Delta Apparel, Inc.

Third Quarter Fiscal 2014 Results Conference Call

August 6, 2014

Operator: Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal 2014 Third Quarter Earnings Conference Call. Joining us from Management are Bob Humphreys, Chairman and Chief Executive Officer; and Deb Merrill, Vice President and Chief Financial Officer.

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 risks and uncertainty, and actual results or actions 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 and the Company's Form 10-Q for its fiscal 2014 third quarter. These documents contain and identify important factors that could cause actual results or actions to differ materially from those contained in the projections and 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 such statements or any projected results will not be realized, or that any contemplated actions or initiatives will not be implemented.

I'll now turn the call over to Delta's CFO, Deb Merrill, who will provide the details of the Company's fiscal 2014 third quarter results.

Deborah H. Merrill: Good afternoon. I'll begin by stating the obvious. Our third quarter financial results were very disappointing. While the cause of the sales decline primarily stems from external economic conditions that have had severe effects on the apparel industry and the retail marketplace in general, the more than proportional decline in our operating profit stems from the existing level of fixed cost within our organization, weighing against previous net sales. This issue is on us and we have already begun implementing strategic initiatives intended to correct this, which Bob will give you more details on in just a few minutes.

Let me first briefly review the financial results for the quarter. Net sales for our fiscal 2014 third quarter were 123.5 million, a decrease of 7.5% from 133.6 million in net sales for the comparable 2013 period. Net income for the 2014 third quarter was 2.2 million or $0.27 per diluted share compared to 2013 third quarter net income of 3.9 million or $0.48 per diluted share. For the first nine months of fiscal 2014, net sales were 338 million compared to 360.4 million in the prior year period. We had a net loss for the 2014 first nine months of 195,000 or $0.02 per diluted share compared with net income of 5.6 million or $0.67 per diluted share in the prior year period.

Looking now at our two business segments, net sales for the Basic segment were 73.5 million in the 2014 third quarter, a 5.8% decrease from 78 million in the prior year period. The decrease was primarily driven from one private label customer that in the prior year had success at retail with a licensed product that they sourced from us. This business did not repeat this year as the license ran its course and declined at retail. Sales to our core private label customers increased during the quarter, but the increase was not enough to offset the decline of this one license program.

We are encouraged by some new programs that are currently being developed, both with existing customers as well as with new customers. This new business is now in the pipeline and we anticipate that it will drive growth in future quarters, although we will be comping against the higher sales from the prior year success of the licensed program I just mentioned until we get to the second half of fiscal 2015.

The overall market for basic undecorated tees continued to be weak despite it being the seasonally strong quarter for this product. Low demand, coupled with a healthy supply of tee inventory in the market drove customers to price-shop all orders across competitors. Although we strove to achieve unit growth this quarter, in light of market conditions we were satisfied that this year's volume matched the prior year, a year in which we gained market share. Selling prices in the June quarter remained relatively flat with the March quarter and we were in line with selling prices a year ago.

Our margins in the last several quarters have been negatively impacted by higher raw material and other inflationary costs, including higher cotton, dyes and chemicals, energy, transportation and labor costs. While these impact both of our segments to some extent, our Basic segment, and principally, our basic undecorated tees are impacted most significantly as there is less ability to timely pass these costs along to customers. To quantify this, higher cotton costs alone negatively impacted our earnings by approximately $0.12 per diluted share in the June quarter compared to the prior year. The other areas mentioned also negatively impacted results as we have not yet seen them reflected in higher selling prices.

As you are aware, the future price of new crop cotton, which will start shipping to manufacturers in November is significantly lower than recent old crop prices. Cotton costs flowing through cost of sales in our fiscal 2014 fourth quarter and into the first half of fiscal 2015 will reflect the higher cost from old crop cotton. Margins in the second half of fiscal 2015 should then benefit from lower cotton cost to the extent that the lower cotton costs are not passed along to customers in lower selling prices.

Moving to our branded businesses, Branded segment sales for the fiscal 2014 third quarter were 50 million compared to 55.5 million in the prior year period, almost 10% decline. Salt Life and Art Gun continued double-digit sales growth during the quarter but not at a pace adequate to offset sales declines in the other Branded segment businesses. Sales of the Salt Life branded products increased 16% in the June quarter over the prior year quarter, with sales up 24% year-to-date.

