



Delta Apparel, Inc.

Fiscal 2017 First Quarter Earnings Conference Call

February 6, 2017

Operator:

Good afternoon to everyone participating in Delta Apparel's Fiscal 2017 First Quarter Earnings 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 risks 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.

I'll now turn the call over to Delta's Chief Financial Officer, Deb Merrill, for an overview of Delta Apparel's results.

Deborah Merrill:

Good afternoon. For our first quarter of fiscal 2017, we had net sales of \$85.3 million. This was down \$4.8 million or 5.4% from the \$90.2 million reported for the 2016 first quarter. While net sales for the quarter were negatively affected by a number of factors that Bob will discuss in more detail, overall gross margins remained solid at 20.6% about on par with the prior year quarter. The Company had a net loss of \$607,000 or \$0.08 per diluted share in the 2017 first quarter compared with net income in the prior year quarter of \$681,000 or \$0.09 per diluted share.

Net sales for the branded segment were down by \$4.2 million due to the struggling retail environment that negatively impacted the traditional brick and mortar customers of Softe and Junkfood. This includes the closer of The Sports Authority and similar challenges with other specialty retails.

In addition, Salt Life experienced a slow start to the quarter due to Hurricane Matthew in the unseasonably warm winter weather, but was still able to grow nearly 4% during the quarter, reaching record first quarter revenue. Despite the lower sales, margins for the branded segment expanded 160 basis points compared to last year's first quarter.

In the basic segment, there was a 1.1% decline in net sales due entirely to slower business with Activewear's retail license account, as mass channel retailers de-stocked inventory. This was partially offset by sales growth in its other sales channel and strong sale at Art Gun, where sales exceeded \$5 million for the quarter, an all-time record.

Gross margins declined slightly in the basic segment, but are expected to increase significantly as the year progresses with the benefits of lower product cost from the manufacturing realignment and continued process improvements in operations.

Total capital spending for the quarter was \$1.7 million. This was principally related to our direct-to-consumer initiative, including e-commerce upgrades and our retail store build out. In addition, we invested in expanding printing capacity and in our distribution facility. We anticipate capital spending for the full 2017 fiscal year to be somewhat lower than that of 2016 and will come in around \$10 million.

Depreciation and amortization, including non-cash compensation, was \$3.1 million for the first quarter. During the 2017 first quarter, we repurchased 46,643 shares in Delta Apparel stocks at an average cost of \$17.60 per share for a total cost of about \$0.8 million. At the end of the first quarter we had \$8.3 million remaining of our board authorization for share repurchases. We continue to believe that the intrinsic value of the Company is significantly higher than its current share price range.

While the first quarter's top and bottom line comparisons are not indicative of the growth we expect to see, there are many other factors signaling to us that growth will return as we progress through the year.

Many of the transient conditions that hampered our first quarter results have passed. We're introducing exciting new products, our inventory levels correspond to our growth objective, our e-commerce businesses and sites continue to prosper, and margins are solid and expanding. I believe we have good reason to feel optimistic about the year ahead.

Now I'll turn the call over to Bob to give you more insight into our business unit.

Robert Humphreys:

Good afternoon. Thank you all for your interest in Delta Apparel and thank you for joining us on the call this afternoon.

As you saw from the earnings release that we issued, sales in the fiscal 2017 first quarter were off a little more than 5% from the prior year's first quarter, but our results continue to be on track with our expectations. While we have made Delta Apparel more agile and less vulnerable to this difficult retail environment, our sales in the first quarter were negatively impacted by circumstances that were out of our control.

Hurricane Matthew slowed retail spending in the affected states, and while spending did return to normal the shortfall was lost for the season, especially as resort areas were dealing with the effects of the damage. Unseasonably warm weather also hindered sales of our long sleeve tee and other cooler weather products. These should not, however, have a lasting effect on the growth of Delta Apparel, and we anticipate growth through the back half of the fiscal year.

In the meantime, we are focusing on those activities that will have a positive impact on our top and bottom line, and on our continuing efforts to improve efficiency and service for our customers while expanding our gross margins. The positive results of these efforts can be seen in our first quarter and should become more apparent throughout the rest of the fiscal year.

