



# Delta Apparel, Inc.

## Fiscal Third Quarter 2016 Results Earnings Conference Call

*August 8, 2016*

### **Operator:**

Thank you and good afternoon to everyone participating in the Delta Apparel's Fiscal 2016 Third Quarter Conference Call. Today's conference is being recorded. Joining us from Management are Bob Humphreys, Chairman and Chief Executive Officer; and Deb Merrill, Chief Financial Officer and President, Delta Basics.

Before we begin, I'd like to remind everyone that during the course of this conference call, projections or other forward-looking statements may be made by Delta Apparel's Executives. Such statements suggest prediction and involve risks and uncertainty, and actual results may differ materially. Please refer to the periodic reports filed with the Securities and Exchange Commission including the Company's most recent Form 10-K. This document contains and identifies important factors that could cause actual results to differ materially from those contained in the projections or forward-looking statements. Please note that any forward-looking statements are made only as of today, and the Company does not commit to update or revise these statements even if it becomes apparent that any projected results will not be realized.

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

### **Robert W. Humphreys:**

Good afternoon. Thank you for joining us for Delta Apparel's Third Quarter Earnings Conference Call. We have just completed yet another quarter of solid profitability despite persistent softness in the retail apparel marketplace. The results of the quarter demonstrate that our continued focus on efficiency, cost savings, and net income growth that began nearly two years ago now allows us to compete from a position of strength even when the marketplace is weak. As we announced in May, our focus on our manufacturing strategy has evolved into the rigorous manufacturing realignment that will reset our fix manufacturing cost and is expected to bring an annual cost savings of about \$8 million or \$0.70 per diluted share. We should begin to realize the savings in the first half of fiscal 2017 and expect it to be fully annualizing by our fiscal 2017 yearend.

We began the realignment initiative with the expansion of our Honduran textile and sew facility which brings greater efficiency to those operations, increases capacity, leverages fix costs, and gives us the added advantage of utilizing the latest dye and finishing technologies. All of the manufacturing equipment for this expansion has been received and the vast majority of it has been installed. We began operating the new equipment in June and should be at full production levels by the end of calendar 2016. Concurrently, we've been expanding our sew (phon) capacity in Honduras and El Salvador, as well as modernizing our El Salvador screen print operations so that we can more efficiently produce blank (phon) and full package programs for our customers.

In July, we closed our domestic textile operation in Maiden, North Carolina and are in negotiations with a contract to sell the real estate and certain equipment used in that operation. While it was a difficult decision to close the facility that resulted in the loss of jobs for our employees there, we are pleased that the potential new owner plans to continue using it as a wet-processing facility that will provide a new stream of employment opportunities in the Maiden community. We have successfully partnered with contractors in the US sourced fabric for our USA-made products. In May, we consolidated our Mexico sew operations, again sourcing in-country fabric to support it and are currently in the process of modernizing the screen-print operation there to increase efficiency and shorten lead times in our catalog full package programs. More than half of the expense for our manufacturing realignment, \$0.18 per diluted share was reflected in our third quarter earnings and we expect the remainder, about \$0.12 per diluted share, to be taken in the fourth quarter.

In addition to our manufacturing initiatives, we're also working to improve top line growth by focusing on our business units with the highest immediate potential. Salt Life continues to gain consumer penetration and many of those consumers now consider Salt Life their go-to lifestyle brand. With strong sell-through of the Spring 2016 line, Salt Life continued its double-digit growth trend with 45% growth over the prior year quarter, bringing its year-to-date 2016 growth to 30%. Salt Life direct-to-consumer sales led the way with 80% growth on its e-commerce site. We expect the new Salt Life store in San Clemente, California, will drive consumer enthusiasm for the Salt Life style that has made the brand so successful and we plan to open a few stores each year for the next several years to continue to expand our customer reach. To that end, we plan to start selling Salt Life products at our Junkfood store in Venice Beach, California, beginning with the Spring 2017 line which includes some new California-centric designs. We're also leveraging cross-selling opportunities inherent in our Art Gun business unit which has solidified its leadership position in the digital printing marketplace. For example, Art Gun also utilizes catalog blinds (phon) supplied by our Delta Business Unit as a garment for its customers. In addition to providing services to e-retailers, Art Gun also increasingly provides digital print fulfillment services to other parts of our business with over 20% of Junkfood's e-commerce business now being produced through Art Gun.

