Delta Apparel, Inc.
Second Quarter Earnings Conference Call
May 5, 2015

CORPORATE PARTICIPANTS

Deborah H. Merrill, *Vice President, Chief Financial Officer and Treasurer*

Robert W. Humphreys, *Chairman and Chief Executive Officer*

CONFERENCE CALL PARTICIPANTS

Mike Hughes, *SGS Capital*

Jamie Weiland, *Weiland Management*

PRESENTATION

Operator:

Thank you and good afternoon to everyone participating in Delta Apparel's Fiscal 2015 Second 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 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 of 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, but that any contemplated actions or initiatives will not be implemented.

I will now turn the call over to Delta's CFO, Deb Merrill, who will provide the results of the Company's fiscal 2015 second quarter ended March 28, 2015.

Deborah H. Merrill:

Thank you and for everyone joining the call, we appreciate your interest in Delta Apparel. I'm pleased to report that during our fiscal 2015 second quarter, Delta Apparel resumed net sales growth and profitability. Our fiscal 2015 second quarter net sales were $115 million compared to $114.5 million in the prior year period. While the growth may appear modest, there are a couple of important factors to consider.

Net sales during the quarter were affected by the sale of The Game college bookstore business and the associated removal of that revenue stream in the quarter. Our operations were interrupted as we separated The Game from our ERP systems and pulled The Game screen print and apparel distribution operations out of our Fayetteville location and relocated our Salt Life headquarters to a new office.

Cooler weather across the country in February and March also hampered results. In spite of these headwinds, we are pleased to achieve sales growth in each of our business units with the exception of one.

Gross margins expanded 210 basis points from the December quarter to 18.5% in the March quarter. Gross margins were actually 60 basis point higher at 19.1% if you adjust for the indirect expenses associated with the sale of The Game, which were recorded in cost of sales. I'll walk you through the reporting of this sale transaction in more details in a few minutes.

While gross margin in the Delta activewear business continue to be hindered by marketplace dynamics including lower selling prices and higher input cost all of our other business units expanded gross margins from the prior year March quarter.

We also had indirect expenses associated with the sale of The Game, which were required to be included in selling, general and administrative expenses. Adjusting through these expenses, we reduced selling, general and administrative expenses by $1 million to 17.6% of sales compared to 18.6% in the prior year period. The 100-basis point improvement resulted primarily from lower fixed compensation and benefit costs of about $1.2 million along with lower professional fees offset partially from higher advertising expenses associated with the Salt Life and the Soffe Brand.

Net income for our 2015 second quarter was $3.6 million or $0.46 per diluted share with $0.03 per share attributable to ongoing operations and $0.43 per share to the sale of The Game asset. This compares with our 2014 second quarter net loss of $763,000 or $0.10 per diluted share.

As you know, about six months ago, we set forth a number of strategic initiatives to improve the profitability of Delta Apparel. We are proud of the progress we have made and the results that can already be seen in our financials from the implementations of these initiatives.

As mentioned earlier, our SG&A expenses reflect the reduced fixed compensation expense and other reductions we have implemented. We also engaged in a comprehensive rationalization analysis of our operating units, product lines and sales channels. From this, we decided to sell The Game branded collegiate headwear and apparel business and completed that sale on March 2nd. We believed these transactions further strengthen our balance sheet and now enables us to focus on areas of our business that are more strategic to our long-term goal.

While we sold the business consisting of The Game branded products sold nationally in college bookstores and through team dealers, we continue to own Salt Life and our corporate business that operated within through The Game, LLC and have changed the name of that entity to Salt Life, LLC.

The sale included all decorative finished goods inventory, certain undecorated finished goods inventory, fixed assets and some other assets net of certain liability. The transaction did not include accounts receivable and certain undecorated apparel inventory from which we anticipate collecting approximately $6 million from these assets.

We are incurred about $400,000 in direct selling expenses associated with the transaction. In addition, we encouraged certain indirect costs associated with the transaction including about $800,000 of evaluation on inventory that was not included in the sale and $1.4 million of indirect incentive based expenses.

The pre-tax gain on the sale of the The Game assets inclusive of the direct and indirect expenses was $5.6 million. This net gain was recorded across our financial statement as follows; $800,000 of expense in cost to sales, lowering our gross margin by 60 basis points; $1.4 million of expense and SG&A expense increasing our SG&A expenses as a percentage of sales by over 100-basis point; and the remaining $7.7 million gain on the sale of the business.

