Delta Apparel, Inc.

Fiscal First Quarter FY18 Results Earnings Conference Call

February 5, 2018

Operator:

Thank you, and good afternoon to everyone participating in Delta Apparel's Fiscal 2018 First Quarter Earnings 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 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 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 except as required by law, the Company does not commit to update or revise any forward-looking statements, even if it becomes apparent that any 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. Please go ahead.

Robert W. Humphreys:

Good afternoon. Thank you, all for your interest in Delta Apparel and for joining us on the call today. We really like what we saw in our business during the first quarter of our 2018 fiscal year. As many of you know, our first quarter is traditionally our slowest of the year due to the seasonality of our product line. Achieving 19% sales growth during this quarter, with double-digit sales growth in each of our business units, is evident of the strength of our brands and product lines.

As important as the top line growth, we also increased operating profit almost threefold from the prior year period. While some improvement in the retail environment and a pick-up in consumer demand for apparel during the holiday season were positive external factors, they certainly were not the whole story behind our strong performance during the quarter. Our efforts to rationalize our business, improve our operational efficiencies, and to execute on our market engagement initiatives were very much a part of our success in driving both top and bottom line growth for the quarter.

For Art Gun, the first quarter was a period full of milestones, including record units shipped, record sales, and record operating profit. Art Gun's successful launch of several new customers, as well as its execution and service-level excellence during the important holiday season, grew 26% sales growth year-over-year. Art Gun's recent move to a manufacturing facility that fully integrates with our Delta Activewear vertical garment production capabilities differentiate it from competitors and allows us to provide a seamless fulfillment solution for our customers.

Looking ahead, this year Art Gun will expand its geographic footprint, with facilities to service the West Coast and East Coast, with significantly shorter shipping times. More and more businesses are seeing the benefit of the online virtual inventory model and we believe Art Gun is uniquely positioned to leverage this growing market dynamic.

Salt Life also had a good quarter, with sales growth accelerating to 12.4% year-over-year. The top line growth was fairly evenly spread across most of Salt Life's distribution channels, and drew on the strength of the new product categories and additional retail doors. Salt Life provides its customers a seamless shopping experience, from shop-in shops and retail doors to its fully branded retail stores, to its web store. Ecommerce sales to California have been particularly strong, and coupled with the growth at Salt Life's branded retail stores in Huntington Beach and San Clemente, continue to have us optimistic about the brand's growth potential in the California market.

Salt Life's new retail door in Daytona Beach, Florida also performed extremely well throughout the quarter. We are also excited about Salt Life's positioning going into the spring selling season and the prospects of adding additional retail doors through new regional and national accounts as the year progresses.

Soffe was a bright spot for us during the quarter, and we believe it is gaining solid momentum as we move further into fiscal 2018. Soffe sales increased 28% year-over-year, which was the strongest top line performance of any of our businesses. Strong sales in the military channel with military-issued products and graphic programs, along with success with some new programs in the strategic sporting goods channels, were the key growth drivers for Soffe.

The steps taken by the Soffe team in recent years to operate more efficiently and lower our costs allowed it to capitalize on the strong first quarter demand and achieve solid profit improvement. These operational improvements and ongoing cost structure initiatives, along with the strong utilization of our U.S. manufacturing operations, should continue to position Soffe for improved profitability as the year unfolds.

We are excited about the opening during the quarter of Soffe's fourth retail store in Jacksonville, North Carolina, and believe it will resonate well with the military and other consumers in that market.

Delta Activewear also had a great quarter, with sales up in this business 20% year-over-year. Double-digit increases in units shipped and the year-over-year increase in selling prices drove the growth at Activewear, which was well-balanced across both catalog and FunTees. Catalog's strong inventory position allowed it to take advantage of the improving market conditions in the retail licensing and other channels during the quarter.

Catalog also benefited from the success of its Delta Platinum line, another fashion basics product expansion. Sales in these higher margin products increased 73% over the prior-year period. Our private label business within Activewear saw strong growth driven from the diversification of the customer base and strength within the strategic brands we service. The investments we've made to expand our capabilities and flexibility in our manufacturing platform allow us to continue to attract leading apparel brands seeking a reliable and sophisticated source of private label products.

Overall, we are pleased with our first quarter performance and what our team was able to accomplish. The rationalization efforts we've undertaken in recent years had us well-positioned to take advantage of the improving market environment and holiday demand, and we believe we are ready to see similar opportunities that may materialize going forward.

I'll now turn the call over to Deb to provide more specifics on our financial results for the quarter.

