



Delta Apparel, Inc.

Fiscal Second Quarter FY18 Results Earnings Conference Call

May 7, 2018

Operator:

Thank you, and good afternoon to everyone for participating in Delta Apparel's Fiscal 2018 Second 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 would 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 projections and 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 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 as of today and, except as required by law, the Company does not commit to update or revise any forward-looking statements, even if it becomes apparent that any projected results will not be realized.

I will now turn the call over to Delta's Chairman and Chief Executive Officer, Bob Humphreys. Please go ahead.

Robert Humphreys:

Thank you. Delta Apparel had a solid second quarter and completed a number of strategic initiatives that should help us build Shareholder value in the future. Both sales and earnings were up year-over-year after adjusting for last year's sale of the Junkfood Clothing business. All of our businesses achieved organic sales growth except for Soffe, which was down slightly for the quarter but is up almost 10% year-to-date.

Our team continues to focus on the things that can have the most impact on our business results. Consistent with that strategy, during the quarter, Art Gun, our digital print subsidiary, acquired DTG2Go, one of its primary competitors, and nearly doubled in size in this growing marketplace. The combined business, which we now go to market under the DTG2Go trade name, gives us the most comprehensive, on-demand apparel offering in the high-growth digital print space.

We expect the acquisition to be immediately accretive from both a sales and earnings perspective. This acquisition also accelerates our geographic expansion plans for digital print. DTG2Go now has multiple locations in Florida, a location in Nevada serving the Western United States and an additional manufacturing location on our Soffe campus scheduled to begin production this week. The new location gives us one to two-day shipping to consumers in the important Northeastern marketplace.

We expect the increase in size and scope of our digital print business to provide more cross-selling opportunities with active wear as customers migrate to the virtual inventory model and see the efficiency gains from using blank garments produced on our vertical manufacturing platform.

We are encouraged by the results we are seeing in our direct-to-consumer channels of business. First half sales on our e-commerce site increased 16% year-over-year, including 19% on our consumer site and 15% on our B2B sites. Importantly, our e-commerce business also operates profitably, which is somewhat unique in this channel and something we take a lot of pride in.

Sales from our brick-and-mortar retail stores also continue to grow, and our omni-channel consumer strategies continue to gain traction.

Salt Life's direct-to-consumer sales in the California market provide a good example of the success we're seeing in this area. Direct-to-consumer sales in California, including both e-commerce and retail stores, grew 88% for the quarter and essentially doubled for the first six months of fiscal 2018. In addition, the percentages of California visitors to the Salt Life e-commerce site that made purchases, what we call conversion rates, were up sharply as well. We believe these trends bode well for the brand's overall penetration in the California market.

Our Activewear business was able to achieve sales growth during the quarter despite some cost-related headwinds. The growth was strongest in the retail licensed and regional spring print channels, but demand was solid across the board. Sales of our fashion basics products continue to accelerate during the quarter, and we expect this to continue in the back half of the year, as we roll out more fashion-forward fabrication styles and colors.

Private label shipments were down slightly during the quarter due to customer request to pull orders into the prior quarter to satisfy holiday demand. Despite these timing issues, we are seeing solid demand from brands for our private-label platform, and we are also seeing a welcome shift among brands toward sourcing more products in the Western Hemisphere. The sophistication and versatility of the FunTees manufacturing platform should uniquely position us to benefit from this trend and expand our customer base.

Salt Life also achieved solid top line growth for the quarter while also maintaining strong bottom line performance. Its customer base is also expanding, with shipments to all doors at Buckle during the March quarter and shipments to a 100 Dillard's stores started in April. Salt Life's retail stores, including its newest addition in Daytona, Florida, performed well during the quarter, and a second outlet store in the Florida market is targeted for late fall.

Looking forward to the second half of the year, Salt Life plans to expand its lifestyle brand offering with the introduction of a craft beer line in Florida during the fourth quarter. We have several other product extensions planned for fiscal 2019, including a licensed women's swimwear line that many of our customers have been expressing interest in over the years.

Salt Life continues to expand its marketing efforts to increase the visibility of the brand. It expects to reach its largest television audience yet through its titled sponsorship of a new fishing show airing on the Discovery Channel later this year.

Salt Life's Internet presence is also growing, with a direct social media reach of almost 1.4 million and over 19 million views on its YouTube channel.

Soffe's second quarter performance was mixed, but we are encouraged by its double-digit growth in first half sales. Soffe is also aggressively marketing its brand through various initiatives in the dance, cheer and other channels. In addition, its direct-to-consumer footprint will expand, once again, with the opening

of a fifth branded retail store in Greenville, North Carolina during the third quarter. A recent virtual inventory partnership with DTG2Go also gives Soffe another avenue for growth in the future.

