



Delta Apparel, Inc.
Second Quarter Earnings Conference Call
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C O R P O R A T E P A R T I C I P A N T S

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

C O N F E R E N C E C A L L P A R T I C I P A N T S

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Lynn Parry, *Wilco Management*

Michael Hughes, *SGF Capital Management, LP*

P R E S E N T A T I O N

Operator:

Thank you and good afternoon to everyone participating in Delta Apparel's Fiscal 2015 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, projections or other forward-looking statements may be made by Delta Apparel's Executive. Such statements suggest prediction and involve risk and uncertainty, and actual results may differ materially. Please refer to the periodic reports filed with the Securities and Exchange Commission, including the Company's most recent Form 10-K. This document contains and identifies important factors that could cause actual results to differ materially from those contained in the projections or forward-looking statements. Please note that any forward-looking statements are made only as of today and the Company does not commit to update or revise these statements even if it becomes apparent that any projected results will not be realized, or 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 third quarter ended June 27, 2015.

Deborah H. Merrill:

Thank you, and thank you all for joining us on the call. I'm happy to report that Delta Apparel had a good June quarter. Net income doubled to \$4.4 million, or \$0.55 per diluted share, compared to the prior-year third quarter of \$2.2 million or \$0.27 per diluted share. Operating profit for the 2015 third quarter was 5.7% of sales, a \$5.3 million improvement over the comparable 2014 period, while sales, after adjusting for the \$5 million revenue reduction due to the second quarter sale of The Game, grew a modest 1.7%. Based on current retail conditions, overall, we are satisfied with this improving trend for our Company. Our gross margins continued to strengthen with a 260-basis-point sequential improvement from the March quarter and a 270-basis-point improvement year-over-year.

For the first nine months of fiscal 2015, net sales were \$328.9 million, compared with \$338 million in the prior-year period. The sale of The Game collegiate business in March contributed \$6.4 million to the decline. Net income for the 2015 first nine months was \$3.9 million, or \$0.48 per diluted share, compared with a net loss of \$195,000 or \$0.02 per diluted share in the 2014 period.

Our basic segment had net sales of \$79 million in the 2015 third quarter, a 4.2% increase over the \$75.8 million in the prior-year's third quarter, with both Activewear and Art Gun contributing to this increase. Activewear sales increased 3.6% year-over-year. This was driven by a 12.7% growth in the sale of private label products. We continue to grow our catalog Full Package programs where we are providing our customers with value-added services, including decoration and retail packaging on catalog garments.

We have also had success in new product categories, including Fleece and our Delta Dri Performance products. In the June quarter, we saw 26% growth in our Fleece sales, compared to the prior-year quarter, and a 43% growth in our Performance product sales.

Art Gun, our smallest but fastest growing business, increased sales 26.2% to \$2.9 million on a 41.2% increase in units. The basic segment overall achieved solid margin expansion, both sequentially from the March quarter and year-over-year, due to a stronger product mix, greater efficiencies in manufacturing and operations, and the benefit of balanced selling prices with lower cotton cost.

Our Branded segment had net sales of \$41.5 million, compared with \$47.7 million in the 2014 third quarter. As mentioned earlier, the revenue reduction from the sale of The Game Branded business this past March was the primary reason for the decline. The rest of our Branded segment businesses experienced sales growth and solid margin improvement, with the exception of a slight sales decline at Soffe. Overall Soffe's main sales channels remained flat with the prior year, with a \$640,000 sales decline coming principally from its off-price channel.

Although Salt Life had record sales growth in April, our ability to ship products slowed in May, as we began the process of moving our distribution from leased space in Phenix City, Alabama, to owned real estate in Fayetteville, North Carolina. Due to the temporary disruptions from this move, Salt Life's 4.1% sales growth during the June quarter was less than originally anticipated.

Junk Food sales for the 2015 third quarter were up slightly, with good gross margin improvement both sequentially and over the 2014 third quarter. Continued double-digit sales growth at specialty retailers offset some weakness in other sales channels. Junk Food website continued its strong growth, increasing 22% for the quarter and 61% year to date.

