Delta Apparel, Inc.

Second Quarter Fiscal Year 2014 Results Conference Call

April 24, 2014

Operator: Thank you and good afternoon to everyone participating in the Delta Apparel, Inc. Second Quarter Fiscal Year 2014 Results 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.

Please note that any forward-looking statements are made only as of today and the Company does not commit to update or revise these statements, even if it becomes apparent that any projected results will not be realized.

I'll now turn the call over to Delta's 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 thank you all to everyone joining us on the call this afternoon.

Delta Apparel's fiscal 2014 second quarter net sales were 114.5 million compared to 120.1 million for the comparable 2013 period. The 5% sales decline was due primarily to unseasonably cold and snowy weather throughout the country and a weak retail environment.

Net sales for our Basic segment were 64.1 million in the second quarter, a 5% decrease from 67.4 million in the prior year period. Private-label sales were lower than the prior year quarter by 17%, as some customers review shipments because of slowness at retail and changes in product strategy.

Catalog shipments increased 7% in units, but were offset by the promotional activity in the marketplace that drove average selling prices down about 5%. Sales in our branded business were hurt by the overall slowness at retail with sales coming in at 50.3 million, down 4% from the prior year March quarter.

While the decline in sales was disappointing, there are some positives I'd like to point out. First, strong growth continued at Salt Life and Art Gun, with Salt Life sales up 28% and Art Gun up 34% for the quarter. Although sales were still down at Soffe, we seem to be gaining traction. The new Soffe branded product offering launched for spring, appear to be resonating well with juniors as evidenced by solid sellthrough information received from retailers.

Junk Food continues to grow its branded presence in boutiques and specialty retailers who love the garment styling and creative graphics that Junk Food offers. The Game apparel and headwear lines are also winning new programs as college bookstores begin placing orders for the new school year.

On a consolidated basis, we reduced SG&A as a percentage of sales to 18.6% compared to 19.7% in the prior year period. Over the last several quarters we have taken steps to better leverage our back office function and reduce overhead expenses in our business. You can see the impact of these measures in the 110 basis point improvement in SG&A in our second quarter.

Partially offsetting these SG&A reductions were higher legal costs associated with ongoing litigation and regulatory matters which ran about 30 basis points during the first half of the year. As we mentioned in our previous conference call, we anticipate higher than normal legal costs as these matters are worked through.

Operating profit for 2014 March quarter was 834,000, down from 2.6 million in the prior year quarter. We were pleased that operating margins in the Branded segment improved 160 basis points from the prior March quarter, but this improvement was more than offset by depressed margins in the Basic segment from lower selling prices on basic undecorated tees, coupled with higher raw material cost. This resulted in a net loss for the 2014 second quarter of 763,000 or $0.10 per diluted share, compared with net income for the prior-year quarter of 1.6 million or $0.19 per diluted share.

Capital spending was 1.6 million during the quarter and 5.6 million year-to-date. Our cap ex primarily related to our manufacturing expansion, as well as ongoing enhancements to our information technology infrastructure. Depreciation and amortization, including non-cash comps was 2.6 million for the quarter and 5.1 million for the first six months.

We expect cap ex to be in the 12 to 13 million range during fiscal 2014 and G&A to be to be about 10 million. Total debt at March, which is typically our seasonally highest debt was 143.8 million. As we progress through the back half of the fiscal year, we intend to use our cash flow to pay down debt and we expect debt to decrease approximately 15 million by September.

As a reminder, we have a $9 million payment on the seller financing from the Salt Life acquisition that's due on September 31st, which is the reason for the higher short-term debt on the balance sheet.

During the quarter, we repurchased 12,000 shares of Delta Apparel stocks for $180,000 at an average price of $14.82 per share. There still remains authorization of 5.7 million for our share repurchase program. We believe periodic repurchases are sound investment opportunities, but our stock is trading at a price that's below what we believe is its intrinsic value and we will continue to evaluate share repurchases as we progress through fiscal 2014.

Last quarter, we deferred updating guidance until we had a better idea of how the year was shaping up. We now have enough information to provide updated guidance based on the conditions we see as of today. We believe the second half of 2014 will show sales growth in the mid-single-digits over the prior year, bringing sales to a range of 480 to 490 million for the year. This compares to sales of 483 million for the prior 12-month period.

With the lower sales level we may not be able to reap all of the expected benefits from our manufacturing expansion in the second half of the year. This, coupled with a higher input costs on undecorated tees that we've not yet been able to recoup through higher selling prices, lowers our expected profitability even further than that caused by the miss on sales. As such, we now expect earnings to be in the range of $0.80 to $0.90 per diluted share.