For income tax purposes, this gain net of associated indirect expenses was treated as a discrete item at full applicable statutory rates and resulted in $2.2 million of income tax expense resulting in net earnings per share of $0.43 related to the sale transaction.

Another outcome of the rationalization analysis is the decision to not renew our license with Churchill Downs. Since acquiring to The Game in 2009, we have been the licensee for onsite licensed merchandise sales during the Kentucky Oaks and Derby events, which also allowed us to sell licensed merchandise to certain retailers. Although, it provided a profitable revenue stream of approximately $3 million, this business requires a time and attention of key resources within our organization for a certain period of time each year thereby taking their attention away from our core businesses.

In addition, it carries the inherit risks associated with event driven business where it only takes one day of bad weather to negatively impact profitability. Overall, we enjoyed operating this business, but felt that we are better served focusing our resources on more strategic areas within our Company, areas with strong growth and profit potential.

Another of our strategic initiatives was to continue working on our manufacturing platform to lower overall product cost. We have recently embarked upon an expansion of our Honduran textile operations involving new equipment that will allow us to internally produce open-width fabrics used in many of our business units. We expect to spend approximately $4 million on its expansion, which should allow us to internally produce approximately 80,000 pounds of fabric weekly that we are currently sourcing on the outside.

The equipment is expected to arrive in the fourth calendar quarter of 2015 and we expect it to be fully operational by the end of the first calendar quarter of 2016. This should reduce our reliance on purchased fabric and further leverage our internal production. We expect to realize annualized savings of approximately $2 million that we should start seeing in our results beginning in the back half of our fiscal 2016.

Including the additional capital spending associated with the textile expansion, we now expect capital spending in fiscal 2015 to be approximately $9 million. During the March quarter, we spent about a half a million on capital spending bringing our year-to-date capital spending to $2.5 million. Depreciation and amortization including non-cash compensation was $2.9 million for the quarter and $5.3 million in the first six months of fiscal 2015.

Total debt increased $4.6 million from December to $135.1 million in March. While the sale of The Game generated approximately $14 million in cash after payment of transaction costs, normal seasonality and the working capital in the business still resulted in an increase in debt during the quarter. As we progressed through the back half of the year, we anticipate that inventory levels will continue to decline, both in units and with lower cost inventory.

We believed this, coupled with the profitability we expect in the business should generate strong positive cash flows in the coming quarters and drive debt to be in the $90 million range by September fiscal year end. During the March quarter, we did not repurchase any additional Delta Apparel stock, however, we will continue to evaluate share repurchases against other opportunities going forward.

I'll now turn the call over to our Chairman and CEO, Bob Humphreys and he will provide you with more details on our outlook for the business.

Robert W. Humphreys:

Thanks Deb and thank you all for being on the call with us today. The results of our second quarter are very encouraging and suggest a strong second half of the fiscal year. We've now seeing in many areas of our business, the results of those strategic initiatives that we've implemented over the last six months. Deb mentioned a number of these initiatives, but there are many others as well.

Aside from receiving a 60% premium over book value on the sale of The Game asset, the sale has now enabled us to focus our resources on more strategic areas of our business that have strong growth potential.

eCommerce is an area where we are investing resources and our second quarter has provided a glimpse into its great growth potential. Overall, our eCommerce business grew almost 70% during the March quarter with our B2B and consumer size all increased in sales about over 60%.

In our activewear business, our customers appreciate this easy way for them to place orders as can seen by our business-to-business eCommerce sales growth in the second quarter of 61% and 73% a year-to-date. In no other business is the value of eCommerce more apparent than in Art Gun. Art Gun's facility was cutting edge equipment and industry leading proprietary software specifically geared to facilitate eCommerce business.

Art Gun continued its characteristics of high growth rate during the 2015 second quarter with 43% sales growth on a 52% increase in volume over the comparable year period. We expect this business unit to continue its rapid growth and have invested in systems that can support that growth into the future.

Art Gun's technological competencies are also being leveraged internally to enhance Junkfood's direct-to-consumer business by giving Junkfood more flexibility in its eCommerce product offerings. In the March quarter, Junkfood more than doubled its sales on its consumer side bringing its year-to-date sales increased to 83% over the prior year.

Soffe also experienced strong growth on its consumer website and sales increased from 66% in the March quarter compared to the prior year, a positive indicator of the strength of the Soffe brand with consumers. The eCommerce site also gives us a nice vehicle to engage directly with the Soffe consumer.

