



Delta Apparel, Inc.

Fiscal 2020 Third Quarter Results Earnings Conference Call

July 30, 2020

Operator

Good afternoon to everyone participating in Delta Apparel's Fiscal 2020 Third Quarter Earnings Conference Call.

Joining us from Management are Bob Humphreys, Chairman and Chief Executive Officer, and Deb Merrill, President of Delta.

I would 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 predictions, and involve risk and uncertainty. Actual results may defer 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 defer materially from those contained in the projections of 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 suggested results will not be realized.

Today's conference is being recorded.

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

Robert W. Humphreys

Good afternoon, and thank you for joining us in our Fiscal 2020 Third Quarter Earnings Call.

I will discuss our business results highlighting the progress and momentum that we have experienced across all of our business units, validating that Delta Apparel is not only prevailing through this difficult period but is on a clear path to returning to profitable growth and providing continued value for all of our stakeholders. I will then turn the call over to our CFO, Deb Merrill, for a more detailed discussion of our financial results, including the strong improvement in our liquidity as the quarter progressed placing Delta Apparel in a solid and flexible financial position entering the final quarter of the year.

In light of the COVID-19, there was no playbook that we or our customers could use to predict how the third quarter would play out. With that said, the momentum we experienced across our businesses as our third

quarter progressed has been extremely encouraging, and has further validated Delta Apparel's strategic advantages.

Our diversification of sales channels, our broad geographic footprint, and the strong emotional connection our Salt Life and Softe brands have with consumers resulted in third quarter sales that exceeded our internal expectations. In fact, as we highlighted in our most recent press release, by final month of the quarter we were tracking at nearly 90% of our prior year sales. This strong momentum has continued through July with orders accelerating and derived from an even broader base of sales channels.

We are clearly seeing incredible digital print demand from our unique DTG2Go model. With COVID-19 related disruptions in supply chain this quarter and the inability for consumers to shop in traditional retail stores, the benefits of our DTG2Go model have become even more apparent in the marketplace. We were able to continue operations, utilizing our network of facilities across the country given our existing customers and new customers a source of expanded revenue during times when needed most.

We are the only digital print supplier in the world that can offer a seamless vertically integrated solution utilizing our proprietary software and internal supply chain to offer a fully decorated in demand product shipped directly to the consumer. This model eliminates non value-added costs and reduces the risk that comes with third party supply chains. We see this as a tremendous competitive advantage.

Our DTG2Go business delivered a record non-holiday performance with growth of 32% in the third quarter that accelerated to nearly 40% growth in the month of June. What is even more exciting is the fact that roughly 40% of orders received in the third quarter were from new customers. We continue to see significant opportunities to further increase our DTG2Go business with existing customers, while also gaining new customers and expanding our channels of distribution.

Our near-term and long-term new business pipeline is healthy with more new customer launches expected in the fourth quarter. We are also seeing expanding adoption of the digital inventory model in the brick and mortar retail channel. To provide for the expanded capacity needed for DTG2Go to meet the rapidly growing demands of our digital print model, we are opening a new integrated digital print and distribution facility in Phoenix, Arizona combining DTG2Go digital print business with Delta Apparel's own supply of garment. The Phoenix facility increases DTG2Go's footprint to aid digital printing locations across the U.S., further expanding its one-day shipping reach to multiple markets, including Phoenix, Tucson, and into portions of Southern California. The facility also gives us the ability to increase our overall capacity with additional equipment to better serve our existing customers and onboard new customers.

Despite the challenges with the pandemic our team has been able to stay on target with the opening of this new facility, and we printed and shipped the first products today from Phoenix. The Phoenix facility joins our network of U.S.-based distribution centres that have generally remained open and operational throughout the third quarter to serve customers across all of our businesses. We are committing to servicing all of our customers with same-day shipping, picking to the piece level, retail-ready packaging and EDI support, and operate the majority of our businesses based on at-once orders. We maintained an inventory position at our U.S. distribution centres to service our customers' needs throughout the quarter, including as orders that accelerated into June and have continued to accelerate during July.

