Delta Apparel, Inc.

Fiscal Third Quarter FY17 Results Earnings Conference Call

August 1, 2017

Operator:

Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal 2017 Third Quarter Conference Call. Joining us from Management are Bob Humphreys, Chairman and Chief Executive Officer; and Deb Merrill, Chief Financial Officer and President, Delta Basics.

Before we begin, I'd like to remind everyone that during the course of this conference call, projections or other forward-looking statements may be made by Delta Apparel's executives. Such statements suggest prediction and involve risk and uncertainty, and actual results may differ materially. Please refer to the periodic reports filed with the Securities and Exchange Commission, including the Company's most recent Form 10-K. This document contains and identifies important factors that could cause actual results to differ materially from those contained in the projections or forward-looking statements.

Please note that any forward-looking statements are made only as of today, and the Company does not commit to update or revise these statements, even if it becomes apparent that any projected results will not be realized.

Today's conference is being recorded. I'll now turn the call over to Delta's Chief Financial Officer and President, Delta Basics, Deb Merrill.

Deborah Merrill:

Good afternoon, and thank you all for joining us for Delta Apparel's Third Quarter Earnings Conference Call. Our third quarter was one of progress and profit. With our sale of Junkfood business on March 31, we did not have revenue from that business in our 2017 third quarter. Excluding Junkfood sales, our consolidated net sales this quarter increased 4% over the prior year quarter. Our net income improved significantly for the quarter, coming in at $4.5 million or $0.57 per diluted share compared with net income in the prior year period of $2.5 million or $0.32 per diluted share.

The 2016 third quarter earnings included manufacturing realignment expenses of $0.18 per share. Without that, the prior year earnings were $0.50 per diluted share, showing a 14% improvement this year over the adjusted prior year.

Third quarter 2017 net sales for the Basics segment were $79 million, a 9.6% increase over the $72.1 million in the prior year third quarter.

Operating profit in the Basics segment increased to $7.5 million or 9.5% of sales compared to $5.2 million or 7.2% of sales in the prior year period, which did include a $1.8 million pretax expense related to the manufacturing realignment.

Net sales in our Activewear business grew 11% over the prior year quarter, driven by single-digit sales growth in the Catalog business and a 25% sales increase in FunTees private label goods. Catalog sales benefited from improving conditions in the retail license channel and continued success with its Fashion Basics line. The growth in Activewear was partially offset by a decline in Art Gun, driven by the loss of a customer and delayed new partner launches. These new partners remain in the pipeline, and we anticipate having them online as we move towards the holiday season.

Branded segment net sales for the quarter were $25.3 million compared with $39.5 million in the prior year period, which included $11.3 million sales in the Junkfood business. The decline is due primarily to the impact of retailer bankruptcies, partially offset by sales growth in other channels. Operating profit for the branded segment was $2.1 million compared to $2.7 million in the prior year third quarter.

Salt Life sales increased over 2% from the prior year, with softness in the big-box retail sporting goods channel hampering stronger growth seen in independent retailers and on our Salt Life e-commerce site.

Soffe sales for the quarter were down $2.9 million year-over-year, with the decline primarily due to the loss of sales from the Sports Authority bankruptcy. Soffe is growing with its military channel and having success with e-retailers and on its own website.

The manufacturing—on the manufacturing side of the business, the benefits from our manufacturing realignment are now seen in our results. The manufacturing efficiencies and cost savings have exceeded our expectations to date. These benefits, however, are being tempered by higher-cost raw materials that, due to the softness in the marketplace, are not getting recouped fully with higher selling prices. In order to limit our overall exposure to the higher cost, we shuttered our manufacturing operations for a week during our June quarter to avoid building inventory with higher-cost raw materials. The cost of this shutdown lowered our gross margins by 60 basis points and decreased earnings by $0.07 per diluted share. We plan to continue this with another week out of production in our fourth quarter, which we expect to be our last production curtailment in the short term.

Outside of the impact of the manufacturing shutdown, our Activewear gross margins improved 150 basis points over the prior year quarter. Our Salt Life gross margins also expanded during the quarter, up 160 basis points over the prior year quarter.

Overall, operating profit in the June quarter was $5.9 million or 5.6% of sales compared to $4.2 million or 3.8% of sales in the prior year quarter, which, adjusted for the manufacturing realignment expenses, was $6.1 million or 5.4% of sales.

