Delta Apparel, Inc.

Fiscal Year FY17 Fourth Quarter and Year End Results Earnings Conference Call

August 1, 2017

Operator:

Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal Year 2017 Fourth Quarter Conference Call. Joining us from Management are Bob Humphreys, Chairman and Chief Executive Officer, 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 projections and statements suggest prediction and involve risks and uncertainties, 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 identifies important factors that could cause actual results to differ materially from those contained in the projections or forward-looking statements. Please note that any forward-looking statements are made only as of today and the Company does not commit to update or revise any forward-looking statements, even if it becomes apparent that any projected results will not be realized. As a reminder, today's conference is being recorded.

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

Bob Humphreys:

Thank you for joining us for Delta Apparel's 2017 fourth quarter and year-end earnings conference call. Fiscal year 2017 was another busy year for Delta Apparel. We started the year with market disruptions on the east coast from Hurricane Matthew and ended the year with two additional storms that impacted our shipments in the fourth quarter. In addition, the retail sector and consumer demand for apparel remained weak, resulting in less apparel retail doors in the marketplace. While these circumstances along with our divestiture of the Junkfood business lowered our top line revenue, our margins held strong and Delta Apparel ended the year with a 19% increase in earnings.

Our ability to navigate these challenging market conditions draws from our ongoing efforts to rationalize our business and focus our resources on areas with higher growth and earnings potential. The sale of the Junkfood business was an example of this. Although it lowered our revenue, it enabled us to deleverage, fund additional share repurchases, and improve our investment in acquisition flexibility. Deb will elaborate on the impacts of the Junkfood divestiture on our results later during our call.

Our proactive measures to reduce fixed costs and realign our manufacturing platform also gave us valuable operational flexibility. Our manufacturing realignment was fully implemented during fiscal 2017 and the benefits of that initiative are evident in our profitability. These positive bottom line impacts are the results of a lot of hard work by many individuals within our organization, and we expect the realignment to further enhance our results as our manufacturing volumes increase.

Fiscal year 2017 was a milestone year for Delta Apparel from a product development perspective in many of our business units. In active wear, we continued to expand our fashion basics line and introduced our Delta Platinum collection. The contemporary styles and fabrics utilized in our premium product lines are resonating in the marketplace as indicated by the high double-digit sales growth we are seeing with these products. Soffe and Salt Life introduced new product categories during the year as well that should drive further revenue growth.

We recently launched the new B2B ecommerce site for active wear. The new site gives our customers enhanced functionality and an easier overall shopping experience. We also elevated our service capabilities through the recent opening of a state of the art integrated digital print and distribution facility that provides a seamless fulfillment solution for customers in both our active wear and Art Gun businesses. This larger facility expands our product distribution capacity in the important Florida market.

Our continuing investments in ecommerce infrastructure and service fulfillment allows us to remain in the forefront of apparel trends and keep pace with the ongoing transformation in retail. Soffe is benefiting from growth in its military channel and Made in America programs. The brand is enjoying strong growth in ecommerce and remains a go-to brand for established retailers.

Salt Life turned in another year of strong operating performance and continues on its path of growth. Further expansion into performance products and new retail doors were the primary drivers of Salt Life's success as well as its ability to overcome the loss of doors resulting from customer bankruptcies and the general slowness in retail, not to mention the impact of major hurricanes in Salt Life's primary markets. During the year, Salt Life won additional business with large scale retailers, expanded its door count with established retailers, and added important new customers, such as The Buckle, to our list of retail partners. Salt Life products will be available in most Buckle locations for spring of 2018.

Salt Life's branded stores in California are growing and we expect the new retail stores in Daytona Beach, Florida and Columbus, Georgia to serve as valuable customer touch points in fiscal year 2018. Salt Life's consumer reach also continues to broaden through its social media and team ambassador programs which provide a platform of over eight million followers for Salt Life's brand messaging and grassroots marketing initiatives. These branding and marketing strategies drove ecommerce sales of nearly 40% in fiscal 2017 on top of nearly 70% growth we had achieved in the prior year.

I'll now turn the call over to Deb Merrill to provide you with details of our fourth quarter and full fiscal year.

Deb Merrill:

Thanks Bob. All told, fiscal 2017 was a good year for Delta Apparel despite the numerous challenges that Bob pointed to. For the full fiscal year, net income increased to $10.5 million or $1.33 per diluted share compared with $9 million or $1.12 per diluted share in fiscal 2016, a 19% improvement. Net sales were $385.1 million compared to $425.2 million in the prior year with the Junkfood divestiture largely responsible for the decline. Adjusting for the Junkfood divestiture, net sales were down 1.4% year-over-year primarily due to the severe weather-related disruptions and continued retail softness, coupled with the significant loss of revenue from the prior year bankruptcy of the Sports Authority as well as other customers in the sporting goods channel.