While our non-U.S. manufacturing operations were closed for most of the quarter, by the end of June we had resumed production at all of our manufacturing plants. In accordance with local regulations, we have implemented strict safety protocols, and are operating at a reduced capacity in the near term for the safety of our employees and to align our production levels with anticipated future business. We look forward to ramping up production during our September quarter to support current and anticipated demand.

As I mentioned on our second quarter call, our Delta catalogue business initially experienced an outsized impact from the COVID-19 pandemic. Although the third quarter is our traditionally strong selling season with the Delta catalogue business, we were very pleased to see a steep recovery later in the quarter as the business returned to positive year-over-year growth in June. We are seeing notable strength in the retail

licensing channel as well as good momentum in the screenprinting channel. We believe as the U.S. continues to re-open, we will see other channels pick up, including specialty and promotional products which traditionally have done well post-crisis situation.

Market trends look positive for our catalogue business, as historically through recessionary times, decorated t-shirts have been strong as a modestly priced feel-good product that consumers can purchase during tough times. This, coupled with more consumers dressing in active wear apparel and work from home, should drive solid demand in this business for future quarters.

As a reminder, in January we launched our new distributor model providing our customers with a broader range of product categories, comprising nationally recognized brands and products, including wholesaler exclusives, Original Penguin, Callaway, and Jack Nicklaus lines of golf wear, rounding out our assortment of polos, outerwear, flannels, bags, and accessories. We have successfully added Delta-produced facemasks and coverings, which have quickly become a staple for small and larger businesses alike. We continue to believe our new full-service vertical distributor model leveraging a one-stop shop offering represents a meaningful long-term additional revenue stream.

To further leverage the one-stop offering, we have now merged our Delta catalogue and Softe sales teams to better position Softe for growth. We are seeing very strong demand for the iconic Softe cheer short with a surge in followers and influencers on social media. In addition, Softe web sales jumped 80% in the third quarter, with June results nearly doubled from last year.

In our Fun Tees business, we are a supplier chain partner of choice, offering full-service supply chain management and technology, along with our manufacturing platform which is compliant, flexible in the products and retail-ready services it can provide, and importantly, close to the United States market with nationwide distribution coverage. Over the past few years we have successfully diversified our Fun Tees customer base, including shipping to several new direct to retail programs. Our Fun Tees business was impacted by our El-Salvador plant being closed for the majority of the quarter, although we were able to service several other orders from our Mexican facilities which were operational for several weeks during the quarter. We expect that our diversified customer base within the Fun-Tees business, as well as our new direct to retail programs, will provide a balanced growth strategy for this business overtime.

Throughout the pandemic, our Salt Life crews' e-commerce performance was nothing short of amazing. Salt Life consumers significantly accelerated their engagement through our online channel, driving third quarter web sales growth of about 140%. In late April, we began to reopen our branded stores with all 10 Salt Life stores open, including our recently launched and high-performance store in Destin, Florida. We could not be more pleased with the results that have so far exceeded our expectations. Same-store sales were up 5% since reopening our stores. In addition, our newly opened stores this year generated approximately 50% of additional sales dollars this quarter compared to the prior year. With the reopening of our branded stores, as well as wholesale partner stores later in the quarter, our Salt Life Group June sales turned positive with year-over-year sales growth of 7%. Our strong and broad-based June results have continued into July.

To summarize, while the COVID-19 pandemic impacted most aspects of our business, we acted quickly and managed discreetly as the pandemic unfolded while staying operationally focused on delivering for our current and new customer base. The quarter progressed ahead of our expectations with solid momentum across all of our business segments, giving us confidence that we are back on the path to returning to profitable growth.

I will now turn the discussion over to Deb to review our financial results in more detail.