In the last six months, we have given each of our eCommerce sites a facelift, and just in April, we launched a refresh of our Salt Life site, which not only included a new design, but enhanced the customer experience with improved functionality. Salt Life eCommerce sales increased 68% in the March quarter compared to the prior year and we believe we will continue this growth trend, especially with the new site that was just launched.

In addition to the growth seen in eCommerce, all of our business units have shown improvements during the quarter through sales growth, margin expansion or both. In our activewear business, demand for undecorated tees remained weak overall during the quarter, but strengthened as the quarter progressed.

Our June quarter is starting out strong with April sales growth in undecorated tees and full package products of approximately 8% over the prior year. Pricing seems to have stabilized a bit, but time will tell how the pricing holds through the full spring selling season. We have increased our sales force dedicated to undecorated tees to gain additional strength in underserved areas of the country. We are seeing positive reactions to the new products we introduced in the undecorated tee market, including our new Snow Heather and leather and soft Spun tees.

Pre-books were strong and we are struggling to keep with on the shelf to service the overall demand. Our French terry and fleece product line that we introduced last season did well and we chased inventory throughput the season. We now have many new customers that have put this product into their lines, and we are positioning ourselves with stronger inventory positions to service this line of business this year.

We also have secured new print programs using our catalog line, which should provide a strong foundation for growth in the upcoming quarters. Our private label customer base continues to expand as we win new business based on service levels, our quality and speed-to-market.

In the March quarter, private label sales increased 28% over the prior year period. Based on our order backlog, we anticipate strong running schedules for the next several quarters on our private label products. We just completed and expanded our spring training operations in El Salvador to service our growing private label and full package print businesses.

With respect to our Soffe business, as a reminder, in December, we completed our transition to a new ERP system that affords Soffe greater efficiency and improved customer service, while also reducing its staffing and technology cost. While this is a positive step forward with Soffe now operating with a much lower fixed cost structure, it has hurt a bit in the short term with less efficient shipping operations as new processes and procedures were implemented.

In addition, Soffe had previously provided the spring training and distribution for The Game collegiate apparel line. With the sale of The Game, this had to be pulled out of the Fayetteville locations and caused a build disruption within the facility during the March quarter. This has now been completed and we're already seeing the favorable results of spring training from the elimination of a small print line associated with the college bookstore business.

We are seeing positive indicators that the Soffe’s spring line sell-through is good at retail. There seems to be a resurgence in the iconic Soffe shorts. We had a large retail account tell us that the Soffe short was the strongest sell in junior short on their floor and we are chasing product now and in several new stores.

Soffe has launched a new marketing campaign to support a refined brand position including a targeted consumer outreach effort to drive engagement and loyalty to Soffe’s core consumers. Soffe has started the quarter with April sales ahead of the prior year. Due to actions we've taken over the last several quarters and what we're seeing from our customers, we believe Soffe has stabilized and is in a good position for future growth.

The Junkfood team continues to be intensely creative in developing new apparel garments and graphics, and as well as producing marketing programs attuned to the latest social media trends. Junkfood continues to be sought after for its creativity by customers and licensors. Although Junkfood's business was still down slightly with one of its large retail customer groups, this was more than offset by growth within other sales channels during the quarter resulting in sales growth at 2.3%. The improvement in other sales channels including boutique and specialty retailers has also included Junkfood's gross margins which expanded about 250 basis points compared to the prior year quarter.

Our flagship Junkfood store is meeting our expectations from a marketing and brand building standpoint and its revenue continues to grow. Based upon its expanding customer base, new programs, eCommerce growth and fresh product launch, we anticipate stronger sales growth out of Junkfood over the next several quarters.

Demand for Salt Life products continues at record levels. Large national retailers are reaching out to us to get Salt Life products in their doors. Unfortunately during the quarter, disruptions from the sale of The Game hurt Salt Life sales as product shipments were delayed as systems had to be separated and also smoothened. The cool weather in February and March also hindered sales as independent and resort retailers delayed bringing in products until normal weather, yet consumers were actually visiting their stores.

We're pleased that Salt Life spring line is being well received and is selling well. We anticipate a strong June quarter. We are already seeing this with our April sales for Salt Life up over 60% compared to the prior year April. Consumer demand is driving retail door expansion for the brand. More independent retailers desire to carry the Salt Life brand. Our national and regional retailers are expanding in store shops and fixtures for Salt Life, and we are getting additional interest for new national retailers to carry the line. Retail partners continue to buy into our expanded product category including kids, ladies, and performance products further expanding the Salt Life presence in retail doors.

