different packagings, with decreasing amounts of nicotine - QUEST 1, 2 and 3. QUEST 1, the low nicotine variety, contains 0.6 milligrams of nicotine. QUEST 2, the extra-low nicotine variety, contains 0.3 milligrams of nicotine. QUEST 3, the nicotine-free variety, contains only trace levels of nicotine no more than 0.05 milligrams of nicotine per cigarette. QUEST cigarettes utilize proprietary, patented and patent pending processes and materials that enables the production of cigarettes with nicotine-free tobacco that tastes and smokes like tobacco in conventional cigarettes. All six QUEST varieties are being sold in box style packs and are priced comparably to other premium brands.

QUEST was initially available in New York, New Jersey, Pennsylvania, Ohio, Indiana, Illinois and Michigan. At the launch of Quest, these seven states accounted for approximately 30% of all cigarette sales in the United States. A multi-million dollar advertising and marketing campaign, with advertisements running in magazines and regional newspapers, supported the product launch. The brand continues to be supported by point-of-purchase awareness campaigns.

The premium segment of the industry continues to experience intense competitive activity, with significant discounting of premium brands at all levels of retail. Given these marketplace conditions, and the results that we have seen to date with QUEST, we have taken a measured approach to expanding the market presence of the brand. In November 2003, Vector Tobacco introduced three menthol varieties of QUEST in the seven state market. In January 2004, QUEST and QUEST Menthol were introduced into an expansion market in Arizona, which accounts for approximately 2% of the industry volume nationwide.

During the second quarter 2004, based on an analysis of the market data obtained since the introduction of the QUEST product, we determined to postpone indefinitely the national launch of QUEST. Any determination as to future expansion of the market presence of QUEST will be based on the ongoing and projected demand for the product, market conditions in the premium segment and the prevailing regulatory environment, including any restrictions on the advertising of the product.

QUEST brand cigarettes are currently marketed solely to permit adult smokers, who wish to continue smoking, to gradually reduce their intake of nicotine. The products are not labeled or advertised for smoking cessation or as a safer form of smoking.

In October 2003, we announced that Jed E. Rose, Ph.D., Director of Duke University Medical Center s Nicotine Research Program and co-inventor of the nicotine patch, had conducted a study at Duke University Medical Center to provide preliminary evaluation of the use of the QUEST technology as a smoking cessation aid. In the preliminary study on QUEST, 33% of QUEST 3 smokers were able to achieve four-week continuous abstinence. In March 2006, Vector Tobacco concluded a randomized, multi center phase II clinical trial to further evaluate QUEST technology as an effective alternative to conventional smoking cessation aids. The study was designed with input from the Food and Drug Administration (FDA). In July 2006, we participated in an end-of-phase II meeting with the FDA where we received significant guidance and feedback from the agency with regard to development of the QUEST technology. The FDA provided guidance associated with future testing and data development, including the necessary duration of phase III clinical trials for the QUEST technology. Based in part on the feedback received from the FDA, the company is currently refining and evaluating commercial strategies and clinical development strategies for the QUEST smoking cessation project. Management believes that obtaining the FDA s approval to market QUEST as a smoking cessation product will be a critical factor in the commercial success of the QUEST brand. No assurance can be given that such approval can be obtained or as to the timing of any such approval if received.

Recent Developments

Issuance of New Convertible Debentures. In July 2006, we sold $110,000 principal amount of our 3.875% variable interest senior convertible debentures due June 15, 2026 in a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act. We intend to use the net proceeds of the offering to redeem our remaining 6.25% convertible subordinated notes due July 15, 2008 and for general corporate purposes.

Redemption of 6.25% Convertible Notes. On July 14, 2006, we sent a notice of redemption to the holders of the outstanding $62,492 principal amount of our 6.25% convertible subordinated notes. The redemption date is August 14, 2006, and the redemption price is 101.042% of the principal amount plus accrued interest. The notes are convertible prior to the close of business on August 11, 2006 at a conversion price of $20.92 per share. We anticipate recording a loss of approximately $1,300 in the third quarter of 2006 on the retirement of the notes.

Conversion of 6.25% Convertible Notes. In June 2006, an investment entity affiliated with Dr. Phillip Frost and an investment entity affiliated with Carl C. Icahn converted a total of $70,000 principal amount of our 6.25% convertible subordinated notes due 2008 into 3,283,303 shares of our common stock in accordance with the terms of the notes. In connection with the conversion of the notes, we issued an additional 916,697 shares of our common stock to these holders and paid these holders $1,766 of accrued interest. The additional shares and accrued interest were issued and paid as an inducement to these holders to convert the notes. We recognized a non-cash expense of $14,860 in connection with these transactions in the second quarter of 2006.

Tax Settlement. In connection with the 1998 and 1999 transaction with Philip Morris Incorporated, in which a subsidiary of Liggett contributed three of its premium cigarette brands to Trademarks LLC, a newly-formed limited liability company, we recognized in 1999 a pre-tax gain of $294,078 in our consolidated financial statements and established a deferred tax liability of $103,100 relating to the gain. In such transaction, Philip Morris acquired an option to purchase the remaining interest in Trademarks for a 90-day period commencing in December 2008, and we have an option to require Philip Morris to purchase the remaining interest for a 90-day period commencing in March 2010. It has been our position that, upon exercise of the options during either of the 90-day periods commencing in December 2008 or in March 2010, we would be required to pay tax in the amount of the deferred tax liability, which would be offset by the benefit of any net operating losses available to us at that time. In connection with an examination of our 1998 and 1999 federal income tax returns, the Internal Revenue Service issued to us in September 2003 a notice of proposed adjustment. The notice asserted that, for tax reporting purposes, the entire gain should have been recognized in 1998 and 1999 in the additional amounts of $150,000 and $129,900, respectively, rather than upon the exercise of the options during either of the 90-day periods commencing in December 2008 or in March 2010.

On July 20, 2006, we entered into a settlement with the Internal Revenue Service with respect to the Philip Morris brand transaction. As part of the settlement, we agreed that $87,000 of our gain on the transaction would be recognized by us as income for tax purposes in 1999 and that the balance of the remaining gain, net of previously capitalized expenses of $900, ($192,000) will be recognized by us as income in 2008 or 2009 upon exercise of the options. We anticipate paying during the third quarter of 2006 approximately $42,000, including interest, with respect to the gain recognized in 1999. As a result of the settlement, we will reduce during the third quarter of 2006 the excess portion of a previously established reserve in our consolidated financial statements. We currently estimate the amount of such reduction to be approximately $11,500.

New Valley Exchange Offer. In December 2005, we completed an exchange offer and subsequent short-form merger whereby we acquired the remaining 42.3% of the common shares of New Valley Corporation that we did not already own. As result of these transactions, New Valley Corporation became our wholly-owned subsidiary and each outstanding New Valley Corporation common share was exchanged for 0.54 shares of our common stock. A total of approximately 5.05 million of our common shares were issued to the New Valley Corporation shareholders in the transactions. The surviving corporation in the short-form merger was subsequently merged into a new Delaware limited liability company named New Valley LLC, which conducts the business of the former New Valley Corporation. Prior to these transactions, New Valley Corporation was registered under the Securities Exchange Act of 1934 and filed periodic reports and other information with the SEC.

On or about September 29, 2005, an individual stockholder of New Valley filed a complaint in the Delaware Court of Chancery purporting to commence a class action lawsuit against us, New Valley and each of the individual directors of New Valley. The complaint was styled as *Pill v. New Valley Corporation, et al*. (C.A. No. 1678-N). A similar action was also filed in state court in Miami-Dade County, Florida, on September 29, 2005 by another individual stockholder of New Valley. This action has been stayed, pending final resolution of the *Pill* action, by agreement of the parties. On or about October 28, 2005, a separate action was filed in the Delaware Court of Chancery purporting to commence a class action lawsuit against us, New Valley and each of the individual directors of New Valley. The complaint was styled as *Lindstrom v. LeBow, et al*. (Civil Action No. 1745-N). On November 9, 2005, the Delaware Court of Chancery entered an order of consolidation providing that the *Pill* action and the *Lindstrom* action be consolidated for all

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purposes. On November 15, 2005, the Delaware Chancery Court entered an order certifying the *Pill* action as a class action comprised of all persons who owned common shares of New Valley on October 20, 2005.

On November 16, 2005, we and the plaintiff class in the *Pill* action reached an agreement in principle to settle the litigation, which was memorialized in a memorandum of understanding entered into on November 22, 2005. The memorandum of understanding provided, among other things, that (i) the consideration being offered be raised from 0.461 shares of our common stock per common share of New Valley to 0.54 shares of our common stock per common share of New Valley; (ii) the plaintiff acknowledged that 0.54 shares of our common stock per common share of New Valley was adequate and fair consideration; (iii) we agreed to make supplemental disclosures in the Prospectus with respect to the offer to address claims raised in the *Pill* action; (iv) the plaintiff shall have the right to comment upon and suggest additional disclosures to be made to the public stockholders by New Valley prior to the filing of its amended Schedule 14D-9 with the SEC and such suggested additional disclosures will be considered in good faith for inclusion in such filing by New Valley; and (v) all claims, whether known or unknown, of the plaintiff shall be released as against all of the defendants in the *Pill* matter and the *Lindstrom* matter. On January 20, 2006, the parties executed a Stipulation of Settlement providing for, among other things, payment by us of up to $860 in legal fees and costs. The settlement received court approval on April 10, 2006. We recorded a charge to operating, selling, administrative and general expense for 2005 of $860 related to the settlement.

Tobacco Quota Elimination. In October 2004, federal legislation was enacted which eliminated the federal tobacco quota and price support program through an industry funded buyout of tobacco growers and quota holders. Pursuant to the legislation, manufacturers of tobacco products will be assessed $10,140,000 over a ten year period to compensate tobacco growers and quota holders for the elimination of their quota rights. Cigarette manufacturers will initially be responsible for 96.3% of the assessment (subject to adjustment in the future), which will be allocated based on relative unit volume of domestic cigarette shipments. Management currently estimates that Liggett s and Vector Tobacco s assessment will be approximately $22,000 for the second year of the program which began January 1, 2006. The cost of the legislation to the three largest cigarette manufacturers will likely be less than the cost to smaller manufacturers, including Liggett and Vector Tobacco, because one effect of the legislation is that the three largest manufacturers will no longer be obligated to make certain contractual payments, commonly known as Phase II payments, they agreed in 1999 to make to tobacco-producing states. The ultimate impact of this legislation cannot be determined, but there is a risk that smaller manufacturers, such as Liggett and Vector Tobacco, will be disproportionately affected by the legislation, which could have a material adverse effect on us.