This is obviously not the performance we hoped to achieve in fiscal 2014. We do, however, want to be realistic in the updated guidance we provide at this time in light of the current market conditions. Keep in mind that we are only midway through our fiscal year and a lot of things can change, hopefully for the positive.

We have only recently seen spring weather across the southern region of the country. Pent-up demand from the harsh weather over the last several months could drive sales and improved operating results in both our Branded and Basic segments. Rest assured that we will continue to focus on our cost savings and efficiency programs.

As both Executives and shareholders, Bob and I are not at all happy with the results of the business to-date and are taking necessary action intended to enhance profitability now without relying solely on market conditions for apparel to strengthen.

I'll turn the call over to—now to Bob Humphreys, our Chairman and CEO, to provide more details on our business and plans for the future.

Robert Humphreys: Thanks, Deb, and thank you all for being on the call with us. Delta's disappointing second quarter may be summed up by saying that all the marketplace risk that we had warned about in last quarter's earnings call came to pass in the second quarter.

Although the demand for undecorated tees appeared to be picking up late in the first quarter, it deteriorated again as we went into the spring selling season. Top (ph) demand also caused deferred callouts and slower replacement orders of our Branded products.

Some of the weakness can certainly be attributed to the unseasonable weather that prevailed across the country, but the continuing sluggish economy and its negative effect on consumer purchasing power also played a big part. The promotional activity that was occurring in the undecorated tee-shirt market hampered our ability to pass along any of the higher cotton and other input costs through price increases. In fact, selling prices in the undecorated marketplace decreased about three to 5% net the discounting activity. The lower than expected volumes also decreased the anticipated incremental production we would be able to run through our facilities, reducing our ability to use expanded manufacturing capacity in Honduras to leverage against fixed cost and reduce overall product cost.

Our manufacturing cost in our US textile factory continued to be high due to having older, less efficient equipment in the facility, as well as higher US labor and overhead cost.

In addition, during the March quarter, our costs were negatively impacted due to having to shut the facility down multiple times due to the snow and ice that blanketed the Southeast. These higher costs will impact our back half results as well.

As a reminder, our US textile facility provides several key things for us. First, it supports our Mexico sewing operations, taking advantage of duty-free sewing through the NAFTA treaty. These goods can then be sold in Canada through our recently opened third-party operated distribution facility. Having textile and sewing operations in more than one region provides a diversified manufacturing platform that is less exposed to natural disasters and political risk.

Finally, the US textile facility also supports our Made in the USA programs which are gaining traction with the Game business through our American threads collegiate line. That being said, we continue to evaluate the different opportunities we have to lower our overall product cost with more efficient and lower cost manufacturing operations.

Despite the disappointing financial results, there were many positive things in the second quarter that should bode well for the remainder of the year. We have been improving service levels to the private label and activewear marketplace and this has resulted in our winning additional decorated tee programs.

So far this year, we have shipped nearly $5 million in decorated catalog tees to customers previously purchasing undecorated tees. We intend to build on that success in the upcoming quarters. We've also seen interest from several potential new private label customers who have recognized the world-class service levels we can provide to support their growth. Our recently expanded manufacturing and spring printing capabilities gives us the capacity to continue growing these decorated and undecorated programs in our Basic segment.

We recently opened a third-party operated distribution facility in Dallas, Texas to better service a large market for undecorated tees with shorter shipping times and reduced freight costs. We have also added new upscale fleece products through our line that we expect will attract new customers and help reduce some of the seasonality in this segment of our business.

On the Branded side, Art Gun continues its strong growth with the sales increase of 34% in the March quarter. Art Gun is being recognized by e-commerce retailers who want the flexibility and no risk inventory model that Art Gun Service platform provides. During its peak periods, Art Gun is experiencing demand that is actually outpacing its capacity, so we're currently evaluating expansion opportunities to ensure that we can service our current and future customers to continue Art Guns' consistently rapid growth.

Soffe, while still in a negative sales comp for the quarter, is showing considerable improvement. It appears our new Soffe line that we launched for spring is being well-received by the junior consumer, as evidenced by strong sellthrough numbers in retail despite the weather conditions.

Slowness in the sporting Good channel grow the decrease in sales at Soffe, so this is a channel that's generally been growing for us and we believe we'll see this turn in future quarters. We expect revenue growth at Soffe in the back half of the year, along with a return to profitability.

I'm pleased to say that during the March quarter our landlord was able to work through several construction and permitting issues the caused delays in the scheduled opening of Junk Food's long-awaited flagship retail store on Abbot Kinney Boulevard in Venice, California.

