Delta Apparel, Inc.
Second Quarter FY 2013 Earnings Conference Call
January 28, 2013

Operator: Thank you. And, good afternoon to everyone participating in the Delta Apparel, Incorporated Second Quarter Fiscal Year 2013 Earnings Call. Joining us from management are Bob Humphreys, Chairman and Chief Executive Officer; and Deb Merrill, Vice President and Chief Financial Officer.

Before we begin, I'd like to remind everyone that during the course of this conference, projections or other forward-looking statements may be made by Delta Apparel's 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 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.

I'll now turn the conference over to Delta's Vice President and Chief Financial Officer, Deb Merrill, who will provide the details of the Company's fiscal second quarter.

Deborah Merrill: Thank you, and good afternoon. Despite a continued weakness in our Soffe business, Delta Apparel had record revenue for the quarter in first six months, and was profitable in both periods.

Net sales for fiscal 2013 second quarter were 106.8 million, a 1.2% increase over 2012 second quarter sales of 105.5 million. Net income was 46,000 or $0.01 per diluted share, compared with the loss in the 2012 second quarter of 13.6 million or $1.61 per diluted share. This is a complicated comparison since, as you may remember, net income for fiscal 2012 second quarter in first half was negatively impacted by the one-time inventory markdown of 16.2 million that resulted from the unprecedented record high cotton costs combined with selling price discounts in our line of basic undecorated T-shirts.

During this year's second quarter, we experienced good volume growth and lower costs in our Catalog and FunTees businesses, which resulted in improved margins for the basics segments, despite price reductions in both business units.

The branded segments, while hampered by softness in the Soffe business still had overall sales growth bolstered by higher volumes in Junk Food, The Game, and Art Gun.

Second quarter 2013 sales in our basic segment rose to 58.8 million, a 2.2% increase over the comparative 2012 period. The increase resulted from a 13.1% rise in basic segment volume, which was offset somewhat by lower average selling prices in both the Delta Catalog and FunTees businesses. The addition of new customers in our blank and private label business was the principal driver of the volume increase.

Delta Catalog experienced a 15% increase in unit volume, driving a 7.8% sales growth. Selling prices on both—on our private label products were lower than a year-ago as cotton prices declined. Because of this, FunTees experienced a net sales decline of 7.3%, despite a 6% increase in volume.

During the quarter, we initiated new print programs using Catalog blanks, which broadened our customer base, while also allowing us to better utilize our offshore printing capacity. This, along with the success of our lean manufacturing in Six Sigma initiative, reduced manufacturing costs, driving improved margins for our basic segments.

Branded segment sales for the second quarter were 47.9 million, up slightly from our prior year's quarter. Junk Food, The Game and Art Gun, each experienced double-digit net sales growth, which was offset by weakness in our Soffe business. While Soffe's strategic sporting goods business gained new distribution and better product placement, its independent sporting goods business remained slow. Soffe's juniors business with mid-tier department stores also remained slow, but new girls and missy college programs will be shipping this Spring and Fall to mid-tier department stores.

Junk Food added specialty retail customers a new design design-for-fee business and its professional sports line business continue to grow largely through e-commerce channels.

The Game maintained good growth, led by Salt Life, which is experiencing strong buy-in from customers, and its new footwear line will start shipping this Spring.

Net sales for our Art Gun business grew 83% in the second quarter, and the business has been profitable throughout the first half. Driving its growth were several new e-commerce sites and direct-to-garment fulfillment opportunities that were added to the Art Gun platform since the beginning of our 2013 fiscal year.

For the first six months of fiscal '13, Delta's net sales increased 3.4% to 236.9 million, compared to 229 million for the first six months of fiscal '12. Net income for fiscal 2013 six months period was 3.6 million or $0.42 per diluted per share, compared to a loss of 9.2 million or $1.09 per share in the prior year six months period.

SG&A expenses in our 2013 second quarter were 20.5% of sales, compared to 19.1% of sales in the prior year second quarter. For the first six months, SG&A as a percentage of sales was 20.2% versus 19.5%. The increase in SG&A as a percentage of sales was driven by higher distribution costs from the increased volumes with lower selling prices.

In addition, compensation costs were higher, driven from certain severance costs that were reported during the quarter, as well as higher incentive compensation on the improved performance over the prior year. The full-year SG&A also includes a one-time $1.2 million charge as discussed in the first quarter results.