Deb?

Deborah H. Merrill

Thank you, Bob.

Our third quarter performance was in line with preliminary results we issued a few weeks ago.

Overall, the Company incurred \$23.1 million of non-recurring expenses during the June quarter associated with the impact of the COVID-19 pandemic. These include costs primarily related to the curtailment of our manufacturing operations, incremental costs to right-size production to new forecasted demand, and increased accounts receivable and inventory reserves related to the heightened risk in the market as the U.S. continues its recovery.

These costs, of which approximately \$11 million are non-tax charges, primarily impacted the Delta Group segment. As a reminder, we also took \$1.9 million expenses related to the curtailment of manufacturing operations in our March quarter as the government mandated closures began mid-March. While we believe the most significant cost associated with manufacturing operations are behind us now, we do anticipate approximately \$3 million of additional impact in our fourth quarter related to excess costs as manufacturing output is ramped back up after the curtailment.

Our Third Quarter Fiscal 2020 net sales were \$71.8 million or about 60% of prior year June quarter sales. Our monthly sales performance sequentially accelerated through the third quarter from April sales at 33% of prior year levels to June sales at nearly 90% of prior year levels. During the third quarter, direct to consumer e-commerce sales more than doubled compared to the prior year, led by the sales growth of approximately 104% on the Salt Life site and growth of 80% on the Soffe consumer site.

As Bob mentioned, we were happy to see our catalogue in Salt Life businesses return to growth in June, and most excited about the 30% increase in sales in DTG2Go in the entire quarter, culminating in nearly 40% growth in June.

On a reported basis gross margins were 4.2% compared to gross margins of 20.8% in the prior year third quarter. Adjusted gross margins in our current quarter were 21.6%, and improvement of 80 basis points compared to the prior year, with the improvement attributable to continued efficiencies and process improvement within the Delta Group Segment's integrated vertical manufacturing platform, in addition to margin expansion in the DTG2Go business.

SG&A expenses declined 15.2% to \$15.2 million compared to \$17.9 million in the prior year third quarter, as we took quick and decisive action of where we would like to cut costs given the current environment. Lower variable selling costs associated with lower sales volume also contributed to the decline in the SG&A expenses.

We took a \$1.2 million expense during the current quarter associated with a contingent earnout liability from the 2017 Digital Print acquisition, driven from the growth achieved and expected to continue in the DTG2Go business.

Operating loss was \$21.6 million compared to operating profit of \$8.3 million in the prior year third quarter. Adjusting for the \$23.1 million of non-recurring expenses associated with impact of COVID-19, operating income was \$1.5 million compared to adjusted operating income of \$7 million in the prior year.

Net loss of the quarter was \$17.8 million or \$2.58 per share with an adjusted loss per share of \$0.01. It's encouraging that we were able to receive about break-even profitability with a 40% decline in sales. As well, with the add-back to the \$1.2 million in fair-value adjustment on the contingent earnout, we would have been at \$0.12 earnings per share.

With the continued momentum we are seeing in sales, and assuming no new shocks to the system, we believe that we are well positioned for a profitable fourth quarter.

Now turning to the balance sheet and the impact on cash flows and our liquidity. As we previously communicated, both sales and liquidity improved each month as the quarter progressed, enabling us to end the period in a much stronger position than originally anticipated.

We generated \$32.2 million of operating cash flow and \$31.6 million of free cash flow during the June quarter, and increased our cash on hand and availability under our credit facility at June by nearly 50% compared to March level, ending the quarter with total liquidity of about \$46 million.

Our total net debt including the capital lease financing and net cash on hand as of June was \$127.5 million, which is down approximately \$7 million from September 2019 and down \$21.5 million from a year ago.

Total inventory in June decreased over 11% to \$158 million compared to \$177.8 million a year ago. We serviced customer demand during the quarter with our on-hand inventory position in the U.S. With our manufacturing facilities now open, we are producing products to continue servicing our customers.