Gross margins improved in both our basics and branded segments, but due to the higher mix of sales in the basics segment, overall gross margins declined 100 basis points from the prior year. This decline was partially offset by lower SG&A expenses which improved to 17.5% of sales versus 18% of sales in the prior year.

For the fourth quarter, net income was $2.1 million or $0.27 per diluted share compared with $2.3 million or $0.29 per diluted share in the prior year quarter. Net sales for the fourth quarter were $91.3 million compared with $114.4 million in the prior year fourth quarter. The sale of the Junkfood business, which generated sales of nearly $17 million in the prior year fourth quarter, principally drove the decline. As a reminder, the September quarter was the seasonally strongest quarter for Junkfood and in fiscal '16 was the only quarter that Junkfood was profitable, contributing $1.8 million in operating profit.

Despite solid margin growth in our Salt Life and active wear businesses, overall gross margins were down in the quarter at 18.2% versus 20.9% in the prior year period, while SG&A as a percentage of sales improved to 16.3% from 17.7% in the 2016 fourth quarter. The gross margin decline and the SG&A improvement both resulted primarily from the Junkfood divestiture.

Looking at our basics segment, net sales for the full year increased 1.1% over the prior year to $280.3 million. The increase stems from continued strength in our active wear business where our FunTees private label business achieved record revenue. We also saw solid gains in the ad specialty and regional screen print channels, but these were partially offset by continued challenging conditions in the retail licensing channel. Fourth quarter sales in our basics segment were $69.6 million compared to $73.7 million in the prior year quarter with the decline driven from the soft sales in retail licensing and the impact that Hurricane Irma had on our Florida operations.

Art Gun began and ended the year strong but dealt with new customer launch delays and severe weather challenges along the way. Despite these hurdles, Art Gun sales were down only 1% year-over-year and we're excited about the new opportunities we have for growth in fiscal year 2018. Art Gun's planned geographic expansion and associated enhancements to service levels through quicker customer deliveries should further bolster momentum as 2018 unfolds. Revenue growth along with gross margin expansion resulted in basics segment operating income of $24.2 million, an 8.4% improvement from fiscal 2016.

Moving to the branded segment of our business, net sales for the full year were $104.8 million compared to $148.1 million in the prior year. Excluding Junkfood, net sales declined $8.5 million or 8.7% over the prior year. Fourth quarter net sales in the branded segment were $21.7 million compared with $40.7 million in fiscal 2016 fourth quarter, with the Junkfood divestiture responsible for most of the decline. Soffe sales were down $7.9 million year over year primarily due to the loss of the comparable sales in fiscal '17 associated with the bankruptcies of the Sports Authority and other customers. The Soffe team continued to build new relationships with strategic and independent sporting goods retailers and e-retailers throughout the year, and these growing relationships along with Soffe's military and unique Made in the USA programs should provide a strong foundation for growth. Soffe also continues to make strides in its ecommerce business with B2C sales growth 20.1% over the prior year.

Salt Life expanded product offerings and strength in direct-to-consumer sales drove sales growth of 6.3% for the year and 6.9% for the fourth quarter, despite major hurricanes impacting key markets. Salt Life achieved record revenue in its ecommerce business, which grew nearly 40% over the prior year. Gross margins in the branded segment improved over the prior year, resulting in operating income of nearly $4 million for the year.

Turning to our balance sheet, receivables were lower at September than a year ago from improved collections and overall lower sales levels. Inventory levels increased from a year ago to $174.6 million with the increase due to increased cotton costs in inventory and higher units in inventory to support the expanded product lines in active wear and Salt Life.

Total debt continued to decrease and at year-end was $92.9 million compared to $115.8 million in the prior year. Capital spending during fiscal 2017 totaled $7.9 million and principally related to the purchase of manufacturing equipment, expanded direct-to-consumer initiatives, and information technology upgrades. Our capital spending was lower than planned in our fiscal 2017 fourth quarter due to delays in equipment arrivals due to the hurricanes. Our fiscal 2018 capital spending is anticipated at approximately $13 million, which incorporates the carryover from the fiscal 2017 planned capital.