The sluggish economy and unusual weather appears to have decreased traffic to vacation and resort destinations, reducing Salt Life's growth with independent retailers compared to previous quarters. Strong growth has continued for Salt Life and its other sales channel, including department stores and active lifestyle retail chains. The new Salt Life performance products tracked well at retail with strong sell-through. Retailers expanded their offering of Salt Life into new product categories, including juniors and kids, which also performed well this spring and are expected to supplement future sales growth.

Art Gun, reflecting the expanding popularity of e-commerce purchasing, enjoyed sales growth of nearly 25% for the quarter, continuing the strong growth trends of the past several quarters. We have additional capacity coming online in the September quarter in advance of the upcoming holiday season. This should give us the capacity to support the growth expected by our customers while maintaining the service levels Art Gun is known for.

The Game began shipments to college bookstores in the June quarter, and its college sales were on par with the prior year. Based on order backlogs, double-digit sales growth is anticipated for our college line in the September quarter. Private label headwear sales decreased during the quarter compared to the prior year. The prior year saw strong growth resulting from the customer's notable success at retail with licensed product, which they sourced from us. That license eventually ran its course and declined at retail resulting in a sales decline for us this quarter.

Junkfood experienced strong growth at boutique and specialty retailers during the quarter. Although this growth was significant, unsettled conditions within one of Junkfood's large retail customer group hampered sales and resulted in an overall sales decline at Junkfood of nearly 20% for the third quarter. Junkfood continues to be sought after by retailers wanting to bring in a fresh perspective to licensees and we expect to see continued growth in customers and programs as retailers seek fresh ideas to help drive traffic to stores.

Soffe sales were not as strong as anticipated despite return placements at certain major mid-tier retailers. Business remains challenging with better department stores and to a certain extent, with sporting goods retailers. Order deferrals by customers across sales channels also hurt revenue during the quarter, resulting in an overall sales decline at Soffe of about 10% in the third fiscal quarter.

Back on a consolidated basis during the 2014 third quarter, selling, general and administrative expenses as a percentage of sales decreased to 17.1% from 17.6% in the 2013 third quarter. Our continuing efforts to better leverage our back office functions and reduce overhead expenses, along with the reduction in incentive-related compensation were the primary reasons for this 50 basis point improvement. Operating margins declined in both the Basic and Branded segment due to the static fixed cost weighing against reduced net sales. This resulted in a 220 basis point decline in combined operating margins compared to the prior year third quarter. Operating profit for the 2014 third quarter was 1.6 million compared with 4.7 million in the prior year period.

Capital spending was 2.1 million during the quarter and 7.7 million year-to-date. Our capex in the third quarter was spent on ongoing enhancements to our information technology infrastructure, allowing us to further leverage our processes across business units. In addition, we invested in equipment necessary to support new private label production requirements, as well as to upgrade our direct-to-consumer strategies, both online and at the Junkfood retail stores.

Depreciation and amortization, including non-cash comp was 2.3 million for the quarter and 7.4 million for the first nine months. We expect capex to be approximately 11 million for fiscal 2014 and D&A to be about 10 million. As we look to fiscal 2015, we expect capital expenditures to be significantly lower at about 5 million with D&A remaining at about 10 million. Debt decreased 4.6 million from March 2014 to 139.2 million at June. We expect debt to further decline by fiscal year end. However, the strategic initiatives we have begun, as well as those currently under evaluation, carry near-term costs that will put further leverage on the business. We are currently discussing our financing arrangements with our lenders and generally believe that we have their support as we navigate through these choppy economic times in the implementation of our strategic initiatives. Once these initiatives are completed, the expected improvements in profitability should then allow us to de-lever the business to more normal levels.

During the quarter we repurchased 66,000 shares of Delta Apparel stock at an average price of $15.04 for a total of $1 million. Although there still remains an authorization of 4.7 million for our share repurchase program, we are not planning any further share repurchases until after the completion of the strategic initiatives, at which time we will reevaluate the program from a standpoint of stock price and available cash.