Our effective tax rate for fiscal '13 six months period was 23.5%, which is the effective tax rate expected for the full 2013 year. It's a hard comparison to make to the 39.5% effective rate recorded in the prior year period, due to the tax implications from the one-time inventory markdowns reported in the prior year.

Looking at the balance sheet, receivables were 56.8 million, a 10.5% increase from the prior year period. Day sales outstanding were 50 at December 29th, basically in line with the year-ago. Inventories increased 6.7 million from June and is down 14.6 million from a year-ago December, driven primarily from the lower-cost cotton in inventory. We do expect inventory levels to rise during the upcoming quarter, due to our normal build of inventory to support our anticipated growth during the Spring selling season.

Capital spending was 2.2 million during the quarter, and our depreciation and amortization, including non-cash comp was 1.8 million. We continued our stock repurchases during the second quarter using $2 million to buy back 139,000 shares at an average of $14.41 per share. So far this fiscal year, we repurchased 213,000 shares at an average price of $14.29 per share. At quarter-end, we had 2.7 million outstanding under our authorized amount.

The total debt at December was 104.9 million, compared to 120.5 million a year-ago. Our trailing 12-month earnings and lower working capital needs drove the decrease in debt from a year-ago.

While cotton prices seem to have stabilized in the first six months, they remained somewhat higher than we had anticipated. We're comfortable with our cotton position and are gradually lengthening it due to the firming of prices at the cotton level.

I will now turn the call over to our Chairman and CEO, Bob Humphreys, for his thoughts on the first half and the rest of the fiscal year.

Robert Humphreys: Thanks, Deb. And thank all of you for being on the call with us this afternoon. As Deb said, with the exception of Soffe which continues to suffer from a slow retail sales at mid-tier department stores, all of our business units enjoyed good volume and solid margins in our second quarter.

We're experiencing increased demand that enabled us to avoid the manufacturing shutdown plan for the first half of the year, and plan to operate during the one week shutdown initially planned for the third quarter. Although we ended the quarter in six months in line with our expectations, the first half of fiscal '13 certainly was an indicative of the strength and reach of Delta's product and brand. We'll continue to initiate measures that we believe will improve both our top line and bottom line of our business over time.

During the second quarter, we completed several projects designed to reduce cost and leverage customer relationships. Our lean manufacturing and Six Sigma initiatives have already reduced manufacturing costs in a very effectively increased throughput using our existing equipment. We further reduced administrative costs by completing the move of our print sample production to El Salvador and Mexico. This action also significantly improves the service levels we can provide to our customers.

In addition, we finished the final phase of converting FunTees to the Basics ERP platform, again, decreasing costs and improving information flow to customers. The Game's basic tee products now employ a completely vertical Delta production model extending from textiles all the way through screen printing. This model was designed to lower cost and facilitate rapid replenishment of products to our customers.

Salt Life products continue to gain in popularity. Our Fall 2013 line received an excellent reaction from buyers at the recent Surf Expo in Orlando, Florida, and we are making progress in establishing Salt Life brand at the grassroots levels on the West Coast.

We are also moving along with our plans to bring all of our college bookstore business under The Game operation, and we expect to complete the consolidation by the end of this fiscal year. You may recall, our bookstore business began exclusively with Soffe products, but broadened significantly with the acquisition of The Game and the Cotton Exchange. When completed, we believe the consolidation will provide additional leverage to our bookstore relationships, while also reducing our SG&A cost and distribution cost in this part of our business.

In the second quarter, we further improved our Art Gun business with additional equipment and movement to a twenty-four hour, seven day operation to support holiday growth and provide quicker shipping to the end-consumer. Currently, those consumers are located in 65 countries. We also further expanded e-commerce sales of our branded sites, which grew 71% over last year's first half. While still a small part of our business, it's an area of exceptional growth that will continue to gain importance for us over time.

Soffe offers one of our main challenges as well as one of our biggest opportunities. The weakness in Soffe's sales from a sluggish economy, some of the new strategies that mid-tier national department stores are adopting to cope with changing business conditions, and our poor response to these changing conditions. A gradual recovery in the Soffe business is expected, as we seize opportunities to leverage customer relationship with new more creative sales and marketing programs that enhance the rapidly evolving merchandising strategies. Soffe's cost structure is also being addressed to bring it more in line with that of our other business units.

While there continues to be substantial economic uncertainty, we're excited about the opportunities for future growth in Delta Apparel. The Company anticipates significant free cash flow over the next 18 months, and received Board approval last week to move forward with several initiatives that should allow us to continue growth in our business and further value creation for our shareholders.