I'm also happy to tell you that other than the delay in retail revenue stream, we incurred no out-of-pocket expense due to these delays since they were not of our making or within our control. With these major issues behind us, we anticipate opening the first Junk Food store in May of this year.

Salt Life continues to exceed our expectations with its strong topline growth and its profitability. Salt Life sales increased 28% during the March quarter, and sales were up 29% for the first half of this year. Since the onset of our involvement with Salt Life, we have expanded its geographic base from being primarily in Florida to now being in about 2,300 retail doors, stretching primarily from Texas, up the East Coast, as well as in the Caribbean. We continue to expand the product offerings in lifestyle and performance products to reach across consumer bases in fish, diet, board, and beach. This not only broadens the retail doors for Salt Life products, but should help expand the average sales per door.

We saw this in the March quarter, while we were able to increase the Salt Life presence in retail doors and increase the average shipping into existing doors by about 20%. Based on what we are experiencing, we expect that Salt Life products should exceed $30 million in sales in calendar year 2014.

To bolster brand awareness for Salt Life, we have just initiated our first consumer advertising runs in several key publications, including CIRCA Magazine which featured paddleboard professional, Colin McPhillips. We're also sponsoring several paddleboard competitions, principally on the West Coast, to continue our grassroots marketing in that region; and of course, you can't miss the Salt Life decals that you see on cars all around the country. What better marketing than that?

In addition to the brand awareness campaigns we have initiated, we are extremely excited about our Salt Life restaurant licensee's grand opening of the new Salt Life Food Shack restaurant in St. Augustine Beach this week. This location is perfect for experiencing the Salt Life across the street from the St. Augustine Beach pier with a rooftop deck to watch a sunset on one side and the Atlantic Ocean on the other. You may have seen this restaurant featured on the hit television show Tanked on Animal Planet a couple of weeks ago. They installed a 1,300 gallon wave-inspired saltwater fish tank that can be enjoyed from both inside the restaurant, as well as on the bottom outside deck.

With three restaurants now opened, we expect over 0.5 million consumers annually to experience Salt Life through the Food Shack concept, driving significant consumer awareness of our brand.

There are many opportunities for expansion in the Salt Life and we believe it has the opportunity to continue its current growth path for years to come. We're currently generating very strong operating profits on Salt Life and anticipate these to continue for the foreseeable future.

In summary, while we're not at all pleased with our second quarter financial performance, I believe Delta Apparel is in an excellent position for growth as economic conditions improve and consumer buying is renewed. In the meantime, we're keeping our cost in line and introducing new products the consumer wants with the efficiency service and price points that our customers need.

Now, Deb and I'll be glad to answer any question you have. Amber, you can open up the phone lines for questions.

Operator: Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, press star, one to ask a question. We'll go first to Jared Schramm with ROTH Capital Partners.

Jared Schramm: Hi. Thanks for taking my questions.

Deborah Merrill: Good afternoon.

Jared Schramm: Looking at the SG&A, you've done some work in a hundred basis point decline year-over-year. How much more is left, in your mind, to cut out in the SG&A side?

Deborah Merrill: You know, we certainly still have some things that we're looking at doing so there are some further opportunities and, you know, as we work through those and balancing what we want to get done at what time, but there still is, you know, probably some continued focus areas that we are working on.

Jared Schramm: Then turning to Salt Life, up 28% year-over-year, Bob just mentioned that you're expecting $30 million in calendar '14 sales. As far as marketing is concerned, I know a lot (inaudible) the bumper stickers, et cetera. Any incentive down the road for a larger marketing push, and if so, do you have a kegger in line for growth of this business in the next two to three years?

Deborah Merrill: We have just started that expanded marketing. Some of the magazine ads that we talked about and other campaigns that we're doing are an expansion of our current marketing and that will continue. So we're just—the consumers are just now starting to see that expanded marketing plan and that's what we believe will allow us to continue to grow in the future years at the same growth path.

We—you know, we're expecting this 12-month period will be up about 50% over the prior year. Prior to that, we were up 70%, and so, you know, we think that that sort of growth path in the next couple of years to where we're tracking right now can be expected.

Jared Schramm: You mentioned Soffe was well-received in some of the mid-tiers you've been in to-date. How would you try to balance out other growth, first be it, on the product side to help in the mid-tier channel and general? I guess, how do you look at those two separately, if that makes any sense?

Deborah Merrill: I'm not really sure I understand what your question is.

Jared Schramm: I guess, looking at your product versus looking at performance in the mid-tier, do you think that, you know—is the mid-tier channel—is the health of that still going to dictate Soffe at the end of the day?

