



Delta Apparel, Inc.

Fiscal 2021 Second Quarter Earnings Conference Call

May 6, 2021

Operator

Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal 2021 Second Quarter Earnings Conference Call. Joining us from management are Bob Humphreys, Chairman and Chief Executive Officer; Deb Merrill, Chief Financial Officer and President, Delta Group; and John Tester, Chief Accounting Officer.

Before we begin, I'd like to remind everyone that during the course of this conference call, projections or other forward-looking statements may be made by Delta Apparel's executives. Such projections and 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 and Form 10-Q filed today. 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.

As a reminder, today's conference is being recorded.

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

Bob Humphreys

Good afternoon, and thank you for joining us on our fiscal 2021 second quarter earnings call. We are excited about our performance this quarter and I am proud of our team's continued hard work to cultivate and service the broad-based demand we see in the many markets we serve. We are achieving, and in many cases, exceeding, the results we expected from numerous growth initiatives we launched, and believe these will continue to drive value for our stakeholders in the coming quarters and years.

Let me go ahead and turn the discussions over to Deb Merrill, who will go through our business highlights and to John Tester, who will follow with a review of our financial results. I will then join them when we open the call up to questions.

Deb Merrill

Thank you, Bob.

We are indeed very proud of our second quarter performance as we continued to deliver results that outpaced our expectations.

Our second quarter results reflect strong, broad-based demand across our product lines, coupled with significant earnings expansion as we continued to drive efficiencies throughout our operating and cost model. We achieved second quarter sales growth of 12% with double-digit growth in both our Delta Group and Salt Life Group segments. These were outstanding results as we capped off a stronger than expected first half performance in which we delivered sales growth of 6% for the first six months of fiscal 2021, well ahead of our earlier expectations for sales contractions or at best flat to prior year.

With regards to profitability, we delivered earnings of \$0.62 per diluted share, well ahead of last year's reported EPS of \$0.19 and adjusted EPS of \$0.39.

The strong second quarter performance is a true testament to our teams' unwavering dedication to servicing our diverse sales channels, a reflection of our world-class manufacturing capabilities, and most importantly, the flexibility of our business model. As we look to the remainder of the year, I am confident in our ability to continue to drive strong top and bottom line growth.

Turning first to our Delta Group segment, sales growth was led by the demand for activewear apparel, particularly with our retail-direct customers and with the global and regional brands that utilize our full-service supply chain. We are there every step of the way for these customers – from product development to shipment of their branded products, with the majority of products being sold fully-decorated and ready for the retail shelf. Over the last several years, we have broadened our customer base and expanded our product capabilities, and we are seeing these benefits with 40% year-over-year sales growth this quarter in these sales channels. Global trade uncertainty and the need for shorter-lead times, and now the effects caused by the pandemic, has led most businesses to re-evaluate the reliability of their supply chain. We firmly believe that our flexible, full-service approach, utilizing our sophisticated business systems and our near-shore and on-shore manufacturing capabilities, make Delta Apparel an ideal supply chain partner. We are seeing continued business opportunities with expanded programs for our existing customers along with business from new partners interested in utilizing our services.

We remain encouraged by the accelerating adoption of our products and services in the direct-to-retail channel. Utilizing our offshore manufacturing along with our U.S. decoration and packing operations, we have been able to deliver quick-turn, fully-stocked graphic tee pallet displays to retailers, which have performed extremely well at retail and have led to ongoing fulfillment and new programs as we progress through the year.

We are very proud of our ability to drive performance in our Catalog business, despite the inventory constraints we are working through. Our teams worked exceptionally hard to accelerate the ramp up of production to all-time record levels. We are ahead of our initial goals and are now producing more dozens a week within our internal manufacturing platform than ever before in our history.

The Softe integration remains on track for completion by the end of the fiscal year. As a reminder, in January we kicked off the integration of Softe into our Delta Activewear sales and inventory business system, added the complete Softe line to the Delta B2B ecommerce site, as well as launched a new consumer Softe.com site directly integrated with the Activewear ERP system. This has led to a better customer experience and improved inventory management. Now operating with integrated sales and marketing teams, we have already successfully launched several targeted social media and email advertising campaigns showcasing the broad range of Delta, Softe and sourced-branded products. Bringing together both Delta and Softe under one integrated Activewear umbrella is a win-win for both our customers and for Delta Apparel. We have set the stage to expand our market reach while simultaneously enhancing our margin potential.