We reduced overall selling, general and administrative expenses by \$1.4 million from the prior-year quarter, bringing SG&A as a percentage of sales to 16.3%, versus 17.1% in the prior-year period. The

reduction principally resulted from cost savings measures that we put in place almost a year ago, offset partially by higher marketing expense in our branded businesses. For the first nine months, SG&A as a percentage of sales was 18.2%, versus 18.4% in the prior year.

During the June quarter, the fair value of Salt Life contingent consideration was re-measured based on historical and projected sales levels, resulting in a reduction in the fair value of the contingent consideration of \$630,000. As a reminder, the contingent consideration is associated with the acquisition of Salt Life and will be paid to the former owners of Salt Life based on net sales of Salt Life products during calendar 2019. Each quarter the contingent consideration is adjusted to fair value based on the actual sales to date and the remaining time to the measurement period of 2019. We do still expect sales in calendar 2019 to approximate the expectations for calendar 2019 sales used in the valuation of the contingent consideration at acquisition. However, based on the current sales levels, the accrual for the contingent consideration was adjusted downward to its current fair value.

Our effective income tax provision for the nine months ended June 27, 2015 was 40.4%. Excluding discrete tax items associated with the gain on the sale of The Game during the March quarter, and the exercise of stock options in the June quarter, the effective tax provision on normal operations for the nine months was 4.2%. We anticipate our effective tax rate for fiscal 2015 to be approximately 20%. However, changes in the mix of the US taxable income compared to profits in tax-free jurisdictions can have a significant impact on our overall effective tax rate and will not be known until we complete our September quarter.

Capital spending was \$1.8 million during the quarter and \$4.2 million year to date. We anticipate our fiscal 2015 capital expenditures to be approximately \$9 million, which will include approximately \$3 million for the expansion of textiles to manufacture new products, which should decrease purchased fabric and reduce costs by leveraging internal operations.

Depreciation and amortization, including non-cash comps, was \$3 million for the quarter and \$8.5 million year to date, and we believe it will be approximately \$11.5 million for the full fiscal 2015.

During the June quarter, we repurchased 30,700 shares of our common stock at an average cost of \$14.35 per share, for a total cost of \$440,000. As of June 27, we had 4.3 million remaining authorized from our Board for share repurchases. We expect to continue repurchasing our stock under our stock repurchase program, as we believe the intrinsic value of the Company is significantly higher than its current share price range.

Total debt decreased \$22.9 million from March to \$112.2 million in June. As anticipated, inventory levels decreased both in units and in terms of cost per unit. This, coupled with the strong earnings during the quarter, gave us the ability to pay down our debt significantly during the quarter. We anticipate continued strong operating cash flows during the September quarter that, after offset for capital expenditures and anticipated share repurchases, should further reduce our debt by another \$10 million to \$15 million in the fourth quarter.

We believe that Delta's performance in the 2015 fiscal third quarter points to a strong finish for the 2015 fiscal year and an opportunity for robust profitability growth in fiscal 2016.

I'll now turn the call over to our Chairman and CEO, Bob Humphreys, who 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. Delta Apparel had a very good quarter, making progress in a number of areas of our business. During the quarter, the Company not only turned the corner in terms of sales and net income growth, but showed vast improvement in other

areas, such as gross margin expansion and general and administrative cost reduction, resulting in significant improvement in our operating margins. The strategic initiatives that we began implementing a year ago proved successful in regards to cost savings, efficiency gains, profit growth and better service to our customers, and we believe the best is yet to come.

We continue to invest in areas of our business where we expect to yield high returns. The expansion in our Honduran textile facility, Ceiba Textiles, is underway. All the equipment is on order and we should receive it before the end of the calendar year. We expect the equipment to be running in the first calendar quarter of 2016, and we should start seeing benefits shortly thereafter. By expanding our production capabilities and to open-width fabrics, we will reduce our reliance on purchased fabric, which should allow us to better service our customers and expand our product offering. In addition, we'll be further leveraging the fixed costs of our internal manufacturing production. Overall, we expect to achieve annual savings of approximately \$2 million from this investment.

