Delta Apparel, Inc.

Fiscal Fourth Quarter and Year-End 2016 Results Earnings Conference Call

November 29, 2016

Operator:

Ladies and gentlemen, thank you and good afternoon to everyone participating in Delta Apparel's Fiscal 2016 Fourth Quarter Earnings Conference Call. Joining us from Management are Bob Humphreys, Chairman and Chief Executive Office, and Deb Merrill, Chief Financial Officer and President, Delta Basics.

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 risks 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 from those contained in the projections of 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 Chairman and Chief Executive Officer, Bob Humphreys, for an overview of Delta Apparel's results.

Robert W. Humphreys:

Good morning. Thank you all for joining us on the call this morning, and your interest in Delta Apparel. We are pleased with our fourth quarter financial and operational results and are excited about what our actions during the quarter mean for the future of our Company. It was a quarter of net sales growth, margin expansion, and profitability that yielded a strong finish for our 2016 Fiscal Year. Here are some of the highlights.

All of our business units, with the exception of Junkfood, had net sales growth during the quarter. I'm happy to say this includes Soffe, which achieved 8% sales growth. We had double-digit sales growth in Salt Life and Art Gun. We fully implemented our manufacturing realignment and did it at a cost that was about one penny per share less than what we had anticipated.

We completed the sale of the real estate and equipment associated with the Maiden, North Carolina textile facility. We finished the installation of new equipment at our Honduras textile facility and are rapidly reaching our output goals there. We opened a new Salt Life retail store in San Clemente, California. We opened a new third-party distribution center in Chicago that will provide one- to two-day shipping throughout the Midwest. We completed the acquisition of Coast Apparel, a young brand with excellent potential for long-term growth.

For comparison purposes, I need to mention that in 2015 our Fiscal Year comprised 53 weeks and therefore our fourth quarter included 14 weeks of sales whereas this Fiscal Year had just 52 weeks and our fourth quarter included 13 weeks of sales. Our net sales growth percentages are based on 2015 net sales reduced for the extra week of revenue.

On an adjusted basis, we had sales growth in the fourth quarter of 2.5% with pretax earnings adjusted for the $1 million of manufacturing realignment expenses also increasing from the prior-year fourth quarter. Our concentrated actions during the quarter carry a significance that should extend well beyond this Fiscal Year. Our manufacturing realignment, for example, should generate annual savings of $8 million that will begin in Fiscal 2017 and be fully annualizing in the second half of the year. We anticipated expense at about $3 million to complete this initiative, but with thoughtful planning and deliberate action, we were able to reduce the cost to $2.8 million or $0.29 per diluted share; $1 million of that, or $0.11 per diluted share was in our fourth quarter.

We now have additional new state-of-the-art equipment installed in our Honduran textile plant, producing inventory at a lower cost than before. During this year we also began producing open-width fabrics in that same textile facility, expanding our internal production capabilities and reducing our reliance on sourced fabric. This initiative alone is expected to lower inventory cost and improve gross margins annually by about $2 million with those savings being recognized in Fiscal Year 2017.

Salt Life had a very solid quarter and finished the year strong with demand continuing to grow, particularly in Performance and Juniors products. Salt Life's flagship store in Jacksonville Beach, Florida continues to attract consumers, growing revenue nearly 20% this year, its fifth year of operation, a tremendous achievement for any apparel retailer in the current environment. We believe our new San Clemente, California store that opened in September will also perform well and allow us to directly connect with consumers in California.

We had strong attendance at the store's grand opening where we also kicked off the Pacific Paddleboard Games that took place at Doheny State Park in Dana Point. This is the second year that Salt Life was the presenting sponsor of the Games. We will continue to enhance Salt Life's presence in California, opening a second California location in Huntington Beach in early calendar 2017, and will be showcasing the Salt Life spring 2017 line in the Junkfood store on Abbot Kinney. We look forward to further strengthening our ties to these great beach communities.

Our experience and success in nurturing and growing young brands and startup businesses, like Salt Life and Art Gun, have proven the benefit of early stage investment in high potential brands and business extensions, and we will apply this experience to our most recent acquisition, Coast Apparel. This young Company with sales of less than $1 million has excellent growth potential and is a good fit in our Brand portfolio. Primarily marketing direct-to-consumer, Coast Apparel should receive a boost from Delta Apparel's digital marketing expertise. Our Team is already at work to enhance the functionality and merchandising on the coastapparel.com site in order to improve the consumer experience and grow E-commerce sales.