We've implemented many changes over the past few years, all intended to drive us towards high margins and greater profitability. The past five quarters stand as evidence that our strategy is working and we anticipate that our quarterly performance will continue to improve as the expense reductions and efficiency gains from our manufacturing initiatives are seen in our results. We're also focused on improving top line growth by full exploiting the potential within our existing business units, continuing to stay on top of the latest trends, and providing high-quality apparel that is (inaudible) consumers, as well as evaluating strategic acquisition opportunities that will further enhance our growth. I believe that today we're in very good position to do all of it.

I'll now turn the call over to Deb Merrill to give us more details on our third quarter results. Deb?

**Deborah H. Merrill:**

Thanks Bob. Overall, we had a very good quarter and exceeded analysts' expectations. Our earnings for the quarter included an \$0.18 restructuring charge comprised of a million dollars of non-cash impairment on fixed assets and certain inventory, as well as about \$600,000 in severance and \$200,000 in startup costs, all related to the manufacturing realignment Bob touched on. Including the charge, earnings for the 2016 third quarter were \$0.32 per diluted share on net income of \$2.5 million. Excluding the charge, we would have achieved net income of about \$4 million or \$0.50 per diluted share on net sales of \$111.6 million. This compares with net income for the prior year third quarter of \$4.4 million or \$0.55 per diluted share on net sales of \$120.5 million. While net sales in our 2016 third quarter were unfavorably impacted by continued weakness in the retail environment and by the absence of the Kentucky Derby license which we did not seek to renew for this year, gross margins continued strong in most of our business units resulting in a 150-basis point overall margin expansion quarter-over-quarter. For the first nine months of fiscal 2016, net sales were \$310.9 million compared with \$328.9 million in the prior year period which

included about \$13 million in sales attributed to the since divested, The Game business and since discontinued Kentucky Derby license. Net income increased to \$6.7 million or \$0.84 per diluted share compared to \$3.9 million or \$0.48 per diluted share in the prior year period.

Now looking a bit at our segment, gross margin expansion of 210 basis points resulting from a stronger product mix and continued manufacturing efficiencies, drove third quarter operating profit for the Basic Segment to \$5.4 million or 7.5% of sale. Net sales in the Basic Segment were \$72.1 million, 8.8% lower than the \$79 million reported in the prior year's third quarter. Although Activewear sales were down 10% comparatively for the quarter, the business continue to migrate to a more profitable product mix with over a 100% growth in the fashion basics including our Delta drive performance product, Delta soft line and a variety of fleece and French terry garments, as well as nearly 50% increase in our catalog full package products. We expect the growth in these areas to continue in future quarters. These products have higher selling prices and on average carry margins nearly a thousand basis points higher than those of basic tees. This sales growth was not enough though to fully offset lower unit sales of basic tees which were hindered by inventory constraints and a \$1.8 million reduction in our private label sales. While there has been a slowdown from lower callouts and in an over-inventoried environment within several international brands, our private label business is experiencing strong growth from on-trend regional brands as well as new customers acquired mid 2015. Art Gun delivered strong net sales growth of 28% for the quarter driven from a 38% increase in units sold. In addition to strong top line growth, Art Gun posted a record quarterly operating profit. Art Gun is launching several new customers that we expect will drive good growth in the fourth quarter and into fiscal 2017.

