Delta Apparel, Inc.

Fiscal Second Quarter 2016 Results
Earnings Conference Call

May 12, 2016

OPERATOR:

Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal 2016 Second Quarter conference call. Joining us from management are Bob Humphreys, Chairman and Chief Executive Officer, and Deb Merrill, Chief Financial Officer and President, Delta Basics. Before we begin, I'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 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.

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

Bob Humphreys: Thank you for joining us for our second quarter conference call. If you have read the earnings release issued this morning, you already know that Delta Apparel had another good quarter. This marks the fourth consecutive quarter in which we have reported margin expansion and improved profitability. In each of those quarters Delta has shown increasing strength despite a number of negative market forces that continue to plague our industry. The general economy remains sluggish and consumer spending on apparel is down, driving some retailers into bankruptcy. Yet through all this, Delta Apparel has become stronger and improved our market position.

The increasing strength of Delta Apparel is a testament to the effectiveness of the strategic initiatives we announced 18 months ago and the ability of our team to successfully implement them. We streamlined our administrative workforce, and completed a comprehensive rationalization of all of our business units, product lines and sales channels in order to refocus our capital and other resources on the areas we believe are most strategic to our business. We also made important improvements to our manufacturing platform, increasing our capacity and expanding our flexibility in the products we produce. The result has been higher demand for Delta Apparel products, lower manufacturing costs, significant margin expansion and increased profitability.

We continue to invest in areas of our business where we expect to yield high returns. This quarter we began production on our new equipment in our Honduran textile facility, Ceiba Textiles. By extending our production capabilities into open width fabrics, we will reduce our reliance on purchased fabric, which should allow us to better serve our customers and expand our product offerings. In addition, we will be further leveraging our fixed costs of internal production. Overall, we expect to achieve an annual savings of approximately $2 million from this investment, which should be reflected in our fiscal 2017 results. We have also continued to make investments in our full-package offerings, expanding our screen print and retail package operations to support growth in our catalog full-package and private label programs.

During the past two years, we have taken steps to consolidate fabric production for basic tees into our lower-cost Ceiba Textiles facility and reduced our overall domestic textile production. We also continued our focus on process improvement and cost reductions in order to remain competitive in the apparel marketplace. After a careful evaluation of our entire manufacturing platform, we have decided to embark upon a further manufacturing realignment that we expect will result in an $8 million annual reduction in manufacturing costs. This realignment will include additional expansion in our Honduran textile facility that will give us the ability to leverage the latest dyeing and finishing technology available and will also result in the closure of our domestic textile facility. The decision to stop production at the Maiden plant and eliminate the jobs of about 160 employees who have contributed significantly to our growth and success over the years was obviously difficult. However, we can no longer justify the additional cost and longer lead times associated with domestic fabric production in the highly competitive tee shirt business.

As a part of this realignment, we are expanding our sew facilities in Honduras and El Salvador, and further modernizing and increasing capacity in our El Salvador screen print operations. We will be supporting our Mexico sew and screen-print production with in-country sourced fabric. We will also be sourcing domestic fabric from our existing U.S. supplier base, which we believe should create additional job opportunities within those organizations. This domestic fabric will be sewn into garments in our Rowland, North Carolina apparel facility to support our Made in the USA programs.

This realignment will require a capital investment of about $7 million, which should all be incurred during fiscal 2016. Approximately $3 million in expenses, or about $0.30 per diluted share, is expected to be incurred in the fiscal 2016 third quarter in connection with this realignment, including severance, shutdown and start-up inefficiency and other expenses. Much of the work to complete this manufacturing initiative is well underway. Sew production has already been expanded in Honduras and El Salvador and the screen print equipment for El Salvador has been received. Additional dye equipment and dryers are on order and will be installed in the next several months. The realignment should be completed by the end of fiscal year 2016 and we expect to begin realizing the associated cost benefits in the first half of fiscal 2017, with the savings in the back half of fiscal 2017 expected to annualize at approximately $8 million, or about $0.70 per diluted share.

Although there is a lot of work to be done in the back half of fiscal 2016 to complete these initiatives, we are excited about what they will mean to the future of Delta Apparel. We are pleased with the progress we have achieved in the first two quarters of fiscal 2016, and believe Delta Apparel is financially and operationally strong, and poised for further growth in the last half of the year.