In early Calendar 2017, we will also be opening a new Coast store on Main Street in Greenville, South Carolina to showcase the Coast brand. We are excited about Coast's geographic versatility across regional markets, which we believe can be levered by the strength of Delta's marketing, merchandising, manufacturing, and sourcing capabilities.

We continue to evaluate other such acquisition opportunities, large and small, to further enhance our growth. These acquisitions may further expand our Brand portfolio, broaden our product line, increase production on our manufacturing platform, or enhance our go-to-market strategy. In May, we executed and amended a restated US credit facility that gives us financing flexibility for the next five years and a debt cost that is 50 basis points less than our previous agreement. To give us additional flexibility to access capital markets in a timely and cost-effective manner, we also just renewed our universal shelf filing, increasing it to $150 million.

All of our activities throughout Fiscal 2016, and particularly in our fourth quarter, have built a great deal of positive momentum as we begin Fiscal 2017. Although the retail apparel market is not as strong as we would like, we believe we have positioned Delta Apparel to have a solid year with continued sales and profit growth.

I'll now turn it over to our CFO, Deb Merrill, who will explain how that looks from the financial perspective. Deb?

Deborah H. Merrill:

Thank you, Bob, and good morning. As Bob indicated, it was a good quarter. Sales for the 13-week Fiscal 2016 fourth quarter were $114.4 million compared to $120.2 million in the prior-year 14-week quarter. Adjusting for the one additional week in the prior-year period, we had net sales growth of 2.5% in the 2016 quarter. During our fourth quarter, we expensed $1 million of costs associated with the manufacturing realignment, with all but $78,000 of this being included in our cost of sales. Gross margins, excluding these expenses, increased in each of our two segments. However, due to a stronger mix of Basic sales, overall gross margins were down just 20 basis points.

While 2016 fourth quarter operating margins, excluding the manufacturing realignment expenses, were on par with the prior year at 4.3% of sales, adjusted earnings were $0.40 per diluted share compared to $0.53 per diluted share in the prior-year quarter. The prior-year earnings were favorably impacted by the earnings associated with the additional week of sales and a sizable tax benefit compared to tax expense this year, with these two things adding about $0.15 of earnings in the prior-year fourth quarter. Thus, on an adjusted comparative basis, this year's fourth quarter earnings improved by $0.02 per share.

For the full 2016 Fiscal Year, net sales were $425.2 million, down about 0.5% from the prior year, adjusted for the shorter sales period, the sale of The Game business, and the discontinued Kentucky Derby License business from which we voluntarily withdrew. For the 53-week Fiscal 2015 Year, we reported net sales of $449.1 million. Gross margins, excluding the $1.1 million of manufacturing realignment expenses that are in cost of sales, were 22.2% for the year, a 250 basis point improvement from the prior fiscal year. Operating profit for Fiscal 2016 was $16.3 million, or 19.2 million excluding the manufacturing realignment expenses, bringing operating margins to 4.5% of sales. This compares to operating margins of $10.5 million in the prior year after excluding the $5.6 million gain, including related expenses on the sale of The Game, or 2.3% of sales. Adjusted earnings were $1.41 per share, 147% increase from the adjusted $0.57 per share in the prior year.

Total capital spending for the quarter was $3.6 million, bringing total capital spending in Fiscal Year 2016 to $14.7 million. During the year, we invested about $2 million in the open-width project, about $6 million on the manufacturing expansion, and about $3 million on screen and digital print equipment, with the remaining spent on e-commerce, IT and system enhancements, and other projects. We expect total capital spending for Fiscal 2017 to be approximately $10 million. Depreciation and amortization, including non-cash compensation, was $11.9 million for the full year and $2.7 million in the fourth quarter.