Robert Humphreys: Well, I don't think so. I mean, we lost a lot of the revenue and Soffe was in the mid-tier channel and we are gaining some of that back and, you know, no doubt it has been fairly challenged. I think from a positive standpoint for us, in going back around and rebuilding some of the business we had there, you know, that channel is very supportive of the Soffe brand and think it fits well into their strategies.

So, you know, the good news at Soffe is we have a lot of channels of distribution. So there's a lot of different ways that product, you know, gets to the end-consumer. You know, so we would see that mid-tier channel as a growth opportunity for the next couple of years as we rebuild some of what we lost there.

Jared Schramm: Okay. Thanks for taking my questions.

Operator: We'll go next to James Fonda with Sidoti & Company.

James Fonda: Hey, guys. How are you?

Deborah Merrill: Okay.

James Fonda: So just in terms of Art Gun, why was that so strong during the quarter? You said it was related to e-commerce, and do you think that growth can continue in the back half of the year?

Deborah Merrill: The Art Gun business, that is an e-commerce business channel, so that's where it's focused and it has been growing, you know, at that growth pace or higher year-over-year for the last two years.

James Fonda: Okay.

Deborah Merrill: So, you know, that's just a growth of new customers and growth within the existing online retail partners that they have.

James Fonda: Okay. I guess just in terms of right now, what you're seeing in the promotional activity, do you think this will continue for the next couple of months?

Robert Humphreys: Well, I think that's the big question that, you know, a lot of people have that participate in this space. Typically, you know, in April the sales of undecorated tees gets robust and it's certainly picking up seasonally, but, you know, not as robust as we would have expected three or four months ago. So I think it's still a question mark. Clearly as weather gets better around the country and outdoor activities increase and, you know, fun runs and all the things that drive T-shirt sales, you know, we'll see where that goes. But it is somewhat weaker than what we would expect.

I would point out in that marketplace over the last couple of years we've had significant unit volume growth and we're actually up 7% in unit volume during the March quarter. We expect it to be up higher than that, quite frankly. So we are gaining market share in that. We have new manufacturing capacity in place to service that business, and while we haven't gained that share as quick as we would have liked, it will come and we'll run that manufacturing.

James Fonda: Right. Okay. But with the guidance that you're giving out, I guess, you guys are still anticipating a pretty strong second half?

Deborah Merrill: Correct.

James Fonda: Okay. All right. That's all I have.

Robert Humphreys: But down from our previous expectations. I mean, we certainly…

James Fonda: Right. Right.

Robert Humphreys: (Cross talking) you know, the situation as we see it right now.

James Fonda: Yes. Okay. All right. Thank you, guys.

Operator: We'll go next to Liz Pierce with Ascendiant Capital Markets.

Elizabeth Pierce: Thanks. Good afternoon.

Deborah Merrill: Good afternoon.

Robert Humphreys: Hey, Liz.

Elizabeth Pierce: So a couple of questions. Actually, maybe Bob, just kind of big picture question. When you think about what's happening on the convergent or getting customers to move from undecorated to decorated, what—I don't know if you can give us, like, a percent of that business do you think could actually migrate over to decorated tees. Was there a number that you've got in the back of your mind that you think, you know, could be up for grabs so to speak?

Robert Humphreys: Well, again, if you want to look globally and kind of on a revenue base, not on a unit base, we're probably shipping about a third of our business now in decorated form versus undecorated form; and I think, you know, that could grow to probably 50% or so. If you look at the big run retail license programs, you know, there's obviously continued margin pressure and where people have those programs, they can more effectively be printed and the retail put up or it provided offshore versus domestically. So, you know, we see that continue to grow. Obviously, you know, the smaller runs for kind of local business will continue to be printed locally by local screen printers.

Elizabeth Pierce: Okay. In terms of Soffe—and you said that you're getting some pretty good indications on sellthrough—what's happening—even if you haven't had formal kind of orders put in, reorders or chase, what's kind of the feedback you're getting in terms of perhaps increasing orders, maybe not just for fall but also for next spring, if they're looking at the sellthrough, especially at the mid-tier?

Robert Humphreys: Yes, well the discussions have been, you know, very positive now. You know, they'll look at our new spring merchandise that we'll be showing them very soon, and they're also looking to see what part of our new success that we will put in as Basic items and also replenishment owned (ph), so I think those two things are still to be worked through, but, you know, an encouraging environment so far.

Elizabeth Pierce: Are you getting expansion into—because I think you were perhaps only in, you know, not all the—quite all the junior categories that you had been in before.