Deborah H. Merrill:

Thank you, Bob. For our first quarter of fiscal 2018, we achieved net sales of $90.3 million, an increase of $14.4 million or 19% from the prior year first quarter sales of $75.9 million, after excluding the $9.4 million of sales from our Junkfood clothing business in that quarter in the prior year. As a reminder, we sold our Junkfood business at the end of last year's second quarter. As Bob mentioned, demand was strong within all of our business units during the quarter, with double-digit growth across the board.

Overall gross margins for the quarter were 18.1%, down from 20.6% in the prior year period. While branded segment gross margins improved significantly, expanding to 37.2% from 31.1% in the prior year quarter, this increase was offset by a gross margin decline in the basics segment, to 13.6% from 16.3% due to higher raw material costs flowing through cost of sales.

Selling, general and administrative expenses improved to 16.6% of sales from 20.3% in the first quarter of fiscal 2017. Our strong sales results and cost structure improvements led to operating income of $1.7 million for the quarter, which is a 271% year-over-year increase. This led to first quarter pre-tax profit of $404,000, compared to a loss of $832,000 in the prior year quarter.

In the quarter, we recorded the estimated impact of the recent U.S. tax reform legislation, which significantly impacted our net earnings. We recognized a discrete tax expense of $10.6 million in connection with the new legislation, which impacted our earnings by $1.45 per share. This expense included $1.1 million related to the revaluation of our net deferred tax asset, which is a non-cash item, and $9.5 million related to the transition tax on deemed repatriated cumulative earnings of our foreign subsidiaries, which we will pay over the next eight years. We expect the benefit of the lower Federal tax rate to offset the future payments of this transition tax and have minimal cash flow impact to us.

The tax expense we recorded during this quarter is based on our reasonable estimate of the impact of the new tax legislation, and may change as more information becomes available.

After recording tax expense, we had a net loss of $9.95 million, or $1.37 per diluted share. Adjusting for the discrete impact of tax reform, we achieved net income of $0.08 per diluted share as compared to a net loss of $0.08 per diluted share in the prior year period.

Looking at our balance sheet, we ended the quarter in a strong financial position, with both debt and inventory levels down year-over-year as of December 30. Total long-term debt at the end of the first quarter was $106 million compared to approximately $120 million a year ago. Inventory levels declined $4.5 million year-over-year to $174.5 million at quarter-end, despite higher raw material costs than a year earlier.

Total capital spending for the quarter was $4.9 million, and principally related to digital print equipment, facility expansion and our direct-to-consumer initiative. We anticipate that capital spending for the full 2018 fiscal year will be approximately $13 million, including some carryover spending from fiscal 2017.

Depreciation and amortization, including non-cash comp, was $2.9 million in the first quarter.

During the 2018 first quarter, we repurchased 145,000 shares of our common stock for a total cost of approximately $3 million, or an average cost of $20.59 per share. At the end of the first quarter, we had $8.3 million remaining on our Board authorization for share repurchases. Share repurchases will continue to be an important consideration for us as we allocate capital and look at opportunities to improve Shareholder value.

Now, I'll turn the call back over to Bob for some final comments.

Robert W. Humphreys:

Thanks, Deb. Delta Apparel is off to a good start for fiscal 2018. Strong top line growth and the pre-tax profit during our seasonally slowest quarter are achievements our team is proud of. Our solid first quarter performance and the general increase in consumer demand for apparel during the quarter give us reason to feel good about the year ahead. Even in a challenging environment for traditional retailers, we believe that fiscal 2018 will be another year of growth and improved profitability for Delta Apparel.

We expect to generate strong free cash flows during fiscal 2018 that can be used to support our share repurchase program, pay down debt or help fund acquisition opportunities that may arise.

Now we'll be glad to try to answer any questions you might have so Stephanie, you can open up the call for questions.

Operator:

Absolutely. 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. Again, press star, one to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions.

We'll take our first question from Dave King from Roth Capital. Please go ahead.

David King:

Thanks, good afternoon and nice quarter.

Deborah H. Merrill:

Thank you.

David King:

I guess, first off, on the 28% growth at Soffe. How much of that was military versus growth in the sporting goods channel, and I guess more importantly, how sustainable do you think that growth is, both overall in each of those two categories as we look out over the course of the year?

Robert W. Humphreys:

Well, the strongest category of growth was military, and we were flat to slightly up in most of our other channels. We did get some new programs in the strategic sporting goods channel, so we were excited about that as well.

We see military growth continuing and some traction in other areas, particularly driven by our graphic tee capability and Made in America program. We don't have the capacity right now to achieve 28% growth in every quarter, but we see growth for the rest of the year.