Tobacco Settlement Agreements. In October 2004, Liggett was notified that all participating manufacturers payment obligations under the Master Settlement Agreement, dating from the agreement s execution in late 1998, were recalculated utilizing net unit amounts, rather than gross unit amounts (which have been utilized since 1999). The change in the method of calculation could, among other things, require additional payments by Liggett under the Master Settlement Agreement of approximately $12,300 for the periods 2001 through 2005, and require Liggett to pay an additional amount of approximately $2,800 in 2006 and in future periods by lowering Liggett s market share exemption under the Master Settlement Agreement. Liggett has objected to this retroactive change and has disputed the change in methodology. No amounts have been accrued in the accompanying consolidated financial statements for any potential liability relating to the gross versus net dispute.

On March 30, 2005, the Independent Auditor under the Master Settlement Agreement calculated $28,668 in Master Settlement Agreement payments for Liggett s 2004 sales. On April 15, 2005, Liggett paid $11,678 of this amount and, in accordance with its rights under the Master Settlement Agreement, disputed the balance of $16,990. Of the disputed amount, Liggett paid $9,304 into the disputed payments account under the Master Settlement Agreement and withheld from payment $7,686. The $9,304, which has since been released to the Settling States although Liggett continues to dispute that this money is owed, represents the amount claimed by Liggett as an adjustment to its 2003 payment obligation under the Master Settlement Agreement for market share loss to non-participating manufacturers, which is known as the NPM Adjustment. At June 30, 2006, included in Other current assets on our consolidated balance sheet was a receivable of $6,513 relating to such amount. The $7,686 withheld from payment represents $5,318 claimed as an adjustment to Liggett s 2004 Master Settlement Agreement obligation for the NPM Adjustment and $2,368 relating to the retroactive change, discussed above, to the method for computing payment obligations under the Master Settlement Agreement which Liggett contends, among other things, is not in accordance with the Master Settlement Agreement. Liggett withheld approximately $1,600 from its payment due under the Master Settlement Agreement on April 15, 2006 which Liggett claims as the NPM Adjustment to its 2005 payment obligation and $2,612 relating to the gross versus net dispute.

The following amounts have not been accrued in the accompanying consolidated financial statements as they relate to Liggett s and Vector Tobacco s claim for an NPM Adjustment: $6,513 for 2003, $3,789 for 2004 and approximately $800 for 2005.

In March 2006, an independent economic consulting firm selected pursuant to the Master Settlement Agreement rendered its final and non-appealable decision that the Master Settlement Agreement was a significant factor contributing to the loss of market share of participating manufacturers for 2003. As a result, the manufacturers are entitled to a potential NPM Adjustment to their 2003 Master Settlement Agreement payments. A settling state that has diligently enforced its qualifying escrow statute in 2003 may be able to avoid application of the NPM Adjustment to the payments made by the manufacturers for the benefit of that state.

Since April 2006, notwithstanding provisions in the Master Settlement Agreement requiring arbitration, 36 settling states have filed declaratory judgment actions, complaints or motions seeking a determination that they diligently enforced their respective escrow statutes enacted in connection with the Master Settlement Agreement and, therefore, are immune from any downward adjustment to their 2003 annual payments. The participating manufacturers have filed motions to compel arbitration of the dispute. These actions are limited to the potential NPM Adjustment for 2003, which the Independent Auditor under the Master Settlement Agreement previously determined to be as much as $1,200,000. To date, 10 courts have issued decisions: nine state courts (Colorado, Hawaii, Idaho, Kentucky, Massachusetts, New Hampshire, Vermont, New York and Connecticut) have ruled that the 2003 NPM Adjustment dispute is arbitrable and one state court (North Dakota) ruled that the dispute is not arbitrable. The participating manufacturers have appealed the North Dakota decision.

In 2004, the Attorneys General for each of Florida, Mississippi and Texas advised Liggett that they believed that Liggett had failed to make all required payments under the respective settlement agreements with these states for the period 1998 through 2003 and that additional payments may be due for 2004 and subsequent years. Liggett believes these allegations are without merit, based, among other things, on the language of the most favored nation provisions of the settlement agreements. In December 2004, Florida offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of $13,500. In March 2005, Florida reaffirmed its December 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. In November 2005, Florida made a revised offer that Liggett pay Florida $4,250 to resolve all matters through December 31, 2005, and pay Florida $0.17 per pack on all Liggett cigarettes sold in Florida beginning January 1, 2006. After further discussions, Florida s most recent offer is that Liggett pay a total of $3,500 in four annual payments, $1,000 for the first three years and $500 in the fourth year, and defer further discussion of any alleged future obligations until the end of Florida s 2006 legislative session. Liggett has not yet responded to this most

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recent offer from Florida and there can be no assurance that a settlement will be reached. In November 2004, Mississippi offered to settle all amounts allegedly owed by Liggett for the period through 2003 for the sum of $6,500. In April 2005, Mississippi reaffirmed its November 2004 offer to settle and provided Liggett with a 60 day notice to cure the alleged defaults. No specific monetary demand has been made by Texas. Liggett has met with representatives of Mississippi and Texas to discuss the issues relating to the alleged defaults, although no resolution has been reached.

Except for $2,000 accrued for the year ended December 31, 2005 in connection with the foregoing matters, no other amounts have been accrued in the accompanying consolidated financial statements for any additional amounts that may be payable by Liggett under the settlement agreements with Florida, Mississippi and Texas. There can be no assurance that Liggett will prevail in any of these matters and that Liggett will not be required to make additional material payments, which payments could adversely affect our consolidated financial position, results of operations or cash flows.

Real Estate Activities. In December 2002, New Valley purchased two office buildings in Princeton, New Jersey for a total purchase price of $54,000. New Valley financed a portion of the purchase price through a borrowing of $40,500 from HSBC Realty Credit Corporation (USA). In February 2005, New Valley completed the sale of the office buildings for $71,500. The mortgage loan on the properties was retired at closing with the proceeds of the sale.

New Valley accounts for its 50% interests in Douglas Elliman Realty LLC, Koa Investors LLC and 16th & K Holdings LLC on the equity method. Douglas Elliman Realty operates the largest residential brokerage company in the New York metropolitan area. Koa Investors LLC owns the Sheraton Keauhou Bay Resort & Spa in Kailua-Kona, Hawaii. Following a major renovation, the property reopened in the fourth quarter 2004 as a four star resort with 521 rooms. In August 2005, 16th & K Holdings LLC acquired the St. Regis Hotel, a 193 room luxury hotel in Washington, D.C., for $47,000.

Recent Developments in Legislation, Regulation and Litigation

The cigarette industry continues to be challenged on numerous fronts. New cases continue to be commenced against Liggett and other cigarette manufacturers. As of June 30, 2006, there were approximately 162 individual suits, 11 purported class actions and eight governmental and other third-party payor health care reimbursement actions pending in the United States in which Liggett was a named defendant. A civil lawsuit was filed by the United States federal government seeking disgorgement of approximately $289,000,000 from various cigarette manufacturers, including Liggett. A federal appellate court ruled in February 2005 that disgorgement is not an available remedy in the case. Trial of the case concluded in June 2005. On June 27, 2005, the government sought to restructure its potential remedies and filed a proposed Final Judgment and Order. That relief can be grouped into four categories: (1) $14,000,000 for a cessation and counter marketing program (the government s proposed remedy would require that additional monies be paid to these programs if targeted reductions in the smoking rate of those under 21 are not achieved according to the prescribed timetable); (2) so-called corrective statements ; (3) disclosures; and (4) enjoined activities. Post-trial briefing was completed in October 2005. In one of the other cases pending against Liggett, in 2000, an action against cigarette manufacturers involving approximately 975 named individual plaintiffs was consolidated for trial on some common related issues before a single West Virginia state court. Liggett is a defendant in most of the cases pending in West Virginia. In January 2002, the court severed Liggett from the trial of the consolidated action. Two purported class actions have been certified in state court in Kansas and New Mexico against the cigarette manufacturers for alleged antitrust violations. As new cases are commenced, the costs associated with defending these cases and the risks relating to the inherent unpredictability of litigation continue to increase.

There are currently four individual smoking-related actions pending where Liggett is the only tobacco company defendant. In April 2004, in one of these cases, a Florida state court jury awarded compensatory damages of $540 against Liggett. In addition, plaintiff s counsel was awarded legal fees of $752. Liggett has appealed both the verdict and the award of legal fees. In March 2005, in another case in Florida state court where Liggett is the only defendant, the court granted Liggett s motion for summary judgment. In June 2006, a Florida intermediate appellate court reversed the trial court s decision and remanded the case for further proceedings. In March 2006, in another of these cases, a Florida state court jury returned a verdict in favor of Liggett. The plaintiff s appeal has been withdrawn.