For the first nine months of fiscal 2017, net sales were $293.8 million compared with $310.9 million in the prior year period. After excluding Junkfood sales from both years for comparison purposes, net sales for the first nine months of fiscal 2007 (sic) [2017] are slightly ahead of the prior year.

Net income in the 2017 9-month period was $8.4 million or $1.07 per diluted share, including an $0.11 gain on the sale of the Junkfood business. This compares to $6.7 million or $0.84 per diluted share in the prior year period or $1.02 per diluted share adjusted for the manufacturing realignment expenses.

During the quarter, we repurchased 122,000 shares of our stock at an average price of $19.30 for a total of $2.4 million of share repurchases. This brings our year-to-date repurchases to nearly $4 million, buying back a total of 218,000 shares. At the end of the third quarter, we had $5.1 million remaining on our Board authorization for share repurchases. We plan to continue our approach to share repurchases consistent with our view of the intrinsic value of the Company relative to its share price range while also evaluating other alternatives for returning value to our Shareholders.

Capital spending for the third quarter was $1.5 million, bringing our total to $5.5 million year-to-date. We continue to make investments in our e-commerce platforms, store—our retail store build-outs and manufacturing equipment upgrades. We expect total capital spending for the fiscal year to be around $10 million, somewhat less than fiscal 2016.

Depreciation and amortization, including noncash compensation, was $2.8 million in the quarter and $8.4 million year-to-date.

I'll now turn the call over to Bob Humphreys to provide additional color on our third quarter performance and outlook for the year.

Robert Humphreys:

Thanks, Deb. Overall, we had a good quarter, particularly in light of the difficult retail conditions we continue to see. We are pleased with the strong growth in net sales and operating profit in our Delta Activewear business. Sales of fashion basics products continued their growth trend, being up 60% over the prior year quarter. We are excited about the broader color palette and silhouette expansions planned for the Delta Platinum line in 2018 and expect to see these double-digit growth trends continue. We are also excited about the newly redesigned business-to-business website that just launched in our Activewear business and believe it will greatly enhance the online experience for catalog customers.

Efforts to diversify the FunTees private label customer base and product offerings have paid off, and we are seeing this with the continued sales growth in this business. Based on current momentum, we expect this year to be an all-time record revenue year for FunTees.

Art Gun has enjoyed consistent double-digit growth over the past several years but experienced some headwinds this quarter as its customers deal internally with increased competition for the consumer dollar. We expect the late new partner launches that Deb mentioned to be completed in the coming months and Art Gun to regain momentum. Art Gun is making further investments in infrastructure and technology as well as to expand its geographic footprint to improve customer service levels and further shorten the time for its products to reach the end consumer. We are optimistic about a quick return to the historic growth patterns at Art Gun and have increased capacities by more than 50% to service the expected upcoming holiday 2017 season. Art Gun's virtual inventory and fulfillment model continues to be an innovation point for forward-looking retailers and apparel businesses, and we are seasoned upon this trend in cross-selling Art Gun services across the Delta Apparel customer base.

As Deb mentioned, softness in the big-box retail sporting goods channel and the loss of retail doors to bankruptcies tempered overall growth for Salt Life, but it was still able to increase sales year-over-year as well as achieve margin expansion. This led to record third quarter sales and operating profits in this business. Salt Life continues to thrive in the independent channel, and several new customer launches in the specialty retail channel are anticipated and should drive future growth. Salt Life's direct-to-consumer strategy also continues to expand with a new retail store in Columbus, Georgia and the first Salt Life outlet store scheduled to open soon in Daytona Beach, Florida.

Salt Life achieved an almost 50% year-over-year increase in e-commerce sales during the quarter and year-to-date. As you look at the e-commerce sales, we are pleased with what it shows us about the Salt Life consumer and the potential for further geographic growth, with five of the top 10 selling states on the site from both a revenue and transactional basis located outside of Salt Life's traditional stronghold in the Southeast.

We continue to receive positive feedback across the retailer and consumer spectrums on Salt Life's product direction and brand identity. Consumers continue to seek Salt Life's new performance products, incorporating leading-edge fabrics. We expect Salt Life to resume its double-digit growth patterns as it continues to expand its product line, geographic reach and market penetration.

We see sales in our Soffe business stabilizing, and Soffe continues to gain traction with the military, e-retailers and on its own branded e-commerce sites. While many traditional retail channels remain challenging, we are excited about the made-in-America opportunities for Soffe.

