Delta Apparel, Inc.

Fiscal Year 2020 First Quarter Results Earnings Conference Call

February 3, 2020

Operator

Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal 2020 First Quarter Earnings Conference Call.

Today's conference is being recorded, and joining us from Management are Bob Humphreys, Chairman and Chief Executive Officer; and Deb Merrill, Chief Financial Officer and President of Delta Group.

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 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. These documents identify 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 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 CFO, Deb Merrill. Please go ahead.

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

Good afternoon, and thank you for joining us on our fiscal 2020 first quarter earnings call.

I'll start the call with a discussion of our results, and then turn it over to our CEO, Bob Humphreys, to share with you our growth initiatives and why we continue to believe Delta Apparel remains well positioned for profitable future growth.

Before I dive into our results, I wanted to take a moment to walk through the dynamics of the challenging 2019 holiday calendar, how it influenced our business result and more importantly discuss the 2020 calendar and the benefit it should provide for next year.

As many on the call are aware, the 2019 holiday calendar had six fewer selling days between Thanksgiving and Christmas compared to the holiday 2018, which in and of itself created capacity challenges and compressed sales for many of our customers, as well as in our own businesses.

In anticipation of the shorter holiday period our DTG2Go customer started running their holiday specials a week prior to Thanksgiving. Unfortunately, consumers didn't respond to the early promotions and instead waited until Black Friday and Cyber Monday to do their holiday shopping. Another thing that might not have been as clear of a challenge was the fact that Christmas fell on a Wednesday, which meant that the holiday selling shipping cut-off for our DTG2Go digital print business was Thursday of the prior week, resulting in several lost production days for the weekend before Christmas week.

The midweek Christmas, coupled with a later Hanukkah, also impacted our final week of the quarter's shipping across all our business units, as many customers enjoyed the holiday and pushed shipments into the new calendar year. Although all of this hurt our topline results, the positive news is that we maintained a high degree of pricing integrity, we benefited from improved process efficiencies and we continued to successfully leverage our integrated vertical manufacturing platform.

This all fueled significant gross margin expansion that more than offset the lower sales for the first quarter and even more importantly bodes well for the balance of the fiscal year. Fast forward to holidays 2020 and we see a much more favorable calendar set up including two extra selling days between Thanksgiving and Christmas. Also, due to the leap year, Christmas falls on a Friday, which allows for later season shipping cutoff and increased production days. This is all good news for next year's first quarter compared to fiscal 2020 first quarter.

Now diving into our results a bit deeper for the first quarter, overall net sales were $95.9 million, down 5.7%, from $101.7 million in the prior year first quarter. Net sales in the Delta Group segment decreased 5.8% over the prior year period. Bolstered by an expanded customer base, as well as broader products and service capability, FunTees achieved double-digit sales growth. This growth partially offset the low double-digit decline we experienced in catalog, Soffe and DTG2Go.

Net sales in the Salt Life Group segment decreased 4.7% from the prior year period. However, we were pleased to see double-digit growth in our direct to consumer channel, which includes our e-commerce site and our branded retail stores. Despite the sales decline, gross profit increased 7.1% to $19.9 million compared to $18.6 million in the prior year first quarter. The 240 basis point improvement was driven by Delta Group's continued process efficiency and further leveraging of our integrated vertical manufacturing platform.

SG&A expense as a percentage of sales was 18.8% compared to 16.5% in the prior year first quarter. The increase was primarily driven from investments in our distribution expansion that were not yet leveraged with the lower sales volume in the quarter, coupled with higher equity compensation expense resulting from our higher stock price.

Operating income for the quarter was $2.6 million compared to $41,000 in the period year first quarter. Prior year operating income was impacted by a discrete $2.5 million pretax expense resulting from the resolution of a litigation stemming from a 2015 customer bankruptcy. Net income for the quarter was $0.9 million or $0.13 per diluted share compared to a net loss of $1.1 million or $0.17 per share in the prior year period.

Excluding the impact of the discrete litigation expense, adjusted earnings per diluted share for the first quarter of fiscal 2019 was $0.14. While pretax income in the 2020 first quarter was ahead of the adjusted prior year, a lower tax benefit this year compared to the prior year resulted in the penny less per share income.

