# Delta Apparel, Inc.

**Third Quarter Fiscal Year 2013 Earnings Conference Call**

*April 25, 2013*

**Operator:** Good day, everyone and welcome to everyone participating to the Delta Apparel, Incorporated Third Quarter Fiscal Year 2013 Earnings Conference Call. Joining us from Management today 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's Executives. Such statements suggest predictions and involve risks and uncertainties and actual results may differ material—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 than 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. Just a reminder that today's call is being recorded.

And I would now like to turn the conference over to Delta's CFO, Deb Merrill. Deb, please go ahead.

**Deborah Merrill:** Thank you and good afternoon, everyone. There were two key factors that negatively impacted Delta's revenue and net income during its 2013 fiscal third quarter.

First, the difficulties that we've been experiencing at Soffe continued through the period and second, demand for products was delayed somewhat due to cooler weather and the unusually late spring this year. We'll go into more detail later, but the result was that our consolidated net sales for fiscal 2013 third quarter were 120.1 million, down about 4% from our 2012 third quarter sales of 125.5 million.

Net income was 1.6 million, or $0.19 per diluted share, compared to 1.9 million, or $0.22 per diluted share, for last year's third quarter. Despite the overall declines, we want to point out that we had revenue growth in our basics segment in every one of our branded businesses, with the exception of Soffe.

Gross margins and operating profit also improved across the board, with the exception of Soffe. Had Soffe performed this third quarter, as it did in the prior year third quarter, we would've experienced overall sales growth of about 3%, with operating profit growth of about 83% over the prior year third quarter.

In reviewing our segment results, all of our branded businesses experienced good sales growth being offset by the 30% sales decline in our Soffe business. Net sales for our branded segment came in at 52.6 million, down 10%, compared with 58.5 million for last year's third quarter.

The Game had a strong quarter with 15% sales growth being driven from Salt Life products. Sales for Junk Food products increased about 9%, with another good showing from the professional sports license business.

Art Gun continued its rapid growth, achieving a 60% sales increase in the third quarter, and a 95% increase for the nine-month period. Net sales in the basics segments were up slightly to 67.4 million, compared with 67 million for last year's third quarter.

Sales at FunTees, the private label business, grew 4% for the quarter and nearly 10% for the nine-month period. The catalog business achieved unit sales growth of 6%, but this was offset by lower average selling prices, leaving sales relatively flat for the quarter.

Sales in the catalog business are up over 8% for the nine-month period on unit growth of over 17%. Margins improved in the basics segment, driven primarily from the improved manufacturing performance.

For the first nine months of fiscal 2013, overall net sales increased slightly to 357 million, from 354.6 million in the comparable period of 2012. Net income for the 2013 nine-month period was 5.2 million, or $0.61 per diluted shares.

For comparison, the prior year's nine-month period includes the second quarter 2012 inventory markdown in the basic segment that was necessitated by the record-high cotton cost. This resulted in a net loss in the 2012 nine-month period of 7.3 million, or a loss of $0. 86 per diluted share.

SG&A expenses in our 2013 third quarter were 19.7% of sales, compared to 17.7% of sales in last year's third quarter. For the first nine months, SG&A as a percentage of sales was 20%, versus 18.9 in the prior year. Much of this increase was due to royalties which we pay on our licensed products, which we experienced strong growth in this year.

Our effective tax rate for fiscal 2013 nine-month period was 16.8%, compared to a tax benefit of 45.6% on our loss in the prior period.

At March 30th, receivables reached 70.8 million, a 4% decrease from the prior year launch, resulting from the lower sales.

Day sales outstanding stood at 52 days, which is at consistent with the DSOs for the prior year period. Capital spending was 1.6 million during the quarter and our depreciation and amortization, including non-cash compensation, was 2.4 million.

We continued our stock repurchased during the third quarter using $1.5 million to buy back 103,000 shares at an average of $14.34 per share. So far this fiscal year, we've repurchased 316,000 shares at an average price of $14.31 per share.

