Delta Apparel, Inc.
First Quarter Fiscal 2012 Earnings
October 27, 2011

Operator: Please Stand by.

Good Afternoon, and welcome to the Delta Apparel, Incorporated, Delta Apparel Fiscal 2012 First Quarter Earnings Conference Call. At this time, all participants have been placed in a listen-only mode. The floor will be open to questions following the presentation. As a reminder, today's conference is being recorded.

It is now my pleasure to turn the conference over to your host, Brendon Frey of ICR. Please go ahead, sir.

Brendon Frey: Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal 2012 First Quarter Earnings Conference 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 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 than those contained in the projections or forward-looking statements.

With that out of the way, I'll now turn the call over to Bob Humphreys. Bob, please go ahead.

Bob Humphreys: Thanks Brendon. Good afternoon and welcome to the Delta Apparel Conference Call. I'd like to start our call with a few highlights from our results for the first quarter of Fiscal 2012, then Deb will give you some more details on our financials, and we will discuss our outlook and objectives for the rest of the year. Overall, we're pleased with our results for the first quarter and feel we have the gotten the year off to a good start. We achieved sales growth of over 14%, all realized through organic gains. More importantly, each of our operating divisions grew compared to last year's first quarter, and each of them had all time record first quarter revenue. The brands and licenses that we have acquired over the last several years continue to grow and allow us a platform to ship higher value product to our retail partners and directly to consumers through our e-commerce sites. Our higher revenue combined with the elimination of some non-recurring admin and advertising expense resulted in record first quarter earnings of $0.50 per share, up 163% from the prior year.

At this time, I'm going to ask Deb to review our first quarter financials with you and then I'll update you on some of our key objectives for Fiscal Year 2012.

Deborah Merrill: Thank you Bob, and good afternoon. In our first quarter of Fiscal '12, net sales were $123.5 million, up $15.6 million over the prior year first quarter. Each of our business units contributed to the overall 14.5% organic sales growth. The basic segment revenue increased 6.6% driven by higher average selling prices, offset partially by lower unit sales, down about 9.5%. The branded segment revenue was up 21.5%. Sales of vintage-inspired tees through our Junkfood business and Salt Life products drove the gross in the branded segment with Junkfood sales up 53% and To The Game sales up 36%. Gross margins improved 130 basis points from a year ago to 25.3% in this year's first quarter. Each of our segments expanded gross margins, with the higher mix of branded sales also contributing to the overall margin improvement.

SG&A expenses were 19.9% of sales compared to 21.2% of sales in the prior year first quarter. As a reminder, the prior year included additional expenses associated with brand marketing campaigns, the start up of Art Gun, and the acquisition of The Cotton Exchange. In addition, we are leveraging our fixed general and administrative costs that should drive continued improvement in SG&A costs as a percentage of sales in future quarters. Our effective tax rate was 24% in the first quarter, compared to 23.6% for the 2011 Fiscal Year. Net income increased 167.7% to 4.4 million or $0.50 per diluted share, compared to net income of 1.6 million or $0.19 per share in the prior year first quarter.

On the balance sheet, receivables increased from the prior year September by $12.3 million, driven primarily from the higher sales. Day sales outstanding were 50 at September, basically in line with a year ago at 49 days. Inventory has increased $27.1 million from June and is $49.4 million higher than a year ago September. Higher priced cotton drove a little more than half of the increase in inventory from a year ago, with the remaining resulting from higher units to support new programs. In addition, higher production levels coming from our manufacturing platform contributed to the increase.

Capital spending was $1.3 million during the quarter, and our depreciation and amortization, including non-cash compensation, was $2.5 million. We continued our stock repurchases during the first quarter using $1.5 million to buy back 93,000 shares at an average of $15.73 per share. At quarter end, we had 7 million remaining authorized for repurchases. As such, we have the flexibility to continue our share repurchases if we believe the market is undervaluing our stock and believe we can pursue expanded share repurchases without sacrificing any further growth plans. The debt at September was $105.3 million compared to $76.7 million a year ago. Our capital expenditures and share repurchases, coupled with our higher working capital needs, drove the increase in debt from a year ago.