I'll now turn it over to Deb Merrill to provide details of our second quarter results.

Deb Merrill: Thanks Bob.

As you saw in the press release, margin expansion and earnings growth are the highlights of our fiscal 2016 second quarter, with Delta Apparel enjoying strong margin improvement in both the basics and branded business segments.

Net sales in our fiscal 2016 second quarter were impacted to some degree by the bankruptcy of a large retail customer, but still came in at $109.2 million. That is just four tenths of a percent below the $109.6 million of sales in last year's second quarter, after adjusting for $5.4 million of sales in the since-divested *The Game* business and sales of products under the Kentucky Derby license that we did not seek to renew for 2016.

Our overall gross margins expanded 510 basis points over last year's second quarter and 270 basis points sequentially. This led to an operating profit of $5.9 million, or 5.4% of sales, and net income of $3.4 million, or $0.43 per diluted share. This compares to earnings of $0.03 per diluted share in the prior year second quarter after adjusting to exclude the $0.43 gain on the sale of The Game business realized during that quarter.

Gross margins in the basics segment expanded by 810 basis points over the prior-year period, continuing the sequential margin improvements that have occurred over the past several quarters. This yielded an operating profit of $6.9 million or 9.9% of basics-segment sales. Net sales in the basics segment were $69.8 million, off 2.2% from $71.4 million in the prior year second quarter. The decline primarily was due to a 7% decline in unit sales of basic tees. While this was offset somewhat by excellent growth in fashion basics products, which exceeded 250% year over year, and catalog full package growth of 15%, it reduced catalog sales 1.5% for the quarter. While such a decline is never welcome, it primarily affected our lower margin products and ultimately resulted in a more profitable overall product mix in our Delta catalog business. Private label sales improved 4%, with growth coming from regional, trendy brands as well as new customers acquired in mid-2015. Art Gun, which showed good year-over-year growth in March, experienced a sales decline of about $500 thousand for the full second quarter as it made necessary adjustments to correct inefficiencies that surfaced during the extremely high-volume 2015 holiday season.

Turning to the branded segment, adjusted for The Game and Kentucky Derby sales, branded segment net sales grew 2.8% in the second quarter while enjoying margin expansion of 110 basis points year-over-year and 470 basis points sequentially. Net sales for the fiscal 2016 second quarter were $39.3 million versus $38.2 million in the 2015 second quarter, after adjusting for The Game and Kentucky Derby sales. The branded segment experienced the negative impact of The Sports Authority bankruptcy mainly in our Soffe business unit, which otherwise would have achieved sales growth near 5%. Soffe has improved service levels to the independent sporting goods channel and recently launched a new business-to-business website that should further enhance Soffe's recent double-digit sales growth in that channel. While the Junkfood.com ecommerce website saw growth of 26% for the second quarter, overall Junk food sales were down $1.9 million from the prior year period. The decline is attributed to unsettled conditions in the retail apparel market and management team changes among some of Junkfood's specialty apparel customers. Such changes normally lead to more deliberative buy decisions and slower order placement during the transitions, which was the case in the second quarter.

Salt Life continued its high-growth trend with sales in the second quarter up 23% over the prior year quarter. The relocated Salt Life distribution center is functioning well and capable of handling the record shipment volumes we are seeing in that business. The robust demand for the Salt Life brand continues, and we are seeing strong sell-through of the Spring 16 product line. Sales on the Salt Life ecommerce website grew 48% during the second quarter, bringing its year-to-date growth to nearly 70%. We continue to make progress with our direct to consumer initiatives on the West Coast, with California driving the highest viewership on our Salt Life YouTube channel. We are making progress on the new Salt Life store in San Clemente, California, and look forward to its opening in mid-summer this year.

In this year's first six months we increased our net sales to $199.3 million from $197.6 million in the prior year period, after adjusting for sales attributed to The Game and the Kentucky Derby license. Net income was $4.1 million or $0.52 per diluted share in the 2016 six months period compared with a net loss in the prior year period of $565 thousand or $0.07 per diluted share.

Capital spending was $3.3 million for the second quarter and $6.7 million year-to-date. Final payments related to our open-width project and the purchase of equipment for our textile expansion constituted the majority of our capital spending. Depreciation and amortization, including non-cash compensation, was $3.0 million in the quarter and $5.9 million for the six-month period.