In May 2003, a Florida intermediate appellate court overturned a $790,000 punitive damages award against Liggett and decertified the *Engle* smoking and health class action. In July 2006, the Florida Supreme Court affirmed in part and reversed in part the May 2003 intermediate appellate court decision. Although the Florida Supreme Court affirmed the decision to decertify the class and the order vacating the punitive damages award, the court upheld certain of the trial court s Phase I determinations (including that: (i) smoking causes lung cancer, among other diseases; (ii) nicotine in cigarettes is addictive; (iii) defendants placed cigarettes on the market that were defective and unreasonably dangerous; (iv) the defendants concealed material information; (v) the defendants agreed to misrepresent information relating to the health effects of cigarettes with the intention that the public would rely on this information to its detriment; (vi) all defendants sold or supplied cigarettes that were defective; and (vii) all defendants were negligent) and allowed plaintiffs to proceed to trial on individual liability issues and compensatory and punitive damage issues, provided they commence their individual lawsuits within one year from the court s mandate. The defendant tobacco companies have moved for reconsideration and/or clarification of the decision. If the Florida Supreme Court s decision is allowed to stand, it could result in the filing of a large number of individual personal injury cases in Florida which could have a material adverse effect on us. In November 2000, Liggett filed the $3,450 bond required under the bonding statute enacted in 2000 by the Florida legislature which limits the size of any bond required, pending appeal, to stay execution of a punitive damages verdict. In May 2001, Liggett reached an agreement with the *Engle* class, which provided assurance to Liggett that the stay of execution, in effect under the Florida bonding statute, would not be lifted or limited at any point until completion of all appeals, including to the United States Supreme Court. As required by the agreement, Liggett paid $6,273 into an escrow account to be held for the benefit of the *Engle* class, and released, along with Liggett s existing $3,450 statutory bond, to the court for the benefit of the class upon completion of the appeals process, regardless of the outcome of the appeal. Since the Florida Supreme Court s July 2006 decision decertifying the *Engle* class, entitlement to the escrowed monies is uncertain. In June 2002, the jury in *Lukacs v. Philip Morris, et. al.*, an individual case brought under the third phase of the *Engle* case, awarded $37,500 (subsequently reduced by the court to $24,860) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. Entry of the final judgment in *Lukacs*, along with the plaintiff s motion to tax costs and attorneys fees, was stayed pending appellate review of the *Engle* final judgment. On August 2, 2006, plaintiff filed a motion for entry of partial judgment on the compensatory damages and requested a trial date on punitive damages. The defendants intend to oppose the relief sought, but there can be no assurance that the trial court will not grant the requested relief. Liggett may be required to bond the amount of the judgment against it to perfect its appeal. It is possible that additional cases could be decided unfavorably and that there could be further adverse developments in the *Engle* case. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so. Management cannot predict the cash requirements related to any future settlements and judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met.

Federal or state regulators may object to Vector Tobacco s low nicotine and nicotine-free cigarette products and reduced risk cigarette products it may develop as unlawful or allege they bear deceptive or unsubstantiated product claims, and seek the removal of the products from the marketplace, or significant changes to advertising. Various concerns regarding Vector Tobacco s

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advertising practices have been expressed to Vector Tobacco by certain state attorneys general. Vector Tobacco has previously engaged in discussions in an effort to resolve these concerns and Vector Tobacco has, in the interim, suspended all print advertising for its QUEST brand. If Vector Tobacco is unable to advertise its QUEST brand, it could have a material adverse effect on sales of QUEST. Allegations by federal or state regulators, public health organizations and other tobacco manufacturers that Vector Tobacco s products are unlawful, or that its public statements or advertising contain misleading or unsubstantiated health claims or product comparisons, may result in litigation or governmental proceedings.

In recent years, there have been a number of proposed restrictive regulatory actions from various Federal administrative bodies, including the United States Environmental Protection Agency and the Food and Drug Administration. There have also been adverse political decisions and other unfavorable developments concerning cigarette smoking and the tobacco industry, including the commencement and certification of class actions and the commencement of third-party payor actions. These developments generally receive widespread media attention. We are not able to evaluate the effect of these developing matters on pending litigation or the possible commencement of additional litigation, but our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any smoking-related litigation. See Note 8 to our consolidated financial statements for a description of legislation, regulation and litigation.

Critical Accounting Policies

General. 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, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Significant estimates subject to material changes in the near term include restructuring and impairment charges, inventory valuation, deferred tax assets, allowance for doubtful accounts, promotional accruals, sales returns and allowances, actuarial assumptions of pension plans, embedded derivative liability, the tobacco quota buyout, settlement accruals and litigation and defense costs. Actual results could differ from those estimates.

Revenue Recognition. Revenues from sales of cigarettes are recognized upon the shipment of finished goods when title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sale price is determinable and collectibility is reasonably assured. We provide an allowance for expected sales returns, net of any related inventory cost recoveries. In accordance with the Emerging Issues Task Force (EITF) Issue No. 06-3, How Sales Taxes Should Be Presented in the Income Statement (Gross Versus Net) , our accounting policy is to include federal excise taxes in revenues and cost of goods sold. Such revenues totaled $39,686 and $79,803 for the three and six months ended June 30, 2006 and $37,011 and $70,443 for the three and six months ended June 30, 2005, respectively. Since our primary line of business is tobacco, our financial position and our results of operations and cash flows have been and could continue to be materially adversely affected by significant unit sales volume declines, litigation and defense costs, increased tobacco costs or reductions in the selling price of cigarettes in the near term.

Marketing Costs. We record marketing costs as an expense in the period to which such costs relate. We do not defer the recognition of any amounts on our consolidated balance sheets with respect to marketing costs. We expense advertising costs as incurred, which is the period in which the related advertisement initially appears. We record consumer incentive and trade promotion costs as a reduction in revenue in the period in which these programs are offered, based on estimates of utilization and redemption rates that are developed from historical information.

Restructuring and Asset Impairment Charges. We have recorded charges related to employee severance and benefits, asset impairments, contract termination and other associated exit costs during 2003 and 2004. The calculation of severance pay requires management to identify employees to be terminated and the timing of their severance from employment. The calculation of benefits charges requires actuarial assumptions including determination of discount rates. As discussed further below, the asset impairments were recorded in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , which requires management to estimate the fair value of assets to be disposed of. On January 1, 2003, we adopted SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. Charges related to restructuring activities initiated after this date were recorded when incurred. Prior to this date, charges were recorded at the date of an entity s commitment to an exit plan in accordance with EITF 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) . These restructuring charges are based on management s best estimate at the time of restructuring. The status of the restructuring activities is reviewed on a quarterly basis and any adjustments to the reserve, which could differ materially from previous estimates, are recorded as an adjustment to operating income.

Purchase Accounting. We account for business combination transactions, including the exchange offer and merger with New Valley, in accordance with SFAS No. 141, Business Combinations . SFAS No. 141 requires that we allocate the cost of the acquisition to assets acquired and liabilities assumed, based on their fair values as of the acquisition date. Estimates of fair values for the non-consolidated real estate businesses of New Valley are generally based on independent appraisals and other accounts are based on management s best estimates using assumptions that are believed to be reasonable. The determination of fair values involves considerable estimation and judgment, including developing forecasts of cash flows and discount rates for the non-consolidated real estate businesses.

Impairment of Long-Lived Assets. We evaluate our long-lived assets for possible impairment annually or whenever events or changes in circumstances indicate that the carrying value of the asset, or related group of assets, may not be fully recoverable. Examples of such events or changes in circumstances include a significant adverse change in the manner in which a long-lived asset, or group of assets, is being used or a current expectation that, more likely than not, a long-lived asset, or group of assets, will be disposed of before the end of its estimated useful life. The estimate of fair value of our long-lived assets is based on the best information available, including prices for similar assets and the results of using other valuation techniques. Since judgment is involved in determining the fair value of long-lived assets, there is a risk that the carrying value of our long-lived assets may be overstated or understated.

Contingencies. We record Liggett s product liability legal expenses and other litigation costs as operating, selling, general and administrative expenses as those costs are incurred. As discussed in Note 8 to our consolidated financial statements and above under the heading Recent Developments in Legislation, Regulation and Litigation , legal proceedings covering a wide range of matters are pending or threatened in various jurisdictions against Liggett. Management is unable to make a reasonable estimate with respect to the amount or range of loss that could result from an unfavorable outcome of pending smoking-related litigation or the costs of defending such cases, and we have not provided any amounts in our consolidated financial statements for unfavorable outcomes, if any. You should not infer from the absence of any such reserve in our financial statements that Liggett will not be subject to significant tobacco-related liabilities in the future. Litigation is subject to many uncertainties, and it is possible that our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such smoking-related litigation.

Settlement Agreements. As discussed in Note 8 to our consolidated financial statements, Liggett and Vector Tobacco are participants in the Master Settlement Agreement, the 1998 agreement to settle governmental healthcare cost recovery actions brought by various states. Liggett and Vector Tobacco have no payment obligations under the Master Settlement Agreement except to the extent their market shares exceed approximately 1.65% and 0.28%, respectively, of total cigarettes sold in the United States. Their obligations, and the related expense charges under the Master Settlement Agreement, are subject to adjustments based upon, among other things, the volume of cigarettes sold by Liggett and Vector Tobacco, their relative market shares and inflation. Since relative market shares are based on cigarette shipments, the best estimate of the allocation of charges under the Master Settlement Agreement is recorded in cost of goods sold as the products are shipped. Settlement expenses under the Master Settlement Agreement recorded in the accompanying consolidated statements of operations were $4,119 and $11,707 for the three and six months ended June 30, 2006, respectively, and $5,568 and $7,015 for the six months ended June 30, 2005, respectively. Adjustments to these estimates are recorded in the period that the change becomes probable and the amount can be reasonably estimated.

Derivatives; Beneficial Conversion Feature. We measure all derivatives, including certain derivatives embedded in other contracts, at fair value and recognize them in the consolidated balance sheet as an asset or a liability, depending on our rights and obligations under the applicable derivative contract. In November 2004, we issued in a private placement 5% variable interest senior convertible notes due 2011 where a portion of the total interest payable on the notes is computed by reference to the cash dividends paid on our common stock. In December 2004 and during the first half of 2005, we issued additional notes on the same terms. This portion of the interest payment is considered an embedded derivative. Pursuant to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities , as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities , we have bifurcated this embedded derivative and, based on a valuation by a third party, estimated the fair value of the embedded derivative liability. At issuance of the November 2004 notes, the estimated initial fair value of the embedded derivative liability was $24,738, which was recorded as a discount to the notes and classified as a derivative liability on the consolidated balance sheet. The additional issuance of $46,864 of Notes in 2004 and 2005 resulted in an additional derivative liability of $17,760. The Company recognized non-cash interest expense of $1,289 and $1,528 in the second quarter of 2006 and 2005, respectively, and $2,715 and $2,594 in the first half of 2006 and 2005, respectively, due to the amortization of the debt discount attributable to the embedded derivatives.

At June 30, 2006, the derivative liability was estimated at $37,132. Changes to the fair value of this embedded derivative are reflected quarterly as an adjustment to interest expense. We recognized gains of $1,015 and $299 in the second quarter of 2006 and 2005, respectively, and $2,239 and $1,127 for the first half of 2006 and 2005, respectively, due to changes in the fair value of the embedded derivative, which were reported as adjustments to interest expense.