Branded Segment net sales for the third quarter were \$39.5 million, virtually flat with the prior year period after adjusting for the \$2.2 million of Kentucky Derby sales that didn't reoccur in 2016. The Branded Segment produced operating profit of \$2.7 million or 6.7% of sales. Salt Life continued its double-digit growth trend with 45% growth over the prior year period. The new Salt Life distribution center functioned extremely well, efficiently handling record high shipment levels during the quarter. Strong demand for the Salt Life brand continues and we believe that its double-digit growth trend will be accompanied by leveraged cost efficiencies that should drive further improved margins in future quarters. Soffe sales declined \$1.6 million for the quarter primarily due to the soft retail environment. However, Soffe has experienced notable growth with amazon.com and its own e-commerce website, including a 33% sales increase from its recently re-launched B2B site and a 14% increase from its B2C site. We anticipate continued strong growth in Soffe's e-commerce business over the next several quarters. Additionally, Soffe's improved product line, enhanced customer service, and solid in-stock position, continued to be instrumental in gaining floor space at key strategic sporting goods stores, which should further bolster Soffe's return to growth. Junkfood's specialty business performed well during the quarter with sales growing 15%. However, that growth was insufficient to overcome sales declines at a national retailer that negatively impacted Junkfood's business. That impact, combined with lower than expected boutique sales, resulted in a \$1.7 million decline in net sales for the quarter.

Looking at the balance sheet, receivables were down from a year ago from the lower sales levels and improved day-sales-outstanding. Inventory levels increased from a year ago to \$167.1 million. The increase was due to higher in-stock finished goods to support the expanded product lines and to better service our customers. Total debt at quarter end was \$122.3 million and included an increase in our Honduran debt which is not guaranteed by the US entity and was used to finance the capital expenditures to increase capacity in our Honduran operation. Capital spending for the third quarter was \$4.4 million and \$11.1 million year-to-date with the spending principally related to the purchase of equipment for the Honduran expansion. Depreciation and amortization, including non-cash compensation, was \$3.2 million in the quarter and \$9.1 million for the 9-month period.

Now, I'll now turn the discussion back to Bob for a final comment.

**Robert W. Humphreys:**

Thanks, Deb. We believe Delta Apparel will continue to make solid progress over the next several quarters. While our recent initiatives have focused a great deal on improving margins and in strengthening our bottom line, we are confident that the strength of our own trend, high-quality products, and solid marketing programs, will bring renewed vigor to our top line as well. Our fourth quarter has gotten off to a good start in July with record shipments of basic tees, record shipments of Salt Life branded products, record shipments from Art Gun, and record ecommerce shipments. We're encouraged with these trends and expect a good finish to fiscal 2016 with further progress to come as we go into fiscal 2017. At this time, we'd like to open up the floor to any questions anybody may have.

**Operator:**

Thank you. If you'd 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 signals to reach our equipment. Once again, that is star, one if you'd like to ask a question and we'll pause for just a moment to allow everyone an opportunity to signal for question. We'll take our first question from Dave King with Roth Capital Partners.

**Nick Meyers:**

Hello, guys. This is Nick Meyers on for Dave King. How are you?

**Robert W. Humphreys:**

Good Nick. How are you doing?

**Deborah H. Merrill:**

Good. Thanks.

**Nick Meyers:**

I'm doing wonderful. Thank you. So first off, in terms of revenue impact this quarter, I know you already mentioned Kentucky Derby was \$2.2 million, are you able to identify other various factors, whether that's the one last week you had or TSA, anything in regards to that?

**Robert W. Humphreys:**

Well, (inaudible).

**Deborah H. Merrill:**

It's...

**Robert W. Humphreys:**

...a number of things and then Deb, I'll let you maybe give a little more detail but we have one more, one last week actually in the fourth fiscal quarter. So, it was a 13-week quarter as the prior year. But I'd say the TSA bankruptcy had an overall bad effect on the whole sporting goods industry where people slowed up and waiting to see where those inventories would ultimately go so people definitely got in a cautious mode with that, lower spending on apparel in general and lack of any real trends or hot license that were really driving business. So, and obviously there we connect with the consumers directly, like Salt Life, for example we had really strong growth. So, as usual in our business, we got through a lot of different

distribution channels and they're not always up but the overall mix as good and we had some that were up and some that were down.