We added more equipment and made improvements to the production flow at Art Gun, which gives us the capability to print more than 15,000 unique garments per day and ship them to customers across the world. We handled that level of volume and scope during the holiday peak season without a snag to the complete satisfaction of our customers. Our excellent performance during that time has attracted additional customers, who should support Art Gun's continued growth during the upcoming quarters.

For a better understanding of Art Gun's new capabilities, consider that we can now print and ship more than 5 million unique garments per year on over 6,000 different garment SKUs. When the order is placed

on an e-retailer site, it can be produced and shipped to the customer that same day or the next day. This virtual inventory model is the wave of the future for many of today's traditional retailers, and Art Gun is uniquely positioned to seize this opportunity.

Our belief is certainly bolstered by Art Gun's first quarter performance, featuring record revenue and sales up 28% on 34% higher unit volume. Gross margins expanded 650 basis points yielding record double-digit operating profit, and we believe Art Gun is poised for another year of record revenue and profitability in 2017.

We are also seeing strong results and future growth opportunities with Salt Life. It's new Fayetteville, North Carolina distribution center is already lowering costs and improving service to customers, and it is one of the drivers of Salt Life's improved profitability over last year's first quarter. While sales growth was hampered by Hurricane Matthew and unseasonably warm weather, Salt Life still had record first quarter profits on 3.8% sales growth. Performance in junior's products continued solid growth and saltlife.com had record sales, up nearly 50%.

Significantly, during the first quarter, we had e-commerce sales of Salt Life products in all 50 states as our geographic reach continues to build. We also had sales on all 52 styles of Salt Life decals selling nearly 5,000 Salt Life decals on the website alone, which our customer surveys indicate is the number one way consumers learn about Salt Life.

Salt Life is continuing its consumer outreach in California, and will soon open its Huntington Beach store. We are excited about the opportunity for this location, as well as San Clemente as we approach the spring and summer season. Salt Life ended the quarter with a strong order position that we believe points to double-digit sales growth in 2017 with improved profitability.

We are applying the experience gained through the development of Art Gun and Salt Life to Coast Apparel, the young, direct-to-consumer business that we required in August. Although still small, it is doing as we had expected with the growing ecommerce business, which is benefiting from Delta Apparel's digital marketing expertise and financial backing.

Coast Apparel will open its flagship store in Greenville, South Carolina this quarter, and we look forward to solid direct-to-consumer growth along with new opportunities to expand Coast wholesale distribution.

Soffe, which was hindered by the closing of The Sports Authority and a large winter product return, had strong e-commerce growth with B2C sales up 30% and B2B sales up 40%. Soffe continues to expand its customer base and growth with existing customers. Soffe has a unique US-made product offering with deep roots in the military channel. The combination of the Soffe brand, domestic manufacturing, and military heritage gives us a significant advantage in this growing market and should be a source of future growth for Soffe. Along with building sales volume, we expect to lower inventories and reduce costs to improve profitability.

Junkfood, without the benefit of sales momentum generated in the prior year first quarter from a large-scale movie rollout, was also hampered by sales decline at traditional brick and mortar retailers, particularly in the specialty sales channel.

Delta Activewear saw sales growth in many of its sales channels. However, this was not enough to fully offset the decline with retail license accounts resulting from mass channel retailers de-stocking inventory. We saw a strong growth in our other sales channels, including ad-specialty and regional screen-printers.

Catalog's higher margin fashion basics continue their strong growth trend with sales up more than 50% over the prior year quarter. We expect our new fashion basics introductions coming online as we speak, including Delta Dri female silhouettes and our Delta Platinum line of triblends, will continue to expand fashion basics sales throughout fiscal 2017.

We saw positive results in our manufacturing platform during the quarter, where we met our production and cost reduction goals set in connection with our recently completed manufacturing realignment. These benefits could be seen in lower cost of sales beginning late in the 2017 March quarter, and should be fully realized in the second half of the fiscal year.