David King:

Okay, great. In terms of the retail side of it, those new programs—did those programs start to ramp in the first quarter or are they just ramping now since then?

Robert W. Humphreys:

No, we had some nice ramp-up in the first quarter that we were able to really achieve some quick turns on some big graphic t-shirt and short program.

David King:

Okay. Then, Bob, what sort of—I mean, it sounds like gross margins there were up fairly materially. I guess, what sort of gross and operating margins are you generating at Soffe now? Then, where do you think those should be, and I guess what's sort of a reasonable timeframe to try and get there?

Robert W. Humphreys:

That's a mouthful. We need to regain some more volume at Soffe to help lever our fixed costs. We expect to do that over the next 12 to 18 months, so we're operating in a low single-digit operating margin at Soffe now. We'd like to think we could get that back to a mid to high single-digit within the next four to six quarters.

David King:

Great, okay. Then…

Deborah H. Merrill:

Yes, and we're doing that and generating cash along the way by lowering Soffe's inventory. We see that continuing as we can hire more people, get our domestic sewing capacity up. We have a great point of leverage there, and obviously a unique go-to-market position. There's good things at Soffe; we've made some good progress over the last year, have a really focused management team up here and have good things to come, we think.

David King:

Okay, great. Switching gears to the basics side, what's the right way to think about that in terms of what's driving the growth there? How much of it is ASPs versus unit growth?

Then, in terms of the commodity price pressures, can you just remind us, again, on when you expect those to abate?

Robert W. Humphreys:

Well, I don't know when they're going to abate. I think, clearly, there's inflation in the apparel delivery system right now, principally driven by higher cost raw materials, cotton, but also transportation costs. There's a supply/demand issue with transportation that's driving up those costs. Power costs around the globe are going up, so there's definitely cost increases coming, higher domestic wages.

But there's also price increases getting moved through the system, so we see price inflation on undecorated and decorated tees and fleece rolling out through this calendar year. Traditionally, we would build inventory for the spring market during the December quarter and we did not because we had nice sales growth there. We'll be entering the really strong spring selling season with inventories well in check, which will give us more constitution on price increases pushing through the pipeline.

We've had strong unit growth. We've had some price increases. Our new products are resonating well with our customer base. Good private label production that checks all the boxes on compliance and sustainability and size and scale and scope, and on-time delivery and quality. It's not on every corner, and so we've had strong demand for our private label capabilities and we think we're uniquely positioned there as well. I think, good things off of that manufacturing platform to come.

David King:

Great. Then, maybe a question for Deb; in terms of—I guess, along the lines of Bob's comments, where should we expect—as you move through the spring selling season, how much do you think you can bring that $175 million or so in inventory, how much do you think you can bring that down? Similarly, how much of that could be used towards the debt, or what's the right way to think about where you could end the year on debt versus the $106 million or so currently?

Deborah H. Merrill:

Sure. We believe, and just as we had mentioned when we did our year-end earnings call, that while we typically do see a quite even buildup of inventory as we head through December, as Bob mentioned, and then even into the March quarter getting into that spring selling season this year, we're actually at lower inventory than we expected to be. We see now that inventory remaining about flat as we head through the March quarter, and then certainly, in the June and September quarter is when we typically, through that selling season, see that decline. We would anticipate that inventory will be lower than it was last September, and quite a bit lower than it was at the end of last September.

As far as debt is concerned, kind of similarly we would expect not to see that big of a debt increase as we head through March, and then to see a nice debt pay down as we go through the year. As we mentioned, we are doing some strong share repurchases, especially with where our stock price is sitting as we speak. We think that's a good use of that cash flow to be buying back those shares. But as we always say, we don't let that hinder our investment in our growth, whether that's in our investments internally or investment for acquisition opportunities if they should arise.

David King:

Thanks for the color there. Thanks for taking all my questions, and good luck with the rest of the year.

Deborah H. Merrill:

Thanks.

Operator:

We'll now move on to Joe Furst from Furst Associates. Please go ahead.

Joseph Furst:

Thank you, very good quarter, and you just answered my question about the stock repurchase, I was going to ask you what kind of priority you were putting that at but you answered the question.

Do you have any thoughts about cotton prices and what they're likely to do over the next three to six months, any thoughts on that at all?

Robert W. Humphreys:

Joe, it's kind of a tough time to have a strong constitution on that one way or the other. There's some quality issues out in what's been harvested and graded so far. The cotton crop is in and harvested now so there's only x amount, so it's hard to see a big selloff. I think in general we would expect maybe some slight softening in the market, but we always hedge that now. There's so much money going into that market as the speculative market can transcend supply and demand. It's kind of a hard time to get a good feel for that.