**Nick Meyers:**

Then how should we be thinking about modeling any further impact from TSA over the next couple of quarters?

**Robert W. Humphreys:**

Well, I think TSA is going the way as we in the industry knew it. So, that was a significant piece Soffe's business so we won't enjoy that in the upcoming year. But at the same time, we're going up with a number of sporting goods retailers in other parts of the marketplace. So, we think based on our current outlook that we will replace at TSA business at Soffe that we're directly impacted and we'd hope that over the next quarter or two, the TSA inventory overhang, so obviously the inventory they have, that they closed out and the inventory that people had in the pipeline for TSA, will work through retail in an orderly way and in the next quarter or two that marketplace be back to good balance.

**Nick Meyers:**

Right. That's good color. Thank you, and then broadly speaking, it seems like multiples getting paid for certain brands have been fairly robust recently. Can you talk about whether you'd like to maybe take advantage of that in anyway, and then conversely what's your current appetite for acquisitions?

**Robert W. Humphreys:**

Well, we don't have any plans to take advantage of it in any way. I wouldn't say at this point, so really no comment on that. But I think we are as we mentioned earlier, getting into a position where acquisitions are becoming something that we have some time and energy for. A couple of years ago, we acquired Salt Life and used up our borrowing ability to do that and are now in much better shape from that standpoint. Also during that time, we went to work on some cost areas and SG&A and manufacturing and are seeing that major project come to an end and seem to be showing up on our bottom line, or the rest of it showing up on our bottom line. So, we do feel like we're at a point in time where we could digest the right type of acquisitions and—but we'll continue to be selective as we have over the years and look at things that we think are priced right and meet our criteria of being accretive in businesses that we understand that we can fit into our Company and bring some value too.

**Nick Meyers:**

Okay. Perfect. Thank you very much for that. I'll step back for now and I thank you guys.

**Operator:**

Thank you. As a reminder, that is star, one if you'd like to ask a question. We'll now take our next question from Lynn Parry with Wilen Management.

**Lynn Parry:**

Hi everybody. How are you doing?

**Deborah H. Merrill:**

Good Lynn. How are you?

**Lynn Parry:**

If I repeat some of these or ask you questions that might have already been answered, we had a couple of power bumps here. On the last call, you were going to look into how many stickers have been sold on the business. Do you happen to have any idea how many that was?

**Deborah H. Merrill:**

We did look that up and that is well over a million decals have been sold simply since we started operating the business. So, we would hope and believe that most of those are out there on vehicles further supporting our Salt Life brand.

**Lynn Parry:**

They're on mine (phon) for sure, I'm so glad. That's a great number. It's incredible. Is the increase of Salt Life (inaudible) due to an increase on a number of doors or sell-through on existing doors, and also does this brand have the ability to go beyond the US borders?

**Robert W. Humphreys:**

So, Lynn, we are selling beyond the US borders now, certainly the Caribbean, the Bahamas area. We recently took on a Canadian distributor that has already opened a number of doors up there and they're in the kind of ocean lifestyle business with hard goods already, so feel good about that. The growth was really coming from everywhere we take Salt Life, so we have an expanded product line, and as we add new powerful products to our product line, they are retailing well. We have a lot of really leading-edge performance products that are resonating with consumers. We are opening new doors but at the same time, don't want to over saturate areas that already have a good retail footprint of Salt Life products, and then obviously our ecommerce business for Salt Life is on fire and our whole social media part of Salt Life is on fire with increased participation there.

So, that's all going well, and then I would say that the back stop of all that as you may recall this past—a year ago, we were opening up our new (inaudible), North Carolina and so we did a really nice job of expanding our service levels, particularly for this quarter. We're really reaching so stride so we got product, we were getting it out the door. We had a huge effort from our Management and on the floor Employment Team, getting that done and it's really helping us as we go into this quarter too as we're being very successful with quick-turn re-orders and that sort of thing that really help our retailers for their indices, restocking and gaining that extra turn of sales.