With the significant initiatives that we are undertaking, along with those currently being evaluated, we're unable to confirm prior financial guidance and believe it is prudent to suspend financial guidance for the remainder of our 2014 fiscal year and for fiscal 2015. We intend to keep you informed on our progress with these initiatives.

At this time our Chairman and CEO, Bob Humphreys, will walk you through our new initiatives to improve profitability and better position our business for the future.

Robert W. Humphreys: Thanks, Deb, and thank you all for being on the call with us today. As Deb mentioned, weak market conditions resulting from the continued sluggish economy are having a negative effect on the apparel industry in general. Much of our retail customer base is struggling to meet their sales goals and are deferring orders until inventory is worked through. Historically, our broad customer base across most channels of distribution has allowed us to continue to grow even in the periods of weak retail demand. This has not proved to be true over the past 12 months, where we have experienced a decline in sales for the first time in more than a decade.

Given this environment, it's imperative that we adjust the fixed cost structure within Delta Apparel to give us the ability to operate profitably in the current business conditions. Beyond that, when conditions improve, anticipated incremental sales growth is expected to be reflected to a much greater degree in our bottom line results. While there is nothing we can do to control the weather or improve the national economy, we can implement changes within our Company, designed to moderate the adverse effects that these negative drivers have on Delta Apparel's financial picture and particularly, on our bottom line results.

To this end, we have initiated a reorganization of key business functions and administrative structure at all levels and across all business units to streamline decision-making and information flow, as well as reduce duplicate and excess fixed cost. As a part of this, our President and Chief Operating Officer has resigned from the Company. I have assumed those duties and have returned to the role of overseeing the day-to-day operations of our business. Additional workforce reductions are taking place designed to further de-layer the management structure, leverage back office functions and streamline departments through the use of information technology systems that have recently been or are currently being implemented. This reorganization is expected to result in approximately $7 million in annualized savings with about $5 million recognized in fiscal year 2015. We expect to incur approximately $2.5 million in severance-related expenses with the majority being expensed in the 2014 fourth fiscal quarter.

We are also evaluating other initiatives focused on improving net profitability in the face of continued marketplace weakness. These include the restructuring of our manufacturing platform to lower product cost and strategically reduce capacity on certain product lines and a comprehensive rationalization of all underperforming business units, product lines, and sales channels.

With respect to our manufacturing platform, we continue to maintain a sharp focus on improving our supply chain, lowering product cost, and reducing the operating capital required in the business. A number of steps have already been taken on this front, and we anticipate taking further action during fiscal year 2015. The restructuring of the manufacturing platform should allow us to improve service to our customers with streamlined product development and shorter lead times to fulfill orders.

The actions under evaluation, along with steps already taken, should reduce capacity in certain product lines until marketplace conditions improve, allowing us to recoup capital currently incurred in the business. Further actions that we may take related to our manufacturing platform would most likely come with up-front cash and non-cash restructuring cost that are expected to further position the Company for significantly lower overall product costs as capacity is brought back online when the market strengthens.

The comprehensive rationalization of our underperforming business units, product lines, and sales channels that is under evaluation should enable us to focus our capital and other resources on the areas that show the most profitable growth opportunities and to de-emphasize or eliminate others.

We have invested in a number of new product lines and distribution channels over the past several years. Some such as Art Gun and Salt Life have become our current growth engines and have strong profit potential. Others have not met our expectations and may be reduced or eliminated, with the capital currently associated with these initiatives redirected to areas where we can achieve a superior return.

One such example is the addition of our third-party logistic service to distribute our basic Delta tees in Canada. We have gained new customers and sales are increasing in that market. But the level of sales growth has not met expectations necessary to justify the additional distribution and logistical expense, along with the additional capital associated with maintaining inventory in Canada. As such, while we'll continue to service our customers in Canada from one of our US distribution facilities, we will no longer maintain a distribution facility in Canada, saving us approximately $0.5 million annually.