We had a strong start to Fiscal 2012 with the first quarter but are now in our historically lowest volume quarter. Based on the momentum we are seeing with our new products, we expect sales to continue to grow in the upper single digit range for the upcoming quarters. Our highest cost cotton is expected to flow through our cost of sales in the December and March quarters. Based on stable selling prices, our gross margins would be expected to decline about 400 basis points from the prior year in these two quarters. After we are through our higher priced cotton, we would then expect our fourth quarter margins to return to levels more in line with our first quarter. We believe we will offset some of the margin decline with lower selling general and administrative costs in quarter two and quarter three. We expect our earnings will be less than prior year in these quarters but would anticipate our June quarter to return to earnings growth resulting in the full year earnings growth over the prior year. Although we are facing these short term challenges, we believe the strength of our brands and products will allow us to continue to grow sales and earnings for the full 2012 Fiscal Year and into the future.

I'm now going to turn the call back over to Bob to give you further information regarding our outlook for Fiscal '12.

Bob Humphreys: Thanks Deb. Fiscal 2011 was a record sales and earnings year for us, and now with our first quarter of Fiscal 2012 behind us, we have trailing 12-month sales of $491 million and trailing 12-month earnings of $2.29 per share. While we are encouraged with these results, we continue to operate in a weak economy and are still managing through the effects of higher energy and transportation costs. The volatility in cotton and synthetic fiber costs is providing additional challenges as we plan and forecast our business. Our basic segments continued to build market share during the first quarter, and we expect to maintain this trend as Fiscal 2012 unfolds.

Demand is solid for our private label business, particularly in areas where we can provide the decorating and retail packaging. We are gaining new customers in this market due to our ability to offer excellent levels of service and quality to these major brands. Demand for undecorated tees remains weak and inventories have increased significantly at the distributor level. Pricing has weakened in this market since summer despite higher cost raw material flowing through cost of sales for much of the industry. We expect this weakness will continue until spring when excess inventory levels can be worked through in an orderly manner.

While raw material costs are high, we are making progress on the manufacturing front. Our manufacturing facilities are achieving further efficiency gains and improvements in material utilization. We have been able to run our plants full to this point and currently expect to do so for the remainder of the fiscal year. If we see further weakening of demand, we may take additional downtime during the holiday shutdown to manage overall inventory levels.

Current indicators lead us to believe that our branded segment will continue its growth trends as we navigate through the rest of the year. We are seeing strong demand for our products from the sporting goods, outdoor, military, and specialty retail channels. This is offsetting some weakness in the department store channel and the boutique business, which continues to be hurt by the difficult economy. We anticipate revenue growth will be strong at The Game and Junkfood through this year driven by our Salt Life business at The Game and by the unique creative style at Junkfood. The Soffe business is growing at a slower rate but has a number of new product offerings which could accelerate this growth in the future. Soffe will have additional doors with two customers this spring, and retailers continue to promote our merchandise through increased signage and enhanced merchandising displays of our Soffe branded product.

One of our primary goals for Fiscal 2012 is to work through the unprecedented volatility in raw material and energy cost while maintaining our trend of sales and earnings growth. Of course, this started impacting us last fiscal year and will certainly be dealing with these unusual circumstances through the remainder of this fiscal year. So far we think our raw material procurement and pricing strategies have served us well given the challenges we have faced. As Deb discussed, we anticipate that our highest cost raw materials will flow through our cost of sales in the second and third quarter and then we should start seeing a slight easing in our fourth quarter. The good news for us is that our sales results are allowing us to consume our higher priced cotton in an orderly manner. We have dramatically reduced our forward commitment of cotton and will watch the overall market demand for cotton in our particular products carefully as we make future cotton commitments. While we are well positioned to take advantage of a weakening cotton market, I would caution you to remember it can easily be six to nine months before these future commitments flow through cost of sales.

We remain concerned about the retail climate for apparel and the U.S. economy in general. For every step forward on the apparel demand or the economy, we seem to shortly see a step backwards. Despite this, the creative talent in Delta Apparel continues to produce products that resonate with consumers. This has led us to eight consecutive years of revenue growth. We expect Fiscal 2012 to mark our ninth consecutive year of revenue growth. Heightened risk factors will remain with us as we manage our way through the balance of Fiscal 2012. We have taken these risks into consideration as we updated our expectations for this year, but it's impossible to predict the ultimate impact they may have on our business. We still expect total revenue for Delta Apparel to be in the range of 500 million to $520 million for the year. Our current forecast for diluted earnings per share is $2 to $2.15 for the fiscal year.

Operator, at this time, I'd like to open the lines for questions.

Operator: Thank you. The question and answer session will be conducted electronically. To signal for a question, please press star then one on your telephone keypad. Again, star one to signal for a question. A reminder, if are using a speaker phone then please make sure you mute function is turned off to allow your signal to reach our equipment.

We will pause for just a moment to assemble the roster.