I'll now turn the discussion over to Deb to provide the financial details of our second quarter results.

Deborah Merrill:

Thanks, Bob. The fiscal year 2018 second quarter was a successful one for Delta Apparel. Net sales came in at \$100 million, up \$1.9 million or 2% from the prior year's \$104.1 million after excluding the \$6 million of sales from the Junkfood Clothing business we divested last March.

Net income from the quarter was \$3.6 million or \$0.48 per diluted share, an increase over the prior year period's \$0.47 per diluted share after excluding the approximately \$0.11 per share gain we realized on the Junkfood sale. While margins expanded in most of our businesses during the quarter, overall gross margins declined to 22.2% from 23.3% in the prior year. Higher raw material prices and other inflationary cost pressures at Activewear drove the decline. Basic segment net sales were \$73.7 million in fiscal 2018 second quarter, up 4% from sales of \$70.8 million in the prior year quarter.

As Bob indicated, the second quarter was an exciting one for our digital print business. Our DTG2Go business achieved sales growth of nearly 60% year-over-year, including approximately 20% organic sales growth. The organic growth drew on momentum generated by our strong execution and service levels during the holiday season. Gross margins at DTG2Go increased 330 basis points to 24.4% driven from improved operational efficiencies and the incremental benefit of running higher sales volumes through the digital platform. We expect the strong growth trend to continue as we leverage further investments in equipment in our proprietary platform. DTG2Go is now better positioned than ever to win business, both within its traditional customer base and in new channels that recognize the benefits of the virtual inventory model.

Activewear sales for the quarter increased 2% year-over-year, with 15% growth in Catalog sales driven by increased units, higher selling prices and continuing velocity in fashion basics. Fashion basics sales more than doubled over the prior year quarter. Private-label sales were down during the quarter but remained up 3% in the first half of the year. While gross margins in the Activewear business were lower in the first half from the higher-cost environment, price increases, a favorable mix of products sold and further manufacturing efficiencies are expected to improve gross margins in the back half of the year.

Net sales for the quarter in the branded segment were \$26.3 million compared to \$33.3 million in the prior year quarter, with the lower sales resulting from the divestiture of the Junkfood business last March. Salt Life revenue increased almost 7% for the quarter, with growth across most sales channels. Escalating demand for performance products and other new categories, combined with strong momentum in direct-to-consumer channels, drove the topline growth.

Salt Life e-commerce sales continue to strengthen, increasing 21% overall year-to-date and led by 38% growth in California. Salt Life gross margins were consistent with the prior year period and drove solid profitability for the quarter. Soffe's second quarter sales were down slightly from the prior year quarter but are up nearly \$2 million in the first half of the year. Gross margins improved 130 basis points as a result of cost structure enhancements and a more profitable product mix.

For the first six months of fiscal 2018, net sales increased to \$190.3 million from \$189.5 million in the prior year period and were up 9% year-over-year, excluding prior year sales from the since divested Junkfood business. A discrete provisional tax expense of \$10.6 million associated with the tax reform legislation drove a net loss for the 2018 first half of \$6.3 million or \$0.87 per diluted share. Excluding the impacts of the tax reform legislation, the first half earnings were \$4.2 million or \$0.50 per diluted share, a 12% increase over the prior year period and a 36% increase over the 2017 first half if you exclude the prior year \$0.11 gain on the sale of Junkfood.

Capital spending for the second quarter was \$1.7 million, bringing the year-to-date total to approximately \$6.7 million. The expenditures were primarily related to machinery and equipment as well as direct-to-consumer investments, including retail stores. We anticipate capital spending for the full fiscal year to be approximately \$13 million. Depreciation and amortization, including noncash comp, was \$3 million in the second quarter and \$5.9 million year-to-date.

During the second quarter, we purchased almost 75,000 shares of our common stock at an average price of \$19.52 per share for a total cost of \$1.5 million, bringing our total first half purchases to just over 220,000 shares at an average price of \$20.29 per share and a total cost of approximately \$4.5 million. At the end of the quarter, we had \$6.8 million of our board authorization remaining for share repurchases. We continue to believe that our current share price range does not accurately reflect the intrinsic value of our company, and we will continue to consider share repurchases in the second half of the year.