It will be challenging as we steer through these strategic initiatives, but the leaders of our businesses are committed to taking the necessary steps to position Delta Apparel as a strong and profitable business and provide value for our shareholders. We have a solid management team and a loyal workforce and have confidence we can successfully navigate through these tough times and become a much stronger Company.

Beyond the steps being taken with these initiatives, we have other reasons to be encouraged about our business. Salt Life continues to have good top line growth with strong profitability. The brand recognition is expanding rapidly as evidenced by a proliferation of Salt Life decals and products seen across the entire US, both on the coast as well as inland. The marketing push we have focused on in California is taking root, and we're seeing Salt Life decals on vehicles there also.

We are continuing our efforts on the West Coast through tournament sponsorships and ambassadors, pro-athletes as well as up-and-coming teams who love and live the Salt Life every day. Salt Life's new performance line is having great success, and we're pleased to say that Salt Life has become the number one apparel brand with certain resort retailers.

In May, our Junkfood flagship store opened in Venice, California, an excellent location to showcase the iconic Junkfood brand to consumers. Currently the fashionable new store on Abbot Kinney Boulevard, the coolest block in America, according to GQ Magazine, is meeting our expectations and we anticipate seeing strong growth as new businesses open in the area surrounding our store.

While our Soffe business remains challenging with better department stores, we did re-establish the Soffe brand on the retail floor space in key mid-tier stores with good success this spring. It appears our Soffe spring products were on trend and received well by consumers. Our military business remains solid and we are pleased to be awarded new government contracts for products which should start shipping in the first quarter of fiscal 2015. We continue to get positive feedback on the Soffe brand and believe it can return to a place of prominence in our brand portfolio.

Our brands continue to enjoy strong consumer recognitions and our products appear to be on trend. As retail traffic improves we anticipate a solid rebound in sales of our Branded and Basic products. Our efforts to reduce costs and further improve our supply chain should provide for greatly improved profitability as the economy and consumer spending for apparel strengthens.

Now, Deb and I would be glad to try to answer any questions you may have. So Brandon, would you open up the floor to questions?

Operator: Yes, ladies and gentlemen, to ask a question please press star, one on your telephone keypad at this time. Please ensure that your mute function is turned off to allow your signal to reach our equipment. Once again, it is star, one if you do have a question.

We'll go first to James Fronda with Sidoti & Company.

James Fronda: Hey, guys how are you?

Robert W. Humphreys: Hey, James.

James Fronda: I mean, you guys talked about the economy having effect on your top line results, but I know that Gildan and Hanes kind of did well for the quarter. Do you have any, I guess, insight into that?

Robert W. Humphreys: Well, I think you just have to look at the different marketplaces that they participate in and how many weeks were in their quarter compared to prior years and things like that. I think in the US screen print market that we held our market position, which has been growing over the last several years, certainly we're not satisfied with how our brands did at retail and perhaps are not as positioned as some others. Although when you look at our Salt Life growth and our Art Gun participation I think we're proud of the growth that they've been able to achieve in these conditions.

James Fronda: Okay, and did you say, I guess, towards the end of the call, that brands might be discontinued, some of them?

Robert W. Humphreys: Well, no, I didn't say that. I said that we're looking through really all product lines, channels of distribution, probably products within brands that we'll be taking a closer look at and make sure that we see the opportunity to grow that and achieve the profit margins that we need to within those lines or else rationalize those and invest that money somewhere else.

James Fronda: Okay, thank you.

Operator: Next, we'll go to Liz Pierce with Ascendiant Capital Markets.

Robert W. Humphreys: Hi, Liz.

Elizabeth Pierce: Okay and you kind of just answered my first question. Brands are—so everything is up for review, I guess is the simple way to ask this, a less direct way. So brands, all parts of the business, in terms of—under review? I just want to clarify.

Robert W. Humphreys: Yes.

Elizabeth Pierce: So what—can you give us some guidance what you're going to look for to determine whether or not you can grow these brands or maintain the profitability, or what types of profitability should we be thinking about versus historical margins? That's kind of the first half of that question.