Now turning to the balance sheet and cash flows, during the quarter we spent approximately $2.5 million on capital expenditures and our depreciation and amortization including non-cash stock was approximately $3.8 million. We did not make any share repurchases during the quarter and as of the end of the quarter $9.5 million remains under our authorized share repurchase program.

Total inventory increased about 10% from September fiscal year and because of our seasonal build in the preparation for the spring selling season, coupled with the lower-than-expected sales in our first quarter. We believe our inventory is well-positioned as we start the season, allowing us to have good opportunity for growth compared to the prior spring season. Total debt, including capital lease financing, as of the end of the first quarter of fiscal 2020 was $147.4 million, up about $12 million from September from the seasonally higher working capital, along with the investments in distribution facility.

Before turning the call to Bob, I wanted to give more color on our expectations for the second quarter, as well as additional insight into our outlook for fiscal 2020. While our DTG2Go sales in the first quarter were lower than we expected, we are encouraged with the pipeline of new accounts and additional non-holiday sales opportunities. Although down from the original expectation of a 20% topline growth, we don't anticipate DTG2Go to achieve double-digit sales growth with double-digit operating margin.

Our Salt Life business, through its expanded geography and product extension, coupled with our direct-to-consumer initiatives, should also see double-digit sales growth. Our remaining business unit should collectively contribute mid-single digit growth. Gross margins should continue to benefit from the process efficiencies and improved leverage on our vertically integrated manufacturing platforms, coupled with a favorable sales mix.

We expect gross margin improvement both sequentially and year-over-year in each of our quarters, which, coupled with solid sales growth in the future quarters, should result in strong profitability improvement as the year progresses.

I'll now turn the call over to Bob to give you more insights into the business and the exciting growth initiatives we have.

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

Thanks, Deb.

Despite the challenging holiday calendar, we are encouraged with the results delivered for the first quarter of fiscal 2020. During the first quarter we saw significant growth in our FunTees business, bolstered by an expanding customer base, as well as broader product and service capabilities. We also expanded our manufacturing capacity ahead of schedule, which is expected to support anticipated growth in our activewear business as fiscal 2020 unfolds.

Within our digital print business, DTG2Go, we made great strides in the first quarter, migrating customers to use Delta catalog lines, further increasing efficiencies within our free Activewear integrated facilities. For our DTG2Go business, we saw an encouraging pipeline of new accounts, especially within the new channels of business that we are targeting which should start to lower out the seasonality of this business and make it less reliant on the four-week holiday season.

Within our Salt Life business we saw good momentum in the (inaudible) in the Salt Life products in retail, with positive results from test stores in new national and regional retailers, as well as existing accounts expanding into additional product categories. Given the strength in our underlying business, we believe we are well-positioned to deliver against our goals for the full year.

The continued strength of our FunTees business is the culmination of several initiatives over the past year to expand this business with a diversified customer base and broader product capabilities. Our strategy of being the supply chain partner through our customers has enabled us to grow and diversify our business and customer base with brands and retailers who are interested in full service supply chain management and technology.

We have successfully diversified across large and regional brands and expect further diversification in 2020. We have also recently began shipping several new direct to retail programs and expect this business to continue to grow.

Within our catalog business, during the first quarter we made a business decision to not chase sales in December by offering discounted pricing for our customers to buy ahead of the traditional spring selling season but rather focus our efforts on replenishing our inventory levels to better serve our customer needs in this upcoming season. That decision led to stronger margins in our first quarter and should drive future growth with improved service levels as the spring selling season ramps up.

We were excited in January to launch our new distributor model, providing our customers with a broader range of product categories with nationally recognized brands and products including polos, outerwear, headwear, bags and other accessories. We are thrilled to be the exclusive wholesaler of the original Penguin, Callaway and Jack Nicklaus lines of polos and outerwear.

In addition, we are carrying other well-known brands such as DRI DUCK, Burnside, Sierra Pacific, Outdoor Cap and Liberty Bags. With these product lines, we are now positioned to be a full service provider for the fast-growing and specialty and promotional market, and better service the screen print and retail channels that we believe can drive notable long-term growth. We see the distributor model as a low risk, large opportunity proposition which adds another growth leg to the Delta Apparel story.