Depreciation and amortization, including non-cash comp, was $11.8 million for the full year. We repurchased 413,000 shares of Delta Apparel stock during the year for $7.8 million at an average price of $18.86 per share. As of our fiscal year end, $11.3 million remained available for purchases under our share repurchase program. We currently plan to continue to repurchase shares of our stock under our share repurchase program as we believe the intrinsic value of Delta Apparel stock is not fully recognized by the market.

I'll now turn the discussion back to Bob for final comments.

Bob Humphreys:

Thanks Deb. We anticipated fiscal year 2017 to be challenging due to persistent weakness in the retail sector, and the year generally played out as expected. We could not have anticipated the multiple severe weather events and related challenges brought on by Mother Nature, which made the year more difficult. Despite these hurdles, it was a good year for Delta Apparel with strong improvement in profitability and substantial momentum building within several of our businesses. In addition, the divestiture of Junkfood and the harvesting of the accumulated profits in that business to redeploy into higher return investments was an important milestone for our Company.

We believe our Company will achieve additional performance gains in fiscal 2018. We expect marketplace challenges to continue in the upcoming year but expect to see organic growth of sales in each of our business operations led from strong growth at Salt Life, Art Gun and our ecommerce sites. While we'll be shipping product with higher cost cotton in the first half of the year, more traditional cotton costs should flow out in our third and fourth quarters. Continued profit improvement driven from higher sales and our cost reduction efforts, coupled with anticipated lower inventory levels, should drive strong free cash flow for the full year. We anticipate using the cash flow to lower debt and continue our share repurchase program. We will also take advantage of other business opportunities that may arise that would provide further value to our shareholders.

Operator, we'd be happy to open up the call to questions now.

Operator:

Certainly. If you would like to signal for a question at this time, please do so by pressing star, one on your telephone keypad. If you are using a speakerphone, please ensure that your mute function has been turned off to allow your signal to reach our equipment. Again, that's star, one for any questions at this time.

We'll take a question from Dave King with Roth Capital. Please go ahead, sir.

Dave King:

Thanks, good afternoon.

Deb Merrill:

Good afternoon.

Bob Humphreys:

Hey Dave.

Dave King:

I guess first off on the gross margin, the 270 basis points or so year-on-year decline, how did that trend by segment between branded and basics? I guess I'm trying to get a sense of the various impacts between cotton prices, if I remember correctly I think there was going to be a manufacturing shutdown for a week or so, what impact did Junkfood have? I guess just some color on each of those would be helpful, thank you.

Deb Merrill:

Overall, the gross margins again within the business unit segments did improve. A lot of this is a mix between the two segments that impacted our overall gross margins. Now we did, as we went through into the fourth quarter, the higher cotton cost and some manufacturing curtailment that we took time out of the manufacturing platform in our fourth quarter did impact our gross margins, principally in the basics segment.

Dave King:

Okay, so it sounds like basics was down due to those factors, and then obviously the--did Junkfood have an impact on the branded segment in terms of margins?

Deb Merrill:

It does overall from a mix standpoint of taking that out of it, because that did carry a little on the higher side of the margins within that segment, so taking that out of it did overall impact those margins slightly but not dramatically.

Dave King:

Okay. Then in terms of the inventory, Deb, you gave some color there in terms of what drove that, and then Bob, I think you talked a little bit about the ability to kind of work through some of the cotton prices, I think at the back half of this year. How quickly overall do you think you can bring down that inventory balance in terms of trying to generate some of that working capital to drive free cash flow and further debt pay down? How should we be thinking about the magnitude of debt pay down and cash flow generation in the coming year?

Bob Humphreys:

Well, we'll see the biggest impact in the last half of the year primarily driven by the seasonality of our business, so we generally build inventories in the first quarter, and we will this year but not to the level that we traditionally have, and you've got still higher price cotton in inventory yet to flow out and then we'll start seeing that flow out really in our third quarter and fourth quarter, so you'll have the combined effect of higher cost cotton out with lower price cotton replacing it, and less units in inventory.

Deb Merrill:

Dave, I think what you normally see as an inventory build as we go in through the March quarter, you just won't see that as much because that will be offset by the lower cotton cost replacing the higher cotton cost, so I think that's seasonally the difference that you'll see, is you just won't see that big of a build through your March quarter as you historically have seen, because of the higher cost cotton flowing out and not being in there offsetting that, those higher units.

Dave King:

Okay, that helps. Then for Salt Life, did hurricanes weigh at all on the business in the quarter? I guess it looked to me like that was down $600,000 or so if I did my math correctly. How are you feeling about the business? Is it still expanding doors, how is the sell through at some of your wholesale accounts, and then how is the retail--the retail stores in California, how are those performing?