We are in the process of relocating the majority of Soffe inventory to our new, fully integrated Phoenix distribution center, where we will be servicing Soffe products on a go-forward basis. Our Soffe Military business will continue to be serviced from our North Carolina production and distribution facility. As we mentioned on our December quarter call, with the Soffe transition into the Delta platform we expected to see incremental expenses of about \$0.08 per diluted share in the March quarter. While we are on pace to meet our completion timeline, we were able to lessen the impact of this in the March quarter and spread some to the June quarter, where we believe the expense will be substantially offset by cost-savings from the integrated facility. Importantly, we continue to anticipate annual benefits from this integration initiative in the range of \$0.12 to \$0.15 beginning in fiscal 2022.

Looking at our DTG2Go business, we had a slower start to the quarter but ended the period on a strong note with March unit growth up in the double digits. The early softness in the market was experienced across our customer base as consumer sentiment was hesitant with the uncertainty surrounding the COVID pandemic, the stimulus packages, and unemployment rates and related incentives. Also, as the traditional retail channel becomes more prominent in our DTG2Go business mix, we have continued to build a greater understanding for the seasonality of the business trends with the post-holiday lull having a larger impact than originally anticipated early in the quarter.

As we closed out the March quarter and continuing into April and May, we have seen a resurgence in orders coming from existing customers as well as newly launched partners, many of whom are forecasting to do significant volume with us as they ramp up. The traditional retail channel continues to grow, with more than triple the units shipped compared to prior year quarter. We continue to see this channel of distribution as a significant future growth opportunity for DTG2Go, especially with our new strategic partnership with Dallas-based Autoscale.ai, whose technology automates the product design, marketplace listings and advertising management for on-demand retail. We believe that one of the headwinds with the growth of on-demand retail has been the time and energy to take graphic libraries and turn them into online product listings available for sale to consumers on limitless garment styles and colors, and across multiple marketplaces. While DTG2Go's on-demand supply chain takes care of everything once the consumer buys the product, we wanted to expand our solution to give customers the tools to quickly and efficiently bring more graphic designs to the on-demand model. Autoscale is the automation software that does exactly that, bringing products to market faster with fewer resources. We believe that combining DTG2Go's on-demand supply chain with Autoscale's design automation technology will further revolutionize the on-demand apparel retail.

Utilizing our proprietary technology and our expanding geographic network, DTG2Go is able to quickly and easily scale operations to support the rapidly growing on-demand industry. As we noted last quarter, we are now operating nine fulfillment facilities, including two locations recently opened in the December 2020 quarter. One is the first in the industry, our 'On-Demand DC', and the second is our new Phoenix, Arizona integrated distribution and fulfillment center. With the Phoenix location, we operate five facilities fully integrated with our Delta Group distribution centers providing a seamless supply of garments, while eliminating a significant amount of non-value added costs and further leveraging our facility costs. Our customers continue to realize the benefits of the use of Delta garments, with DTG2Go's usage of Delta Catalog blanks reaching a new record high of approximately 50% utilization in the March 2021 quarter compared to 30% in the prior year quarter. This trend is promising as it creates a more efficient operation, reduces garment costs for our customers, and lowers working capital needs in the business. We will look to expand our network through potential future DTG2Go facilities within our remaining Delta DCs, the addition of new On-Demand DCs, and expansion into international markets.

With respect to our Salt Life Group, as evident by the 15% second quarter sales growth, demand for the Salt Life brand remains very strong. The Salt Life direct-to-consumer business more than doubled compared to last year, led by branded retail store sales growth of 175%, inclusive of a same store sales gain of 25%. Our retail stores have continued to drive impressive results, and we could not be more pleased with the outstanding performance at our new stores including Estero and Palm Beach Gardens, as well as our locations in key vacation destinations including Destin, Tampa, Key West and Daytona, Florida. As we kick off the summer vacation season, we look forward to seeing consumers experience the lifestyle brand

in person at our retail doors, with new locations opening in Myrtle Beach, South Carolina and then next in Texas.

Consumers also continued to actively engage with Salt Life while online, with ecommerce sales up over 40% for the period. The strength of Salt Life's e-commerce business was driven by all-around impressive KPI's for the quarter, including 40% traffic growth and first-time saltlife.com visitor growth of 35%. Consumers are spending more time on the site, which we believe is leading to growth in average order values compared to the same period last year. They are also visiting, more-often-than-not, on their mobile devices, with over 70% of visitors and over half of purchases, originating on their phone or tablets. During the March quarter, consumers also subscribed themselves to our email lists at a pace 75% greater than new email subscribers in the March quarter last year. This is important as about a quarter of all online sales these last three months originated from the email channel, which bodes well for future growth.