We are still in the early days of launch, but we are very pleased with the initial response to the new model and we look forward to updating you on our progress on future earnings calls. The big news for DTG2Go in the first quarter was the significant customer migration to use our Delta catalog lines. Our customers are seeing the advantage we offer with our seamlessly supply chain, thereby eliminating non-value added costs in the pipeline which serves as a win-win for them and us.

During the first quarter, 27% of DTG2Go's fulfillment was utilizing the Delta garment compared to only 7% in last year's first quarter. The increased usage of Delta apparel blanks does impact sales dollars due to the more efficient supply chain offered to our customers, while importantly it strengthens our relationship with customers by improving their profitability and enhancing service levels. This also improves our performance as we maintain the internal blank profit and gain efficiencies within our Delta integrated fulfillment locations.

DTG2Go is the only digital print supplier in the world providing customers with a seamless fulfillment solution integrated with a vertical manufacturing platform and this gives us a tremendous competitive advantage. DTG2Go has risen as the industry leader in this high growth on-demand economy and we remain very excited about the prospects for our digital fulfillment platform as more and more businesses see the advantages of this model. We continue to view on-demand digital print and fulfillment as a large and generally untapped market.

We are in a unique position as the most comprehensive on-demand direct-to-garment apparel printing solution in the global market. With our innovative technology, we are the go-to partner for customers seeking a flexible, multiple location fulfillment partner that can consistently deliver quality products on time. DTG2Go's on demand solution eliminates inventory risk for our customers and allows them to better leverage their intellectual property portfolios and creative design teams by offering their customers a significantly wider range of product choices.

Moving to Salt Life, while disappointed with the overall sales decline during the first quarter, we believe the double digit growth in Salt Life's direct-to-consumer channel with broad based performance across retail and the Salt Life e-commerce site shows the strength of the brand. On the wholesale side we continue to see good momentum with Salt Life product placement in retail and positive results in test stores with new national and regional retailers.

Our existing Salt Life accounts are also expanding into additional categories. We continue to see strong demand for the Salt Life brand outside of the traditional Southeast market, which bodes well for future growth. We see very positive response to a number of test stores with national and regional retailers, further indicating the strength of the Salt Life brand.

We continued to achieve strong gross margins across both the direct-to-consumer and wholesale channels, achieving overall blended gross margins nearing 50%. Our Salt Life branded retail door initiative is progressing well. Our newest Salt Life store, which opened during the first quarter in Key West, Florida, is performing extremely well and helped contribute to strong direct-to-consumer results.

An additional Salt Life store will open in Charleston, South Carolina later this month and we'll follow with three new Florida stores over the next few months. With the Charleston store opening, Salt Life will operate nine standalone branded retail stores, which gives us more direct engagement from our consumers as we further build the Salt Life brand.

In summary, we remain uniquely positioned to compete and grow in today's dynamic retail market. We are continuously focused on building our foundational capabilities and expertise to best serve our existing customers, while also attracting new customers. The diversification of our customer base and expansion of our sales channels remain key pillars of our success and the growth we see ahead for DTG2Go and our activewear businesses.

Our strategy with FunTees for being the supplier chain partner to our customers has enabled us to grow and diversify our customer base with brands and retailers who are interested in a full service supply chain management and technology. We see the catalog distributor market as a low risk, large opportunity for significant growth within activewear. We are also in a distinctive position as the most comprehensive and innovative on-demand direct-to-garment apparel printing solution in the global market with a tremendous opportunity to capitalize on what remains as untapped demand.

The strength of our Salt Life brand continues to drive direct-to-consumer growth with e-commerce and Salt Life branded retail doors and we are also expanding our reach of the Salt Life lifestyle brand to existing and new wholesale partners. All of this should drive topline growth coupled with strong gross margins and improved profitability for 2020 and beyond.

Before I close, I'd like to thank all of our teams for their hard work and dedication to Delta Apparel. We now have approximately 8,500 associates spread across four countries and they remain the key drivers of our success as a Company.

Operator, we'd happy to now open up the call to questions.

Operator

Of course. If you would like to ask a question, please signal by pressing star one on your telephone keypad. If you’re using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star one to pose a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions.

We'll now take our first question from Ross Licero at Telsey Advisory Group. Please go ahead.

Ross Licero, *Telsey Advisory Group*

Hi guys. It's nice to hear the great progress you're making on the business initiative. Just wanted to get a little bit more color on the DTG2Go side, could you maybe give us the organic growth rate during the quarter and what you expect for each segment in the quarter?