At the end of the third quarter, we had 11.2 million of our authorization remaining, which includes the additional 10 million authorization approved by the Board of Directors at its meeting in January.

We believe our stock is currently trading at a price that's below its intrinsic value and such periodic repurchases are a sound investment opportunity that we can pursue without sacrificing future growth plans.

Total debt at March 30th was 112.9 million, compared to 132.6 million a year ago. Lower working capital requirements, primarily as a result of lower cotton prices, were the principal reason for the decrease in debt level.

Cotton prices continue to require careful scrutiny. While they've come down significantly from the high and are more in line with historical levels, they are still somewhat volatile. Speculation in the market, coupled with actions in China, contribute to the volatility we are seeing in the cotton market.

Seeing these factors, we have taken steps to hedge our cotton positions for the upcoming year. As mentioned when I started, the difficulties that we've been experiencing at Soffe and the unusually late spring this year have hurt our ability to meet our sales and profitability goals. While spring appears to be finally here, it may not have come quickly enough to bring the fourth quarter in line with our earlier estimates. This, coupled with the third quarter results that did not meet our expectations, necessitate that we reduce our guidance for the 2013 fiscal year.

We now believe revenue will be in the range of 490 to 495 million, and earnings will be in the $1.05 to $1.10 range. As a bridge for everyone to help understand this change in outlook, if you adjust for the sales and profitability decline in Soffe year-over-year, we would be looking at sales at over 520 million, or 6.5% sales growth, and earnings per diluted share of approximately $1.80 for this year compared to last.

As I turn the call over to our Chairman and CEO, Bob Humphreys, he'll provide more details on the Soffe business and our plans going forward.

**Robert Humphreys:** Thanks, Deb and thank you all for your interest in Delta Apparel. As you've heard, the two factors that had the greatest negative impact on our third quarter were the late spring, the cooler than expected weather and the poor performance in our Soffe business.

There's little we can do about the weather, but there are many things that we're doing about Soffe so I'll discuss that first. Soffe's difficulties primarily stem from a high degree of turmoil that is occurring in the retail industry and our failure to make adjustments in our go-to-market strategy and operations in a timely fashion.

Retailers working to stay profitable in the face of persistently sluggish economy are making adjustments in their buying patterns, which are having a direct effect on Soffe's sales and marketing success with these customers.

Specifically, some large retailers are shifting to a strategy that emphasizes private label products. Historically, we've seen this strategy isn't as effective for Soffe consumers, and only time will tell how customers react to this shift. If these retailers eventually revert to their previous branded strategy, Soffe's branded products could be brought in to their marketing plan.

That being said, we're not waiting for that happen. Instead, we have realigned our merchandising, marketing, and sales leadership. We are now focused on expanding the retail customer base and replacing the business we lost.

Realizing this won't happen overnight, we are taking immediate steps to reduce costs and make Soffe profitable at current volumes. We see a number of things that we believe will happen—have Soffe better positioned as we begin fiscal 2014.

First, we'll have lower cost inventory on hand to ship to our customers, driven by lower raw material costs and improved manufacturing performance. Excess costs associated with the college bookstore business are being eliminated with the consolidation of the sales channel into the The Game operation.

We have evaluated the entire cost structure of the business and are making adjustments to support the current sales level. In addition, we're implementing the lower cost operational platforms at Soffe that are now established in our other business units.

Moving past Soffe, the rest of our business did well, especially when you consider the additional challenge they faced with the unusually cool weather.

In our branded segment, Junk Food grew more than 9% to strong margins. One of our most innovative businesses, Junk Food brings new meaning to licensing of products to help businesses connect with their consumer's designs.

We also have introduced to the premium department store a fashion line called Stray Heart that is free of graphics. It focuses on the fashionable Junk Food silhouettes and fabrics. These products will be available soon.

The Game, which grew nearly 15%, was driven by good performance from Salt Life products. The new footwear line is in stores this spring along with new products made from our performance fabric, U Vapor (ph), which provides UV, moisture and odor protection for the more active beach lifestyle.