E-commerce is another area we believe we can make investments, which should yield high returns. In the June quarter, we grew sales on our internal websites by 56%, with each of our direct-to-consumer sites seeing growth in excess of 20%. We continue to enrich our e-commerce presence and recently added several new functions to further enhance the customer experience. We're also making investments in e-commerce in our Art Gun business. The Art Gun facility boasts cutting-edge equipment and industry-leading proprietary software specifically geared to facilitate e-commerce business.

We mentioned last quarter that Art Gun's technological competencies were also being leveraged internally to enhance Junk Food's direct-to-consumer business by giving Junk Food more flexibility in its e-commerce product offerings with web-exclusive designs. This feature is now operational and producing high-margin revenue. Additionally, Art Gun's digital printing capability complements Delta Activewear by providing greater opportunities for value-added services for our customers.

Junk Food, now long-known for its creativity and ingenuity, continues to build its direct-to-consumer business through its flagship store on Abbot Kinney Boulevard in Venice Beach. As an example, in June, Junk Food partnered with Connor Franta, an American YouTube blogger and Internet personality whose self-named main channel on YouTube has over 4.5 million subscribers. Together, we launched an exclusive capsule of apparel to be sold only on the Junk Food e-commerce site and at the Junk Food retail store. Some fans stood in line for over 24 hours to get a chance to meet Connor at the store. Over 2,000 fans visited, with some traveling over seven hours to come see Junk Food. Junk Food already has in place plans to do other similar events. Junk Food's retail sales at its store grew over 100% from the prior-year June quarter and increased over 30% from the March quarter.

We see the third quarter as a turning point for Soffe. Soffe sales were nearly flat compared to the prior-year quarter and the business broke even for the first time in several quarters. The core Soffe short, in various colors and patterns, is trending well with consumers and a number of major retailers are expanding the retail doors with the short. We look forward to Soffe's new fall line on the retail floor for back-to-school and expect it to resonate well with consumers. Soffe has a large consumer fan group and its direct-to-consumer sales continue to increase, with growth of 24% during the June quarter and 32% year to date.

As Deb mentioned, during the quarter we began moving Salt Life's distribution center from Phenix City, Alabama to Fayetteville, North Carolina. This allows us to leverage real estate we own instead of leasing distribution space. The DC will be specifically set up to distribute Salt Life products efficiently to better service our customers. In addition to having a distribution on the same campus where we are printing Salt Life graphic tees, we should be able to significantly improve cycle time and lower cost by avoiding freight expenses between facilities and duplicate handling of product.

Unfortunately, the move caused disruption in shipping Salt Life products, which resulted in a single-digit growth rate that is uncharacteristic for Salt Life. Currently, we're working through the order backlog and

shipping delays are being corrected. This is a temporary situation and we're not seeing any decline in the strong demand for Salt Life products. In fact, had the order backlog been shipped in June, Salt Life's growth in the third quarter would have been nearly 30%.

Salt Life's gross margins remain strong, having expanded by about 300 basis points, compared to the prior-year quarter. Salt Life has received an overwhelmingly strong response to its new spring line. Our major regional and national retailers are adding new doors and expanding product categories. We feel confident that as the new efficient distribution center with this inherent cost savings and improved customer service becomes fully functional, Salt Life will return to its traditional strong double-digit growth rates.

We're excited about the positive trends we're seeing in each of our business units. We have completed a lot of hard work over the past year to improve the Company and we are now seeing the results of our efforts. Sales have increased, margins have expanded, and the bottom line has improved as we expected it would. We will continue to be diligent in our efforts to build off the recent success to drive further growth and profit expansion in the coming quarters. Bottom line, we believe we've built the foundation that should provide steady growth and improved profitability for Delta Apparel.

Operator, at this time we'd be happy to open up the call to any questions.

Operator:

Yes, thank you. Please press star, one on your phone to ask a question. Make sure your mute button is disengaged to allow your signal to reach our equipment. We'll go first to Dave King with ROTH Capital Partners.

David King:

Thanks and good afternoon, Bob and Deb.

Deborah H. Merrill:

Hey, good afternoon.