After giving effect to the recording of the embedded derivative liability as a discount to the notes, our common stock had a fair value at the issuance date of the notes in excess of the conversion price resulting in a beneficial conversion feature. EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Convertible Ratios , requires that the intrinsic value of the beneficial conversion feature ($22,075 at date of issuance) be recorded to additional paid-in capital and as a discount on the notes. The discount is then amortized to interest expense over the term of the notes using the effective interest rate method. We recognized non-cash interest expense of $835 and $834 in the second quarter of 2006 and 2005, respectively, and $1,581 and $1,358 in the first half of 2006 and 2005, respectively, due to the amortization of the debt discount attributable to the beneficial conversion feature.

Effective January 1, 2006, we adopted EITF Issue No. 05-8, Income Tax Effects of Issuing Convertible Debt with a Beneficial Conversion Feature. In Issue No. 05-8, the EITF concluded that the issuance of convertible debt with a beneficial conversion feature creates a temporary difference on which deferred taxes should be provided. The consensus is required to be applied in fiscal periods beginning after December 15, 2005, by retroactive restatement of prior financial statements retroactive to the issuance of the convertible debt. The adoption of EITF Issue No. 05-8 reduced income tax expense by $340 and $643 for the three and six months ended June 30, 2006, respectively. The retrospective application of EITF Issue No. 05-8 reduced income tax expense by $296 and $482 for the three and six months ended June 30, 2005, respectively, and increased long-term deferred tax liabilities and decreased stockholders equity by $7,759 as of January 1, 2006. See Note 1 to our consolidated financial statements for a reconciliation of stockholders equity accounts.

In July 2006, we issued $110,000 of our 3.875% variable interest senior convertible debentures due 2026. A portion of the total interest payable on the debentures is computed by reference to the cash dividends paid on our common stock. We anticipate that there will be an embedded derivative liability and may be a beneficial conversion feature associated with the debentures. We are in process of determining the value of the embedded derivative liability and beneficial conversion feature, if any, at the date of issuance.

Inventories. Tobacco inventories are stated at lower of cost or market and are determined primarily by the last-in, first-out (LIFO) method at Liggett and the first-in, first-out (FIFO) method at Vector Tobacco. Although portions of leaf tobacco inventories may not be used or sold within one year because of time required for aging, they are included in current assets, which is common practice in the industry. We estimate an inventory reserve for excess quantities and obsolete items based on specific identification and historical write-offs, taking into account future demand and market conditions. At June 30, 2006, approximately $1,041 of our leaf inventory was associated with Vector Tobacco s QUEST product. During the second quarter of 2004, we recognized a non-cash charge of $37,000 to adjust the carrying value of excess leaf tobacco inventory for the QUEST product, based on estimates of future demand and market conditions. If actual demand for the product or market conditions are less favorable than those estimated, additional inventory write-downs may be required.

Stock-Based Compensation. In January 2006, we adopted SFAS No. 123(R), Share-Based Payment", under which share-based transactions are accounted for using a fair value-based method to recognize non-cash compensation expense. Prior to adoption, our stock-based compensation plans were accounted for in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees with the intrinsic value-based method permitted by SFAS No. 123, Accounting for Stock-Based Compensation as amended by SFAS No. 148. We adopted SFAS No. 123(R) using the modified prospective method. Under the modified prospective method, we recognize compensation expense for all share-based payments granted after January 1, 2006 and prior to, but not yet vested as of January 1, 2006 in accordance with SFAS No. 123(R). Under the fair value recognition provisions of SFAS No. 123(R), we recognize stock-based compensation net of an estimated forfeiture rate and only recognize compensation cost for those shares expected to vest on a straight line basis over the requisite service period of the award. Upon adoption, there was no cumulative adjustment for the impact of the change in accounting principles because the assumed forfeiture rate did not differ significantly from prior periods. We recognized compensation expense of $129 and $315 related to stock options for the three and six months ended June 30, 2006, respectively, as a result of adopting SFAS No. 123(R). In addition, effective January 1, 2006, as a result of the adoption of SFAS No. 123(R), payments of dividend equivalent rights on the unexercised portion of stock options are accounted for as reductions in additional paid-in capital on our consolidated balance sheet ($1,578 and $3,156 for the three and six months ended June 30, 2006). Prior to January 1, 2006, in accordance with APB Opinion No. 25, we accounted for these dividend equivalent rights as additional compensation expense ($1,503 and $3,273 for the three and six months ended June 30, 2005, respectively). As of June 30, 2006, there was $65 of total unrecognized cost related to employee stock options. See Note 9 to our consolidated financial statements for a discussion of the adoption of this standard.

Employee Benefit Plans. The determination of our net pension and other postretirement benefit income or expense is dependent on our selection of certain assumptions used by actuaries in calculating such amounts. Those assumptions include, among others, the discount rate, expected long-term rate of return on plan assets and rates of increase in compensation and healthcare costs. In accordance with accounting principles generally accepted in the United States of America, actual results that differ from our assumptions are accumulated and amortized over future periods and therefore, generally affect our recognized income or expense in such future periods. While we believe that our assumptions are appropriate, significant differences in our actual experience or significant changes in our assumptions may materially affect our future net pension and other postretirement benefit income or expense.

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Net pension expense for defined benefit pension plans and other postretirement benefit expense aggregated approximately $4,250 for 2005, and we currently anticipate such expense will be approximately $4,650 for 2006. In contrast, our funding obligations under the pension plans are governed by ERISA. To comply with ERISA s minimum funding requirements, we do not currently anticipate that we will be required to make any funding to the pension plans for the pension plan year beginning on January 1, 2006 and ending on December 31, 2006. Any additional funding obligation that we may have for subsequent years is contingent on several factors and is not reasonably estimable at this time.

Results of Operations

The following discussion provides an assessment of our results of operations, capital resources and liquidity and should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report. The consolidated financial statements include the accounts of VGR Holding, Liggett, Vector Tobacco, Liggett Vector Brands, New Valley and other less significant subsidiaries.

For purposes of this discussion and other consolidated financial reporting, our significant business segments for the six months ended June 30, 2006 and 2005 were Liggett and Vector Tobacco. The Liggett segment consists of the manufacture and sale of conventional cigarettes and, for segment reporting purposes, includes the operations of The Medallion Company, Inc. acquired on April 1, 2002 (which operations are held for legal purposes as part of Vector Tobacco). The Vector Tobacco segment includes the development and marketing of the low nicotine and nicotine-free cigarette products as well as the development of reduced risk cigarette products and, for segment reporting purposes, excludes the operations of Medallion.

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30 2005	June 30, 2006	June 30, 2005
Revenues:				
Liggett	$ 111,628	$ 110,229	$ 227,367	$ 211,864
Vector Tobacco	1,727	2,884	3,692	5,422
Total revenues	$ 113,355	$ 113,113	$ 231,059	$ 217,286
Operating income (loss):				
Liggett	$ 30,850	$ 34,345	$ 61,271	$ 66,215
Vector Tobacco	(2,742)	(2,749)	(6,290)	(7,180)
Total tobacco	28,108	31,596	54,981	59,035
Corporate and other	(5,648)	(7,234)	(12,294)	(16,025)
Total operating income	$ 22,460	$ 24,362	$ 42,687	$ 43,010

Three Months Ended June 30, 2006 Compared to Three Months ended June 30, 2005

Revenues. Total revenues were $113,355 for the three months ended June 30, 2006 compared to $113,113 for the three months ended June 30, 2005. This $242 (0.2%) increase in revenues was due to a $1,399 (1.3%) increase in revenues at Liggett and a $1,157 (40.1%) decrease in revenues at Vector Tobacco.

Tobacco Revenues. All of Liggett s sales for the first half of 2006 and 2005 were in the discount category. For the three months ended June 30, 2006, net sales at Liggett totaled $111,628, compared to $110,229 for the three months ended June 30, 2005. Revenues increased by 1.3% ($1,399) due to an 8.0% increase in unit sales volume (approximately 148.3 million units) accounting for $8,784 in favorable volume variance partially offset by $3,666 in unfavorable sales mix and unfavorable pricing and increased promotional spending of $3,718. Net revenues of the LIGGETT SELECT brand decreased $16,100 for the second quarter of 2006 compared to 2005, and its unit volume decreased 25% in 2006 period compared to 2005. Net revenues of the GRAND PRIX brand increased $16,058 for the second quarter of 2006 compared to the prior year period when there were no material sales.

Revenues at Vector Tobacco for the three months ended June 30, 2006 were $1,727 compared to $2,884 in the 2005 period due to decreased sales volume. Vector Tobacco s revenues in both periods related primarily to sales of QUEST.

Tobacco Gross Profit. Tobacco gross profit was $44,051 for the three months ended June 30, 2006 compared to $47,212 for the three months ended June 30, 2005. This represented a decrease of $3,161 (6.7%) when compared to the same period last year, due primarily to increased promotional spending offset by lower Master Settlement Agreement expense. Liggett s brands contributed 99.3% to our gross profit and Vector Tobacco contributed 0.7% for the three months ended June 30, 2006. Over the same period in 2005, Liggett s brands contributed 97.7% to tobacco gross profit and Vector Tobacco contributed 2.3%.

Liggett s gross profit of $43,732 for the three months ended June 30, 2006 decreased $2,395 from gross profit of $46,127 for the three months ended June 30, 2005. As a percent of revenues (excluding federal excise taxes), gross profit at Liggett decreased to 60.5% for the three months ended June 30, 2006 compared to gross profit of 62.5% for the three months ended June 30, 2005. This decrease in Liggett s gross profit in 2006 period was attributable to increased promotional spending offset by lower Master Settlement Agreement expense.

Vector Tobacco s gross profit was $319 for the three months ended June 30, 2006 compared to gross profit of $1,085 for the same period in 2005. The decrease was due primarily to the reduced sales volume.

Expenses. Operating, selling, general and administrative expenses were $21,591 for the three months ended June 30, 2006 compared to $22,850 for the same period last year, a decrease of $1,259 (5.5%). Expenses at Liggett were $12,882 for the three months ended June 30, 2006 compared to $11,649 for the same period in the prior year, an increase of $1,233 or 10.6%. The increase in expense for the three months ended June 30, 2006 was due primarily to an increase in the sales force. Liggett s product liability legal expenses and other litigation costs of $1,090 for the three months ended June 30, 2006 compared to $1,221 for the same period in the prior year. Expenses at Vector Tobacco for the three months ended June 30, 2006 were $3,061 compared to expenses of $3,834 for the three months ended June 30, 2005 primarily due to reduced employee expense. Expenses at corporate for the quarter ended June 30, 2006 were reduced as a result of the adoption of SFAS No. 123(R). Payments of dividend equivalent rights on unexercised stock options previously charged to compensation cost ($1,503 for the three months ended June 30, 2005) are now recognized as reductions to additional paid-in capital on our consolidated balance sheet ($1,578 for the three months ended June 30, 2006).