During the quarter we repurchased 45,460 shares of Delta Apparel stock at an average price of $15.42 per share, for a total cost of $700 thousand. Our remaining authorization for stock repurchases is approximately $10.8 million.

This week we executed an amended and restated U.S. credit facility. The agreement, which extends our current $145 million facility for five additional years, also lowers our interest expense by some 50 basis points. We believe this underscores the solid financial and operational strength of Delta Apparel and the recognition of that strength by those in the financial community.

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

Bob Humphreys: Looking ahead to the second half of this fiscal year, we expect continued sluggishness in the retail marketplace. Given this environment, we still believe we can achieve further organic growth, perhaps in the low single digits, and continued gross margin expansion. This should be driven by market share gains based on the demand for our products, a trend toward a more profitable mix of products sold, and the expansion of emerging channels of distribution. We also expect the strong growth in our ecommerce business to continue following the high double-digit growth of our B2B and B2C sites in the second quarter. These things combined with our significant fixed cost reduction efforts, point us toward a strong second half of the year and provide a foundation for further improvement in fiscal 2017.

Operator, you can now open up the call to any questions our participants might have.

Operator:

Thank you, sir. Ladies and gentlemen, if you would like to ask a question today, please signal by pressing star, one on your telephone keypad. If you are using a speakerphone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Again ladies and gentlemen, that is star, one to ask a question at this time. We'll pause for just a moment.

And once again, that is star, one to ask a question, and we will take our first question from Dave King from Roth Capital Partners.

Dave M. King:

Thanks. Good morning, everyone.

Deborah H. Merrill:

Good morning.

Robert W. Humphreys:

Good morning, Dave.

Dave M. King:

I guess, first off in terms of the gross margin it shows up nicely yet again. I guess—can you talk about the drivers—that improvement, how much of it is attributable to mix? I think that (inaudible) Deb in your comments, but versus manufacturing efficiency versus pricing benefits, etc., and then, I guess, as a follow-up to that as we think about the outlook exclusive of obviously the initiatives you've announced, the $2 million one, and then the $8 million one, of course the new one. How should we be thinking about gross margins going forward? Thank you.

Deborah H. Merrill:

Dave, good question on that and I think you did hit on the different pieces of what that gross margin expansion was. We did see that in both of our business segments and across our different business units. So I would say that the larger contributor to that during this quarter was in the Basics segment. And I'd say it's probably during the quarter pretty evenly split across on the couple of the things you mentioned. Certainly the product mix to a much higher fashion basic private-label and catalog full package and that having strong growth in the decline in those sales coming from the core basic tees that product mix changed certainly contributed to it. We have our ongoing manufacturing initiative or process improvement that consistently quarter-after-quarter does add gross margin as that lowers the product costs. And then, we did have some lower of our raw material prices that benefited us this year compared to the prior year. So, none of the initiatives, either the open-width or obviously the newly announced impacted those gross margins in this quarter. Then in the branded segment as well, we had gross margin expansion and that certainly, with the strength of the gross margins in the Salt Life business and a nice sales growth that we had in that certainly contributed to that as well. But our other businesses are also carrying some lower product costs benefiting those gross margins. As we go forward for the rest of the year, we still believe that in the back half of the year we'll see continued gross margin strength both year-over-year and sequentially in the quarters and—so we expect that trend to continue and then as we mentioned in 2017 we get the added benefits of our open-width project and now the new recently announced structuring alignment that will continue to add strength to those gross margins.

Dave M. King:

Yes, that's great color. Thanks, Deb. Then (inaudible) a bit in terms of revenue, I guess, first-off what sort of drove the pressures in the basic tees, maybe just a little bit of color there would be helpful. Then, Bob, in terms of your low single-digit outlook or I think (inaudible) single-digit outlook, what are sort of the drivers there obviously TSA I would think is weighing, general retail pressures I would think weigh, some of the benefits in the catalog business etc., offsetting, I guess—I will let you answer what you're sort of thinking are the drivers to get towards that outlook? Thank you.

Robert W. Humphreys:

Yes. So, I guess, to start with your question about the Basics business in the quarter, I think there is maybe a couple of things that are important. One is you may recall the second quarter of last year was a huge growth quarter for us in that business, somewhat moving past the first quarter for the industry which was a tough quarter as raw material prices and selling prices were misaligned and some action was taken by various competitors. So, anyway that delayed some first quarter business, first calendar quarter.