And we'll take our first question today from David Griffith, Roth Capital Partners.

David Griffith: Hey, good afternoon.

Deborah Merrill: Good afternoon.

David Griffith: Could you touch a little bit more on some of the success you're seeing in Junkfood and To The Game. I know, you know Junkfood when I visited the booth, was really hitting its stride, but it sounds like you see that continuing through the year.

Bob Humphreys: Yes. You know, we continue to garner new license agreements, sometimes additional distribution rights with the agreements we have. We've really got a strong merchandising and art and graphics team at Junkfood right now that is resonating at retails, so we've been able to leverage some of the businesses we've had and expand there. We've been approached by other retailers who like that success and have asked to participate. We've got several tests we'll be rolling out here in the next, just few months on the some of that. So we do feel good about the direction and momentum that Junkfood has. And then The Game's growth, not exclusively but primarily, is being driven by our new Salt Life license that we took on last year and that is, you know, meeting or exceeding our expectations. It's been rolled out still along the coastal regions of, the East Cost and Florida and now the Gulf Coast, but mostly through boutiques and small specialty chains but it's getting more and more adoption by regional and national retailers, and they'll be rolling out those programs this spring. So we feel good about both of those programs.

David Griffith: Very good. Bob, you mentioned on the basic side that you're gaining share, and—make sure I heard this right—kind of on the decorated side but that the undecorated remains a little bit tough which, you know, we are seeing a little of that in the pricing environment at this point. Did I get that right?

Bob Humphreys: Yes. Now, you know, there is a lot of different ways to do the math on market share, particularly in that undecorated side.

David Griffith: Sure.

Bob Humphreys: I think certainly through the quarter we just ended, we gained share there as well and, you know, kind of how we see the market, we would anticipate doing that, you know, through the rest of this fiscal year. There is, like always, there's some winners and losers out there in that share, particularly as measured at the distributor level, but you have to remember there's a lot of that product that's not sold through distributors, us being a prime example of that.

David Griffith: Sure. Now you talked about the potential to take some downtime on the manufacturing side over the holidays. Is that incorporated in the gross margin discussion or, or would gross margin be hurt even further if you had to do that.

Bob Humphreys: Yes, it depends on how much we took. You know, so far we've actually taken a little bit less than what we have built in for holidays and so we could still take that over the Christmas holiday with no impact. If we had to take additional weeks down, then it would ultimately have an impact.

David Griffith: Gotcha. And then Deb, on the working capital side, it sounds like that part of that drawdown was just to fund working capital, but, kind of, how do you see that playing out over the next couple quarters as, you know, hopefully cotton costs come—you are able to buy cotton yarn cheaper.

Deborah Merrill: Correct. And, and I think as you go through, I mean we are entering what would be historically our increased working capital requirement as we go through the December quarter and into the early part of the March quarter. And so, you know, overall that is, that trend is going to continue. So you'll do just like historically and see those debt levels probably continue to increase into the December quarter, which is typically our highest quarter debt level and then that should start coming down in March. And that's over those two periods where we would be flushing through the higher cost cotton and then come back down in the June quarter, where now you've flushed through your higher cost and are replacing that with a lower cost cotton. So, the trend is going to continue, kind of, in the historical manner, but what you should expect to see is that June quarter decrease potentially more dramatic than normally happens in the June quarter because you're going to see the impact of, now the inventory has the lower cost cotton in it.

David Griffith: Right, right. Okay great. Well thanks and good luck.

Deborah Merrill: Thank you.

Operator: Moving on to James Fronda with Sidoti & Company.

James Fronda: Hey guys, how are you?

Deborah Merrill: Good.

James Fronda: Great quarter. Most of my questions are pretty much answered already. I guess, could you just give us—give me a sense, I guess, from your personal point of view in more details how the retail sector is looking in general? I mean, do things seem like they're picking up?

Bob Humphreys: You know, we've seen some pickup really just in the last week or so as we started seeing some cooler weather out there. So I think for merchandise in stores the weather is now getting more correct. I did see what looked like some odd numbers where actually apparel prices at retail declined, I think, for the September period a couple percent, which is odd considering the much higher cost raw materials that's rolling through the marketplace right now. So again still really mixed signals.

James Fronda: Right.

Bob Humphreys: We see some stuff that we're encouraged by and, you know, before you get over that then you see something that makes you really think about—

James Fronda: Right.

Bob Humphreys: —what the consumer's doing and how this is all going to play out but, you know, I'd say so far so good.