We could not be more excited about the strength of the Salt Life brand and have invested in fueling the lifestyle brand growth with the launch of The Daily Salt. Team members, influencers, and staff will showcase, guide, and demonstrate "how-to" videos and provide exclusive articles from amazing destinations around the world covering anything you want to know about living the Salt Life. The Daily Salt is another way we are authentically engaging with enthusiasts of the brand and everything it represents. We also engage on multiple social media platforms which saw a 10% year-over-year increase in followers of Salt Life, including the launch of our Salt Life branded LinkedIn page. Notably, our popular YouTube videos saw a seven-fold increase in viewership this quarter compared to last year since we began more actively promoting the channel on our website.

With the strong results from our retail and ecommerce sites, we have increased our direct-to-consumer penetration to 25% of total sales from 15% last year. This is meaningful growth for our strategy to ultimately achieve a two-thirds mix of Salt Life direct-to-consumer sales. At the same time, our wholesale channel continues to perform well with our retail partners. We ended the second quarter with our largest order book on record for Salt Life, which should lead to strong Salt Life sales for the back half of the year.

Our results showcase the benefits of our broad customer base and diversified channels of distribution. And we believe the momentum is just beginning! We are excited by the many opportunities we see for continued top and bottom line growth.

Let me now pass it on to our Chief Accounting Officer, John Tester, for a more detailed review of our second quarter financial results.

John Tester

Thank you Deb.

For our fiscal 2021 second quarter, we delivered sales of \$108.6 million, a 12% increase compared to our March quarter of fiscal 2020. This performance was driven by double-digit growth across our two business segments, with the Delta Group segment up about 12% and the Salt Life Group segment up over 15%.

Gross margins increased 150 basis points to 22.8% compared to 21.3% last year and sequentially from 21.4% in the December quarter, driven by favorable product mix, higher selling prices, and manufacturing efficiencies and process improvements, offset by inflationary cost increases in labor, freight, fuel and raw materials. Just as we have been discussing inventory constraints as a headwind to growth, the difficulty in obtaining labor in the U.S. has also become a challenge as we are competing for labor against increased unemployment payments and other programs available to non-working individuals. These labor constraints impact us across our businesses, including in our U.S. production facilities and in our distribution and retail stores.

While sales dollars increased approximately \$12 million compared to prior year, selling, general and administrative expenses decreased \$0.8 million, or 4%. The savings are from cost reductions implemented during the pandemic that have continued, including fewer administrative staff, reduced travel expenses, and a more digitally-focused sales and marketing strategy, which more than offset the additional costs incurred in the Delta Group for the integration of Softe into the Activewear business.

Operating income for the quarter more than doubled to \$7.6 million, or 7.0% of sales, compared to \$3.6 million, or 3.7% of sales, in the prior year. Net income for the quarter was \$4.4 million, or \$0.62 per diluted share, a significant increase to last year in which reported net income was \$1.3 million, or \$0.19 per diluted share. On an adjusted basis, excluding the impact in the prior year March quarter from the government-mandated shutdown in our offshore manufacturing as the pandemic began, earnings were \$0.39 per diluted share.

With regards to our balance sheet and liquidity, total inventory as of March 2021 was \$148.5 million, down \$48.8 million, or 25%, from a year ago, as we enter our seasonally strongest quarter of the year. As previously discussed, the stronger than anticipated sales trend we have seen over the past 9 months, combined with the hurricane disruptions experienced during the December quarter, impacted our normal seasonal inventory builds. We are continuing to ramp up production at an accelerated pace and are producing at all-time record levels to replenish inventory to normalized levels before next year's spring selling season.

Total net debt increased \$5.4 million from December 2020 to \$135.2 million as of March 2021, but is down about \$23 million from net debt levels a year ago. Cash on hand and availability under our U.S. revolving credit facility totaled \$44.2 million as of March 2021, a \$0.5 million increase from December 2020 and a \$14 million, or approximately 50%, increase from a year ago.