David King:

I guess first off, congrats on the strong quarter, sort out of the gates, and then I guess along those lines, I was just particularly encouraged by the growth in private label this quarter. I guess, can you comment on what might be driving that? Then, sort of as an offset, it looked like the catalog business, that business might've been down a bit, if I saw that correctly, and I'm just curious, Bob, if you have any color there in terms of how you're thinking about the environment these days. It looks like you were able to maintain pricing, given what I think some of your competitors are doing, so maybe you can just talk a little bit about that and sort of the strategy there. Thank you.

Robert W. Humphreys:

Okay. Probably, it's a little bit confusing between private label and just catalog tees. Demand for both of those products was strong during the quarter, I think for a couple or three different reasons. Our traditional private label business with kind of the major activewear brands is good, just from a number of different reasons. We've been working to add customers, which we've been successful at, and really cycled into the full shipping time with them. Our existing customers asked us to make more product, so on our Fun Tees platform, we shipped more product than we ever have. At the same time, demand for our undecorated tees was steady, and what you saw is some movement from blank tees to those traditional customers that we now decorate and rebrand for them. So, we categorize that as Private

Label, but really see selling that product to traditional blank tee customers, who are just having us do more value-added to the product.

David King:

Okay, and then, in terms of just the ability to maintain pricing, it sounds like that's sort of what—the ability to do that in this environment and sort of is that then the strategy on a go-forward basis, it's the value-add sort of scenarios, but then also is it—are you guys also expanding the mix of the products that are available as well as a go-forward?

Robert W. Humphreys:

We certainly have. We've added three or four different product categories over the past 12 months, as some of them are, you know, anniversarying now, like our Performance products and Fleece, so we see that driving additional volume and better profitability. We saw pricing fairly stable during the quarter and we'd expect that for the next at least several months, anyway, as we're still in a strong shipping environment. Our business in private label and undecorated tees started out our fourth quarter that we're just in, very strong.

David King:

Okay, great. Then, switching gears maybe a bit, in terms of the Salt Life DC transition, when did that exactly occur? It sounds like you're still not necessarily caught up there, but I think the demand still remains strong. I guess, along those lines, have you seen any cancellations, do you anticipate any cancellations, and by when do you think you might have that fully addressed in terms of being caught up?

Robert W. Humphreys:

Yes, so just a little bit of background on that. When we first contemplated selling The Game business, our intent was to not move this distribution process until the December quarter, which is typically our slowest shipping quarter, and then just through that process and when the lease expired on the building, we needed to move that up, so, you know, we ended up moving it into a busier time of the year for us. We had strong shipments through April, as Deb said, I think our strongest growth month maybe ever for Salt Life, and then, you know, we did hurt our ability to ship in May and June. We certainly started catching up by the end of June, but we're still not completely caught up. So far, you know, we proactively reached out to our major customers and they're very supportive of us, continue to give us more orders and continue to make significant expansion plans going into what will be our next fiscal year, particularly starting with spring.

We ended up really moving from two DCs. In Phenix City, we'll be in one DC really set up for Salt Life. We started shipping \$4 million or \$5 million out of that DC in Phenix City and grew to the mid-\$20 million kind of revenues. So, it's natural, as you're doing that, to have to move into some additional space and larger, more efficient space.

David King:

Right, now that makes sense and that helps. Then, I guess lastly, and then I can take the rest offline, in terms of the outlook, it sounds like, if I heard you correctly, Deb, you said fiscal '16, obviously, you still expect improving profitability. Also, I guess, obviously, you have a lot of initiatives that are driving that, in terms of gross margin, expense savings, but how are you guys thinking about the top line as we move forward from here, both for the rest of this year and then, you know, what's sort of embedded in that thought of driving the profitability improvement in '16, what's embedded on the top line? Thank you.

Deborah H. Merrill:

You know, as Bob mentioned in his discussion points, we do see a lot of positive things happening across our business units. That all being said, the retail environment is not very strong right now out there and we have to take that into consideration. So, we believe in coming quarters we should continue to see growth across our business units, but we are being cautious about that just with what the environment is. So, you know, I would say not—you know, that we should see single-digit growth in the fourth quarter and out in the coming quarters, but being conservative in that. I mean, in this environment, if we can have just low single-digit organic growth, I think we're much improved over what we're seeing with a lot of competitors and out there in the retail marketplace.