For the three months ended June 30, 2006, Liggett s operating income decreased $3,495 to $30,850 compared to $34,345 for the same period in 2005 primarily due to higher promotional spending and increased operating, selling, general and administration expenses partially offset by higher revenues and lower Master Settlement Agreement expense. For the three months ended June 30, 2006, Vector Tobacco s operating loss was $2,742 compared to a loss of $2,749 for the three months ended June 30, 2005 due to reduced employee expense offset by lower sales volume.

Other Income (Expenses). For the three months ended June 30, 2006, other income (expenses) was an expense of $17,457 compared to an expense of $5,696 for the three months ended June 30, 2005. The results for the three months ended June 30, 2006 included expenses of $14,860 associated with the issuance in June 2006 of 916,697 additional shares of our common stock in connection with the conversion of $70,000 of our 6.25% convertible notes, interest expense of $8,802 and a loss on investments of $17, offset primarily by equity income from non-consolidated real estate businesses of $3,870 and interest and dividend income of $2,321. The equity income of $3,870 for the 2006 period resulted primarily from income of $4,450 related to New Valley s investment in Douglas Elliman Realty, LLC offset by a loss in Hotel LLC of $290 and Holiday Isle of $290. For the three months ended June 30, 2005, equity income from non-consolidated real estate businesses of $2,324 and interest and dividend income of $1,170 were offset by interest expense of $9,242 and loss on investments of $5.

Income from Continuing Operations. The income from continuing operations before income taxes was $5,003 and $18,666 for the three months ended June 30, 2006 and 2005, respectively. The income tax provision was $8,352 in 2006. This compared to a tax provision of $8,781 and minority interests of $392 in 2005. Our income tax rate for the three months ended June 30, 2006 does not bear a customary relationship to statutory income tax rates as a result of the impact of the nondeductible expense associated with the conversion of our 6.25% convertible notes, nondeductible expenses and state income taxes. Our tax rate for the three months ended June 30, 2005 does not bear a customary relationship to statutory income tax rates as a result of the intraperiod allocation at New Valley between income from continuing and discontinued operations and the utilization of deferred tax assets at New Valley, nondeductible expenses and state income taxes.

Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005

Revenues. Total revenues were $231,059 for the six months ended June 30, 2006 compared to $217,286 for the six months ended June 30, 2005. This $13,773 (6.3%) increase in revenues was due to a $15,503 (7.3%) increase in revenues at Liggett and a decrease of $1,730 (31.9%) in revenues at Vector Tobacco.

Tobacco Revenues. All of Liggett s sales for the first half of 2006 and 2005 were in the discount category. For the six months ended June 30, 2006, net sales at Liggett totaled $227,367 compared to $211,864 for the first half of 2005. Revenues increased by 7.3% ($15,503) due to a 14.2% increase in unit sales volume (approximately 503.2 million units) accounting for $30,181 in favorable volume variance partially offset by $4,917 in unfavorable sales mix and unfavorable pricing and increased promotional spending of $9,761. Net revenues of the LIGGETT SELECT brand decreased $9,749 for the six months ended June 30, 2006 compared to the same period in 2005, and its unit volume decreased 6.6% in the 2006 period compared to 2005. Net revenues of the GRAND PRIX brand increased $28,058 for the first half of 2006 compared to the prior year period.

Revenues at Vector Tobacco were $3,692 for the six months ended June 30, 2006 compared to $5,422 for the six months ended June 30, 2005 due to decreased sales volume. Vector Tobacco s revenues in both periods related primarily to sales of QUEST.

Tobacco Gross Profit. Tobacco gross profit was $88,414 for the six months ended June 30, 2006 compared to $92,386 for the six months ended June 30, 2005. This represented a decrease of $3,972 (4.3%) when compared to the same period last year, due primarily to the reduced sales volume. Liggett s brands contributed 99.1% to our gross profit and Vector Tobacco contributed 0.9% for the six months ended June 30, 2006. Over the same period in 2005, Liggett s brands contributed 97.9% to tobacco gross profit and Vector Tobacco contributed 2.1%.

Liggett s gross profit of $87,652 for the six months ended June 30, 2006 decreased $2,833 from gross profit of $90,485 for the six months ended June 30, 2005. As a percent of revenues (excluding federal excise taxes), gross profit at Liggett decreased to 59.1% for the six months ended June 30, 2006 compared to 63.5% for the same period in 2005. This decrease in Liggett s gross profit in the 2006 period was attributable to increased promotional spending and higher Master Settlement Agreement costs.

Vector Tobacco s gross profit was $762 for the six months ended June 30, 2006 compared to gross profit of $1,901 for the same period in 2005. The decrease was due primarily to the reduced sales volume.

Expenses. Operating, selling, general and administrative expenses were $45,727 for the six months ended June 30, 2006 compared to $49,376 for the same period last year, a decrease of $3,649, or 7.4%. Expenses at Liggett were $26,382 for the six months ended June 30, 2006 compared to $24,271 for the same period last year, an increase of $2,111 or 8.7%. The increase in expense for the six months ended June 30, 2006 was due primarily to an increase in the sales force. Liggett s product liability legal expenses and other litigation costs of $2,463 for the six months ended June 30, 2006 compared to $2,451 for the same period in the prior year. Expenses at Vector Tobacco for the six months ended June 30, 2006 were $7,051 compared to expenses of $9,081 for the six months ended June 30, 2005 primarily due to reduced employee expense. Expenses at corporate for the six months ended June 30, 2006 were reduced as a result of the adoption of SFAS No. 123(R). Payments of dividend equivalent rights on unexercised stock options previously charged to compensation cost ($3,273 for the six months ended June 30, 2005) are now recognized as reductions to additional paid-in capital on our consolidated balance sheet ($3,156 for the six months ended June 30, 2006).

For the six months ended June 30, 2006, Liggett s operating income decreased to $61,271 compared to $66,215 for the prior year period primarily due to higher promotional spending and Master Settlement Agreement costs partially offset by higher revenues. For the six months ended June 30, 2006, Vector Tobacco s operating loss was $6,290 compared to a loss of $7,180 for the six months ended June 30, 2005 due to reduced employee expense offset by lower sales volume.

Other Income (Expenses). For the six months ended June 30, 2006, other income (expenses) was an expense of $20,191 compared to an expense of $1,348 for the six months ended June 30, 2005. The results for the six months ended June 30, 2006 included expenses of $14,860 associated with the issuance in June 2006 of 916,697 additional shares of our common stock in connection with the conversion of our 6.25% convertible notes, interest expense of $17,068 and a loss on investments of $47, offset primarily by equity income from non-consolidated real estate businesses of $7,605, and interest and dividend income of $4,102. The equity income of $7,605 for the 2006 period resulted primarily from income of $7,040 related to New Valley s investment in Douglas Elliman Realty, LLC and income of $1,154 related to its investment in Koa Investors, which owns the Sheraton Keauhou Bay Resort and Spa in Kailua-Kona, Hawaii, which were offset by losses of $299 from Hotel LLC and $290 from Holiday Isle. For the six months ended June 30, 2005, a gain on the LTS conversion of $9,461, a gain on investments of $1,425, and interest and dividend income of $1,880 were offset by interest expense of $15,889, equity income from non-consolidated real estate businesses of $2,018 and an equity loss in LTS of $299. The equity income of $2,018 for the 2005 period resulted primarily from income of $5,460 related to New Valley s investment in Douglas Elliman Realty, LLC offset by a loss of $3,442 related to its investment in Koa Investors.

Income from Continuing Operations. The income from continuing operations before income taxes and minority interests was $22,496 and $41,662 for the six months ended June 30, 2006 and 2005, respectively. The income tax provision was $16,552 for the six months ended June 30, 2006. This compared to a tax provision of $21,299 and minority interests in income of subsidiaries of $1,624 for the six months ended June 30, 2005. Our income tax rate for the six months ended June 30, 2006 does not bear a customary relationship to statutory income tax

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rates as a result of as a result of the impact of the nondeductible expense associated with the conversion of our 6.25% convertible debt, the impact of nondeductible expenses and state income taxes. Our tax rate for the six months ended June 30, 2005 does not bear a customary relationship to statutory income tax rates as a result of the impact of nondeductible expenses, state income taxes, the receipt of the LTS distribution, the utilization of deferred tax assets at New Valley and the intraperiod allocation at New Valley between income from continuing and discontinued operations.

Discontinued Operations

Real Estate Leasing. In February 2005, New Valley completed the sale for $71,500 of its two office buildings in Princeton, N.J. As a result of the sale, our consolidated financial statements reflect New Valley s real estate leasing operations as discontinued operations for the three and six months ended June 30, 2005. Accordingly, revenues, costs and expenses of the discontinued operations have been excluded from the respective captions in the consolidated statements of operations. The net operating results of the discontinued operations have been reported, net of applicable income taxes and minority interests, as Income from discontinued operations .

Summarized operating results of the discontinued real estate leasing operations for the three and six months ended June 30, 2005 are as follows.

	Three and Six Months Ended June 30, 2005
Revenues	$ 924
Expenses	515
Income from discontinued operations before income taxes and minority interests	409
Income tax expense from discontinued operations	223
Minority interests	104
Income from discontinued operations	$ 82

Gain on Disposal of Discontinued Operations. New Valley recorded a gain on disposal of discontinued operations of $2,952 (net of minority interests and taxes) in the first quarter of 2005 in connection with the sale of the office buildings.

Liquidity and Capital Resources

Net cash and cash equivalents decreased $25,307 for the six months ended June 30, 2006 and increased $53,485 for the six months ended June 30, 2005. Net cash provided from operations was $11,499 and $21,978 for the six months ended June 30, 2006 and 2005, respectively. The difference between the two periods relates to a net change of $16,253 in the 2006 period versus the 2005 period primarily related to increased payments of current liabilities related to promotional accruals, income taxes and bonus accruals and the timing of the $1,765 payment of interest on the $70,000 of our 6.25% notes converted in June 2006 versus the payment of such interest in the prior year in July and decreased net income of $15,829. The amount was offset by an increase of accounts receivable of $3,008 in the

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2006 period versus an increase of accounts receivable of $8,510 in the 2005 period, a decrease of $19,907 of non-cash income items (income from non-consolidated real estate companies, gain from the conversion of LTS notes, equity loss on operations of LTS and net gains, loss on conversion of debt and losses from investments) in the 2006 period, and increased distributions from non-consolidated real estate businesses of $1,155 in the 2006 period.