We continue to focus on cost and inventory reduction efforts at Soffe and look forward to expanding Soffe's brand awareness and omnichannel reach through the opening of two additional retail stores in the upcoming quarters, bringing Soffe's brick-and-mortar store footprint to five. Soffe's consumer e-commerce sites continue to grow, increasing sales by 15% during the quarter, bringing it up 24% year-to-date.

As you've heard, we've had a lot of success in our e-commerce sites, with year-over-year sales growth of 41% on our consumer e-commerce site after excluding Junkfood e-commerce sales from the prior year period and 15% growth on our business-to-business e-commerce sites during the quarter. We're continuing to make investments in our e-commerce platforms and other digital media to broaden our consumer reach and enhance the consumer experience.

It seems that every quarter brings new challenges, particularly within the retail landscape. Our diverse customer base and broad distribution, coupled with our vertical manufacturing platform, allow us to focus on the strongest channels and to operate profitably despite these challenges. This is evident in our recent financial performance, and we believe it will become more evident as we move forward.

We achieved both top and bottom line growth during the quarter. Our margins are solid. We have reduced cost and we have made our entire operation more efficient through our recent strategic initiatives and manufacturing realignment. Delta is now more agile than ever and well positioned to respond to changing market conditions.

In addition, our balance sheet continues to strengthen, and we expect debt to decrease over the next several quarters. Capital expenditures should be lower in fiscal 2018 than this year, and we plan for inventories to be reduced as the year unfolds. Fiscal 2018 should be another year of strong cash flows to redeploy in business opportunities and to reduce debt and to return to Shareholders. We remain sharply focused on our most profitable opportunities and look forward to a strong finish to fiscal 2017 and continued future growth.

Now Deb and I will be glad to answer any questions that you might have.

Operator:

Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one to ask a question, and we will pause for just a moment.

We'll go to Dave King, Roth Capital.

David King:

Hey. Good afternoon, Bob and Deb. I guess, first off, in terms of thinking about these door closings and the impact, are you able to share with us how much—or are you able to see how much of the overall branded revenue was lost due to that and either—and if it's easier, maybe just how much of Soffe or how much of Salt Life was impacted? Would Soffe have been sort of flat without those door closings? Is that the right way to think about it?

Robert Humphreys:

Yes. Soffe would have been flat, and Salt Life would have had further growth.

David King:

Okay, okay. Still a meaningful impact. On the Soffe side, it sounds like a fair amount of that is TSA. Are some of these others starting to wave in as well between Gander and—are you seeing a downtrend like Hibbett's? Go ahead.

Robert Humphreys:

Yes. I would—sporting goods, in general—big-box sporting goods, in general, are challenging. Even if you're doing well there as a brand, you do get weighted down with their overall challenges and limited open-to-buy dollars. Sometimes we see some good at-once opportunities and some opportunities to turn quick on print programs, which we're well positioned to do. Actually, at Soffe, in this quarter, we were more impacted than you—than would be expected on TSA because then it was post-bankruptcy, and they were actually trying to get more merchandise in. We had a bit of an upswing last year in the third quarter with TSA at Soffe.

David King:

Okay, okay. That helps. Then, switching gears a bit. For Salt Life, in terms of the newly opened retail stores, how are those performing now that we're in summer? Then, as we think about the—I think it was 47% growth in e-comm through the first nine months, do you know how that—it sounds from your prepared remarks, Bob, that a fair amount of the revenue is coming from markets—newer markets. I guess, do you know what the—are you able to share what the growth rate might be like in a California or some of that, especially after you've opened these stores?

Robert Humphreys:

Yes. We're definitely seeing every week growth in our new retail stores in California and Columbus, Georgia. Columbus has been a really nice, I'll say, encouraging move. We used to have a little outlet store in Columbus back in our game day, kind of ran out of that merchandise. There was a good location available near the river in Columbus. We quickly converted it to a Salt Life store, and it has really exceeded our expectations. That's our first, I'll call it, inland store of Salt Life, and we have been encouraged on that. Just to give you maybe a little bit of flavor on e-commerce sales at Salt Life. The number one state was Florida. Number two was Texas. Number three was New Jersey. Number four was New York. Number five was North Carolina, Pennsylvania, Virginia, Maryland, Georgia and California. I'm really disappointed that South Carolina didn't make the Top 10. I'm going to have to get out and shake the trees a little bit here.