On January 23rd, our Board of Directors authorized an additional $10 million for the Company's share repurchase program. Comparing our current share price with the book value or intrinsic value indicates that Delta Apparel's own stock is a prudent investment for our free cash flow, and the Board's increased authorization gives us the flexibility to take advantage of it.

In addition, our Board approved a new expansion of our manufacturing facilities, which will increase textile and sewing capacity by approximately 17%. We'll spend over $12 million on new equipment for our Ceiba Textile facility, Maiden Textile facility and several sewing plants. The work on these projects will start immediately. We plan to have most of this capacity up and running prior to the end of this calendar year. This additional equipment will allow us to satisfy the increase in demand we've seen for our basic activewear products and support newly developed specialty products already achieved interaction in the marketplace.

As announced earlier today, Steve Cochran has been promoted to the new position of President and Chief Operating Officer of Delta Apparel Incorporated. Steve has done an outstanding job for the Company since joining us three years ago as President of our Basics Segment. He has built an outstanding team around him, he has streamlined our operations and built significant new customer relationships driving business growth and vastly improved operating results. Under Steve's leadership, we expect to be able to further leverage backroom operations and customer relationships across all of our business units. All of us look forward to working with Steve in his new role, which we believe will drive improved results with our current operations, while allowing more time to pursue new business opportunities we see in the marketplace.

We believe our plans for Delta Apparel are bold but contain enough flexibility to accommodate a variety of economic scenarios by building value for our shareholders. Current economic conditions remain volatile, but we expect to meet the guidance previously provided for fiscal 2013. As we've said in previous calls, based on anticipated net sales growth, we believe we should achieve record revenues in the range of 500 to $510 million for fiscal 2013 or about a 3% increase over 2012. Net income is expected to be in the range of $1.65 to $1.80 per diluted share.

Now, Deb and I'll be happy to try to answer any questions that you may have.

Operator: Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is off for the signal to reach our equipment. Once again, please press star, one at this time. We'll pause for a moment to assemble our queue.

We'll go first to James Fronda with Sidoti & Company.

James Fronda: Hey, guys. How are you?

Deborah Merrill: Good.

James Fronda: Just in terms of the SG&A expense, it was pretty significantly higher than last year. What was the direct cause of this? And, I guess just, I'm curious for the next two quarters, is this a good run rate to use going forward?

Deborah Merrill: Overall, you know, as mentioned, part of the increase in SG&A is in distribution cost.

James Fronda: Okay.

Deborah Merrill: The amount of sales growth was not—did not look as strong, but the unit growth was very strong. So, we had higher distribution costs from that unit growth.

In addition, there were some one-time severance costs as well as some higher management incentive cost on the improved performance this year over last year.

James Fronda: Okay, all right.

Deborah Merrill: So, those three pieces really made up that increase. And I would say, overall, as a percentage of sales, we're going to have a better leverage of our SG&A cost in the back half as we seasonally do historically.

James Fronda: Okay.

Deborah Merrill: So, I think you'll see that as you have historically in the back half of the year.

James Fronda: All right, okay. Okay. And, I was under the impression that with lower cotton costs, it would be significantly better for your gross margin, and it was still pretty good for the quarter. I'm just curious to know why you had lower selling prices within the FunTees business. Is that because, I guess your customers can just come back to you and negotiate on the price?

Deborah Merrill: That's correct, and especially in that private label business, certainly the cotton cost increased to those prices when those cotton costs were higher to make up for that. So, as those lowered, then that amount of those increases came back out. And, that's a pretty standard thing that happens with those cotton prices.

James Fronda: Okay, all right. And, you guys are still affirming your guidance, so obviously you guys believe that you'll have a very, very strong next two quarters, correct?

Deborah Merrill: That would be correct, yes.

James Fronda: Okay. But, if cotton runs up to, I guess, you know, almost a dollar, will that—I guess that will significantly wind the gross margins, right?

Robert Humphreys: It's not going to have that much of an impact on this fiscal year now with…

James Fronda: All right.

Robert Humphreys: …where we've cotton fixed and the flow-through through cost of sales, it would impact next fiscal year.

James Fronda: Okay. And, you said that the mid-tier departments are responding to changing conditions. Could you just give some specifics on how they are actually responding?

Robert Humphreys: Well, I guess J.C. Penney would be a poster child for that. They have obviously altered their whole business strategy pretty dramatically.

James Fronda: Okay.

Robert Humphreys: And I would say, in general, people go into more private label programs trying to (inaudible) margin.