At quarter-end, inventories were down \$8.5 million year-over-year due to the efforts to manage inventory levels to our expected sales. Total debt at quarter-end was \$112.2 million compared with \$97.4 million at the end of the prior year quarter. The increase primarily stems from the acquisition of the digital print business as well as improvement in the timing of payments to suppliers.

Now I'll turn it back over to Bob for a final comment.

Robert Humphreys:

Thanks, Deb. Despite a still-challenging retail environment and cost pressures in a number of areas, overall, we're pleased with our performance in the first half of the year. We remain upbeat about the second half of fiscal 2018 and look for more organic growth and profit improvements, driven by higher gross margins in the second half of the year. We should continue to see the incremental benefits from our new products and category extensions, broadening customer base and investments in the digital print and fulfillment model. Our manufacturing platform continues to operate efficiently and we're finding additional opportunities to increase volumes and capitalize on our new capacity and functionalities, such as our plan to move the productions of our fleece products, in-house, during the third quarter. All told, we believe we're in a position to grow and create more value for our shareholders as we move through the back half of the year.

At this point, Operator, we'd be glad to answer any questions to the—our viewers might have.

Operator:

Certainly. If you would like to ask a question, please press star, one on your telephone keypad. If you're using a speakerphone, it may be necessary to lift the handset before making your selection. Once again, please press star, one at this time if you have any question.

We'll take our first question from Dave King with Roth Capital.

David King:

Thanks. Good afternoon.

Deborah Merrill:

Hey, Dave.

David King:

In terms of the DTG2Go business, do you have what the revenue contribution from the acquired portion was in the quarter? Then, on the improved efficiencies and leveraging of volume with that business, can

you talk about that a bit? Did you already—were you already able to take some fixed costs out? Then, what are some of the other synergies, if you will, as we look forward?

Deborah Merrill:

Sure. The acquisition gave us about \$1.1 million of revenue. Even without that acquisition, we were up on—had about a 1% on sales growth over the prior year. That's good. We only owned that business for three weeks during the year. As far as taking fixed costs out, we really did not have an opportunity to do that for what was in the business in that three-week period of time. But certainly, as we progress through the June quarter, and then as we start going through for a full year, we will be able to leverage the cost structures and back-office functionality in combining those two businesses. I would say what is even more important is just the geographic reach that we now have in that business to reach consumers in a one- to two-day ship time, across the entire U.S., which we've got the broadest range of reach of digital print out there. We're excited about the opportunities that, that has for us to grow with our existing partners and gain new partners, both in the U.S. and then our international shipping capability.

David King:

Have you seen any increased demand on that front in, call it, April and May then as a—May so far, as a result of that? Or is it too early to tell?

Deborah Merrill:

I would say that there is excitement out there in the marketplace. We have seen that with our existing partners that we work with and in the conversations with potentially new partners. That's a key aspect that they are very excited with. The velocity in that business is meeting our expectations and exceeding our expectations at this point.

David King:

Great. Switching gears. Softe, what are the cost improvements that you're realizing there? I guess, more importantly for me, what do you see as the opportunity there? I don't know what the right way to characterize it is, but what—where should margins be? What's sort of the target? Where are you currently? How do you expect to get there, maybe?

Robert Humphreys:

Yes. Cost improvements have been from some of the headcount reductions we've made over the last year. Some of that was already showing up and some more in this quarter. Better manufacturing performance, better performance in our screen printing areas, running fuller schedules in our screen printing areas, all contributed to that. So far so good there. We still got work to do to get Softe running as efficiently as we would like to and at the scale we would like to. It's generating low single-digit operating margins now. As we've said previously, we would expect that to increase into next year and the next year to mid-single-digit operating margins with what we see on the table today. There's great opportunities to improve on that with the right kind of wins in the marketplace and changing dynamics in the military and Made in America, but based on the table as we see it set, right now, that's what we see the opportunity as.

David King:

Great to hear the progress you're making. Then, I guess, lastly for me, and then I'll step back. Salt Life, looks like the growth decelerated a bit from prior quarters? I guess, can you talk about what might be driving that? Then, how is the Buckle business performing in terms of sell-through? Then, on the Dillard's portion, did you say how many locations it'll be launching in?

Robert Humphreys:

Yes. Our customers don't always match their ordering cycles along with our fiscal quarters. No doubt that the storms over, really, the last 12 months, have hurt geographic areas and customer bases and when people are ordering. You still have some of the Florida Keys and all that are just now getting back up. Certainly, they were later in ordering this year, and to some extent, we'll miss some of what would have been the spring business. You still have major retailers at Downer Way and some are under financial pressure, so that affects our business some too. But where our product is out in front of consumers, it's getting purchased briskly. We are sold out of a lot of our performance products for this year, already. We've had huge response to that. We feel good about how that's going along. The product has sold well at The Buckle. I think, in all locations, we're reshipping a lot of stuff and filling fill-in orders. We would love to earn more space in a Buckle store over time and feel like we'll be doing that. They are expanding the offerings they have.