Cash used in investing activities was $9,289 for the six months ended June 30, 2006 compared to cash provided of $59,238 for the 2005 period. In the six months ended June 30, 2006, cash was used for capital expenditures of $2,675, the net purchase of investment securities of $145, investments in non-consolidated real estate businesses of $6,425 and the net purchase of long-term investments of $10. Cash was provided in the 2005 period principally from discontinued operations of $66,912 offset by the net purchases of investment securities for $653 and capital expenditures of $4,505.

Cash used in financing activities was $27,517 for the six months ended June 30, 2006 compared to $27,731 for the 2005 period. In the first six months of 2006, cash was used for distributions on common stock of $44,283, net repayments on debt of $3,191 and deferred financing charges of $100. Cash used was offset primarily by net borrowings under the Liggett credit facility of $19,284, and proceeds from the exercise of options of $773. In the first six months of 2005, cash was used for distributions on common stock of $33,525, repayments on debt of $2,297, net repayments under Liggett s revolver of $341 and deferred financing charges of $1,960, offset by proceeds from the sale of convertible notes of $44,959 and issuance of other debt of $2,100 and proceeds from the exercise of options of $2,546.

Liggett. Liggett has a $50,000 credit facility with Wachovia Bank, N.A. under which $19,284 was outstanding at June 30, 2006. Availability as determined under the facility was approximately $16,593 based on eligible collateral at June 30, 2006. The facility is collateralized by all inventories and receivables of Liggett and a mortgage on its manufacturing facility. Borrowings under the facility bear interest at a rate equal to 1.0% above the prime rate of Wachovia. The facility requires Liggett s compliance with certain financial and other covenants including a restriction on Liggett s ability to pay cash dividends unless Liggett s borrowing availability under the facility for the 30-day period prior to the payment of the dividend, and after giving effect to the dividend, is at least $5,000 and no event of default has occurred under the agreement, including Liggett s compliance with the covenants in the credit facility, including an adjusted net worth and working capital requirement. In addition, the facility imposes requirements with respect to Liggett s adjusted net worth (not to fall below $8,000 as computed in accordance with the agreement) and working capital (not to fall below a deficit of $17,000 as computed in accordance with the agreement). At June 30, 2006, management believes that Liggett was in compliance with all covenants under the credit facility; Liggett s adjusted net worth was $37,333 and net working capital was $32,915, as computed in accordance with the agreement.

100 Maple LLC, a company formed by Liggett in 1999 to purchase its Mebane, North Carolina manufacturing plant, has a term loan of $3,095 outstanding as of June 30, 2006 under Liggett s credit facility. The remaining balance of the term loan is due on October 1, 2006. Interest is charged at the same rate as applicable to Liggett s credit facility, and the outstanding balance of the term loan reduces the maximum availability under the credit facility. Liggett has guaranteed the term loan, and a first mortgage on the Mebane property and manufacturing equipment collateralizes the term loan and Liggett s credit facility.

Beginning in October 2001, Liggett upgraded the efficiency of its manufacturing operation at Mebane with the addition of four new state-of-the-art cigarette makers and packers, as well as related equipment. The total cost of these upgrades was approximately $20,000. Liggett took delivery of the first two of the new lines in the fourth quarter of 2001 and financed the purchase price of $6,404 through the issuance of notes, guaranteed by us and payable in 60 monthly installments of $106 with interest calculated at the prime rate. In March 2002, the third line was delivered, and the purchase price of $3,023 was financed through the issuance of a note, payable

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in 30 monthly installments of $62 and then 30 monthly installments of $51 with an interest rate of LIBOR plus 2.8%. In May 2002, the fourth line was delivered, and Liggett financed the purchase price of $2,871 through the issuance of a note, payable in 30 monthly installments of $59 and then 30 monthly installments of $48 with an interest rate of LIBOR plus 2.8%. In September 2002, Liggett purchased additional equipment for $1,573 through the issuance of a note guaranteed by us, payable in 60 monthly installments of $26 plus interest rate calculated at LIBOR plus 4.31%.

In October 2005, Liggett purchased equipment for $4,441 through a financing agreement payable in 24 installments of $112 and then 24 installments of $90. Interest is calculated at 4.89%. Liggett was required to provide a security deposit equal to 25% of the funded amount or $1,110.

In December 2005, Liggett purchased equipment for $2,273 through a financing agreement payable in 24 installments of $58 and then 24 installments of $46. Interest is calculated at 5.03%. Liggett was required to provide a security deposit equal to 25% of the funded amount or $568.

Each of these equipment loans is collateralized by the purchased equipment.

Liggett and other United States cigarette manufacturers have been named as defendants in a number of direct and third-party actions (and purported class actions) predicated on the theory that they should be liable for damages from cancer and other adverse health effects alleged to have been caused by cigarette smoking or by exposure to so-called secondary smoke from cigarettes. We believe, and have been so advised by counsel handling the respective cases, that Liggett has a number of valid defenses to claims asserted against it. Litigation is subject to many uncertainties. In May 2003, a Florida intermediate appellate court overturned a $790,000 punitive damages award against Liggett and decertified the *Engle* smoking and health class action. On July 7, 2006, the Florida Supreme Court affirmed in part and reversed in part the May 2003 intermediate appellate court decision. Although the Florida Supreme Court affirmed the decision to decertify the class and the order vacating the punitive damages award, the Court upheld certain of the trial court s Phase I determinations. The defendant tobacco companies have moved for reconsideration and/or clarification of the decision. If the Florida Supreme Court s decision is allowed to stand, it could result in the filing of a large number of individual personal injury cases in Florida which could have a material adverse effect on us. In June 2002, the jury in an individual case brought under the third phase of the *Engle* case awarded $37,500 (subsequently reduced by the court to $24,860) of compensatory damages against Liggett and two other defendants and found Liggett 50% responsible for the damages. On August 2, 2006, the plaintiff filed a motion for entry of partial judgment on the compensatory damages award and requested a trial date regarding punitive damages. The defendants intend to oppose the relief sought, but there can be no assurance that the trial court will not grant the requested relief. Liggett may be required to bond the amount of the judgment against it to perfect its appeal. In April 2004, a Florida state court jury awarded compensatory damages of $540 against Liggett in an individual action. In addition, plaintiff s counsel was awarded legal fees of $752. Liggett has appealed both the verdict and the award of legal fees. It is possible that additional cases could be decided unfavorably and that there could be further adverse developments in the *Engle* case. Liggett may enter into discussions in an attempt to settle particular cases if it believes it is appropriate to do so. Management cannot predict the cash requirements related to any future settlements and judgments, including cash required to bond any appeals, and there is a risk that those requirements will not be able to be met. An unfavorable outcome of a pending smoking and health case could encourage the commencement of additional similar litigation. In recent years, there have been a number of adverse regulatory, political and other developments concerning cigarette smoking and the tobacco industry. These developments generally receive widespread media attention. Management is unable to evaluate the effect of these developing matters on pending litigation or the possible commencement of

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additional litigation or regulation. See Note 8 to our consolidated financial statements for additional information.

Management is unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome of the cases pending against Liggett or the costs of defending such cases. It is possible that our consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such tobacco-related litigation.

V.T. Aviation. In February 2001, V.T. Aviation LLC, a subsidiary of Vector Research Ltd., purchased an airplane for $15,500 and borrowed $13,175 to fund the purchase. The loan, which is collateralized by the airplane and a letter of credit from us for $775, is guaranteed by Vector Research, VGR Holding and us. The loan is payable in 119 monthly installments of $125 including annual interest of 2.31% above the 30-day commercial paper rate, with a final payment of $2,709, based on current interest rates.

VGR Aviation. In February 2002, V.T. Aviation purchased an airplane for $6,575 and borrowed $5,800 to fund the purchase. The loan is guaranteed by us. The loan is payable in 119 monthly installments of $40, including annual interest at 2.75% above the 30-day commercial paper rate, with a final payment of $3,931 based on current interest rates. During the fourth quarter of 2003, this airplane was transferred to our direct subsidiary, VGR Aviation LLC, which has assumed the debt.

Vector Tobacco. On April 1, 2002, a subsidiary of ours acquired the stock of The Medallion Company, Inc., a discount cigarette manufacturer, and related assets from Medallion s principal stockholder. Following the purchase of the Medallion stock, Vector Tobacco merged into Medallion and Medallion changed its name to Vector Tobacco Inc. The total purchase price for the Medallion shares and the related assets consisted of $50,000 in cash and $60,000 in notes, with the notes guaranteed by us and by Liggett. Of the notes, $25,000 have been repaid with the final quarterly principal payment of $3,125 made on March 31, 2004. The remaining $35,000 of notes bear interest at 6.5% per year, payable semiannually, and mature on April 1, 2007.

New Valley. In December 2002, New Valley financed a portion of its purchase of two office buildings in Princeton, New Jersey with a $40,500 mortgage loan from HSBC Realty Credit Corporation (USA). In February 2005, New Valley completed the sale of the office buildings. The mortgage loan on the properties was retired at closing with the proceeds of the sale.

Vector. We believe that we will continue to meet our liquidity requirements through 2006. Corporate expenditures (exclusive of Liggett, Vector Research, Vector Tobacco and New Valley) over the next twelve months for current operations include cash interest expense of approximately $23,600, dividends on our outstanding shares (currently at an annual rate of approximately $87,000) and corporate expenses. In addition, as discussed above, $35,000 of Vector Tobacco notes issued in the 2002 Medallion acquisition mature on April 1, 2007. We anticipate funding our expenditures for current operations and required principal payments with available cash resources, proceeds from public and/or private debt and equity financing, management fees and other payments from subsidiaries. New Valley may acquire or seek to acquire additional operating businesses through merger, purchase of assets, stock acquisition or other means, or to make other investments, which may limit its ability to make such distributions.

In July 2006, we sold $110,000 of our 3.875% variable interest senior convertible debentures due 2026 in a private offering to qualified institutional buyers in accordance with Rule 144A under the Securities Act of 1933. We intend to use the net proceeds of the offering to redeem our remaining 6.25% convertible subordinated notes due 2008 and for general corporate purposes.