During the quarter, we repurchased 103,778 shares of Delta Apparel stock at an average cost of $16.63 per share for a total cost of $1.7 million. This brings the total spend during Fiscal 2016 on share repurchases to $3.5 million for 217,568 shares at an average cost of $16.28. At fiscal year-end, we had $9.1 million remaining on our Board authorization for share repurchases. We believe that the intrinsic value of the Company is significantly higher than its current share price range and currently plan to continue share repurchases. Our total debt at fiscal year-end was $115.8 million compared to $102.2 million a year ago. The increase was driven by the higher capital spending, the expenses associated with the manufacturing realignment, and inventory investments, principally in our Activewear business where this past year we believe we did not have appropriate inventory levels to service customers in our at-once Catalog business.

We are currently levered at 3.7 times trailing EBITDA, much improved from a year ago, and expect leverage to be closer to the 3 times a year from now. We have good availability on our US credit facility, and with our current availability, are not subject to any financial covenants.

In summary, we believe we are a strong and growing Company. Even in the current soft retail environment, we have seen areas of strong top-line growth in our business. Our gross margins are solid and expanding and our operating margins are increasing. We are lean and agile and possess the financial power to invest in further growth opportunities when and where we find them.

Now, I'll turn it back to Bob who has some final comments.

Robert W. Humphreys:

Thanks, Deb. Although we anticipate the retail environment will continue to be a challenge, we believe that Delta Apparel is positioned to continue its sales growth during Fiscal 2017. We do have some headwinds to comp from the prior year, including lost revenue from the Sports Authority's store closings and the effects of Hurricane Matthew which is impacting our first quarter of Fiscal 2017. Our overall top-line growth may be in the low single digits, but we do expect double-digit performances to continue in Salt Life and Art Gun.

We have new exciting product lines across our different brands and anticipate strong demand as we introduce our 2017 spring line. Growing demand, combined with cost reduction initiatives that we implemented over the past two years and higher ability to lever fixed costs across higher volumes should result in continued growth, expanded margins, and higher profits in Fiscal 2017 and beyond.

Now, Deb and I will be happy to answer any questions that you might have, and Shannon, you can open up the call to questions.

Operator:

Thank you, sir. Ladies and gentlemen, if you'd like to ask a question, please do so by pressing the star key, followed by the digit one on your touchtone telephone. If you are using a speaker phone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Again, that is star, one to ask a question.

We'll take our first question with Dave King of ROTH Capital Partners.

David King:

Good morning, Bob and Deb.

Robert W. Humphreys:

Good morning.

Deborah H. Merrill:

Good morning.

David King:

I guess a few questions on the branded side, maybe. Salt Life, maybe since that's fairly new in terms of the store in San Clemente, can you talk a little bit about how that store's performing, what are your learnings so far, what are some of the highest volume items in that location in terms of does that differ at all from Florida in anyway? Then, maybe as you think about expanding with Huntington Beach etc., can you maybe just talk about overall kind of store build-out kind of plans looking forward? Thanks.

Robert W. Humphreys:

Okay. That's a few questions. So, I would just say we had a great store opening in San Clemente. We've had a lot of traffic there, so we're certainly happy with where we are, I would say up to a few weeks ago, and now we're getting into the holiday season and we'll see how that goes. Obviously, it is a branding exercise in building the brand in California, which is paramount to us. We have specific graphics designed for that market specific to the West and, interestingly enough, our Head Designer for Salt Life happens to live in San Clemente, so she certainly understands the California vibe.

We expect to do the same thing in Huntington when we get it opened. So, I'd say six to nine months from now we'll be able to look at data that shows more of what's selling there and compare that to what we sell on our E-commerce site that goes to California, etc., etc.

So, our hope would be to then open one more California-based Salt Life store in Fiscal '17 and then that would be a time for us to take calls and evaluate how we're doing there, see if we need to tweak our model or our strategy in California. Then we expect to open one East Coast Salt Life store there as well.

David King:

Okay. Perfect. That's very helpful, Bob. Then maybe switching gears to Coast a bit, the recent acquisition, can you talk about some of the opportunities there? It sounds like it's more digital in retail, if I heard your comments appropriately, but maybe, is there a wholesale opportunity for that? How are you approaching that if so and maybe some color there would be helpful?

Robert W. Humphreys:

Sure. So, Coast was started by some folks in Greenville kind of following another kind of beach lifestyle brand. It's had some wholesale business that they, to some degree, advocated just not really understanding how to service that marketplace. So, we will rekindle some of that, but obviously with today's quickly changing landscape with retail, we think it's a great opportunity to be focused on Direct-to-Consumer and E-commerce strategies with this brand. We're excited about the little bit more sophisticated higher product level than what we really go-to-market with our Salt Life business.