Looking ahead, as Bob mentioned, we have seen sequential monthly improvement in trends as the U.S. begins to reopen and are seeing this continue in July. We are cautiously optimistic that we will continue to see improvements through our fourth quarter, returning the business to profitability this quarter.

If anything, this period of time has shown us, it is that our business and our teams are resilient, and I am very proud of our ability to weather this unprecedented period in history.

Let me now turn the call back over to Bob before we open up for questions.

Robert W. Humphreys

Thanks, Deb.

For our nation and our industry, the environment has been a challenging one to navigate.

We have controlled what we can in the business by prudently managing costs while capitalizing on the strengths of our fully integrated and diversified business model, as well as our emotionally connected Salt Life and Softe brands, to gain market share and expand our reach.

Throughout the third quarter, we strengthened our financial position while smartly investing to support our high growth businesses. We are now putting the final touches for our business plan for Fiscal 2021, and are looking forward to starting a new year in just a few weeks. There remains considerable uncertainty on the effect of COVID-19 on the U.S. economy in general and our business specifically over the next several quarters.

We believe that accelerated demand for DTG2Go is here to stay, with partners across many channels of distribution quickly adopting the technology we have to offer. We have additional equipment on order, and looking forward to the growth of our new facility in Phoenix, which further expands the advantage we enjoy in the marketplace. We anticipate adding further capacity as we progress through the year.

Likewise, we are encouraged with the dramatic acceleration and demand on the Salt Life and Softe consumer website. This is one of our most profitable channels of distribution, and we'll continue to focus on the growth of these businesses through stronger engagement with our consumers. We are very encouraged for the demand we are seeing for our undecorated basic active wear business, evidenced by the sales growth we achieved in the June period. This growth has continued through July, and we believe our expanded product offerings and new distribution channels will continue to drive our business.

While our Fun Tees private label business was significantly impacted by the extended shutdown we experienced in our facilities in El-Salvador, we are now operating our plant, and our customers are anxious for us to rebuild our production for their programs.

Additionally, Fun-Tees has been able to win additional programs to be processed in our Mexican and domestic facilities. We expect the overall competitive landscape to change as well, as new customer requirements could negatively impact weaker suppliers. We believe our higher service level combined with our vertical distributor model will serve us well in this disruptive environment.

We are looking forward to our new fiscal year with great anticipation, and believe future negative impacts to the U.S. economy and off-shore manufacturing facilities are minimal, we will soon return to the improving sales and earnings growth we were enjoying just a few quarters ago.

I want to again thank our Board of Directors and employees who have truly been amazing for their patience, hard work and support throughout this difficult period.

Operator, we would now be happy to open up the call for questions.

Operator

Yes, Sir. 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 speaker phone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, that is star, one if you would like to ask a question.

We will take our first question from Dana Telsey of Telsey Advisory Group.

Dana Telsey

Good afternoon, everyone. Nice to see the progress and our businesses improve, even going into July.

As you think under the hood, in terms of the big components in terms of gross margin and SG&A, what do you see as the main drivers of improvement going forward? How much of the SG&A cost reductions stay permanent? What do you see as the ability in terms of pricing to drive gross margins?

Thank you.

Robert W. Humphreys

Dana, that is going to vary a lot obviously across our different business units. I think a good bit of our gross margin improvement that we see coming is sequentially over the next several quarters, obviously reloading our plants and absorbing the cost is a big help; the demand for our digital printing is at or beyond our capacity right now, so obviously we have some synergies with that - that being a higher gross margin business for sales; and our highest gross margin business, at least direct-to-consumer, probably that are sold through our e-commerce site. When you can start having the outsize growth that we've had there, it does help our overall gross margins.

As all companies in different industries, when you go through something like this you learn new things and what is necessary and what is not necessary. We have obviously had a lot less travel, a lot less travel expense, and so I think we will obviously see that continue that way for quarters or perhaps years to come as we all get used to our new work environment.