The debentures pay interest on a quarterly basis at a rate of 3.875% per annum, with an additional amount of interest payable on each interest payment date. The additional amount is based on the amount of cash dividends paid by us on our common stock during the prior three-month period ending on the record date for such interest payment multiplied by the total number of shares of our common stock into which the debentures will be convertible on such record date (together, the Debenture Total Interest). Notwithstanding the foregoing, however, the interest payable on each interest payment date shall be the higher of (i) the Debenture Total Interest and (ii) 5.75% per annum. The debentures are convertible into our common stock, at the holder s option. The initial conversion price is $21.50 per share, subject to adjustment for various events, including the issuance of stock dividends.

The debentures will mature on June 15, 2026. We must redeem 10% of the total aggregate principal amount of the debentures outstanding on June 15, 2011. In addition to such redemption amount, we will also redeem on June 15, 2011 and at the end of each interest accrual period thereafter an additional amount, if any, of the debentures necessary to prevent the debentures from being treated as an Applicable High Yield Discount Obligation under the Internal Revenue Code. The holders of the debentures will have the option on June 15, 2012, June 15, 2016 and June 15, 2021 to require us to repurchase some or all of their remaining debentures. The redemption price for such redemptions will equal 100% of the principal amount of the debentures plus accrued interest. If a fundamental change occurs, we will be required to offer to repurchase the debentures at 100% of their principal amount, plus accrued interest and, under certain circumstances, a make-whole premium .

In November 2004, we sold $65,500 of our 5% variable interest senior convertible notes due November 15, 2011 in a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act of 1933. The buyers of the notes had the right, for a 120-day period ending March 18, 2005, to purchase an additional $16,375 of the notes. At December 31, 2004, buyers had exercised their rights to purchase an additional $1,405 of the notes, and the remaining $14,959 principal amount of notes were purchased during the first quarter of 2005. In April 2005, we issued an additional $30,000 principal amount of 5% variable interest senior convertible notes due November 15, 2011 in a separate private offering to qualified institutional investors in accordance with Rule 144A. These notes, which were issued under a new indenture at a net price of 103.5%, were on the same terms as the $81,864 principal amount of notes previously issued in connection with the November 2004 placement.

The notes pay interest on a quarterly basis at a rate of 5% per year with an additional amount of interest payable on the notes on each interest payment date. This additional amount is based on the amount of cash dividends actually paid by us per share on our common stock during the prior three-month period ending on the record date for such interest payment multiplied by the number of shares of our common stock into which the notes are convertible on such record date (together, the Notes Total Interest). Notwithstanding the foregoing, however, during the period prior to November 15, 2006, the interest payable on each interest payment date is the higher of (i) the Notes Total Interest and (ii) 6 3/4% per year. The notes are convertible into our common stock, at the holder s option. The conversion price, which was of $18.48 at June 30, 2006, is subject to adjustment for various events, including the issuance of stock dividends.

The notes will mature on November 15, 2011. We must redeem 12.5% of the total aggregate principal amount of the notes outstanding on November 15, 2009. In addition to such redemption amount, we will also redeem on November 15, 2009 and at the end of each interest accrual period thereafter an additional amount, if any, of the notes necessary to prevent the notes from being treated as an Applicable High Yield Discount Obligation under the Internal Revenue Code. The holders of the notes will have the option on November 15, 2009 to require us to repurchase some or all of their remaining notes. The redemption price for such redemptions will equal 100% of the principal amount of the notes plus accrued interest. If a fundamental change occurs, we will be required to offer to repurchase the notes at 100% of their principal amount, plus accrued interest and, under certain circumstances, a make-whole premium .

In July 2001, we completed the sale of $172,500 (net proceeds of approximately $166,400) of our 6.25% convertible subordinated notes due July 15, 2008 through a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act of 1933. The notes pay interest at 6.25% per annum and are convertible into our common stock, at the option of the holder. The conversion price, which was $20.92 at June 30, 2006, is subject to adjustment for various events, and any cash distribution on our common stock results in a corresponding decrease in the conversion price. In December 2001, $40,000 of the notes were converted into our common stock, in October 2004, $8 of the notes were converted, and, in June 2006, $70,000 of the notes were converted. A total of $62,492 principal amount of the notes were outstanding at June 30, 2006. On July 14, 2006, we called the notes for redemption on August 14, 2006. The redemption price is 101.042% of the principal amount plus accrued interest.

Our consolidated balance sheets include deferred income tax assets and liabilities, which represent temporary differences in the application of accounting rules established by generally accepted accounting principles and income tax laws. As of June 30, 2006, our deferred income tax liabilities exceeded our deferred income tax assets by $67,619. The largest component of our deferred tax liabilities exists because of differences that resulted from a 1998 and 1999 transaction with Philip Morris Incorporated in which a subsidiary of Liggett contributed three of its premium brands to Trademarks LLC, a newly-formed limited liability company. In such transaction, Philip Morris acquired an option to purchase the remaining interest in Trademarks for a 90-day period commencing in December 2008, and we have an option to require Philip Morris to purchase the remaining interest commencing in March 2010. For additional information concerning the Philip Morris brand transaction, see Note 16 to our consolidated financial statements in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2005.

In connection with the transaction, we recognized in 1999 a pre-tax gain of $294,078 in our consolidated financial statements and established a deferred tax liability of $103,100 relating to the gain. It has been our position that, upon exercise of the options during the 90-day periods commencing in December 2008 or in March 2010, we would be required to pay tax in the amount of the deferred tax liability, which will be offset by the benefit of any net operating losses, available to us at that time. In connection with an examination of our 1998 and 1999 federal income tax returns, the Internal Revenue Service issued to us in September 2003 a notice of proposed adjustment. The notice asserted that, for tax reporting purposes, the entire gain should have been recognized in 1998 and in 1999 in the additional amounts of $150,000 and $129,900, respectively, rather than upon the exercise of the options during the 90-day periods commencing in December 2008 or in March 2010.

On July 20, 2006, we entered into a settlement with the Internal Revenue Service with respect to the Philip Morris brand transaction. As part of the settlement, we agreed that $87,000 of our gain on the transaction would be recognized by us as income for tax purposes in 1999 and that the balance of the remaining gain, net of previously capitalized expenses of $900, ($192,000) will be recognized by us as income in 2008 or 2009 upon exercise of the options. We anticipate paying during the third quarter of 2006 approximately $42,000, including interest, with respect to the gain recognized in 1999. As a result of the settlement, we will reduce during the third quarter of 2006 the excess portion of a previously established reserve in our consolidated financial statements. We currently estimate the amount of such reduction to be approximately $11,500.

Off-Balance Sheet Arrangements

We have various agreements in which we may be obligated to indemnify the other party with respect to certain matters. Generally, these indemnification clauses are included in contracts arising in the normal course of business under which we customarily agree to hold the other party harmless against losses arising from a breach of representations related to such matters as title to assets sold and licensed or certain intellectual property rights. Payment by us under such indemnification clauses is generally conditioned on the other party making a claim that is subject to challenge by us and dispute resolution procedures specified in the particular contract. Further, our obligations under these arrangements may be limited in terms of time and/or amount, and in some instances, we may have recourse against third parties for certain payments made by us. It is not possible to predict the maximum potential amount of future payments under these indemnification agreements due to the conditional nature of our obligations and the unique facts of each particular agreement. Historically, payments made by us under these agreements have not been material. As of June 30, 2006, we were not aware of any indemnification agreements that would or are reasonably expected to have a current or future material adverse impact on our financial position, results of operations or cash flows.

In May 1999, in connection with the Philip Morris brand transaction, Eve Holdings Inc., a subsidiary of Liggett, guaranteed a $134,900 bank loan to Trademarks LLC. The loan is secured by Trademarks three premium cigarette brands and Trademarks interest in the exclusive license of the three brands by Philip Morris. The license provides for a minimum annual royalty payment equal to the annual debt service on the loan plus $1,000. We believe that the fair value of Eve s guarantee was negligible at June 30, 2006.

In December 2001, New Valley s subsidiary, Western Realty Development LLC, sold all the membership interests in Western Realty Investments LLC to Andante Limited. In August 2003, Andante submitted an indemnification claim to Western Realty Development alleging losses of $1,225 from breaches of various representations made in the purchase agreement. Under the terms of the purchase agreement, Western Realty Development has no obligation to indemnify Andante unless the aggregate amount of all claims for indemnification made by Andante exceeds $750, and Andante is required to bear the first $200 of any proven loss. New Valley would be responsible for 70% of any damages payable by Western Realty Development. New Valley has contested the indemnification claim.

In February 2004, Liggett Vector Brands and another cigarette manufacturer entered into a five year agreement with a subsidiary of the American Wholesale Marketers Association to support a program to permit tobacco distributors to secure, on reasonable terms, tax stamp bonds required by state and local governments for the distribution of cigarettes. Under the agreement, Liggett Vector Brands has agreed to pay a portion of losses, if any, incurred by the surety under the bond program, with a maximum loss exposure of $500 for Liggett Vector Brands. To secure its potential obligations under the agreement, Liggett Vector Brands has delivered to the subsidiary of the Association a $100 letter of credit and agreed to fund up to an additional $400. Liggett Vector Brands has incurred no losses to date under this agreement, and we believe the fair value of Liggett Vector Brands obligation under the agreement was immaterial at June 30, 2006.

At June 30, 2006, we had outstanding approximately $3,432 of letters of credit, collateralized by certificates of deposit. The letters of credit have been issued as security deposits for leases of office space, to secure the performance of our subsidiaries under various insurance programs and to provide collateral for various subsidiary borrowing and capital lease arrangements.

As of June 30, 2006, New Valley has committed to fund as up to $1,175 to a non-consolidated real estate business and up to $423 to a limited partnership in which it is an investor. We have agreed, under certain circumstances, to guarantee up to $2,000 of debt of another non-consolidated real estate business. We believe the fair value of our guarantee was negligible at June 30, 2006.

Market Risk

We are exposed to market risks principally from fluctuations in interest rates, foreign currency exchange rates and equity prices. We seek to minimize these risks through our regular operating and financing activities and our long-term investment strategy. Our market risk management procedures cover all market risk sensitive financial instruments.