James Fronda: All right. Thanks, guys.

Operator: Once again, that is star, one at this time if you've a question. We'll take Tom Lewis with High Road Value Research.

Tom Lewis: Hey, good afternoon. First question, owning your stock few years back, my recollection was that when cotton prices spike like they did last year or so, and it's not something I've been following real close, the—and then come back down, the selling prices tend to come back—your selling prices tend to come down a lot slower than what you pay for cotton. Is that in play in this latest quarter still? Or, is that ancient history?

Robert Humphreys: No. I would say in general, it's the opposite of that. That selling prices come down quicker than cotton or the timing gets solved quicker…

Tom Lewis: I think that's what I meant. Yes, yes.

Robert Humphreys: Okay. All right, that certainly happened this time last year. And, I would say for us, and my guess would be most of the industry right now that's—where cotton is a big component of their cost, cotton has been stable long enough now that we have a pretty good balance between cotton costs and selling prices.

Tom Lewis: Okay. And, when I see a 13% increase in something like basic T-shirts, it suggests either a year-ago was pretty awful or you are doing something really different, like, making your sales guys work harder or something, I don't know. Could you shed a little light on that?

Robert Humphreys: Well, we have been following this business, really over the last 13 years, sometimes, some quarters more than others and what have you, but we have a go-to-market strategy. I think we get fine-tuned that over the last two years under Steve Cochran's leadership, and some other people that came on the team. And, that seems to be resonating with our customer base. And, we are growing both the undecorated and decorated T-shirt business as we have been for a number of quarters. And, that's what's driving this investment in more manufacturing equipment is the growth we're seeing there.

Tom Lewis: All right. And, with respect to fixing Soffe, it sounds like it's mainly about improving your responsiveness on the product, and I was curious is that—is the solution to the situation all about that? Or, just mainly about that? And, is there anything that you might do with respect to tweaking the channels by which they go to market as well?

Robert Humphreys: Yes. At this stage, don't think we will tweak channels that we go to market, and the Soffe brand is very popular and in demand, and we have a lot of ongoing retailers, discussions with new retailers for additional channels of distribution. As we sit here today, I don't see that on the horizon. But then in addition, we do want to be an easier company to do business with at Soffe. We think we can simplify some systems, and some of what we've learned in our other businesses would allow us to be a faster reacting company. We've seen declines in Soffe business before. At times, if we get out of a little—you know, a sink and we've been able to recover that. I would say probably not as much as this one. But anyway, we're optimistic about what we can achieve with the Soffe business.

Tom Lewis: It's my recollection that sometimes a company that sells a basic product like that, there are times when there is something else out there that's hot that people want and basics don't do so well. And then, that kind of dies down and basics do better. Is there any of that in play here? Or, is that…

Robert Humphreys: Perhaps you have some of that. We often experience with Soffe people deciding to do it private label.

Tom Lewis: Yes.

Robert Humphreys: And inevitably, we get most or all of that back, and then sometimes some more. The grass is always greener on the other side until you get there. But, that Soffe brand resonates with junior consumers and girls and they want to go get that product.

Tom Lewis: Okay. And finally, with respect to your balance sheet, do you have a target leverage? Obviously, you've been pretty acquisitive in the last few years, but is there sort of a leverage that you want to be at?

Robert Humphreys: I would say we are somewhat conservative about it, from our viewpoint. Sometimes other people disagree with it, but I would say more opportunistic, money is pretty inexpensive right now. It has stayed in this business longer than we would have guessed a few years ago.

Tom Lewis: Yes.

Robert Humphreys: When we can take advantage of some of these opportunities while money is inexpensive, if we're making a profit off of those, that 3.5% interest costs or 4%, then obviously that can be very accretive to our overall shareholder value, we think.

Tom Lewis: Okay, thanks a lot.

Robert Humphreys: Thanks.

Operator: Once again, that is star, one at this time if you've any question. We'll move on to Jamie Wilen with Wilen Management.

Jamie Wilen: Hey, fellows. I wonder if you could talk a little bit about Salt Life and the progress you're making there. If you can kind of count the number of doors you'll be in this year versus last year? And, is it possible to project a ballpark of sales gains for this year within that category?

Robert Humphreys: You know, we're really not disclosing all of those details, and I think to get into it too much, we'd need to check some of our license agreement. There is a lot of confidentiality requirements in there. But, you know, it's going to grow double-digit. We have introduced footwear, we have all of our footwear product in, a significant amount of it is pre-sold. We actually—we're in Jacksonville, Florida last week, and toured our store there. We had our Board of Directors in and had a presentation on Salt Life. So, without giving specifics, it's going to be in additional doors. We had some really strong sell-through over the Christmas season with new customers we've had this year. So, we're excited about its growth.