**Lynn Parry:**

Great. Do you happen to know the percentage of sale—Salt Life sales are through ecommerce, and has that percentage increased or decreased throughout the year?

**Robert W. Humphreys:**

I think we do—Deb, do we disclose our ecommerce sales in total? I don't think we do that by brand.

**Deborah H. Merrill:**

We don't do it by brand. Yes, overall we're about, I would say about 5% of overall kind of going through our ecommerce site that both are B2B and B2C company-wide, but to answer your question, yes, it is growing rapidly and becoming a larger percentage of the overall sales. As Bob mentioned, our ecommerce sales for Salt Life were up 80% during the quarter and the overall was up 45% during the

quarter, and we've seen that in the last two quarters as well. So overall, year-to-date, I would say, we're up about 70 some percent on that website over a year ago.

**Lynn Parry:**

Great. Great. Okay. Thank you. I'll step back and let somebody ask.

**Deborah H. Merrill:**

Thank you, Lynn.

**Operator:**

Once again, as a reminder, that is star, one if you'd like to ask a question. With no further questions in—I apologize, we'll now take a follow-up question from Lynn Parry with Wilen Management.

**Lynn Parry:**

Okay. On this Soffe, are you performing at breakeven levels?

**Robert W. Humphreys:**

No, we're making money.

**Lynn Parry:**

Great. Okay, and what's on the horizon for the next fiscal to increase sales, raise gross margins and reduce expense to earn a reasonable return?

**Robert W. Humphreys:**

Are you talking about Soffe, specifically?

**Lynn Parry:**

On Soffe, yes, please.

**Robert W. Humphreys:**

Yes, yes. So, we think Soffe has turned the corner. Obviously the TSA bankruptcy earlier this fiscal year did push us back a little bit but we have been working through that we think in an orderly manner. We are growing in a number of our channels of distribution. We've expanded to all the DICK's stores, every location, so that's been a great win for Soffe. Our Intensity Athletics brand within Soffe is getting some expanded placement so we feel good about that. Our direct business that goes to independent sporting goods stores is up double digits. As Deb mentioned, our B2B website in Soffe that we just upgraded is also growing very nicely. So, our core business at Soffe is growing and then they are now enjoying a much lower cost structure from the steps we took a year or two ago, so just a little bit more sales really has a big impact on Soffe's bottom line now, and we are EBIT positive and expect that to continue and grow going into fiscal '17.

**Lynn Parry:**

Okay. Great, and then I had just one final question. As the cotton prices have risen, what do you think the effect will be on your margins, near or longer term, basically your inventory position and any movement in the selling prices?

**Robert W. Humphreys:**

Well, again, when cotton prices go up, it ends up being relatively far out in the future before it really starts flowing through our cost of sales. So, I would say future cotton prices, so again that's kind of December forward for most of the industry have moved up to more what I would consider the higher end of average where we've probably been in the middle to lower end of average for the last 15 or 18 months, and so, I do think they're in an area that the industry can digest, and with the current supply and demand balance, I would expect pricing to move up along with those cotton prices. But, that will take some time as that really starts flowing through and impacting people's actually costs.

**Lynn Parry:**

Okay. Thank you very much.

**Operator:**

Thank you, and that does conclude today's question-and-answer session. I would like to turn the conference back over to Bob Humphreys for any additional and closing remarks.

**Robert W. Humphreys:**

Okay, well thank you all for joining us and your interest in our Company and the questions, and we look forward to finishing up fiscal '16 here in just a couple of more months and giving you an update on how the year ended, and obviously we're looking forward to fiscal '17 with our new manufacturing initiatives under our belt and watching some of these brands continue to grow. So, thank you very much.

**Operator:**

Thank you. That does conclude today's conference. Thank you all for your participation and you may now disconnect.