We're also continuing to consolidate our college bookstore business under The Game. When completed around the end of this year, the consolidation will provide strong sales and marketing advantages for us while lowering our operating costs.

Art Gun has continued its growth in the third quarter and continues to expand its customer base and improve profitability. We expect Art Gun to generate an operating profit for us for the full fiscal year.

Our basics segment has had sales increase over last year's third quarter, continuing first and second quarter growth that put it up nearly 9% year-to-date. Our basics segment recently came out with a new performance product called Delta Draft, which has already proven to be a winner in the marketplace and we expect good things from this product down the road.

We continue to get new customers utilizing our catalog lines and premium capabilities to provide a full package product to customers.

Looking behind the numbers, there are a lot of good things to report. For example, with the exception of Soffe, operating profit improved in the third quarter in all of our business units. In fact, it nearly doubled.

Gross margins have improved overall, primarily due to increased manufacturing efficiencies.

We're continuing our manufacturing expansion within our existing facilities and expect to have new equipment installed in the completion of this project around the end of this calendar year. While we still have some additional costs related to our manufacturing expansion and bookstore consolidation over the next couple of quarters, these activities should result in a lower cost platform going forward.

In addition, because of the actions we have taken regarding Soffe, we expect soon to have it realigned with market demands, which, too, should be contributing to the overall success of Delta Apparel.

So far, this fiscal year has presented us with a number of challenges, not the least of which has been a continuing soft economy and unusual weather. We have met these head on with solid solutions. The benefits of which should become apparent in the upcoming quarters.

As we move through the remainder of fiscal 2013 and into fiscal 2014, we've got three areas of primary focus. The first is to reinvigorate the Soffe brand and business operations returning it to the profitability that we have historically engaged with this business.

The second is the support of growth in our basics segment with the expansion of our manufacturing capacity within our existing facilities.

And the third is the continued development and expansion of our brands. We believe this focus will allow us to continue on our path of growth and drive operating margin improvement needed to meet our longer term profit goals.

At this time, we're going to open up the call for questions. Lorie, if you could manage the questions for us. Thank you.

**Operator:** Of course and thank you, sir. To our audience today, if you would like to ask a question at this time, please press star, one on your touchtone telephone.

Just a reminder, if you are joining us on a speakerphone today, make sure your mute function is turned off to allow the signal to reach our equipment. Once again, ladies and gentlemen, star, one.

And we'll go first to James Fronda at Sidoti.

**James Fronda:** Hi, guys. How are you?

**Deborah Merrill:** Good afternoon.

**Robert Humphreys:** Good. Good.

**James Fronda:** Why is it that you think the, I guess, the Soffe brand just isn't selling as well as the other brands?

**Robert Humphreys:** Well, you know, I think the first driver of that is their big department store customers, like Penney's and Kohl's, you know, really changed strategies, and you know, and I will have to comment on Penney's there, where we lost junior's business but I believe we'll be rebuilding that with some girls product.

And Kohl's moved this basic product line to a private label category, and so, you know, that was significant volume with those two customers. And then, you know, when you start looking, we just feel like we probably lost touch with the marketplace a little bit, was not as quick to react and really had a higher cost platform there than what we've developed at our other business units. So, you know, I think those are the primary drivers.

**James Fronda:** Okay and do you think you could, I guess, fix this by next quarter or would that have to wait till some time in fiscal '14?

**Robert Humphreys:** So I think, you know, we'll continue to be well below our historical performance for Soffe, you know, in our fourth quarter. You know, and the fall business is a small part of the Soffe business so I think where we're really focused is, you know, for spring of next year. We brought in some new merchandising talent and current development and design. We have—we've done focus groups and what-have-you. We're excited about what our spring offering is going to be and that's what we're really focused on. We brought back in, Ron Wagenseil, who used to be oversells at Soffe. We have moved Ron out to the West Coast to run our Junk Food business some years ago, and that's really when we started seeing a decline in the overall sales growth at Soffe so we're happy to have Ron back full time, really focusing on the sales and marketing and merchandising effort of that business for us.