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

Basically in the first quarter, the business was down due to the shortened holiday but as we mentioned, we expect to have the overall strong growth in the next three quarters, which overall should drive a double-digit growth for that business for the full year.

Ross Licero, *Telsey Advisory Group*

Okay, great. It was encouraging to see the blank getting a 27% penetration at Delta. Where do you think that can go over time?

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

Our goal, and we had it up before the acquisition, we had it in that range of the 25% to 30%, and then of course when we acquired the two businesses and they obviously had not been pushing for the Delta products, that's what drove it down into the single digits. We were really pleased to see it get back to the levels we had seen before and we do think there is continued opportunity to grow it beyond where it is now, especially as the product line for Delta becomes broader, both within the Delta brand and our distributor product, that we believe that, that percentage can continue to grow year-after-year and become an even stronger overall percent.

Ross Licero, *Telsey Advisory Group*

Okay, great, and then on the SG&A side you mentioned putting in the new distribution centers. Where are we in that progress and what should we expect to see from an SG&A perspective going forward?

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

Yes, so, overall we have been obviously expanding our distribution centers to support the growth in the business and the expanded product line. We also brought some that were previously third-party distributing facilities in two locations, two internal operations which then we can control and then we have made them integrated facilities with DTG2Go. That's the overall investments that we have been making.

We are also in progress—very early on in the progress that we had announced in our November call, expanding our main distribution location. That one, we actually own the building and over the upcoming year we'll be expanding that building operation, again to support our overall Activewear along with our digital print business, and when you—the two that we changed, when you are opening those in your lowest quarter you're really not leveraging that yet for the full year, but that should start to leverage those facilities as the year progresses.

I would say overall we will be getting back to some of the levels that we’ve experienced from an overall percentage of sale standpoint, for the year probably still be a little higher than we were last year, but not significantly. The expansion in the gross margin should more than offset any of those increases in the SG&A.

Ross Licero, *Telsey Advisory Group*

Great, thanks a lot for the color.

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

Thank you.

Operator

Once again, if you'd like to ask a question, please press star, one.

We'll take the next question from Jamie Wilen at Wilen Management. Please go ahead.

James Wilen, *Wilen Investment Management Corp.*

Hi fellows, back to DTG2Go, with 27% of the goods now being Delta, obviously the Delta brand you're selling at a lower price than if they would have picked a competitive brand off the shelf, that we would have had to have sold at their retail. What impact on revenues did that have in the quarter? In other words as opposed to being 27% Delta, if it would have been 7% Delta, what would the revenue impact have been on DTG2Go?

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

I would anticipate that it probably would've been—I would guess to the tune of 5%, 6% higher if we had not converted those customers to a Delta product.

James Wilen, *Wilen Investment Management Corp.*

Then the increased margin that you're getting goes to the Delta brand as opposed to DTG2Go. You separate those things out, correct?

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

No, it actually would fit within the DTG2Go business. What you end up is—so what we end up with is a margin in there and what we're sharing with our customers is of course the efficiencies and those non-value added costs that ultimately come out of the whole pipeline and the whole supply chain.

James Wilen, *Wilen Investment Management Corp.*

Okay, you talked about gross margin being up year-over-year but sequentially as well. That means you're expecting 20.7% in the first quarter. You're expecting that to be higher in the second quarter versus the 18.4% last year.

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

Correct.

James Wilen, *Wilen Investment Management Corp.*

Okay, and could you talk in DTG2Go of any customers you brought on stream that, whether they be retail or wholesale customers, of recent vintages. You look towards the business, you're looking for double-digit growth. I assume there is some more big chunk guys as opposed to onesies and twosies?

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

Yes, and we don’t really speak about the customers, about who they are but I can say that we're seeing a lot of interest in what I would call that ad specialty and promotional product space and those customers, the great thing about those is that they typically do not have any seasonality to the business, because they control when that business timing is, and so that's where we're seeing a lot of interest right now, coupled with, in the traditional retail space, more and more people are becoming interested, I would say, from an onboarding of customers. That's a little slower process than the promotional product space, which is a little quicker in launching it.