Then we've worked on the Dillard's business for some time now and finally got shipping instructions and started shipping to 100 doors as their initial rollout. We were encouraged some of those doors were in each of their geographic location. I think five of them in their West Coast location. Feel really good about how that customer base is building out in Salt Life. You get some shocks to the system, but when you look at it globally, good things are going on there.

David King:

Okay. Perfect. Thanks for the taking questions.

Robert Humphreys:

Thank you.

Operator:

As a reminder, it is star, one if you would like to ask a question.

We will go next to Jamie Wilen with Wilen Management.

James Wilen:

Hey, fellows, just a follow-up on a couple of Dave's questions. How many doors does Dillard's indeed have?

Robert Humphreys:

I believe it's 245.

James Wilen:

Okay. We started shipping in April and have a—we'll have a full inventory load in those 100 stores through June?

Robert Humphreys:

Different doors are getting product at different times. Some of them are considering already to expand their product base. I don't want to give you the idea that every store is getting the exact same inventory load. But, yes, the rollout will be through June and in the summer, and we'll go from there.

James Wilen:

Okay. You mentioned how California is doing extremely well on the direct-to-consumer side. Is that a function of—the people in California are watching the fishing videos more, and it's more important to do those things than it is to get actual doors out there?

Robert Humphreys:

Well, I think it's a combination of things. When we get product in front of the California marketplace, it sells well. We've done that with our marketing out there and our sponsorship of paddleboard games and things. The stores around the fishing communities, like San Diego, have done well with Salt Life products. I think it's just building the band—brand and building brand recognition and doing that the right way. While you'd love it to be bigger and faster, I mean, clearly, there is traction there, and we're getting eyeballs on the brand, and people are buying the product. The retail door sales are up astronomically, really, over last year. That's really encouraging. Where we've put a stake in the ground there, people have come and seen, and they started buying, and now they're buying at a 50% to 60% clip above last year.

James Wilen:

Got you. On the brewing company arrangement, I assume we're going to get a royalty fee on some sort of regional brewing company. Is that how it's going to work?

Robert Humphreys:

Yes. What we did was the joint venture that we owned 60% of, and then that joint venture is the licensee from us. We'll also get a royalty from the joint venture. Our partner there is based in Florida. Our partner from a distribution standpoint is currently in, I believe, it's 37 states now. We're starting it in Florida, and we'll keep it in Florida for some time with the idea that we will let that grow behind the growth of the apparel.

James Wilen:

Okay, and that's going to debut in the fall?

Robert Humphreys:

That's correct.

James Wilen:

Okay. On the Art Gun acquisition and the on-demand market space. How big is that market space? How quickly is it growing?

Robert Humphreys:

Well, if you look at it today, it's probably \$150 million of revenue or so on what we would really call the apparel space that we're after. How big it can be, I think is, you can let your imagination run wild, because if you look at all the graphic tees that people get on their backs that you have an opportunity to go to a digital environment there. You can look around where digital has gone into the marketplace, and it seems like it's not long that it's, by far, the best supplier to those marketplaces. We really think it's just scratched the surface of what it can and will be. It's a benefit to the consumer. It's a benefit of how they like to buy now. It's a huge benefit to traditional retailers and even e-commerce sites to be able to service this business in a quick and efficient and cost-effective way with no investment in printed inventory. It checks a lot of boxes.

James Wilen:

How do we take advantage of that on the—on our other brands to have them more on-demand product?

Robert Humphreys:

Well, we were doing that with Junkfood with some success. I think it was about 30%, 35% of their online revenue when we sold that business. We've added that at Soffe. At some point, it may be appropriate for Salt Life. But right now, we're managing that brand in a different way.

James Wilen:

Okay. Now, as you've kind of transformed the company with divesting Junkfood, adding more digital on-demand and more Salt Life, what's the seasonality of Delta going forward?

Deborah Merrill:

I mean, I would answer that and say that, over the last years, I mean, we've flattened the seasonality out a bit, but the June quarter still does become our strongest quarter. But again, as you have shift—as we have shifts just in the product space that the different brands are selling, that's becoming less of a strong spring season business than it was but certainly has a bit of that seasonality still in it, with the March and the September quarters quickly gaining speed up against that June quarter.