**James Fronda:** Okay but if it's not until next spring, then I guess it'll probably negative weigh on sales, you know, for the next seven quarters. Am I right?

**Robert Humphreys:** Yes.

**James Fronda:** Okay. All right. Thank you.

**Robert Humphreys:** Less significantly as we go into fiscal '14. It's really …

**James Fronda:** Right, right, right.

**Robert Humphreys:** Next year. But …

**James Fronda:** Okay.

**Robert Humphreys:** But still, we would expect to be below the prior year level.

**James Fronda:** All right. Okay. Thank you.

**Operator:** And moving on, we'll go next to Jared Schramm at Roth Capital Partners.

**Jared Schramm:** Good afternoon.

**Deborah Merrill:** Hi. Good afternoon.

**Jared Schramm:** You mentioned returning Soffe to historical profitability levels. Could you just give us some maybe just little bit better in-depth as far as initiatives specifically that you think will take you there?

**Deborah Merrill:** From a profitability standpoint, I would just kind of repeat some of the things that Bob had mentioned. Some is our fiscal '13 did have higher costs inventory product in it that will not be in it in '14, so that would definitely flow through in fiscal '14 results.

We have—are moving in the process and it will finish by the end of the year. The college bookstore business where we have some excess costs in that business, and as we consolidate that with The Game business, those excess costs are being removed and taken out. So that would certainly be a piece that would come through in fiscal '14; and then we have already, and have already been for the last couple of quarters that we've talked about, really, looking at the overall cost structure of that business and starting to take those steps in evaluating what we need to do in order to right-size that business for the current sales levels, because that's being worked on so some amount of that, you know, you'll see the benefit in fiscal '14.

And then as Bob mentioned, we are looking at the low cost platform that we have in our other branded businesses that's performing well in that operational platform, and we will be implementing that at Soffe. Now, that's probably something we're not going to see that much benefit in '14 but certainly in '15. You see a big benefit of that coming more in '15; so the combination of those, that's not going to get it to the peaks of where Soffe was but we'll at least get that back near the fiscal '12 levels to, kind of, take back what we lost this year and then the continuation of that and then having those sales and marketing and those things come in, should then get that back to the path to the performance levels we've enjoyed prior to '12.

**Jared Schramm:** Okay. You mentioned hedging cotton prices. Is this the new normal you think as far as volatility is concerned with cotton pricing?

**Deborah Merrill:** I would probably say yes. I mean I don't see anything that's going to change, you know, the factors of it not being just based on the fundamentals of cotton anymore but having the impact of China, having the amount of speculation in the marketplace, I don't see those kind of factors going away so I think, you know, you probably will see continued volatility in cotton in any kind of near term outlook, and that's why we've now taken further strategies to hedge those positions and be more aggressive in those hedging transactions just so that we can try to put ourselves in the best place we can on cotton costs.

**Jared Schramm:** Okay and turning to Art Gun, obviously, strong performance here in the quarter. What is the key element you think that drove that 60% gain and where do you see the outlook for that brand, specifically, in the next year or two?

**Robert Humphreys:** You know, really, what's driving that is our virtual inventory model and, you know, we're partnering it up with people who run websites that either have art or allowing others to develop art and put them out there, or have other inventories that they want to speculate on, and it's allowing their customers to come through us. They pick—resell that. They pick the art and we print it and send it through to their customer, wherever that might be so …

**Jared Schramm:** I'm sorry?

**Deborah Merrill:** Wherever that ...

**Robert Humphreys:** We're shipping to about 40 countries now, so I think we're adding new customers and obviously, the phenomenon of people wanting personalized art just continues to expand. People buying stuff through the internet continues to expand and people trying to figure out not to have inventory that's not sold continues to resonate with people. So we see further ability to grow that. We operate it now 24 hours a day, seven days a week, really, as a, you know, service model so we can react very quickly to orders as they come in.