Deborah H. Merrill:

First fiscal quarter.

Robert W. Humphreys:

Of course, yes, fiscal—the December quarter business for us that we had a very robust second quarter. And secondly, you may recall from prior calls that we came into this quarter really lean on inventorial basics. So we were hurt by not having as robust of an inventory position on basic products, so we chose to sell what we could, where we could and quite frankly then got paid better for it, than just chasing volume of stuff that we were in short supply of anyway. So as we move forward, obviously there is a difficult retail environment out there for apparel, particularly through traditional retail channels.

Now one of the strengths of Delta Apparel over the last, really decade has been that we sell our product through a lot of different distribution channels. So we're not relying on just department stores or just mass or just sporting goods. So that always gives us some comfort as we get through times of hesitation like this in the marketplace. We expect continued strong growth at Salt Life. We expect continued strong growth in all of our e-commerce sites. And then you have the other e-retailers out there that we have a growing business with as well. We're growing nicely in the independent sporting good channel and that will help on the Soffe side and offset some of the TSA business. So not easy sledding for sure, but when you add it all up, we think we have an opportunity for some slight organic growth and traditionally we have had good organic growth in more difficult apparel retail markets.

Dave M. King:

That's great color. Then, lastly from me in terms of buyback. Obviously, stock had a pretty good run and there is no longer that opportunity to kind of get the book value accretion from—book value per share improvement right just from doing the buyback at a discount and I guess what are sort of the thoughts around future repurchase activity, how do you weigh that versus debt pay down, etc.?

Robert W. Humphreys:

Well, I'd say the intellectual formula in our mind has not changed. So you sit here, you think about what the intrinsic value of our Company is, based on cash flow and earnings ability and future growth and then how that relates to where our stock is trading, and our other opportunities to invest money that's going to create superior return for our shareholders. So, we are obviously encouraged that the marketplace is (inaudible) worth trading at what we thought was a big discount to intrinsic value and even to our book value. As we pointed out in the past, we do have significant tangible assets and intangible assets that have great value, but they are not valued on our balance sheet. So we still look at that combined and I think you can see that we have significant earnings not only momentum right now, but a platform that's going to continue to drop those for the next 12 to 15 months. So, we will just have to see how the marketplace responds to that and our debt is low cost and as Deb pointed out, gotten even lower cost. Our lenders have been incredibly supportive of us during our whole tenure as a public company and we appreciate that. It gives us a lot of flexibility to keep trying to work to get investments out there that we can leverage our cost of money and make money for our shareholders. So we will take all that into account and we do still have a large availability under our authorized program to repurchase shares.

Dave M. King:

Okay. Thanks, Bob. Nice quarter and good luck for the rest of the year.

Robert W. Humphreys:

Thank you.

Deborah H. Merrill:

Thank you.

Operator:

We'll now take a question from Lynn Parry from Wilen Management.

Lynn Parry:

Good morning, Bob, and Deb. How are you?

Robert W. Humphreys:

Good.

Deborah H. Merrill:

Good morning, Lynn. Very Good. Thank you.

Robert W. Humphreys:

Good morning.

Lynn Parry:

Nice quarter. I've two questions on Salt Life. The Salt Life's stickers are amazing. (Inaudible) for the brand, do you have a number of how many thousands of stickers have been sold since the brand began?

Robert W. Humphreys:

We do not, but we could probably come up with some reasonable estimates. So, we will work on that maybe have a little color on that for our next call. The good call out.

Lynn Parry:

Okay. Okay. And you had mentioned that you're in a test with a West Coast retailer. Could you give any more of an update (inaudible) mid-summer?

Deborah H. Merrill:

Yes. Lynn, you're asking about how we were talking about having a retailer on the West Coast…

Lynn Parry:

Yes.

Deborah H. Merrill:

That would be primarily in California and how that—that was unfortunately hurt that half with the bankruptcy of the Sports Authority. They still now want our products and time will just tell how that bankruptcy plays out. We are working with some other national retailers that have some interest and have some doors in California, so we will see if we can get that placed with some other retailers in light of recent activities there.

Lynn Parry:

Okay. Thank you. Is the sales growth uniform throughout the country or is it coming mostly from geographical expansion?