The other thing that I think is really important and encouraging to us, our e-commerce business in totality. Our two B2B sites, our Soffe sites and our Salt Life site are generating mid-teen operating margins. That's with all costs, including distribution, including our e-commerce teams, including our infrastructure costs to operate these sites, included in that. We have been focused on profitable e-commerce business, which is a little bit unusual in the world we're living in today; and then on the last thing on Salt Life, we are being really true, we believe, to our identity. We could print T-shirts and make a sales number pretty easy. There's lots of people who will take Salt Life T-shirts, but we're trying to make sure we protect out retailers and our sites and our retail stores and grow the brand out properly.

David King:

Okay, okay. Good to hear. I guess, lastly for me, if you—I guess it looks like most of the proceeds from Junkfood, if I'm seeing this correctly—well, there was some inventory build, but it looks like most of that was used for debt pay-downs. I guess, can you talk a little bit about the rationale behind that, say, versus being more aggressive with buybacks here?

Robert Humphreys:

Well, we were pretty dang aggressive during the quarter and spent a lot of money on share buybacks, and that generally gets limited by our safe harbor approach to share repurchases and what that starts limiting you of when you can buy and how much you buy back so...

David King:

Okay. Is liquidity a function—I mean, stock liquidity a function in terms of how much you're able to buy back? I mean, could you...

Robert Humphreys:

Well, it is because you can only buy a certain percent of your trailing, what, three-month average trading volume. Yes, with less volume trading over time, then it does start limiting how much you can buy in any one day.

David King:

All right. I'll step back. Thanks for taking my questions. Good luck with the rest of the year.

Operator:

We'll next go to Jamie Wilen, Wilen Management.

James Wilen:

Just wanted to touch back on the bankruptcies. Were there any charges that you had to endure during the quarter?

Deborah Merrill:

Not any significant impact this quarter.

Robert Humphreys:

Yes, the Gander Mountain was out last quarter. Yes, so nothing material.

James Wilen:

Okay. Then, in total, how much revenue did the—those bankruptcies—how much business did you do with them in the previous fiscal year?

Robert Humphreys:

I don't think we have that off the top of our head. We'll have to get to that number for you.

James Wilen:

Okay. On the Salt Life side, did you do a figure for Salt Life gross margins within there? I was—did you say Salt Life gross margins had changed in the quarter? I know you were breaking that down separately.

Robert Humphreys:

Yes. They were up 160 basis points from the prior year third quarter.

James Wilen:

Okay. Is that a function of more business going through e-commerce and more going through the Salt Life retail stores?

Robert Humphreys:

That and we did implement a price increase on T-shirts since the prior year quarter.

James Wilen:

Okay. Are the number of doors that you have out there similar to—are they expanding, staying about the same?

Robert Humphreys:

They are staying about the same. We've completed some tests with some specialty retailers that, we believe, are going to add a good many doors over the next 12 months that would be a significant increase. We're always tempered by that with what we're seeing on the bankruptcy front from retailers. But right now, the landscape looks good for adding Salt Life doors, both with existing Salt Life retailers and 2 new ones that are coming into the fold. We think a couple of them would provide some nice geographic boost and get more eyes on the brand, both with consumers and other retailers trying to attract consumers to their doors.

James Wilen:

Okay. I assume the retail stores you're doing, both Salt Life and Soffe, are profitable for the Company.

Robert Humphreys:

Yes.

Deborah Merrill:

Yes.

James Wilen:

Okay. I assume, because there's no middleman, you've got much higher gross margins. You got a lot of leeway to play with on both the retail store side as well as the e-commerce side.

Robert Humphreys:

We do, as most brands do. But I will say, most of the things that we see out there, by the time people get through on their e-commerce sites, they're breakeven or negative at the operating line. We've been focused on that for a number of years and particularly now that we're building some volume, it's nice to see those being highly profitable for us.

James Wilen:

Okay. You were talking about mid-teen operating margins on the retail—on the e-commerce side. I don't know what you're looking at on the retail side. But as you move forward, are you going to focus—try to get a greater percentage of your sales in those areas, opening up more retail stores? Also, could you tell us what percentage of your sales are now going through the e-commerce site?