**Jared Schramm:** And is that virtual inventory model something you're looking to replicate across other lines in the branded segment?

**Robert Humphreys:** Ah yes, you know, we've put some Junk Food art out there. That's our first real sign to try to harvest that consumer ourselves and Junk Food is known for its art so we can put out generic art where we don't have royalties or old favorites and different stuff, so we'll continue to do those sorts of things.

**Jared Schramm:** And as well, looking to Salt Life, where does that stand as far as the product development outlook is concerned, I guess, today and then again, where do you see that now and in two years from today?

**Robert Humphreys:** You know, well, you know, it started as principally t-shirts, you know, 18 months or so ago two years ago when we got started, and we've obviously expanded the product offering. You know, as we do it, we've taken that the marketplace and judged the interest level and are they ready for more sophisticated product and what-have-you. So it's becoming a full line of product from board shorts to hoodies and long-sleeved stuff. I mentioned the U Vapor product that we developed, which was been very popular so we just introduced the footwear where we're the licensee for that, as well, and so that's in the marketplace for the first time and continues to grow with our customer base. And we continue to add new doors at retailers that are interested in putting the product in their stores.

**Jared Schramm:** And lastly, returning to guidance, how big of an impact would you say would further to kind of colder weather and what negative impact would that have would you quantify that on the forward-looking guidance? Is that baked in now that we're sitting in warmer weather this colder spring and longer developments have taken its toll already and the outlook now is really just going to be negatively weighted towards Soffe, or is there some weather negatively built into the guidance looking out for '13?

**Robert Humphreys:** Now there's weather negativity built into the guidance, you know, and we've obviously challenged, I think, in the last and hopefully we have enough built in but we saw business slow up really in February, and while we had very good results in all of our operating units, except for Soffe, the fact of the matter is, they did slow up and were not as good. I mean our first couple of quarters Soffe's business was below the prior year, too, but our other businesses were growing and improving profitability and masking that on a consolidated basis. And we saw that really strong growth slow up some in the third quarter and, you know, this spring, we're selling more product. This is our strongest quarter, but you can still see some, you know, slowness out there in the marketplace and weaker demand than we would have expected based on our first seven months came through.

**Jared Schramm:** Okay. Thank you very much.

**Operator:** And I would like to remind the audience, if you do have a question at this time to please press star, one on your touchstone telephone.

And we will go next to Jamie Wilen at Wilen Management.

**James Wilen:** Hi, fellas. Might as well start with Soffe, as well. Obviously, the J.C. Penney and Kohl's business has been tough for you but is the rest of the Soffe's business also trending down, as well, in other places?

**Robert Humphreys:** Well, it varies. I mean our—what we call strategic sporting goods stores, which are the larger chain sporting goods business is down slightly but not very much. It's been performing pretty well for us, was up in some quarters, I believe. Our independent sporting good business has been trending down for years as those businesses have changed.

Now as you may recall, we recently went live with a new B2B business platform. We've been promoting that, and in the last four or five weeks have started seeing higher order activity on that B2B site.

The military business is kind of mixed, you know, one month up, one month down but, you know, we feel good about, you know, our position there.

**James Wilen:** Historically, haven't you gone through this with a number of chains where you had their business, they tried to switch to a private label and then eventually, they come back to you or is this the first time for Kohl's doing this or they've done this before with you?

**Robert Humphreys:** Well, I don't think Kohl's has. A number of retailers have tried to take the Soffe ashore and make it private label and that has not proven very successful at all for people. They generally lose a significant amount of business, and in several cases, then they have come back to us and put the Soffe product back in.

**James Wilen:** Okay. When did they switch to private label and which month did you stop shipping that?

**Robert Humphreys:** Well, really, for this spring season.

**James Wilen:** Okay.

**Robert Humphreys:** So they would have—it started having a big impact on—in our third quarter.

**James Wilen:** Okay. You mentioned you're hedged for cotton prices. Are you hedged for the entire fiscal '14 at this point?