While we anticipate a continuation of the current challenging retail environment, we believe fiscal 2017 will be a year of growth and improved profitability for Delta Apparel. We have entered the year with exciting new products. We have lowered our manufacturing and distribution costs, and we are adopting innovative ways to service our customers. We believe that Art Gun and our various e-commerce sites represent the wave of the future, and we are developing synergies with them that will benefit all of our business units. We are nurturing our brands and expect to see continued strong growth from Salt Life.

We believe the initiatives that we completed in fiscal 2015 and 2016 across all of our business units along with a leveraging of fixed cost across higher volumes should expand gross margins and operating profit, building further value for our shareholders.

Operator, we will now be happy to answer any questions callers may have.

Operator:

If you would like to ask a question, please press star, one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off so that your signal does reach our equipment.

We do have our first question from Dave King with ROTH Capital Partners.

Nick Meyers:

Hi, guys. This is actually Nick Meyers on for Dave King. How are you doing?

Deborah Merrill:

Good. Thanks.

Robert Humphreys:

How are you doing, Nick?

Nick Meyers:

Doing very well. Thank you. Regarding Salt Life, there are several things that had an outside negative impact, but can you—you guys said you guys expect to return to double digits, correct?

Robert Humphreys:

That's correct.

Nick Meyers:

Okay, just making sure. Then on—I heard that right. Then on—about Salt Life, too, in San Clemente, any further learnings there at that store, any differences in customer preferences versus other markets?

Robert Humphreys:

Yes, I mean, there is definitely a different look on the West Coast, different type of graphics, different colors that people are used to, but we are seeing a good sell of our more baseline products, I'll call it.

Obviously, there is different spices of fish and wildlife that are prevalent on the West Coast that aren't on the East Coast, so we make adjustments from that, and have new product coming in for the store and we'll monitor what sells and what doesn't sell and adjust that offering accordingly.

Nick Meyers:

Perfect, I appreciate the color. Then also, can you provide a bit more color surrounding the weakness at retail licensing accounts, and how long do you expect the weakness to continue?

Robert Humphreys:

Well, I would say mass retailers are changing their floor sets, and changing the amount of product on the floor. Actually, I think graphic tees are a little bit late to the party of some of those changes. You've heard about the same story in different product categories over probably the last four or six quarters. Generally, it seems like it's slow to come back. I think the key will be can the same amount of product be sold with less product on the floor? If so, then you have a de-stocking effect and then the velocity is the same, but obviously if there is less product sold because less has been displayed then that changes the game a bit. So, I think too soon to tell on how that will affect the graphic t-shirt business, but I think it is a robust item for the mass market that they will work hard to keep at least the same amount of revenue over time.

Nick Meyers:

Okay, appreciate that, sir. All right, then last one and I'll step back, what are your current thoughts on leverage, I think it's still about—it's still over four times trailing 12-month EBITDA. We realize it's actually a very low cost, but is there an optimal level you guys have?

Robert Humphreys:

Well, I don't know that there is an optimal level because all of the circumstances surrounding it change over time. I think, in our case, not only is it low cost, but it's asset-based, so there is not covenants associated with it to trip you up and that sort of thing.

Generally, we think our job is to make money for our shareholders and take measured risk, and obviously if we can borrow 25% to 40% of our capital at 4% or less and then earn something north of 10%, it helps us leverage that for our shareholders, and we pretty much follow that path for the 16 years we've been public now, striking out on new initiatives or acquisitions and we take on debt and then subsequently pay it back down until we have liquidity to take the next step.

So, we'll continue on that path as long as the credit environment is like it is now, but during this fiscal year if nothing else changes, we would expect to pay down debt and lower that leverage ratio.

Nick Meyers:

Perfect. Thank you, guys, for taking my questions, and good luck for the rest of the year.

Robert Humphreys:

Thank you.

Operator:

Our next question comes from Joe Furst with Furst Associates.

Joe Furst:

Good afternoon, gentlemen. I just had a question about the asset value. First of all, I want to commend you for buying back your own stocks, as it's under book value. The book value is little over 20, but my question is this: the Salt Life brand itself, how much of that is in the book value and what do you think the real value of that business is?

Robert Humphreys:

Well, Deb could answer a little bit more about what it's on the books for, but if you look at what growing lifestyle brands have been selling for, and there's been a number of exchanged hands over the next couple of years, I think they're worth in the 12 to 15 times EBITDA in today's world, and over two times revenue.