Robert Humphreys:

Even the December quarter, with our growth in fleece, is still a very, very fast-growing product category for us. Our e-commerce sites, which obviously, you have all the big holiday shopping, that also affects our DTG2Go business. You're going to definitely see a continued growth in that December quarter as well.

James Wilen:

Okay. You mentioned gross margins in the back half should be stronger in the first half. Obviously, a little bit of seasonality. You've got more on-demand business. But what kind of an increase are you looking for versus the first half?

Robert Humphreys:

I think, our comparison not just to the first half, it's really to the prior year. To your point, comp in that seasonality, and we would expect to be, oh, 60 to 100 basis points over what we achieved in the prior year. What's happened is, to the points you made, more DTG2Go and what have you, but then also by getting price increases through parts of the system that it will affect that. Some of our businesses, we've got price increases that we are now seeing and they have flowed through the system. We've got more work to do on that as we continue with our raw material prices and some pricing pressure on transportation cost, synergy cost and labor cost.

James Wilen:

Okay. Where do you stand cotton price-wise, and where is the industry pricing-wise, on the ability for everyone to pass it through?

Robert Humphreys:

Well, we don't ever say exactly what our cotton pricing is in our inventory and where we have fixed. We continue to believe that we are in reasonably good shape, and if you look at where cotton costs are today, I would say it's in reasonably good balance. Pricing, particularly through commodity products, has

increased to reflect that cost to replacement cotton, and the key is, the volatility that can come up or down, down the road. But so far so good and I think maybe a little inflation in the marketplace has not been all bad.

James Wilen:

Okay. All right, I will hop back in the queue. Thanks.

Robert Humphreys:

Yes.

Operator

Again, it is star, one if you would like to ask a question.

We'll go back to Jamie Wilen with Wilen Management.

James Wilen:

Okay, couple of other quickies. You expect your tax rate for this fiscal year to be around, what, at this point?

Deborah Merrill:

In the about 14%, 15% excluding the discrete item of the tax law change. But outside of that, about 14%, 15%.

James Wilen:

Okay, and working capital-wise, your inventory is down. Yet obviously, with higher cotton costs, the units must be down percentage-wise, even a little bit more than that.

Deborah Merrill:

That would be correct.

James Wilen:

Is that the—are you comfortable with your inventory position or you can you still take it lower in an ideal environment?

Robert Humphreys:

I would say, yes, we think we can be more efficient in inventories in some areas. Right now, we wish we had more inventory of Salt Life performance products on hand and that sort of thing. We'll continue to work on that, but we are—as we always do, work on being more efficient with our inventories, but there are some things that I think we've implemented in the last six or nine months that are starting to show some improvements on how we share products and our manufacturing platforms that are helping us reducing inventories.

James Wilen:

Okay. Bob, you mentioned your moving fleece production in-house. How is that going to impact your cost structure for that?

Robert Humphreys:

Well, it's going to lower our cost structure and also shorten our lead time on replenishment. We started building this business two, two and a half years ago on a source platform, and we made some amounts of fleece in various and sundry locations in Delta Apparel, but it was a little bits here and there and kind of specialty fleece for the military. Now we just are finishing installing some equipment that we ordered some months ago, new nappers primarily to produce nice open whip fleece. Not only will we lower our cost on it, but then we'll start absorbing that fixed cost overhead in our own facilities, and probably the thing we're most importantly excited about is the shortening of our lead time for replenishment.

James Wilen:

Okay. Lastly, as I look into the back half of the year, third and fourth quarters, it would seem the third quarter, seasonally are strong or should be certainly a good bit better than we just recorded from our second, which was pretty decent. Then, when I look at the fourth quarter last year, with the hurricanes in Texas and the East Coast, I would assume August and September were a little rough for you. Comparison-wise, this year's September quarter should be—could be significantly better than last year's as well?

Robert Humphreys:

Yes. Remember, in that quarter last year, we were starting to ship product with increased cotton cost in it. Not the whole quarter, but we started during the quarter prior to getting price increases moved through the system.

James Wilen:

Good. All right, keep buying back a bunch of stuff here. Nice job, fellows. Thanks.

Robert Humphreys:

Okay. Thank you. You bet.

Operator:

With no further questions in the queue, I would like to turn the call back over to Deb Merrill with any additional or closing remarks.

Deborah Merrill:

Well, we appreciate your interest in Delta Apparel, and we look forward to keeping you updated on our initiatives as we go through the June quarter. Thank you.

Operator:

This does conclude today's conference. We thank you for your participation. You may now disconnect.