Robert Humphreys: Yes. (Cross talking) it varies a good bit by retailer. You know, we're probably more girls' areas and, you know, different people have different strategies with that versus juniors, but, you know, clearly we're in a lot more doors now with that product than we were in the middle of the summer and fall of last year.

Elizabeth Pierce: Okay. Perhaps give us an update on when the collapsing (ph) of the college bookstore business. How is that you indicated that you feel like that business is starting to, I think, get ready for the fall season, but has the migration or collapsing between the two businesses kind of fully behind us and you really should start to be able to leverage just one sales channel for this year and into 2015?

Robert Humphreys: Yes, so we put that together really about this time last year. You know, worked through the season last year with some old product and old blanks, and sold through a lot of that. Some of them are still in our line; and so now we're in the selling season for this fall and I think our backlog position right now is about $2 million ahead of where it was last year in that customer segment. So, you know, quite frankly we've been encouraged with the feedback that it's really the college bookstore buyers are showing towards these programs and the support they've been giving us.

Elizabeth Pierce: Okay. Then one last question, you mentioned other cost pressures. Perhaps just, you know, what's happening right now with cotton; and then relatedly, what other cost pressures are you seeing?

Robert Humphreys: Well, cotton has been, you know, averaging up, not down for, you know, a couple of months now. When I last looked today it was up, you know, for nearby deliveries it was in the high $0.92 range. You know, some additional cost on top of that to actually get it, so you're getting close to $1 cotton. You know, we've done more hedging going into this year than we had traditionally done, so we think we're in a reasonable position with nearby cotton. But other costs are going well to—going up to your point. So in general, dyes and chemicals are increasing. You know, some interview (ph) costs are increasing, so there's certainly some cost pressures and we need some pricing help in this Basic undecorated tee market to give that—pass it along to our customer.

Elizabeth Pierce: Okay. All right. Sorry. I can get back in or talk to you guys later. Thanks so much.

Robert Humphreys: Thank you.

Deborah Merrill: Thank you.

Operator: As a reminder to our phone audience, if you have a question on today's call, please press star, one. We'll go next to Jamie Wilen with Wilen Management.

Jamie Wilen: Hey, fellas. On the Salt Life brand, you're talking about $30 million of revenues and a very significant growth rate. What's the business model that you look at as to—what are you going—what percentage of high gross margin product—what are you going to spend on promotional campaigns to get this thing to stay at and to maintain that growth rate?

Robert Humphreys: Yes. Well, just about all of our products are high gross margin, so obviously our source performance products and more fashion products, you know, are high gross margin because of their very nature. But in addition to that, because we're vertical owning (ph), our Basic tees, which are still a growing force—you know, the performance stuff is a lot of new business for us, but anyway, you know, we can make that in our own facilities. We can actually do the spring training offshore for some part of it. We'll be doing more and more offshore, so all of it should have significant gross margins that will be typical of growing lifestyle brands. So, you know, typically you're going to see those in the mid-40% range.

As far as spend on marketing and promotional activities, you know, really very little had been spent prior to our acquisition of that brand and we expect that to be in the mid-single-digits of revenue, you know, which will be new spend and we think can really help drive brand awareness across the country, you know, resulting in additional business for us.

Jamie Wilen: This single-digit of revenue, what did that—I didn't quite follow.

Robert Humphreys: So, like, you know 5 to 7% of sales.

Jamie Wilen: Okay. Okay. Perfect. On the Basic goods, pricing has—is staying depressed even as we head into the spring season?

Robert Humphreys: Yes, we actually implemented a price increase recently. Of course the key in this business is often not necessarily list price, but what's discounted for volume purchases and what have you, so, you know, we'll have to see how that evolves over the next month or two.

Jamie Wilen: Okay. How would you contrast your business there to an All-Style or something in that part of the business?

Robert Humphreys: Well, you know, we've—over the last—and let me just kind of look bigger picture, say, couple of years—you know, we've grown a considerable market share there and All-Style has, you know, lost market share for whatever, you know, reasons and strategies that they've invoked. So, you know, we think we'll continue to gain market share in there and we need to do that to fill up our manufacturing a little bit better; and, you know, if you look at new crop cotton—so that would be cotton starting to be delivered in December—it's about $0.10 to $0.12 a pound less than what's being delivered in the next three or four months, and so with a little pricing help can get to new cotton, you know, I think it could be a good market for us to be in.

Jamie Wilen: Okay. Thanks fellas.

Operator: It appears there are no further questions at this time. I'd like to turn the conference back over to today's speakers for any additional or closing remarks.

Robert Humphreys: Well, thanks for joining with us today and we look forward to updating you in a few months about our third fiscal quarter. Thank you.

Operator: That does conclude our conference. Thank you for your participation.