Bob Humphreys:

Yes, so now we had sales growth at Salt Life during the fourth quarter of 6 points…

Deb Merrill:

Seven percent.

Bob Humphreys:

Yes, right at 7%, despite losing a solid week of shipping in the fourth quarter, so if anything, Salt Life sales growth was gaining momentum as we worked through the year. Our two retail stores in California continue to build momentum and continue to grow their revenue, so so far, so good there. In our customer surveys that we do primarily through our ecommerce customer list, we get good feedback from those stores and where people are learning about the Salt Life. The number one place is decals still, which is great, but then secondly is retail stores, including our own, so that's going well. We replaced our old outlet store in Columbus, Georgia with a Salt Life retail store - I guess it opened about the beginning of the fourth quarter, and that has gone well, and then just a few weeks ago we opened a Salt Life store in the Tanger Outlet Mall just north of Daytona Beach, and it has been on fire. All goods news, I think, on the Salt Life front, really strong ecommerce growth, and we've gotten the attention of other major retailers, including The Buckle that we talked about that's putting Salt Life in nearly all of their stores, so that was—we did a test with them later in the fiscal year. It went extremely well and they moved quickly to put it in the vast majority of their stores, so we'll start without a full collection but if it continues to have the sell through that we've experienced so far, then they'll add product line as we go.

Dave King:

Fantastic. All right, thanks for taking my questions and good luck with the coming year.

Bob Humphreys:

Thank you.

Deb Merrill:

Thank you.

Operator:

Thank you, and again that's star, one if you'd like to signal for a question at this time. We'll go next to Joe Furst with Furst Associates. Please go ahead.

Joe Furst:

Thank you. First off, congratulations on the progress you've made. You're doing a great job of it. I noticed your average price that you paid for your stock was 18-something, and I'm just curious will you continue to buy stock in the very low 20s when it becomes available?

Bob Humphreys:

Yes, we have been and we continue to repurchase our shares through our Safe Harbor program. We were able to acquire a few smaller blocks in the fourth quarter, but we will carry on with that program and have our Board support and financing ability to do that.

Joe Furst:

Thank you. Out of curiosity, how much revenue did you get from selling the decals in the past year?

Bob Humphreys:

I couldn't hear.

Deb Merrill:

How much revenue from selling the decals.

Bob Humphreys:

I don't know off the top of my head, but maybe we'll have that and another Salt Life tidbit or two in our first quarter results - how about that?

Joe Furst:

Okay, that's great. Thank you very much.

Bob Humphreys:

Okay.

Operator:

Thank you, and again that is star, one to signal for a question at this time. We'll go next to Jamie Wilen with Wilen Management. Please go ahead.

Jamie Wilen:

Hey fellows, just a couple areas. First, a follow-up on the inventory question. Inventories increased in the September quarter when they would usually decline. Was that just a function of the hurricanes and you thought you were going to have more revenue, or what would you like to end next fiscal year with in inventory?

Deb Merrill:

Jamie, to answer your question, the increase in the inventory is a couple of things. Certainly having additional inventory from the impact on the hurricanes did impact it, as well as the higher price cotton. More of the inventory had higher price cotton in it and that was building in that quarter. That was the highest cotton price quarter in there, so those two things contributed to that.

As we said earlier, inventory should decline as the year progresses and we should be able to certainly—all of that, depending on where cotton sits, but as it looks right now the impact of the higher cotton should be coming out by the time we get to the back half of next year, and then the inventory turns should be improved next year over this year as well.

Jamie Wilen:

Do you want to give me a target number for inventory for the end of next year—end of this year? What would make a CFO happy?

Deb Merrill:

Down? Jamie, it's going to probably be down, call it in excess of $10 million.

Jamie Wilen:

Okay. On Salt Life, Florida is obviously a very significant percentage of your sales, and in Florida you missed the entire month of September, I would think, with the hurricane. What percentage of your sales actually do come from Florida in Salt Lake?

Bob Humphreys:

You know, we haven't disclosed percentages by state, but Florida is our number one state. Texas is usually number two. We have a surprising amount of business up the east coast - Maryland, New Jersey. In our recent consumer survey, our top 10 states that participated in that were Florida, Texas, Georgia, North Carolina, Maryland, New Jersey, New York I believe, and we're getting an amazing amount of response really in the middle of the country now and we expect to open some new high profile retailers in the middle of the country, so we are seeing continued strengthening of the brand perception across the country as we go.