We spent approximately \$1.5 million on capital expenditures during the March quarter compared to \$4.1 million a year ago, and we continue to expect capital expenditures in fiscal 2021 to be about \$20 million. Our focus is primarily on digital print expansions, manufacturing equipment to expand capacity and broaden our capabilities, additional Salt Life retail store openings, and business systems and technology advancements to enhance our operational efficiency.

As we look back on our business, we are now at the one-year mark from when the pandemic began disrupting our operations in the final weeks of March 2020. I know we all would never have guessed the impact that this would have had on the world! We are so pleased with the quick recovery we have had in our business. As we compare the performance of Delta Apparel compared to pre-pandemic fiscal year 2019, beginning in the September 2020 quarter, and continuing through the first half of fiscal 2021, our revenue has been trending at or above the levels of fiscal 2019, including our March quarter being up approximately 6% compared to the fiscal 2019 quarter. Even more importantly, we have achieved strong gross margin improvement and significant profitability expansion in the prior three quarters as compared to fiscal 2019.

We would expect those same dynamics to continue in the back half of fiscal 2021 as we build on the momentum experienced these last three quarters. While the inventory constraints are a headwind to sequential top line growth in the June quarter, this should begin to ease in coming quarters as our record-level production output begins to build our inventory levels. With respect to inventory, it is important to note that cotton prices and other inflationary input costs are having a large impact on our product costs. We will begin selling through higher cost inventory in the September quarter, which will put some pressure on gross margins compared to the March and anticipated June quarter margins. Having said that, we believe that our margin-enhancing strategies we have put in place over the last several quarters, coupled with the reductions we have achieved in SG&A expenses, should allow operating margins to remain strong. Let me now turn the call back to Deb for her final thoughts.

Deb Merrill

Thanks John.

In summary, we could not be prouder of our performance to date for fiscal 2021 and are confident in our ability to continue to drive strong performance for the remainder of this year and beyond.

And now, Bob will join us and we will open the call for any questions.

Operator

Thank you. We will now take our first question from Dana Telsey at Telsey Advisory Group. Please go ahead.

Dana Telsey

Good afternoon. Congratulations on the nice progress in the quarter and especially relative to 2019 also.

When you think about the growth initiatives that lie ahead, certainly one of the things that was new is the new partnership with Autoscale.ai. Can you tell us how some of these partnerships are going, the Hot Topic partnership? How you see that leading to higher sales and margin opportunities go forward? And then just a follow-up.

Deb Merrill

Sure, Dana. As we mentioned our strategies around growing out the entire traditional kind of retail channel within DTG2Go are going extremely well. The Hot Topic business is growing very nicely, and we're gaining new partners in that channel. The new strategic partnership that we have with Autoscale to combine their technology into our operation I think will only enhance our ability to more quickly grow the traditional retail aspect, because what that provides us is an ability to offer our customers technology advancement so that they can more quickly bring these listings to life.

We have always talked about the endless supply of opportunities with a graphic library to offer those products across a vast number of garments and get those listings posted so consumers could buy them. This technology will basically automate that entire process to bring more listings to life, which then ultimately will drive more consumers buying them and drive growth in our digital print in-fulfillment business. So, we are most excited to be offering these front-end tools to our customers to enhance and accelerate the growth of on-demand as the way to grow business.

Dana Telsey

Got it. Then if you think about commodity prices, cotton costs, what are you seeing out there in the environment, given we are hearing about inflation of some raw materials? And how do you expect inventories to progress going forward, given the healthy demand for your product. Thank you.

Deb Merrill

Sure, I'll take that one as well. To start with, certainly, cotton prices have been volatile in the last few months. Volatility in cotton is what we would all prefer there not to be, but it has been out there. As we mentioned, we are having higher selling prices across our business, that we think are going to offset those costs or at least partially offset those costs and the other inflationary costs that we have seen. I think as John had mentioned, and just trying to make sure everybody understands: those costs will start flowing

through our P&L starting in the September quarter, which does add pressure compared to where we've been in margins in March and where we expect them to be in June.

But we think the things that we have done across our business, both in our product mix and other margin strategies, should help offset those and allow us to continue to have the nice strong profitability that we've had in the business.

One thing with that is our inventory cost per unit as we build back this inventory will be a bit higher on a per unit basis, but then we also expect to then be able to build back the units in inventory that we need to support the business as we go forward. We've said that we expect to be a bit inventory constrained in the next coming quarters; that should again start easing as each quarter goes by, with the anticipation that we will have the inventory to support growth that we expect in the business as we get to the spring selling season a year from now.