As of June 30, 2006, approximately $36,909 of our outstanding debt had variable interest rates determined by various interest rate indices, which increases the risk of fluctuating interest rates. Our exposure to market risk includes interest rate fluctuations in connection with our variable rate borrowings, which could adversely affect our cash flows. As of June 30, 2006, we had no interest rate caps or swaps. Based on a hypothetical 100 basis point increase or decrease in interest rates (1%), our annual interest expense could increase or decrease by approximately $211. In addition, as of June 30, 2006, approximately $111,864 of our outstanding debt had a variable interest rate determined by the amount of the dividends on our common stock.

We held investment securities available for sale totaling $25,020 at June 30, 2006, which includes 11,111,111 shares of Ladenburg Thalmann Financial Services Inc., which were carried at $11,111 (see Note 3 to our consolidated financial statements). Adverse market conditions could have a significant effect on the value of these investments.

New Valley also holds long-term investments in limited partnerships and limited liability companies. These investments are illiquid, and their ultimate realization is subject to the performance of the underlying entities.

New Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154). SFAS No. 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. The provisions of SFAS No. 154 require, unless impracticable, retrospective application to prior periods financial statements of (i) all voluntary changes in accounting principles and (ii) changes required by a new accounting pronouncement, if a specific transition is not provided. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate, which requires prospective application of the new method. SFAS No. 154 is effective for all accounting changes made in fiscal years beginning after December 15, 2005. The impact of the application of SFAS No. 154 is discussed below in connection with the application of EITF Issue No. 05-8, Income Tax Effects of Issuing Convertible Debt with a Beneficial Conversion Feature.

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations an Interpretation of SFAS Statement No. 143 (FIN 47). FIN 47 clarifies the timing of liability recognition for legal obligations associated with the retirement of a tangible long-lived asset when the timing and/or method of settlement are conditional on a future event. FIN 47 is effective for fiscal years ending after December 15, 2005. The application of FIN 47 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In September 2005, the EITF reached a consensus on Issue No. 04-13, Inventory Exchanges. EITF Issue No. 04-13 required two or more inventory transactions with the same party to be considered a single nonmonetary transaction subject to APB Opinion No. 29, Accounting for Nonmonetary Transactions, if the transactions were entered into in

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contemplation of one another. EITF Issue No. 04-13 is effective for us for new arrangements entered into after April 2, 2006. We do not expect the adoption of EITF Issue No. 04-13 to have a material impact on our financial position, results of operations or cash flows.

Effective January 1, 2006, we adopted EITF Issue No. 05-8, Income Tax Effects of Issuing Convertible Debt with a Beneficial Conversion Feature. The issuance of convertible debt with a beneficial conversion feature creates a temporary difference on which deferred taxes should be provided. The consensus is required to be applied in fiscal periods (years or quarters) beginning after December 15, 2005, by retroactive restatement of prior financial statements back to the issuance of the convertible debt. The adoption of EITF Issue No. 05-8 reduced our income tax expense by $340 and $643 for the three and six months ended June 30, 2006, respectively. The retrospective application of EITF Issue No. 05-8 reduced our income tax expense by $296 and $482 for the three and six months ended June 30, 2005, respectively, and increased long-term deferred tax liabilities and decreased stockholders equity by $7,759 as of January 1, 2006. See Note 1 to our consolidated financial statements for a reconciliation of stockholders equity accounts.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Instruments . SFAS No. 155 amends SFAS Nos. 133 and 140 and relates to the financial reporting of certain hybrid financial instruments. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of fiscal years commencing after September 15, 2006. We have not completed our assessment of the impact of this standard.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) , which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We have not completed our assessment of the impact of this standard.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to historical information, this report contains forward-looking statements within the meaning of the federal securities law. Forward-looking statements include information relating to our intent, belief or current expectations, primarily with respect to, but not limited to:

- economic outlook,
- capital expenditures,
- cost reduction,
- new legislation,
- cash flows,
- operating performance,
- litigation,
- impairment charges and cost savings associated with restructurings of our tobacco operations, and
- related industry developments (including trends affecting our business, financial condition and results of operations).

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We identify forward-looking statements in this report by using words or phrases such as anticipate , believe , estimate , expect , intend , may be , objective , plan , seek , predict , project and will be and similar wo their negatives.

The forward-looking information involves important risks and uncertainties that could cause our actual results, performance or achievements to differ materially from our anticipated results, performance or achievements expressed or implied by the forward-looking statements. Factors that could cause actual results to differ materially from those suggested by the forward-looking statements include, without limitation, the following:

- general economic and market conditions and any changes therein, due to acts of war and terrorism or otherwise,
- governmental regulations and policies,
- effects of industry competition,
- impact of business combinations, including acquisitions and divestitures, both internally for us and externally in the tobacco industry,
- impact of restructurings on our tobacco business and our ability to achieve any increases in profitability estimated to occur as a result of these restructurings,
- impact of new legislation on our competitors payment obligations, results of operations and product costs, i.e. the impact of recent federal legislation eliminating the federal tobacco quota system,
- uncertainty related to litigation and potential additional payment obligations for us under the Master Settlement Agreement and other settlement agreements with the states, and
- risks inherent in our new product development initiatives.

Further information on risks and uncertainties specific to our business include the risk factors discussed above under Management s Discussion and Analysis of Financial Condition and Results of Operations and under Item 1A, Risk Factors in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2005 filed with the Securities and Exchange Commission.

Although we believe the expectations reflected in these forward-looking statements are based on reasonable assumptions, there is a risk that these expectations will not be attained and that any deviations will be material. The forward-looking statements speak only as of the date they are made.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations Market Risk is incorporated herein by reference.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of our

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disclosure controls and procedures as of the end of the period covered by this report, and, based on their evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective.

There were no changes in our internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II
OTHER INFORMATION

Item 1. Legal Proceedings

Reference is made to Note 8, incorporated herein by reference, to our consolidated financial statements included elsewhere in this report which contains a general description of certain legal proceedings to which VGR Holding, New Valley or their subsidiaries are a party and certain related matters. Reference is also made to Exhibit 99.1 for additional information regarding the pending smoking-related material legal proceedings to which Liggett is a party. A copy of Exhibit 99 will be furnished without charge upon written request to us at our principal executive offices, 100 S.E. Second St., Miami, Florida 33131, Attn. Investor Relations.

Item 1A. Risk Factors

Except as set forth below, there are no material changes from the risk factors set forth in Item 1A, Risk Factors, of our Annual Report on 10-K, as amended, for the year ended December 31, 2005. Please refer to that section for disclosures regarding the risks and uncertainties related to our business. The risk factor in the Annual Report on Form 10-K, as amended, entitled Our liquidity could be adversely affected if taxing authorities prevail in their assertion that we incurred a tax obligation in 1998 and 1999 in connection with the Philip Morris brand transaction , is deleted as a result of our July 2006 settlement with the Internal Revenue Service. The risk factor in the Annual Report on Form 10-K, as amended, entitled Litigation and regulation will continue to harm the tobacco industry , is revised to reflect the updated information concerning the number and status of cases discussed under Note 8 to our consolidated financial statements and in Management s Discussion and Analysis of Financial Condition Recent Developments in Legislation, Regulation and Litigation.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

No securities of ours which were not registered under the Securities Act of 1933 have been issued or sold by us during the three months ended June 30, 2006, except 916,697 shares issued in June 2006 as an inducement for the conversion of our 6.25% convertible subordinated notes due 2008. No securities of ours were repurchased by us or our affiliated purchasers during the three months ended June 30, 2006.

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

We held our 2006 annual meeting of stockholders on May 22, 2006. The matters submitted to our stockholders for a vote at the meeting were to elect the following seven director nominees to serve for the ensuing year and until their successors are elected and to approve the Vector Group Ltd. Senior Executive Annual Bonus Plan. The votes cast and withheld for the election of directors were as follows:

Nominee	For	Withheld
Bennett S. LeBow	36,322,285	9,822,806
Howard M. Lorber	36,331,713	9,813,378
Ronald J. Bernstein	36,223,751	9,921,340
Henry C. Beinstein	36,736,415	9,408,676
Robert J. Eide	36,872,357	9,666,065
Jeffrey S. Podell	36,872,357	9,272,734
Jean E. Sharpe	36,906,629	9,238,462

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With respect to the plan, the votes cast were as follows: for 36,239,425, against 907,827 and abstain 8,997,837. Based on these voting results, each of the directors nominated was elected and the plan was approved.

Item 6. Exhibits

*4.1	Indenture, dated as of July 12, 2006, by and between Vector and Wells Fargo Bank, N.A., relating to the 3 7/8% Variable Interest Senior Convertible Notes due 2006 (the 3 7/8% Notes), including the form of the 3 7/8% Note (incorporated by reference to Exhibit 4.1 in Vector s Form 8-K dated July 11, 2006).
*4.2	Registration Rights Agreement, dated as of July 12, 2006, by and between Vector and Jefferies & Company, Inc. (Jefferies) (incorporated by reference to Exhibit 4.2 in Vector s Form 8-K dated July 11, 2006).
*10.1	Agreement, dated as of June 7, 2006, between the Company and Frost Gamma Investments Trust, an entity affiliated with Dr. Phillip Frost, relating to the conversion of 6.25% convertible subordinated notes due 2008 (incorporated by reference to Exhibit 10.1 in Vector s Form 8-K dated June 7, 2006).
*10.2	Agreement, dated as of June 7, 2006, between the Company and Barberry Corp., an entity affiliated with Carl C. Icahn, relating to the conversion of 6.25% convertible subordinated notes due 2008 (incorporated by reference to Exhibit 10.2 in Vector s Form 8-K dated June 7, 2006).
*10.3	Purchase Agreement, dated as of June 27, 2006, among Vector and Jefferies (incorporated by reference to Exhibit 1.1 in Vector s Form 8-K dated June 27, 2006).
*10.4	Letter Agreement, dated July 14, 2006, between Vector and Howard M. Lorber (incorporated by reference to Exhibit 10.1 in Vector s Form 8-K dated July 11, 2006).
31.1	Certification of Chief Executive Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer, Pursuant to Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99.1	Material Legal Proceedings.

* Incorporated by reference .

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) 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.

VECTOR GROUP LTD.
(Registrant)

By: /s/ J. Bryant Kirkland III
J. Bryant Kirkland III
Vice President, Treasurer and Chief Financial Officer

Date: August 9, 2006

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