Deborah H. Merrill:

You're asking about the Salt Life growth, if that's centered…?

Lynn Parry:

(inaudible) Salt Life, I'm sorry.

Deborah H. Merrill:

Yes. No, problem. So, I would say that we are getting growth in Salt Life across all of the different areas we're in. We're still heavily working on California. We think that's a big future growth opportunity for us. But as we've said, we're doing that in a grassroots kind of disciplined way with those consumers in California. But we do continue to add different retailers. I'd say a lot of that growth is coming from product expansion, in gender expansion within the doors that we're in where retailers may have started just in a men's category and now are picking up our women's and junior's line or our kid's line as well as our different products that we are growing with our performance products and things like that. So, I'd say those are probably the bigger driver of the growth rather than necessarily new retailers although we are adding those, but we're certainly working on that product expansion of growing that line.

Lynn Parry:

Okay. Thank you. And then, sell-through on Salt Life, is there a reorder cycle from retailers or are they mostly one big stacking order?

Robert W. Humphreys:

No, we have kind of two different lines that go through there that act differently. So we go produce a forward line and we presell that line and we source our fashion products based on the pretty solid demand we have; we will drop things that are not responded to like we were expecting by retailers. Then we may source some safety stock on that. For certain products we can kind of do one reorder in season which we're really doing right now for spring. So that would be all the fashion and performance buys, and then all of the basic products though, all the 100% cotton screen-print that we make in our vertical operations, we're in constant re-supply of that.

Lynn Parry:

Okay. Thank you. Then, lastly on Salt Life, you have 23% sales growth in the first quarter. Is this a pretty good normal from what our sales will be in Salt Life and if you had to give a 5% range, would it be 20% to 25% growth?

Robert W. Humphreys:

I'd say 17% to 22%, how about that?

Lynn Parry:

Okay. Thank you. Okay. Then, I have a question on Soffe. It continues to be a soft brand or soft hedge. Can you talk about the changes in the strategic plan selling or how you dealt with—to the market; I think you could put us back on a better path?

Robert W. Humphreys:

Yes. We are seeing, and particularly in the quarter we just finish and we think we will see more of it in the quarter that we just began. But a lot of the work over the last year or so is starting to bear fruit, in Soffe. So, I would say it started with a better and more updated product offering even in the basic products, some updated looks in packaging and labeling. Then with that, we improved our customer service performance dramatically in that business and a part of that was having a larger in stock position on our Basics' products. And we are seeing that resonate with a number of our traditional channels of distribution. So for example the Soffe Basics short is now in all fixed locations which is a significant increase from prior years. We are seeing a good sell-through there. We are seeing expanded business in our military operations and improved graphics out there in the marketplace. So, some good things really going on on Soffe from a product standpoint and service standpoint and offset to some degree by the toughness at retail in the sporting goods channel.

Lynn Parry:

Okay. Thank you. Then on the—you have a growing retail from kind of with the two Salt Life stores and Junkfood. Are these just marketing endeavors for the brand or are these actually contributing to the profitability?

Robert W. Humphreys:

Yes. So, the current Salt Life store in Jacksonville is for a while profitable and we expect the same thing in San Clemente. The Junkfood store—the store at this point is not profitable and there is more of a branding exercise that is interesting. We just did a recent survey of our e-commerce customers from Junkfood and over 50% of them learned of the brand through that store. So, it's obviously driving people to the brand. But our goal for any retail store, but particularly the Salt Life expansion of doors is to be profitable in the same kind of operating margins that we're enjoying on the brand as a whole.

Lynn Parry:

Okay. On the Salt Life stores, you're planning on targeting more of the stores in other areas around the country?

Robert W. Humphreys:

Well, I'd say short-term, being the next couple of years we will be building out several doors in California and continuing to work on a proof-of-concept and make sure we know what we're doing, and we have the right size store and the right look and the right economic model that makes those stores profitable.

Lynn Parry:

Okay. Great. Thank you.

Deborah H. Merrill:

Thanks, Lynn.

Operator:

We currently have no additional questions at this time.

Robert W. Humphreys:

Okay. Well thank you all very much for joining us on our call this morning and we look forward to updating you on our third quarter results in about three months. Thank you.

Operator:

Ladies and gentlemen, this does conclude today's conference. We do thank you for your participation. You may now disconnect and have a wonderful rest of your day.