Robert Humphreys:

Yes. In the most recent quarter, which was our largest e-commerce revenue, we were—about 6% of our overall sales were through our e-commerce sites. To kind of answer the first part of your question, we'll be more aggressive on building e-commerce business. But again, careful to do it in a way that we think is profitable, not just revenue. We will be adding doors, but I would say more cautiously as we learn to be a better retailer and also to not get that ahead of our ability to manage them and make money doing it.

James Wilen:

Excellent, okay. On the FunTees side, you picked up a number of accounts. Were they—were these one-time shots? Or do you expect that you'll have a continuing boost over there?

Robert Humphreys:

No, we have picked up new customers. Basically, FunTees does a highly customized product. We're not after the one-time shots. It just doesn't fit our business model. Generally, our private label business has been very long term with customers. Now, having said that, I would say that environment is as challenged today as we've seen it. We're fortunate that we were growing in it. We're fortunate that we've diversified our customer base. But when you look and see, and it's primarily driven by major brands, not retailers, although we do have some retailer business, and as these retailers get more focused on private label, that will be an area we expand, but as these brands have challenges in the landscape, it can give us challenges over time there as well. Right now, record revenue. We see that going well as far as we can see, but we're also cautioned by what's going on with the major brands out there in the marketplace.

James Wilen:

Okay. Then, last two, Art Gun, you increased your capacity by 50%. Did you do that before the loss of the customer? Or are you just gearing up because you know what your holiday volume is at this point?

Robert Humphreys:

Exactly. Actually, we lost that customer, and we expect to regain maybe not to the same level, but a good bit of their business because of not being able to produce as much as they wanted—as quick as they wanted over holiday. Although we were giving good service, it still wasn't as much as they wanted. These customers give us forecast and make reservations for how much holiday business they want. We'll have a good holiday season. We'll have more capacity, and we'll have our capacity up and going in California as well. So, that's exciting to us, and it's particularly exciting to these customers.

James Wilen:

Okay. Then, lastly, on manufacturing efficiencies, are they all in now? Were they all in, in the quarter? What is your program moving forward? You always seem to have some sort of way to continue to reduce costs to be more profitable...

Robert Humphreys:

That has to be in your DNA if you're a manufacturer. We met our challenges where we want to get to. There's further efficiencies of—that we want to get to in performance and how our dye house works and cost and so on and what have you. But what we really want to do now is really challenge our manufacturing capabilities because we know we've got some capacity left on the table, and that is highly accretive to earnings when we can produce more product and get—or sell to our customer base. The way that you really find out what you can do and what your next step is, is to run what you have really full. You see what your bottlenecks are, and then you can often just debottleneck a process or two and get capacities and output up even further.

We challenged our marketing people to work hard on that and get more product running through our manufacturing. We're seeing some growth in some of these specialty products that over time, as they grow, will also bring that production back in-house. We've got a really nice model in Activewear, where we introduced a new product. We get established in the marketplace. But then as we grow volume, we can bring those products into our own manufacturing processes.

James Wilen:

Okay. Outstanding. Thanks, fellows.

Operator:

Just a reminder, that is star, one to ask a question.

We'll go to Joseph Furst of Furst Associates.

Joseph Furst:

Good afternoon, gentlemen, and congratulations on your progress. You're doing a good job. One thought. Salt Life is a very recognizable name. Delta Apparel isn't. I've talked to people wearing Salt Life shirts and asked them, "Do you know who Delta Apparel is?" The answer is always no and so my thought is this. Have you ever given any thought to change the name of the Company, Delta Apparel, because it is much more recognizable?

Robert Humphreys:

Well, we have—you're not the only person on the phone that's made that suggestion to us, quite honestly. We are challenging our Salt Life people to grow the business large enough to justify that and to have a kind of a watershed event that would give us reason to do that and to promote it properly and to also spend the money to do it. But that is on our radar screen.

Joseph Furst:

Okay. Also, I appreciate the fact you're buying back stock because, obviously, the value of the Company far exceeds the stock price. Thanks a lot.

Robert Humphreys:

Thank you.

Operator

Again, to ask a question, that is star, one on your touchtone telephone. We will pause again for just a brief moment.

It appears there are no additional questions at this time.

Robert W. Humphreys:

Okay. Well, thank you, all, for being on the call with us today, and we'll look forward to speaking in a few months and wrap up fiscal '17 and give you some insight onto our direction and hopes and expectations for fiscal 2018. Thank you very much.

Operator:

That does conclude today's conference call. We thank you all for joining us.