Robert W. Humphreys: Okay, well, I think the key is to look at where we've got resources and that can be sales, it can be creatives, it can be capital tied up, and we're not seeing the growth that we felt like we should see or the operating margins in there to continue to justify, and so as we talked about before, we believe, over time, this business should create mid-to-high single digit operating margins and as we sit here and take stock at this for lines that we have, that are not doing that, we're going to take a hard look at rationalizing our investment in that pieces of business. It may not necessarily, would be a brand, but maybe parts with a brand or parts within private label or parts in licensed businesses.

Elizabeth Pierce: What kind of time frame are you going to undertake for this type of review, and when can we expect to see a decision?

Robert W. Humphreys: Well, we are well into it and would certainly be in a position to give an update of where we are on that when we announce our fourth quarter results. Not to say that there won't be further reviews and further analysis of options done, but we're all over this right as we speak.

Elizabeth Pierce: Okay, and Bob, from your years of just kind of being in the business, if cotton cost had been more normalized, can you kind of pull that out and then take a look at the business and say, as part of the review process and say, this product is no longer relevant or the brand's not resonating? I guess, my one concern is that a decision being based just on some abnormalities in cotton cost or in other variable costs unless you think those costs are here to stay.

Robert W. Humphreys: Yes, I think, as you say, cotton is a whole different piece of the analysis. We've taken some different approaches on our approach in managing cotton cost over the last four or five months that we think retrospectively looking at, served us well and we'll continue to use some more of those techniques. Prices didn't really go up with the increased cotton cost, at least, in the undecorated tee business so we'll have to see how all that plays out. But yes, we're certainly not going to make a short-term decision without a long runway, but some of our initiatives that we've had in to place that we're just not getting the results that we think and don't see that changing over the next six to 12 months, and we're going to be taking action to do something about that.

Elizabeth Pierce: Do you think that could be—that there's a possibility you might have to take an inventory write-down like you did a couple years ago?

Deborah H. Merrill: No, Liz, that inventory write-down was really related to the cotton price having gone up near $2 a pound and then coming back down. So that was definitely a different situation than anything that we're facing right now. So no, I would not anticipate that.

Elizabeth Pierce: Okay, and then in terms of the manufacturing, I mean, obviously, you made a step in early June. I presume that that's still on the table, and then how are you thinking about how that supports NAFTA? I guess, now with the Canadian it doesn't matter if you're shutting that distribution center down?

Robert W. Humphreys: Yes, and there's been some trade laws changing in Canada that's going to allow goods coming out of Honduras to, I think, get there duty-free. So that is changing those dynamics a bit. So as you said, we did take a step in the June quarter that is lowering our manufacturing costs. We've got a couple other initiatives we talked about on some other cost reduction programs that will start flowing to us soon. We are going to rationalize some capacity over the next few quarters as we get our inventories where we want them to be going into next year and we'll continue to look at our cost of manufacturing for product going into different areas. We have made in the US programs, we have Mexican sell programs that do require fabric to be made in a NAFTA country, and then we are positioning ourselves as business improves to make more of that in our lowest-cost manufacturing for the type of product being made and so on basic tees, that's in Honduras, but on more specialty products, it can be in different locations.

Elizabeth Pierce: Okay, and then just my final question, is—you mentioned that you are now stepping back into Steve's role. What is that taking you away from that perhaps you have been focused on while Steve was onboard?

Robert W. Humphreys: Well, it takes me away from government regulation and SEC work and that sort of stuff and luckily we have able in-house counsel, and they'll have to do more of that for me so, my real love and passion for these businesses is the operating growth and the entrepreneurship that goes with that and working with customers in these business units to aggressively seek new ideas and act on them. So I'm quite frankly looking forward to getting back and involved in that more on a day-to-day basis.

Elizabeth Pierce: Okay, all right. That's all. I'll get back in the queue. Thanks for all the detail.

Operator: Again as a reminder to the audience, if you do have a question, please press star, one at this time. Again it is star, one if you do have a question and we'll pause for a moment. We have no additional questions in our queue.

Robert W. Humphreys: Okay, well, thank you all very much for joining us. We obviously have a lot of work to do and are deep into that right now, and we'll look forward to giving you a status report and update in our next earnings call after our fourth quarter results. Thank you.

Operator: That does conclude today's call. Thank you all for your participation.