We continued to invest in consumer marketing of the Salt Life brand. We recently launched a Salt Life YouTube channel and are seeing strong viewership from that site. For some time, we've been working at the grassroots level to build the Salt Life brand outside of the Southeast. It is interesting that during the March quarter, California had the most views to the Salt Life YouTube channel followed by Florida, Texas, New York and Illinois.

Also, business and merchandise sales coming from California on the Salt Life eCommerce site had nearly tripled over the past year. During the April month, YouTube views were up over 300% versus the entire March quarter, California still coming in as the number one viewership, then Texas, then Florida. So certainly brand recognition of Salt Life is moving out in the Southeast.

Just to conclude, we've made progress on a number of fronts over the last several quarters. We've lowered our fixed cost structure. We streamlined decision making. We have improved our manufacturing performance. We have increased output at our low cost manufacturing facilities. We have expanded branded business utilizing our manufacturing platform, and we have initiated several additional manufacturing projects which should lower our internal cost over the next several quarters.

We anticipate increased sales across each of our business units in the back half of this year. We expect gross margins to continue to expand, not only from the leverage from higher sales, but also the lower product cost that will be flowing through beginning in the June quarter from lower cotton and energy prices combined with improved manufacturing efficiency.

We will continue to benefit from our lower fixed cost and our administrative functions. All of this coupled with our strong April results and current backlog of orders gives us a high degree of optimism that we should see overall good sales growth and greater profitability in the back half of this year. These results should further enhance the Company's market value. However, in the meantime, we believe much of Delta Apparel's intrinsic value still goes unrecognized by the market.

Briefly looking at the book value of our business, which is approximately $17 dollars per share, does not take into consideration some significant intangible assets including over $20 million of recently appraised real estate in Fayetteville, North Carolina, which has no book value recorded on our financial statements.

This along with several other items would add nearly $4 per share in additional value. With our stock price trading at the $12 range, we are only trading it about 60% of book value. Our sale of The Game for 60% premium over book value also indicates that the intrinsic value of Delta Apparel is significantly higher than book value. At current stock prices, we believe this creates a strong buying opportunity anyone interested in investing in Delta Apparel stock as well as strong upside opportunity for value creation for current shareholders.

Operator, we would now like to open the floor to questions.

Operator:

Thank you. If you would like to ask a question at this time, please signal us by pressing star, one on your telephone keypad. If you are using a speakerphone today, please make sure your mute function is turned off to allow your signal to reach us. Once again it is star, one to ask a question and we'll pause a brief moment. Once again everyone, it is star, one if you do have a question or a comment at this time. We do have a question from Mike Hughes with SGS Capital.

Mike Hughes:

Yes. Just referring back to the investor presentation you did at March and there is a slide that just shows getting the debt down to about $90 million level that you referred to, and then trailing EBITDA being three and a half times or less. Is that still a good working assumption that would require an EBITDA number for the year north of $20 million including the gain on The Game business?

Deborah H. Merrill:

Yes. That would still be a good working model.

Mike Hughes:

Okay, and then just one followup on that, the gross margin expansion that used to happen in order for you to hit that EBITDA number, how much of that would come from the lower cost cotton flow through which I assume most of that is going to benefit the basics business?

Deborah H. Merrill:

Yes. You are correct. We should see margin expansion in that activewear business as we saw already in the March quarter, although that was really more from volume and a mix change, but starting in the June quarter, for a portion of that June quarter we will have the lower product cost flowing through there, and then our September quarter should further expand those gross margins as we'll have a full quarter of the lower product cost. But at the same time, we still continue to anticipate continuation of our gross margin expansion in our branded businesses that we've seen in each of the first two quarters. We would expect that to continue as well in those business units.

So, I think you're going to get certainly your biggest dollar impact from that gross margin expansion will come from the basics, but we do anticipate both basics and each of the branded units to continue their gross margin expansion as well.

Mike Hughes:

Okay. So, at this point you're still on plan with where you thought you would be back when you did that presentation in March I think at a West Coast Conference, is that correct?

Deborah H. Merrill:

Yes. I would say that we're still on trend with that.

Mike Hughes:

Okay. Thank you very much. I appreciate it.

Operator:

Just an additional reminder to our audience, it is star one if you do have a question or a comment. We do have a question from Jamie Weiland with Weiland Management.

Jamie Weiland:

Thanks fellows, nice quarter. I want to start with the cost structure. When you sold to the game, was there anything in this quarter of the expenses that would all go into discontinued ops on the gain on sale? You talked about something about some selling expenses that sounded like they were in current operations.