Interesting, we had some great office space in downtown Greenville that we're going to convert to a little retail store for Coast. It's probably as good of a place as you can be in Greenville for retail. It's main street level. You may have seen—you probably didn't notice, but just about three weeks ago, *Wall Street Journal* had, I believe it was 20 places in the world to visit in 2017 and Greenville, South Carolina was the only US-based place. So, having living here, there's getting to be too many people for me, but it should be great for our little Coast store.

David King:

That's great color. Thanks for that. Then, maybe on the Soffe side, can you talk a little bit about the improvement there? Was that mainly new accounts? Did I interpret that correctly? Then—or was it maybe an expanded line with some of those strategic sporting goods channels and better sell-through? Just any color there would be helpful.

Robert W. Humphreys:

I'd say the good news is fairly broad-based. Some of the strategic sporting goods stores, we are expanding with one or two in a major way, so we're excited about that and really encouraged that they're reattaching to current Soffe product. Our Soffe business on Amazon is growing rapidly, our Military business is solid and there's some pockets of growth there and some new programs that we're taking on, and we've had success in growing our B2B business, particularly in the independent sporting goods market. So, I'd say still plenty of work to do to get the revenue and momentum back that we would like at

Soffe, but it was nice to see some growth, and feel good that we're in a position of improvement going into Fiscal '17.

David King:

Yes. Absolutely. Okay. Fantastic. Then maybe lastly, Deb—I didn't want to leave you out—in terms of the operating margins by business, just to understand that one lane of cost that I think, for sale, in cost of goods sold, is that also mainly on the Basic side, I would assume then in terms of…?

Deborah H. Merrill:

Yes. A hundred percent of that is on the Basic segment and so within that you've got about $1 million in cost of sales and about $1.7 million on the restructuring line, but all within Basic.

David King:

Okay. Perfect. All right. Thanks so much and good luck with Fiscal '17.

Robert W. Humphreys:

Thank you.

Deborah H. Merrill:

Thank you.

Operator:

Once again, ladies and gentlemen, if you'd like to ask a question, please press star, one. We'll take our next question from Jamie Wilen of Wilen Management.

James Wilen:

Hey. That was sure a nice quarter and a great fiscal year. I want to start with Salt Life. I love Dave's question about how the difference can be between the West Coast and the East Coast as you're growing this brand. I was just wondering, from—you sell a lot of decals across the country, do you chart the number of decals that are being sold on the West Coast versus the East Coast, and how are things taking hold there?

Robert W. Humphreys:

We don't chart that on a month-to-month basis. We could probably take a look at it from an E-commerce standpoint.

James Wilen:

Okay. The retail stores that…

Robert W. Humphreys:

We could look at Salt Life decals across the country.

Deborah H. Merrill:

The exciting thing is, is that we see them all across the country and have people telling us about seeing them all across the country as well.

James Wilen:

It is truly amazing. You see them in the most unusual places that are not close to any water, but it's a wonderful thing to see.

Robert W. Humphreys:

Yes. We had a Board Member who was in the Paris airport a few weeks ago and took a picture of a guy wearing a Salt Life shirt, so we're in Paris, so it's all good.

James Wilen:

I saw one in the Coliseum in Rome. But on the retail side, the store in Jacksonville, I assume, is profitable.

Deborah H. Merrill:

Yes.

James Wilen:

Okay. Even though you were opening up to be more of a sales center, it is generating profits. You talked—did you say you were going to open up one more store in Huntington in this fiscal year and then in Fiscal 2018 one on the East Coast of the United States; is that what your plan was?

Robert W. Humphreys:

So, we've got the Huntington store, the lease is signed, the build-out is being done, and it will open in early 2017. In our plan, we have one more California store that will open in California, but we don't have a site tick, so that may or may not ultimately happen…

Deborah H. Merrill:

In Fiscal '17.

Robert W. Humphreys:

…in Fiscal '17. Then we will, in all likelihood, open another store in Florida, probably an outlet store in Fiscal '17, and we've had a little outlet store back from our acquisition of The Game years ago in Columbus, Georgia that we are evaluating moving that location and rebranding it a Salt Life store.