James Wilen, *Wilen Investment Management Corp.*

Historically you have to have capacity to satisfy the holiday demand, and some of the capacity is under-utilized the rest of the year. Are you looking to DTG2Go to be a little less seasonal, that your percentage of your capacity that’s utilized in the rest of the year is now going to be a little bit greater as the business is a little bit less seasonal?

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

That's exactly correct. We expect a lot of the growth to become not part of that holiday, to where we are not just making further investments in machinery just for a four-week period of time, but to level out that growth. That growth gets leveled out, as I was mentioning, in a big way in the promotional products and ad specialty space, but also in retail. I was mentioning retail, the main retailer that we're working with has already grown their business about five times as strong as they were a year ago and anticipate again that continued growth in the upcoming year, really leveraging the capability that this on-demand business can have for them.

James Wilen, *Wilen Investment Management Corp.*
Okay, and as we've grown the business, do we now have an adequate level of capacity and equipment to be able to satisfy what we see the outlook for this year and how would you look at cap ex in DTG2Go versus depreciation and amortization in that business?

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

Sure. Overall the seasonal new equipment that we buy, we usually would—we typically would buy that over the summer time as we see the customers that we bring on board during the non-holiday and then what the outlook for the upcoming year is so that capital spend is typically a fourth quarter capital spend on, again, outside of new locations and facilities that we might bring on board.

Each year, we're spending quite a bit of money on capital, but to get the growth rates that we're looking and get that as a non-seasonal growth rate, we think that, that will start to taper off as we more fully utilize the capacity we have the other 48 weeks during the year.

James Wilen, *Wilen Investment Management Corp.*

Sure, and on the Salt Life front, the growth, is that more doors, new customers or greater penetration to existing customers?

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

Jamie, I would say it's really some of all of that. Even with the shorter holiday period we had strong e-commerce growth at Salt Life and we grew in our retail doors as well. There were several tests done over the holidays in some national, one national retailer in particular that is going go into I think about 35 doors starting in Hawaii and really a little bit across the country and down into Florida. That was really encouraging. They're really targeting the high end of our line, the more sophisticated product.

We've actually got some good stuff going on with our independent retailers in Salt Life as well. We remain excited about it. I think there's some disruptions in the marketplace that are probably going to help us and make people look harder at Salt Life as being a reliable supplier into this particular space as well.

James Wilen, *Wilen Investment Management Corp.*

Okay, and last question and I'll hop back into the queue. Revenue is down in the first quarter but as you're looking at the second quarter and beyond, how would you—should revenues be back on the positive side?

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

Absolutely.

James Wilen, *Wilen Investment Management Corp.*

Okay, thanks, fellows.

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

Thank you.

Operator

Once again, if you'd like to ask a question, please press star, one on your phone.

We'll take our next question from Jamie Wilen at Wilen Management. Please go ahead.

James Wilen, *Wilen Investment Management Corp.*

Just one last question on FunTees, you had double-digit growth in the first quarter but, A, can that continue and where did the growth come from? Is it new accounts that we picked up, or we're broadening the product line that we're selling?

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

Yes, I think if you think about our discussions last year on FunTees is we were increasing our capabilities and onboarding new customers. In the first part of the year our revenue was down and then our units were growing and by the fourth quarter our units were setting all-time records and our revenue was growing over the prior year and we see that sequentially continuing throughout this fiscal year.

We have broad capabilities in FunTees. That Management team is doing an extremely good job of executing, delivering high-quality product on time. It's more sophisticated. We're offering more technology in that pipeline that really differentiates us from other competitors out there. We have a clear and transparent social platform there, a manufacturing platform where people can really see into what we're doing.

Our plants are audited by outside groups and brands and so just as the world is changing, I think right now that gives the FunTees business some tailwinds on products being made, how it's being delivered, the speed to market and then we've got a really seasoned Management team there that's delivering well for us.

James Wilen, *Wilen Investment Management Corp.*

Outstanding, good stuff ahead. Thanks, fellows.

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

All right, thank you.

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

Thanks.

Operator

There appears to be no further questions at this time. I'd like to turn the conference back to the presenters for any additional or closing remarks.

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

Okay, well, thank you all for your time and interest in Delta Apparel and we look forward to updating you on our second quarter results in just a few months. Thank you.

Operator

That concludes today's call. Thank you for your participation. You may now disconnect.