James Fronda: Okay. And I guess the tax rate going forward, I mean, could (inaudible) for modeling purposes say at around 24%?

Deborah Merrill: That's what I would (inaudible), yes.

James Fronda: All right, thank you. Okay thanks guys.

Operator: And as a reminder, the signal for a question, star and one on your telephone keypad. We'll pause for just a moment.

And next, we'll hear from John Kurti with Singular Investment Research.

John Kurti: Good afternoon.

Deborah Merrill: Good afternoon.

Bob Humphreys: Hi John.

John Kurti: Question on your inventory levels year over year. Can you kind of give us an indication what it is in units versus dollars, given the dollar increase of $15 million, kind of a percentage gain in units or decrease in units.

Deborah Merrill: And I don't have the exact percentage increase in the units of the dollars, you know, as I mentioned is probably about half of it that is increased units—sorry, is not related to the increase in the cotton cost. Some of that is related to the new programs we have now that we didn't have, for example, the Salt Life, the inventor associated with the Salt Life collection. And then the remainder of that is related to some higher units. Those higher units are primarily in our basics business, and as mentioned those come in from some of the reduced unit sales but more so from the higher production levels that we're doing as we increase production in our manufacturing facilities.

John Kurti: So those are basically the undecorated tees awaiting—

Deborah Merrill: Correct.

John Kurti: Okay.

Bob Humphreys: And I would just add to that, if you went back a year ago, we were still under inventoried in that marketplace and, you know, basically shipping everything we could kind of get our hands on from a practical standpoint and keep inventories balanced. So we may be slightly over-inventoried today where we'd like to be in units but it's not significant.

John Kurti: Okay. And then with respect to the basic segment, pretty good increase in the average selling prices. Units were down about 10% and 10%—9.5% or so. Given the fact that you're still going to have to flush through on some higher priced cotton, and you mentioned you are seeing some weakness on the undecorated side, is it kind of reasonable to expect unit volumes over the next quarter or two to be down in that range of 8 to 10% on the basic side offset by higher prices?

Bob Humphreys: That would be, you know, that's what we have modeled is just that. We actually, if you just looked at how it flowed through, July and August were weaker months, we were actually ahead on units in September. I think some of that was driven by anticipated price increases, and you had customers buying more, you know, in the late May and June timeframe. Those price increases didn't materialize. And so now I think it's a hand-to-mouth situation. People are buying what they need; not concerned about further price increases probably at this state of the game, and it is the seasonal weakest time of year. So, you know, it's just a slower period time there, and we'll just have to see how it all unfolds.

John Kurti: Given that you're going to be flushing through this higher priced cotton, you're gross margins are going to be—get—as you indicated, are you going to be able to get a little bit of price increase through?

Bob Humphreys: You know, I don't know. If you had asked me six months ago, I would have said that I thought prices would be a bit higher now than what they were then. Actually, prices have decreased here in the last 90 days in that marketplace, so it's clearly a supply and demand and a commodity piece of our business. So we'll have to remain competitive.

John Kurti: And then on the branded segment, could you talk about unit volumes in the first quarter as a component of the total—

Bob Humphreys: Yes.

John Kurti: sales increase?

Bob Humphreys: Yes, I can. I'd caution you, you know, so much of that can depend on if we're selling it decorated or non-decorated or it's got two prints on it or one print on it but units were up and Soffe units were up at Junkfood and units were up pretty dramatically at The Game. Now again, that's that new piece of business driven by Salt Life.

John Kurti: Right. Okay. All right, thank you.

Bob Humphreys: Okay.

Operator: And now as a reminder, star one on your telephone keypad to signal for a question.

Next, we'll hear from Jamie Wilen at Wilen Management.

Jamie Wilen: Hi fellas. Great quarter.

Bob Humphreys: Hi Jamie.

Jamie Wilen: Hi there. I've got the same questions everybody else did about inventory but as we get to year-end, and we flow through the cotton, got your—obviously your business is growing so the unit volume of cotton of inventory you're going to have is higher but the pricing is lower. Where would you like to be dollar-wise with your inventory as we come to the end of this fiscal year?

Deborah Merrill: You know, I think what you're going to see is., you're going to see, as you mentioned, the, kind of, price per unit on that inventory is going to down, and we would expect that to go down more dramatically than historically between our March quarter and our June quarter. But that being said, we are going to have increased units. So I would say overall we anticipate being lower than the June of last fiscal year but there is going to be some amount of just higher units and higher inventory needs but continue to support, what would be a larger business. So I would say in total dollars I would expect it to be lower than it was the end of last fiscal year but not, not as low as we had been in prior years before the cotton increase just because we do need the units to support that—the ongoing business growth.