Jamie Wilen:

When you talked about large scale retailers, who—other than The Buckle, who were you referring to?

Bob Humphreys:

Well, they're national chains and one in particular has given us the green light that they are going to move forward, but they have not given us store-ready orders yet so we don't have a store count to really reference at this point, so I think we'd like to talk about that when that's all done and put to bed in their stores.

Jamie Wilen:

Any guesstimate as to what The Buckle will bring for you in revenue?

Bob Humphreys:

You know, I think it's too soon to tell. We need to get these original spring floor sets out there and see how that sells through, see how we can replenish it and see how we can expand that footprint. They'll be in excess of 400 doors and if you just looked at our average, we'll ship wholesale about $18,000 to $20,000 per door, and that's an average over a lot of different types of doors, but anyway, I would think in that range to start off.

Jamie Wilen:

And again, that will begin in your fiscal second quarter?

Bob Humphreys:

That's correct.

Deb Merrill:

Yes.

Jamie Wilen:

Okay. On the Art Gun side, you added equipment and capabilities, as always. What is your expectation of 2018 versus what occurred in '17 in Art Gun?

Deb Merrill:

We would anticipate Art Gun will be back to a double digit growth rate in ’18. Certainly as we mentioned, we headed out strong in ’17, we did in our fourth quarter. The good news was we did get the partner launches that had been delayed during the year - those came on board. Now certainly the hurricanes took probably about two weeks of production time out of that Art Gun facility and had some slow start up in dealing with all of that, but we overcame those challenges for the year. We are in certainly the busy holiday season with Art Gun right now, and by all accounts things are tracking as we expect.

Jamie Wilen:

Okay, and lastly on your cost reduction efforts, you did—I’m sorry, did I interrupt you, Bob?

Bob Humphreys:

Well, I was just going to add on Art Gun, there’s a couple other, I think, important factors. One, it is a four quarter profitable business now, which was a great milestone. You know, when we guided to profitability, it was really a one quarter profit that did offset the losses in the other quarters, but for all of last year it was profitable, it will be this year, and will grow and will continue to probably lead the pack in Delta Apparel on return on capital employed.

Jamie Wilen:

Okay, and your calendar fourth quarter is obviously the strongest for Art Gun, I would think?

Deb Merrill:

The first quarter.

Bob Humphreys:

I’m sorry, calendar—yes, calendar fourth quarter, fiscal first. Yes.

Jamie Wilen:

Okay. Lastly as far as your cost reduction efforts, you’ve done some things in the past. I was wondering if they have indeed flowed through. I thought they were going to catch the back half of this fiscal year and the early part of next fiscal year, and what do you have on the table moving forward as far as creating manufacturing efficiencies in the next fiscal year or two?

Bob Humphreys:

We did complete that cost reduction initiative in the first part of the year, and our measurements of that say that we slightly exceeded our internal goal on that. Some of that was offset in the back half of the year of higher cotton prices that were not reflected in market prices on a lot of products, so we’re eating some of that until we get back to more normalized cotton that will certainly help our performance for the year. We have some additional equipment on order that’s coming in as we speak that will allow us to take product that we’re currently sourcing and bring in-house, and not only does that lower our cost on that product but it provides volume efficiencies through those manufacturing facilities, so our expectation over the next year or so is that we will drive lower cost by running higher volume through those plants without a lot of cap ex specific for cost reduction.

Jamie Wilen:

Got you, and as you look forward, what is your new gross margin objective? You don't have Junkfood, you have a little different mix, you've got Art Gun, you've got more efficiencies, but maybe a greater percentage of the basics. What is your objective for gross margin in the businesses overall?

Deb Merrill:

I would say in the upcoming years that we should be able to drive that up to the 24%, 25% blended gross margin rate.

Jamie Wilen:

Okay, very good. Thank you very much, fellows. Nicely done.

Bob Humphreys:

Thank you.

Deb Merrill:

Thanks.

Operator:

Thank you, and as a final reminder, that is star, one if you would like to signal for questions at this time. We'll pause for just another moment to allow everyone the opportunity.

Seeing no further questions in our phone queue at this time, Mr. Humphreys, I'll turn the call back to you for any additional or closing comments.

Bob Humphreys:

Okay, well I thank all of you for joining us today for our earnings call, and we'll look forward to talking to you in just a few months about our first quarter of fiscal '18.

Operator:

That will conclude today's conference. Thank you all once again for joining.