That combined with higher production going through our facilities over time, whether they're distribution facilities or manufacturing facilities, allows us to further leverage our fixed costs. We are seeing that as we speak, and we expect that to continue if there's no further shocks to the system.

Deb, you got anything to add on the cost side or any of those points?

Deborah H. Merrill

I think you covered that well, Bob. Thanks.

Dana Telsey

Next up, on these new customers: what are you seeing in new customer growth? What are you seeing from existing customers? It seems like the opportunities in new customer growth are extensive.

Robert W. Humphreys

Yes. I will let Deb talk about that on the DTG2Go side and maybe I will talk about the other parts of the business, since she's ultimately familiar with that.

Deborah H. Merrill

Sure, good question on that Dana. We have been saying for a long time that the digital business is growing and the adoption rates are increasing. I would say that through the COVID situation and the disruptions in the marketplace, there have been new ways that more and more consumers are shopping, and obviously the brick-and-mortar retailers have to find new ways to service that business.

It has just really increased the acceleration rate of people looking at a digital model, and we experienced that as we mentioned with all of the new customers that we actually on boarded during the June quarter; that provided a lot of that sales growth, as well as the pipelines of expecting to bring new customers here in the September quarter and the quarters to come.

I think that there are definitely new customers that will be coming onto the digital print model and in new channels on the distribution that we have been talking about, whether that is traditional retailers that decide to go through an on-demand model, whether that is more in the promotional product area or just even with our existing customers, as more and more shopping is happening online.

We are quite excited about the growth opportunities in the business, and as Bob had talked about earlier, that all of our new ways to provide the capacity to service the growth in this business, which we are doing and are right in the middle of and excited about - all of those opportunities.

Robert W. Humphreys

Just to add to that in some other aspects of our businesses.

Our e-commerce business has been growing strongly; retailers see that. But we are also seeing more interest from retailers for different product across our larger geographic regions; that would certainly be true with Salt Life. And we were able to keep most of our distribution running throughout the pandemic - or the first phase of it - and where we maybe would not have our primary one running, we were able to service our customers through other ones.

I think we provided a really high level of service to our customers throughout this period of time, and we are seeing that gaining new business for us, quite frankly. We believe with our customer base they are all looking for higher level of service, quicker reaction times, quicker shipment, and being to be able to react to their needs. And we do that by picking to the piece, by shipping the same day, and by providing other

services, such as EDI. Obviously, we have screen printing, both domestically and offshore, and our domestic screen printing really helped us out in periods of time when offshore screen printing was down when these countries were closed.

I think all in all we did a nice job of serving customers over the last quarter, and we are seeing them come back to the table with larger and more frequent orders - even already.

Dana Telsey

Thank you.

Operator

Once again, that is star, one if you would like to ask any questions.

We will now take a question from Jamie Wilen with Wilen Management.

Jamie Wilen

Hi. Just a few on DTG2GO to start. Did you say beyond Phoenix you're also going to be adding capacity to several of your other centers this year?

Deborah H. Merrill

That is correct. We do have opportunities in our other facilities to put more equipment and increase those outputs. We actually started to do that in the quarter already to service the business that we had, and we will continue to do that. It really will be the Phoenix addition, and expansion at the other existing seven locations.

Jamie Wilen

Would you care to hazard a guess at what type of revenues we can do in the next fiscal year in this business?

Deborah H. Merrill

Well, Jamie, what I would say is, prior to the pandemic, we were talking about this business being a 20% growth business, and what we are seeing is acceleration from that and foresee that continuing.

I would say that, from our outlook, it is going to be a nice strong business as more and more people in the U.S. and worldwide adopt to this model of an on-demand type product space.

Jamie Wilen

Throw the numbers at me: what we did last year, this fiscal year—or what you expect this fiscal year, and I'll do the math from there.