Joe Furst:

Okay, thank you.

Operator:

Once again, that is star, one if you would like to ask a question. Our next question comes from Jamie Wilen with Wilen Management.

Jamie Wilen:

Hi. Just want to follow-up on the previous question, what is it on the books for now? You gave the metrics for what it could be worst, but what is it on the books for today?

Deborah Merrill:

Yes. The brand on that is on the book for a little bit less than \$40 million.

Jamie Wilen:

Okay. Okay. When I look at the balance sheet, inventory is up significantly, is that part of the game plan or just a seasonality aspect or the price of cotton rising a little bit, but what's the strategic plan with inventory and how does that affect how you're going to—the earnings moving down the pipe?

Robert Humphreys:

Well, I think it's a little bit of a combination of all of that. Cotton price in our inventory and going forward is higher than it was a year ago. So, that is a piece of it. You may recall last year at this time we were under inventory, particularly in Activewear, and running out of product in the strong spring selling season. So, we have purposefully built up our Activewear inventory to some degree. Then we brought in our Salt Life, particularly fashion product that we sourced about four or five weeks earlier this year than we had in previous years, and it's paying off with early shipments in this quarter, but to have that product on hand to ship earlier to customers.

So, all in all, we feel good about where we are on inventory. We have some aggressive plans to lower inventory as the year goes on and we are always trying to make it a better inventory, but where we are today is pretty much where we had planned.

Jamie Wilen:

Okay. You mentioned how the cost savings will come in in the third and fourth quarters pretty much totally, are you still on track for when you did the consolidations and equipment purchases to gain cost savings of the—I guess it was \$7 million or \$8 million on an annual run rate?

Robert Humphreys:

Yes. At least \$8 million, and we'll get about four or five weeks of that in the March quarter that we are in now. So, we'll start seeing it and then a full quarters' worth by the June quarter.

Jamie Wilen:

Okay. Are there other things you put into motion for—you're always seen to be doing cost savings for—that will come into play a year or two down the pipe, is that—are there other things in the wings as well?

Robert Humphreys:

We are constantly scratching our head and working on things. I think we got a few more things to leverage our platform that we are working on, and maybe you can have more color on that by the time we get to March.

Jamie Wilen:

Okay. What percentage of your sales now go through brick and mortar stores versus direct, whether it's your websites, Art Gun, even what you sell through Amazon; what percentage of your sales do not go through brick and mortar stores today?

Robert Humphreys:

It's a significant—and we actually had that question come to us a few days ago when we were doing a little bit of math on that, but it's somewhere in the—and we will—maybe that will be our tidbit of information for next quarter's call, but somewhere in the 60% or 65% of our revenue does not go through traditional brick and mortar.

Jamie Wilen:

Okay. Lastly, on the Salt Life program, anything you are doing unique this year, marketing-wise and geographically? Any territories you are targeting for and any national retailers that have come into the fold or are you going to keep it more in the specialty vein as you move forward?

Robert Humphreys:

Yes. I think there is the couple of national—or just about national retailers, Bass Pro, as they combine with Cabela's, has a pretty national footprint. There is one or two others that might be appropriate for Salt Life that we have done some business in just particular areas previously like stickers. Right now, if you look at what's going on with the national retailers that are going through transition and you compare that with our ability to grow our e-commerce sales and already being in 50 states with e-commerce combined with some branding stores located in places where we want to build, I think that's a good path for us as long as we can maintain good growth and that we are positioning the brand for the future.

Jamie Wilen:

Good stuff. Looks like an exciting year. Thanks, fellows.

Robert Humphreys:

Yes, thank you.

Deborah Merrill:

Thank you.

Operator:

Once again, that's star, one if you have a question. This is our final call. If you would like to ask a question, please press star, one.

It looks like we have no further questions. I'll turn the call back over to our speakers for any closing comments.

Robert Humphreys:

Okay. Well, thank you, all, for being with us this afternoon, and we look forward to talking to you about March here in the not-too-distant future. Thank you.

Operator:

Once again, that does conclude today's call, and we appreciate your participation.