Joseph Furst:

Okay, but you do hedge on that, you were saying?

Robert W. Humphreys:

Yes, we forward contract cotton and then we hedge both ways based on what our expectation of the market and managing our overall risk, so taking a big swing off the table from hitting our P&L.

Joseph Furst:

Okay, thank you. One other quick question; can you expand a little bit on your thoughts and expectations for Salt Life?

Robert W. Humphreys:

I would say through the roof. My general counsel would beat on me for saying that, but we've got good things going on at Salt Life. It was another record quarter for the business, which is what we have come to expect. But particularly rewarding, when you think about—we had three hurricanes within their primary market; two in Florida, one in Texas; and a lot of our customers who would have been reordering during December were unable to or deferred shipments until later in this quarter, and so to have that kind of sales growth during all that, having a really strong e-commerce growth—we just finished the Surf Expo and probably had the busiest time we've ever had, and we're generally always pre-booked solid. We don't really have a position where a new customer can come talk to us, but given that, the activity around the booths, existing customers wanting to add doors now is really at the high that we've ever seen. We're feeling good about Salt Life.

While we don't have a good wholesale distribution on the West Coast yet, we continue to see, where we have product out there, product available in e-commerce, product available at events that we're sponsoring, it sells pretty robustly. We continue to be encouraged on that.

Joseph Furst:

Great, thank you. Keep up the good work. We appreciate it.

Robert W. Humphreys:

Thank you.

Operator:

As another reminder, it is star, one if you would like to ask a question.

We'll move onto our next caller, Sally Wallick from Epoch Financial. Please go ahead.

Sally Wallick:

Hi, Bob. Hi, Deb.

Robert W. Humphreys:

Sally.

Sally Wallick:

Jamie Wiland of Wiland Management couldn't be on the call today and since he couldn't do it in person, he asked me to ask you several questions about the quarter in his place.

The first one is for you, Bob. I think you may have indirectly answered this previously; it's about Soffe. Do you expect Soffe to be profitable for the full year?

Robert W. Humphreys:

Yes, we do. It was profitable in the quarter, which is our weakest seasonal quarter, so we do expect Soffe to be profitable and cash flow positive.

Sally Wallick:

Okay, very good. Secondly, on Art Gun, the question is, capacity for the December 2018 quarter. Do you feel like you have enough capacity? Will you need to add capacity prior to that quarter this year?

Deborah H. Merrill:

Yes, Sally, and at the end of the day, this past December quarter, we sold out the capacity that we had for that strong quarter. As we made mention, we are geographically expanding Art Gun with other locations to service the West Coast and better service the East Coast that we'll do throughout 2018. With that expansion and probably further expansion in our existing facility, we'll get that added in order to then fully support what we would anticipate to be another strong December quarter next year.

Sally Wallick:

Okay, great. Then, final question, this relates to Salt Life. Can you provide a bit more color on the growth drivers at Salt Life? Currently, increased stores, increased sales at existing doors, geographic expansion; just in general, can you give us a sense of where the strength is or whether it's across the board?

Robert W. Humphreys:

Yes, I think it's the same strategy that we've had for several years now of having elevated products, so we do have more expensive products that are customers are asking for, and when we get it out there, buying, so more outerwear, more fleece. We have more accessories; we actually brought on board a few months ago, a designer specifically for accessories, so we'll continue to be rolling out more there.

We've got some new product categories that we'll be announcing soon, and then we're definitely adding doors. We talked about The Buckle on the last call. Other established customers are adding additional doors, both big box people and smaller, regional stores too. It's really a combination of all that. You end up with the headwinds of the weather that we've had this year, bankruptcies the prior year that offset some of that growth. Anyway, we're really trying to cover a lot of different bases to get the Salt Life brand out there and our ecommerce business, all in all, is probably the fastest growth vehicle, which is a great vote of confidence from our real end customers every week.

Sally Wallick:

All right. Thank you very much.

Deborah H. Merrill:

Thanks, Sally.

Operator:

There are no further questions in the queue at this time. However, as a reminder, please press star, one on your telephone keypad if you would like to ask a question. We'll pause for just a few more moments.

There are no further questions. I'd like to turn the call back over to Mr. Bob Humphries for any closing remarks.

Robert W. Humphreys:

Okay, well, thank you, all, for joining us this afternoon on our first quarter call. We'll look forward to speaking with you in just a few months and talk about the second quarter and the rest of the year. Thanks so much.