Deborah H. Merrill:

But, Jamie, to answer your…

James Wilen:

Will these stores be Junkfood and Coast or is it just going to be strictly Salt Life?

Robert W. Humphreys:

They are going to be primarily Salt Life and Salt Life branded stores. As we get through that, we may augment them with some other brands.

James Wilen:

Okay. On the Soffe side, are you looking for sales growth now in 2017, even cycling through what you did earlier in the year with Sports Authority?

Robert W. Humphreys:

That is our plan. There is some of the uphill climbing because of the Sports Authority loss business, but if we can count—come in with some slight sales increase, having given up the Sports Authority business, we'll feel like a reasonably good job done there.

James Wilen:

Okay. Are the margins on Soffe similar to what they were in the good old days or has it changed the business model?

Robert W. Humphreys:

They are not. Yes. No; they are not, and for a number of different reasons, none of which we like, obviously. But one of our focus points on Soffe is strategies to rebuild some of that lost gross margin.

James Wilen:

Okay. Are there any residual financial effects of the Sports Authority bankruptcy? I know we had some receivables in question. Have we addressed them on the income statement or is it still hanging out there?

Robert W. Humphreys:

So, we have collected all of the receivables from the Sports Authority and we are in litigation with them. We have the money and we're in litigation with them over being a—preferential treatment, basically.

James Wilen:

Okay. Then, on the manufacturing synergies, have we taken all the cost that we were going to be taking for that? Is that all done on the income statement?

Robert W. Humphreys:

Yes.

Deborah H. Merrill:

It is, yes.

James Wilen:

Okay. No transitional impacts from everything, from the location we sold in Maiden, North Carolina, everything is done there as well?

Robert W. Humphreys:

That's correct.

Deborah H. Merrill:

Yes.

James Wilen:

Okay. In total, you were looking at, I believe, $7 million of cost reductions on an annual basis once they're fully realized; is that the right number?

Deborah H. Merrill:

Yes. It was about $8 million.

James Wilen:

Okay. As that transition in, how much do you believe we'll get in Fiscal '17 and will we be at the full run rate in Fiscal '18?

Deborah H. Merrill:

So, yes, we'll be at the full run. We are expecting to be at the full fiscal run rate in Fiscal '18. Those will start in Fiscal '17 and we'll start to see a little bit of that in the March quarter, but really then start seeing it in the June and September quarters. So, by the time you're looking at the back half and really the September quarter, we will be at that full run rate so that then in Fiscal '18 the full amount should come through in the fiscal year.

James Wilen:

Okay. But in the higher volume quarters towards the end of the year we'll be achieving those manufacturing efficiencies?

Deborah H. Merrill:

Yes. Yes. We're seeing the benefits of those coming through now, but because we're still—and we are right on our track and goal for our production levels and we'll be increasing those production levels through the end of Calendar '16, and so that's why the full amounts don't really start rolling out, because we're just seeing those now and those will start hitting our P&L in the back half of the year and then be at those full levels by the time we get to the fourth quarter, and then we'll be running at those levels to achieve the full amount in '18.

James Wilen:

Got you. Last two: the expected tax rate for next year is?

Deborah H. Merrill:

I would anticipate that being in the kind of low 20% range.

James Wilen:

Okay. I very much applaud the buyback program. It's a wonderful thing for all the Shareholders, and just wanted to see what was your shares outstanding at fiscal year-end?

Deborah H. Merrill:

I believe it was like 7.7 million shares.

James Wilen:

Okay. Okay. Outstanding job with running the business for the Shareholders; we greatly appreciate it. Thanks.

Robert W. Humphreys:

Thank you.

Deborah H. Merrill:

Thank you.

Operator:

Ladies and gentlemen, again, if you'd like to ask a question or if you do have a follow-up question, please press star, one at this time, and we'll pause for just a moment.

It does appear we have no further questions at this time.

Robert W. Humphreys:

Okay. Well, thank you all for your interest in Delta Apparel and joining us this morning. We look forward to updating you on our first quarter results here in just a couple of months. Take care and have a good week.

Operator:

That does conclude today's teleconference. Thank you all for your participation.