**Robert Humphreys:** No, not all the cotton that we would consume, but we have changed and fine-tuned some of our strategies just looking back retrospectively on what's happening with cotton markets in the last couple of years. We had some different strategies back years ago that we used where we were thinking things were more volatile, and so we've just kind of taken a harder look at some of that stuff and tried to take, you know, some of the runaway potential off the table.

**James Wilen:** Yes, but cotton prices for the last year have been relatively stable compared to what they had been over the previous two or three years.

**Robert Humphreys:** Well, yes, relatively, and that's true but just like the July contract, just the current, you know, kind of at-once contract has been up and down about 14 or 15% in the last four or five weeks.

**James Wilen:** Is that okay?

**Robert Humphreys:** Yes, that's an $0.11 swing on, you know, just from 90, probably 91 or $0.92 down to about 80, you know, so that's a significant change in cost of our products.

**James Wilen:** And when did you lock in your prices?

**Robert Humphreys:** Well, you know, we're not going to go to exactly where we are on cotton. And you don't lock them all in any one day but, you know, so far, we think, so good on what we've done from a cotton standpoint but, you know, if it drops $0.20 tomorrow, then we didn't do as good as we thought.

But the fact of the matter is, we have some hedging strategies out there so that if it does, you know, we'll participate in that downside.

**James Wilen:** Okay, a couple of things, the shares outstanding at the end of the quarter, please tell me that.

**Deborah Merrill:** Yes, shares outstanding at the end of the quarter are—they're about eight point three million shares outstanding.

**James Wilen:** Eight point three even though it …

**Deborah Merrill:** I'm sorry. Jamie, I'm sorry. I was in the wrong. The weighted average is eight point three. Shares outstanding is eight million one fifty.

**James Wilen:** Eight one fifty, okay and going forward, next fiscal year, what kind of tax rate do you think you would anticipate paying?

**Deborah Merrill:** Right now, I would say to think about that in the, you know, low to mid 20s like 23 to 25% tax rate.

**James Wilen:** Okay. Okay. And lastly, on the Salt Life expansion, you're heading to the West Coast. How successful or unsuccessful have you been in your initial foray out there?

**Robert Humphreys:** We think we're right on plan. We are now opening doors. We—people are sending us photos of Salt Life stickers that they're seeing on the interstate, and that's always encouraging. So, you know, we've got feet on the ground making calls and telling the Salt Life story. We've got a professional paddle boarder who happens to live on the West Coast who is one of the Salt Life paid athletes who's doing a lot of appearances and telling the stories well. So we think we're doing the right things to build the grassroots demand out there.

**James Wilen:** Okay. And as you put in footwear and the West Coast expansion, you want to hazard any guesses to what kind of growth rate or top line you can get just from Salt Life in fiscal ’14?

**Robert Humphreys:** Not yet, but as we finish putting together our business plans and talk about what our outlook is from July, then perhaps we can add a little color there.

**James Wilen:** Okay. And the last thing, well, you’re lowering your guidance by about 15 million on the top line, but on the bottom line, it seems like you’re lowering your guidance by $4 million. Is that just the incremental profitability once you’ve covered your fixed overhead is huge (ph) in both directions?

**Deborah Merrill:** Yes, correct.

**James Wilen:** Okay. Very good. Thanks, fellas. Appreciate it.

**Robert Humphreys:** Thank you.

**Operator:** And just a final reminder, if you’d like to ask a question at this time, to please star, one on your touchstone telephone.

And it appears we have no further questions at this time. I’d like to turn the call back over to our speakers for any additional or concluding remarks.

**Robert Humphreys:** Okay. Well, thank you for your interest today and we look forward to giving you a further update in just a few months.

**Deborah Merrill:** Thank you.

**Operator:** And once again, ladies and gentlemen, that does conclude our conference for today. I would like to thank everyone for your participation.