Jamie Wilen: Okay. And, on the footwear side, what's the market you're going after for that line? And, how big can that be for you?

Robert Humphreys: Yes. Well, the market is that casual outdoor person that's either going to be boating or on the beach or what have you, it's a—everything is under $100 at retail. The vast majority of it is under $60 at retail. For the most part, it's stuff that will be hanging. We have store fixtures available to customers. And so, it's a simple but we think well thought outline and we're all really excited about it. And, it's going to have an initial sell in this year. It's not going to be a number so big that it just jumps out at—on our income statement, but we think given a year or two, it can be a significant part of that business.

Jamie Wilen: Okay. And lastly on Salt Life, the sell-through with your customers overall, has it been constant and…

Robert Humphreys: Good and improving.

Jamie Wilen: Okay. Okay, and you're just getting started on the West Coast or your West Coast has not gotten started yet?

Robert Humphreys: No, we're just getting started. We've got a full-time employee out there. We've got a celebrity user who is a retired pro surfer and now a professional paddle border that's going around and making appearances and doing the exact same seating that we had in Florida some years ago. We're starting to see Salt Life stickers on vehicles out there, and you know, are inviting people to send us photos and all, and we seem to get it almost every day now. We have agreements with some small surf shops to put the product in. So, we're trying to do the right things to build the right foundation and have a real grassroots approach to Salt Life on the West Coast.

Jamie Wilen: Great. On the Junk Food side, you mentioned for the first time your design-for-fee business, what is that for Junk Food?

Robert Humphreys: Yes. We've done—a number of different retailers now where we have designed product for them, and it has sometimes been art, it has sometimes been art and the product, and sometimes it's just been merchandizing art and that sort of thing. So, we're always excited about those opportunities. Generally, our first choice would be to provide the whole garment, but sometimes it's—garments is not really our business, but they want the Junk Food filter applied to it. And so, we can do that and we'll continue to do it.

Jamie Wilen: Okay. As you're expanding down in Central America, you talked about newly developed specialty products that are—you need the capacity for, could you expand a little bit on that at this point?

Robert Humphreys: Yes. They are generally performance products that we developed over the last 18 months and gotten in the marketplace. And, we just don't have really the correct kind of equipment to make them in volume. We can make lower production runs and what have you. We have some military fabrics that same thing, there is more modern equipment out there that helps our quality and our cost and some of these piggyback that same equipment. So, we have enough business now to add that. A lot of that will actually be put into our Maiden, North Carolina Textile facility. And then, we'll be adding new equipment to expand our Ceiba Textile operation within the four walls that we have there, which was—has been designed in. And then, really through our Six Sigma initiatives, we're using less floor space in our sewing plant. And so, where if you had asked us a couple of years ago, you know, we would have said we were selling all we can in those facilities and would have go to new facilities to expand. We have freed up floor space. So, with additional textile capacity, we'll be putting more sewing equipment in existing facilities, which will obviously increase our output and help our leverage their fixed cost.

Jamie Wilen: Okay. And lastly, Bob, on Art Gun, when you first got into it, it struggled initially and I think it was a little bit of a concern, but all of a sudden now you're starting to add equipment. I assume you've—once you reach the breakeven point in this business since it's a 24/7 business during parts of the year, the incremental margins are a bit higher than normal once you get there. And, I guess you're at breakeven now and adding equipment gets you to the point where you can actually start to make money here?

Robert Humphreys: Yes. And we made money, significant money as a percent of revenue in the second quarter. We think we'll be obviously profitable for the full-year. It's cash flow positive. It was cash flow positive last year. It will be more cash flow positive this year, and the additional equipment allows us to take our own incremental business. So, still a start-up, still finding its way in life, but we are proud of the revenue that it is now generating and the fact that it is operating in a positive mode for us.

Jamie Wilen: Okay. Thanks fellows, I appreciate it.

Robert Humphreys: Okay.

Operator: And, as a final reminder today, that is star, one at this time if you do have a question.

And, we have no further questions at this time.

Robert Humphreys: Okay. Well, thank you all for being with us this afternoon, and we'll look forward to updating you in a few months on our third quarter results.

Operator: And, this does conclude our conference call for today. We'd like to thank you for your participation.