David King:

Fantastic. Congrats again and good luck.

Deborah H. Merrill:

Thank you.

Operator:

As a reminder, it is star, one for your questions today, or star, two to exit the queue if your question has already been addressed.

We'll go next to Lynn Parry with Wilen Management.

Lynn Perry:

Hi, Deb and Bob. How are you?

Deborah H. Merrill:

We're doing good. Thank you.

Lynn Perry:

It was a really nice quarter.

Deborah H. Merrill:

Thank you.

Lynn Perry:

I have some questions on Salt Life. Can you talk about the number of doors you've added in the past year; and in addition, since it's your prime selling season, do you have any feel for how well the items sold through, so you can forecast if you're adding more doors next year?

Deborah H. Merrill:

I would say, in total numbers, we don't have any door count right now. We are in the process of several expansions with customers, not only of new doors with existing customers, but then some potential new

retailers that should come onboard in the coming quarters, so we don't have specific numbers, but I can tell you that the door count does continue to expand and we expect that will continue in coming quarters.

Lynn Parry:

Okay.

Deborah H. Merrill:

Then, on the existing doors that we have, we'll also mention that we have a number of them that are expanding the product categories. So, there might not be expansion in the number of doors, but then they also are expanding the categories that the existing doors are carrying.

Lynn Parry:

Right, okay. To me, it seems like your Salt Life line had a lot more appealing items this year, both in terms of, like, color and stock. Do you plan on doing a wholesale upgrade to the Salt Life line, either by invest in some areas or stepping back from others?

Robert W. Humphreys:

Yes, particularly the spring line, which we're obviously selling right now, I would say is a really big step forward. As we mentioned, we got just overwhelming response with our retail customers and it really starts showing it true lifestyle product line. Even though consumers thought about Salt Life as a lifestyle brand, the product line started primarily as T-shirts and then headwear, but when you see the spring line, you really get that feel of a true lifestyle product line. So, we're very excited about the reception to that and we'll have our most aggressive buy on our fashion products that we've ever had for Salt Life. We've been very conservative on those buys and generally run out of them early in the selling season, but several of those products were becoming staples and we're certainly planning on expanding our inventory position on those for spring of '16.

Lynn Parry:

Well, I just got back from a beach vacation and Salt Life was every place.

Robert W. Humphreys:

Great.

Lynn Parry:

Whether it was on the locals, surfboards, T-shirts, it was every place. Then, lastly, on Salt Life, in terms of marketing, are you going to devote more dollars here and is less of the money going in the digital direction?

Robert W. Humphreys:

Yes, so a couple of things. I think we're pretty much set for calendar '16. We do a little bit of print ad, mostly in surf and standup paddleboard. We have devoted a lot to digital with our, you know, e-commerce sites and also the Salt Life YouTube channel. We've got a new country music singer coming onboard, that'll be announced in the next couple of weeks, and we were just announced as the title sponsor for the Standup Paddleboard Championship, which is going to be held in Dana Point in October. It's going to be a really big event. I believe it's the largest purse ever for a standup paddleboard

competition. So, that's, you know, pretty much set for the upcoming year and we think we're getting a lot of bang for our buck, particularly on the social media aspect of Salt Life.

Lynn Parry:

Well, that's great. Well, thank you very much and nice job on a great quarter.

Robert W. Humphreys:

Okay. Thank you.

Deborah H. Merrill:

Thank you.

Operator:

Our next question comes from Mike Hughes with SGF Capital.

Michael Hughes:

Good afternoon. I have a couple of questions for you. I first want to start with Junk Food. I think traditionally the September quarter is the strongest quarter there, but I think one of your large customers has announced that they're going to close a large number of doors. So, how do you feel about that business just moving from June into December? Will it, you know, shows its traditional sequential strength?

Robert W. Humphreys:

It will, and Mike, based on the order backlog we had going into the quarter, we think we'll have nice growth over last year's September quarter. We're certainly aware of the retailer you mentioned and believe the vast majority, if not 100%, of the doors that they are closing are doors that Junk Food was not in.