Jamie Wilen: Okay, so at least $25 million less than the minimum, probably more.

Bob Humphreys: From where we are now.

Deborah Merrill: Now, yes.

Male Speaker: (cross talking).

Jamie Wilen: As, as you move forward with Salt Life now that you—I assume you've taken over full production and you're manufacturing everything yourselves. What kind of sales volumes were they doing, what do you expect to do in that business, and how would you describe the margins there relative to Junkfood or other brands of merchandise?

Bob Humphreys: Okay, I think if you look at for this fiscal year, you know, I think we'll grow the business a little over 100% from where it was when we took it over. You know, I don't think we've put out specific dollar amounts but, you know, it will be in the mid-teens in millions of dollars for this fiscal year, and we would anticipate strong growth for the next couple years. We are manufacturing and designing and creating the art all in-house, and it would—it's going to generate operating margins similar to Junkfood.

Jamie Wilen: Most of the volume this fiscal year is still going to be in the southeast?

Bob Humphreys: Yes. And yes, we're—and really prior to that it was almost exclusively in Florida, you know, when we took it over. I'd say something over 90% of it was in Florida, so it's just starting to get out and so that—our definition of the southeast has expanded greatly from Florida to up the east coast. It is doing well in midland, you know, areas or cities off the cost in coastal states and it's in Texas and again we'll be, particularly starting in February, delivering more and more product to retailers who have a footprint much beyond just the coastal areas.

Jamie Wilen: Right. And then lastly, you know the acquisitions you've made in the previous year with Art Gun and Cotton Exchange you had some investment spending that happened in the first quarter of last year that's now behind us, but are either of those contributing now on the bottom line, now that we're through the transitional period?

Bob Humphreys: We expect Art Gun to be slightly profitable this year. We got a big second quarter underway and that'll drive a big part of that, so we'll have to see where we're going there but certainly our major investment in losses, we believe, is behind us.

Jamie Wilen: Okay, and Cotton Exchange, is that on track from where—what your expectations were when you purchased it, and then—

Bob Humphreys: Yes. You know, I would say on the revenue side is a little bit less than our expectations when we purchased it, but we've made good progress on getting it integrated and, and it's contributing, and we think it'll be a good part of our future success.

Jamie Wilen: Okay, and how is the acquisition hunt going out there?

Bob Humphreys: Well, you know, the kind of good news for us right now is we've really got a lot of excitement on the stuff that we've already either acquired or licensed and what have you, and a lot of growth opportunities obviously. I think the 15% organic growth in this quarter speaks to itself. There's a lot of internal opportunities right now that we're probably more focused on so, if the right thing that we think is really good for our company and shareholders comes along, we'll certainly take a look at it. When Deb redid our loan agreement, it's got a lot of previsions in there for us to do acquisitions in an easy and orderly way but right now, we, we really like our organic growth opportunities.

Jamie Wilen: Fantastic. Great job. Thanks, fellas.

Deborah Merrill: Thanks.

Operator: And a final opportunity. Star one on your telephone keypad to signal for a question, and we'll pause for just a moment.

And, we'll take a follow-up question from John Kurti with Singular Investment Research.

John Kurti: Yes, so I was wondering if you could provide any additional update on the underwear hat license and the Louisville Slugger license that you had signed earlier.

Bob Humphreys: Yes, on the Under Armour side, we're shipping product now, so that's, you know, underway. It's not going to be a huge business for us out of the gate but this will be on unfilled, high-end product, and we'll have that at—the versions of that at retail as well. And then we did conclude our Louisville Slugger license agreement. We have the first line designed and approved, and we'll be taking that to market very shortly. And so, again, it's not really producing revenue for us yet but we see that as a future driver of growth.

John Kurti: And what type of product under the Louisville Slugger license?

Bob Humphreys: Yes, additionally it'll be mostly tees, you know, and some fleece items, and we've got really very broad rights, you know, in other areas and other types of products, and we'll just work through that based on the attraction we get at retail.

John Kurti: Okay. Thank you very much.

Bob Humphreys: Okay.

Operator: I show no further questions at this time. I would like to turn this conference back over to the speakers for any additional or closing comments.

Bob Humphreys: Okay, thanks operator. Thanks for joining call today, and we look forward to giving you more updates as the year unfolds. Thanks so much.

Operator: That does conclude today's conference. Thank you all for joining us.