Deborah H. Merrill:

Yes, Jamie, unfortunately the way that that had to be recorded for some of the indirect expenses from that because we did not sell certain of the assets and we only sold certain assets and because those were split there were indirect costs associated with that. So, there was about $800,000 of expenses sitting in cost of sales that reduced our reported gross margins by about 60-basis points, and there was about $1.4 million of expenses of indirect expenses that had to be reported in the SG&A line.

So, that increased our SG&A expenses by about 100 basis points, and then there was $7.7 million which was the direct gain and direct selling cost that is on that line of the financials. So, it all nets to the $5.6 million net gain, but you're correct, when you look at the financials we do have an unfavorable impact in our gross margin and in our SG&A costs because those indirect expenses had to be reported on those line items.

Jamie Weiland:

But your actual…

Robert W. Humphreys:

Those won't be ongoing indirect expenses. They peaked at that quarter.

Jamie Weiland:

So, the profit from operations that you've recorded was actually the profit from operations by the time you got through with all the stuff.

Deborah H. Merrill:

Correct, correct, and so you can think of that, yes that the—everything related to that is recorded in this quarter which yielded $0.43 net gain from that transaction.

Jamie Weiland:

Okay, you had talked about overhead reductions last year being somewhere I think in the $7 million variety. I think you said you did $1.2 million this quarter. When are we going to start to see the full impact of all those overhead reductions?

Deborah H. Merrill:

I think, I mean, as of right now, the head counts are fully taken out of those, so I think in the June quarter will be the full quarterly impact of those reductions.

Jamie Weiland:

Okay, and on to Salt Life, I'm always amazed seeing the diversity of the brand. When I go around town I saw a Mercedes parked next to a Pick-up truck both with the Salt Life decaf on the back. When you go after the market, how are you' hitting both the high end and the low end? It seems like you're not just a low end product. How are you hitting all different economic groups, male-female, et cetera?

Robert W. Humphreys:

Well, I think it starts with how your brand idea and presence and then we're being careful to instill that into our merchandizing and body development efforts that we have probably to appeal to a lot of different socioeconomic groups and a lot of different types of activities that do have that core thread of Salt Life participation, living, wanting to be at the beach and what have you, and I think it's—and our success is that so far and I think we mentioned maybe on our last call the really encouraging results we got from extensive consumer survey, but anyway to date we've been able to do that and it's not making one part of our group shy away from the product.

So, I mean truly from people wanting service tumblers with Salt Life volume (phon) to have their summer drinks, to people who want performance products to go fishing in, to do board chores and kind of everything in between. So far, it's resonating well and I give a lot of credits to that to our design group and Jeff Stillwell who leads that effort that has an ability to kind of hit those taste levels.

Jamie Weiland:

Did you quantify the number of doors that Salt Life is now in versus where they were a year ago?

Robert W. Humphreys:

We did not. Maybe we will do that on our next call. We've had a lot of new information on Salt Life, particularly with the YouTube channel and eCommerce site that we concentrated and did not go and re-reconciled that door count.

Jamie Weiland:

Lastly, branded goods this quarter had operating margins of 15% and it is the best number in a long time. What's—is there an operating margin target that you're looking at on the branded side?

Deborah H. Merrill:

So Jamie, I mean, I would say that yes. You know, we are pleased that that continues to improve. We've been able to improve our gross margins coming in that business, and you know, that's obviously as the overhead costs are being allocated in there and some obviously are overall headcount reductions across both our business units and our corporate overhead structure has certainly helped to that. Now, we would certainly look for that to continue to improve. So, that's certainly not where we would like it overall, but it is certainly improving. The other thing that you can see in there is that all of that gain is also in that when you're looking at those operating margins this quarter. So, just be aware of that as well.

Jamie Weiland:

Okay. Well, it sounds like you had a great April and hope for continued success looking forward. Thanks.

Operator:

Just a final reminder, it is star, one if you have a question or a comment. We'll move next to David King with Roth Capital Partners. Mr. King your line is open. Please release your mute function. We're unable to hear you. Once again Mr. King, your line is open now. Please release your mute function. I'm hearing no response from that line at this time and there are no further questions in our queue. I'll turn the call back over to our speakers for any final or additional comments.

Robert W. Humphreys:

Okay. Well, thanks everyone for joining us and we'll look forward to updating you on our June quarter in just a few months. Thanks so much.

Operator:

Everyone, that does conclude our conference call for today. Thank you all for your participation.