Deborah H. Merrill

Well again, as we had prior reported, we were down in the first two quarters, but this quarter we were up 30%, up 40% in the month of June and continuing on that pace as we head through the fourth quarter. So you take those numbers and put something north of a 20% growth rate on that and that would be what we would expect to see in the business in the future year and years to come.

Jamie Wilen

Okay, and EBITDA margins in the business, given that we are spreading the SG&A around more facilities?

Deborah H. Merrill

Correct, our gross margins with the additional production through there are improving in the business; that, coupled with the higher usage of the Delta product, our operating profit remains in the double-digit range; and our EBITDA profitability is north of that 20% mark that we have seen, and expanding from there.

Jamie Wilen

Fantastic.

Dana asked a question about how much of the decline in SG&A is going to be permanent. You took a couple million off and obviously you can see how you can run your business a little differently, as necessity is the mother of invention. How much of that decline will be permanent?

Deborah H. Merrill

I would say, and do keep in mind, that some of that decline is just the variable selling cost associated with the lower sales level, so that will pick back up in dollars as the top line continues to expand. We did take action, and as Bob mentioned, during these times you can figure out how to do things differently in your business.

There will be some amount that I think will continue; as he mentioned in travel, I think advertising and things like that will continue to be done differently than they might have been done in the past. So we would think that there is some opportunity to continue to keep the cost out of there. At the same time we do run the business in a very lean manner just as part of our culture, and so there is not a lot of added areas where we can just continually have the costs out as the business returns back to a pre-COVID level.

Jamie Wilen

Obviously, the pandemic created a bunch of difficulties for everybody, and it does create some opportunities to gain new customers. Are any of your competitors having difficulty and been forced to move accounts or go fully out of business?

Robert W. Humphreys

I think yet to be seen on the overall effect of that; certainly, in the suppliers in the private label arena that are not as well capitalized as the public companies in this space, that had probably more difficulty. They don't have the diversity of customers and distribution channels as we do. We think even the pond of the big players, our diversity of customer base is a real asset that we have.

There is changing currents out there about service level and go-to-market strategies and all those things. We will just have to see how that plays out over the next several quarters, but given a solid economy to work from, we are confident of our position and our customer base and how that has evolved over time and having some new high-tech businesses really driving our growth in these consumer sites and DTG2Go.

Jamie Wilen

Lastly, Hanes had a big number for what they did in protective clothing in the quarter, which is really surprising. I know you were doing some of that business, but is that going to be a focus or just minor league item for you.

Robert W. Humphreys

Yes, we won't have a big focus on that going forward. Like you said, they did a really nice job on that. I don't think we are positioned to do that. There's some good, large scale players in that industry that I am sure will gear up. A lot of it's branded, so I think we will stay focused on what we think we know how to do better and stay with that.

Jamie Wilen

One last thing. Industry pricing: with no one able to produce for most of the quarter and now production coming back on stream, what does industry pricing look like now?

Robert W. Humphreys

I would say solid, right now. There are people out there with different promotions going on for undecorated tees. What we are seeing is demand is strong and supply is relatively high, and that's normally a combination where you have solid price.

Jamie Wilen

Great. Thanks. Nice job.

Robert W. Humphreys

Thank you.

Deborah H. Merrill

Thank you.

Operator

As a reminder, that is star, one if you would like to ask a question. We will pause for a just a minute.

It appears that there are no further telephone questions. I would like to turn the call over to our presenters for any additional or closing remarks.

Robert W. Humphreys

Thank you all very much for joining us today.

We will continue to be probably more proactive to keep the market informed of our results as the quarter goes on, since we are all operating in unusual circumstances. We feel like we need to keep people informed, so we will do that.

We look forward to having another conference call in just over three months.

Thank you very much.

Operator

Once again, that does conclude today's conference, and we thank you all for your participation. You may now disconnect.