Michael Hughes:

Okay, great. Then, I think in the past you've mentioned potentially testing Junk Food in another large retailer. Any update on that?

Deborah H. Merrill:

We've had some new retailers picked up, especially in the specialty channels, and those are going well and continue to grow. I think we've mentioned that those specialty doors that we've been in have been growing at about 20% for the last several years, and we expect to see continued growth in that sales channel, which encompass a number of those doors that we've been working with.

Michael Hughes:

Okay, great. I may have missed this, because a number of questions were asked on Salt Life, but the lost sales at Salt Life, which I would estimate at around \$2 million, first, is that a correct number?

Robert W. Humphreys:

Just a little bit less than that.

Michael Hughes:

Okay, a little less. Will you recapture the lost sales in the September quarter?

Robert W. Humphreys:

Well, certainly some of them, the order backlog. You know, the thing that you worry about is when you're in a situation where you can't ship replenishment orders, particularly with smaller retailers, you can lose sales, that that group of vacationers, and what have you, are simply gone when the product gets there. So, it certainly doesn't help your overall sales, but we expect to have sales growth in the September quarter, as we did in the June quarter, but just on up our expectations.

Michael Hughes:

Right, and then you sound very constructive on Soffe at this point. Remind me, you're introducing the refreshed fall line in the September quarter, is that correct, and then what type of growth would you expect out of that business line in September?

Robert W. Humphreys:

Yes, I don't think we've put forth a specific growth plan publicly on Soffe. We were encouraged with the spring line and its sell-through, good response to our fall line, which is seasonally our slower line, and have a lot of excitement around our spring line that we're out there showing our customers today, but, you know, at this point I'm happy to have Soffe back, we think, stable on a sales standpoint, basically breaking even at the operating line in the June quarter, and expect to improve from there.

Michael Hughes:

Okay. Then, the \$2 million in savings, when will that start to hit the P&L, the savings?

Robert W. Humphreys:

Yes, so we should start seeing that—that's obviously an annualized rate, so we'll start seeing that in the March 2016 quarter, and then it'll take about another quarter for it really to start rolling through cost of sales. We'll start manufacturing that product, you know, in probably the beginning of March, and 60 to 90 days later, that savings will start rolling through and be seen in higher gross margins.

Michael Hughes:

Okay, and then just two detail questions on the P&L. I believe the interest expense was up sequentially despite the nice reduction in the long-term debt, so, Deb, could you just speak to that?

Deborah H. Merrill:

The interest expense in the June quarter—we end up with our highest working capital kind of as you're going through and ending that March quarter into the beginning of the June quarter, and then that starts coming down quite dramatically as you get towards the end of that June quarter, so we paid off a lot of debt really towards the end of the June quarter. So, the interest expense was certainly on some higher debt levels that we had at the beginning of the quarter and then should come down now in our September quarter as we pay down some further debt in that September quarter.

Michael Hughes:

I see, and then one last question. The other income line, I think it was around \$425,000, which was a little bit higher than what I expected. What contribute to that?

Deborah H. Merrill:

Yes, we had some investment income on our joint venture that we have, that we have a joint venture in our Honduran, and that contributed to that, as well as—so that was about a \$0.25 million, and then in that line item we also have our foreign currency gains, and then some income on where we sublease some of our facilities out to other people is in that line item, as well.

Michael Hughes:

The \$250,000 piece, is that recurring from this point forward?

Deborah H. Merrill:

Yes, that is basically—we book that investment income about once a year when we get the audited financial statements from that JV, and so that was recorded in the current year. So, that's not a quarterly reoccurring, but it does continue year after year.

Michael Hughes:

I see. Thank you very much for your time.

Robert W. Humphreys:

That's our investment in the Green Valley Industrial Park in Honduras, where our textile facility is located.

Michael Hughes:

Okay. Thank you.

Operator:

As a reminder, it is star, one for your questions today. We have no more questions at this time.

Robert W. Humphreys:

Okay. Well, thank you all for joining us and we'll look forward to updating you on our full-year results in just a few months. Thank you.

Operator:

This concludes today's call. Have a wonderful day.