Dana Telsey

Thank you very much.

Operator

Thank you. We will now take our next question from Jamie Wilen of Wilen Management. Please go ahead

James Wilen

Hi, that was a nice quarter. But sticking with inventory for a second, you anticipated that there'll be about a \$20 million sales impact in the March quarter due to the light inventory. How will you overcome all that?

Deb Merrill

Jamie, good call out on that, because this is now basically the second quarter in a row that we've overcome that headwind. I think a lot of that comes from the efficiencies we've found in the business; our manufacturing teams that is even more laser-focused on manufacturing the items that we need to support the business. All that being said and while we are most pleased with the growth that we did achieve in the March quarter, I think you would have seen even stronger growth had we had more inventory to support that.

I think it is a combination of both of those and we certainly expect to continue to do the same thing in the June and September quarters. It is a headwind, but we have been successful against that in the last two quarters.

James Wilen

Okay. As you said, your cost per unit in the inventory is higher. Your inventory is significantly lower. In terms of units, how much lower is your inventory level? As well as, where would you like the inventory level to be right now?

Deb Merrill

Yes, I would say, as we speak right now, our inventory costs have not increased that much. They will start increasing as we're bringing in the higher raw materials into the production standpoint. As we speak right now, I would say our inventory levels, the units, we do need more units; but the good news is that we have determined that we don't need as much as we had. So, I would expect when we get back to the levels we need, we will still be lower in both our inventory units and our inventory dollars than we were running pre-pandemic levels.

Not quite as where they are right now, but we do think we can grow the business and operate the business with growth opportunities with less inventory than we were running pre-pandemic.

James Wilen

On the DTG2Go side, you mentioned in Hot Topics growing nicely; obviously, this must be incremental profits for the retailer. They are pleased with their progress?

Deb Merrill

Absolutely. They all continue to implement new initiatives and new things that continue to expand that, but I think it has far exceeded their expectations and ours from when we started doing business back with them, and I think there is more great stuff to come from that partnership and relationship. I think there's a lot of other retailers out there that are realizing the benefits from it as well, and as we mentioned, our overall traditional retail business has grown nicely. That comes from additional partnerships and additional platforms that are picking up these on-demand listings. So, we believe, as we said before, that this really revolutionizes how that can be. As you said, it's free growth for all of them, and I think that channel is the one that just has tremendous opportunities to push more through an on-demand model.

James Wilen

When you talk about gaining new partners in that channel, are you talking about similar situations to where you'd be in-house with a retailer?

Deb Merrill

I think ultimately yes. As a reminder, we started doing business with Hot Topic a couple of years prior to actually putting the facility in theirs. So, I think you're just seeing that same thing happen where people get on board, understand and grow their business, get excited, see the potential of it; and then we just want them to know we are there for them when they are ready to put it and get the secondary benefits of having it right there integrated within their own distribution center. So, it's really a service model to quickly begin with them using our network facilities and then ultimately give them the additional benefits that come with having their own operations in their distribution center.

James Wilen

Got you. Lastly, Deb, on Soffe. Obviously, you have changed the cost structure there, so you'll have better operating margins in that business; but the ability to drive increasing sales is what's going to be the catalyst moving forward. Does the new structure help you do that? Have you seen any difference in what Soffe's top line is looking like or will look like?

Deb Merrill

Yes. Those are great questions. Again, what we are doing is not only setting it up from a cost standpoint but also much more efficient to operate and service our customers, and certainly that in and of itself can drive additional revenue. We spent basically the last year to 15 months integrating and working through our salesforce channel and structure within our sales organization, along with our marketing and merchandising and eCommerce organization. And so, we think now with those already set and then the operational cost improvements in place that we are wrapping up right now and systems that we have, that the combination of those two will allow us to then focus on the sales growth and be able to achieve that as we go through 2022. So, we are most excited about the opportunities, having the eyes on the Soffe brand, and be able to now start building back the revenue in that way.

James Wilen

Excellent. That was a heck of a quarter. Thanks fellas.

Deb Merrill

Thank you.

Operator

I would now like to turn the call back over to the speakers for any additional or closing remarks.

Bob Humphreys

Thank you all for joining us today. We'll look forward to a new call in about three months to update you on our third-quarter results. Thank you very much.

Operator

This concludes today's call. Thank you for your participation.