Delta Apparel, Inc.

Fiscal 2022 Third Quarter Earnings Conference Call

Operator

Please standby as we're about to begin. Thank you and good afternoon to everyone participating in Delta Apparel's Fiscal 2022 Third Quarter Earnings Conference Call. Please note that today's call is being recorded. Joining us from management are Bob Humphreys, Chairman and Chief Executive Officer, and Simone Walsh, Chief Financial Officer and Treasurer.

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 and Form 10-Qs.

These documents identify 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.

As a reminder, today's conference is being recorded. I'll now turn the call over to Delta Apparel's Chairman and Chief Executive Officer, Bob Humphreys.

Robert Humphreys

Good afternoon, and thank you for your interest in Delta Apparel. We are pleased to be with you today to discuss our third quarter results. I would like to give a special thank you to our over 9,100 employees throughout Mexico, Honduras, El Salvador and the United States who continue to work hard to serve our customers in the many markets we operate.

As reported in our earnings release, sales for our third quarter ended July 2, 2022 were $126.9 million, up 7% from the prior year June quarter.

Our third quarter results reflect continued broad-based demand for our products, with the Delta Group segment delivering 3% growth year over year, and the Salt Life segment registering 30% growth year over year. In our Delta Group segment, we continue to benefit from our broad channels of distribution and saw increased demand for both Global Brands and on-demand digital print, moderated by a decline in our Delta Direct business. Global Brands continue to expand revenue and unit growth while we provide a high service level to our customers with our expanded array of value-added services. Over time we will migrate more production to meet the demand we are seeing in this channel of business. Our value proposition with multiple channels of distribution in our vertically integrated supply chain allows us to cater to our customer's needs. We are also seeing continued revenue growth at DTG2Go. The partnership with Fanatics continues to grow and we have now installed new digital print equipment in a fourth facility, allowing us to be even closer to the end consumer and better serve the important Northeast market. We expect this growth to continue in the fourth quarter as we position ourselves for the holiday season.

We further leverage our vertically integrated supply chain by using Delta Direct blanks in our DTG2Go production, creating efficiencies within the business and for our customers. We anticipate continued momentum in upcoming quarters as our 'on-demand' digital-first solution brings on additional production to meet customer demand.

In our Delta Direct business, we have seen the market decline for replenishment orders for mass channel activewear at large retailers, although it appears excess inventories are working their way through the channel.

The Salt Life segment registered very strong growth over the prior year third quarter, with sales increasing 30%. We have seen strong results in both the retail and wholesale channels of distribution and with a better inventory position combined with an updated eCommerce site, we have seen a nice increase in web traffic over the previous quarter's results.

During the quarter, we expanded our Salt Life branded retail footprint with four new locations. As we previously discussed, in April we opened stores in Foley, Alabama, and Hilton Head, South Carolina. In May we also opened stores in Boca Raton, Florida, and Rehoboth Beach, Delaware. With these openings, we have achieved our initial fiscal 2022 goal, bringing the total number of retail doors to 20 locations across seven states. Our recent Salt Life retail location openings continue to meet our initial sales expectations, validating the strength of the Salt Life brand. We believe our omnichannel strategy is working well for Salt Life and is building overall consumer demand for the brand.

While we are achieving positive sales results in our business, we are also actively managing cost pressures across all areas of our Company. We are being challenged by inflationary cost pressures which we expect to continue for the foreseeable future. We are managing capital deployed in our business by balancing additional capital expenditures to support growth while scheduling production to meet market demand. We have completed our plans for the current year to install new digital print technology in four of our DTG2Go locations. For Salt Life, we continue to explore new retail location opportunities while having already met our target of opening twenty retail stores by the end of fiscal 2022.

In the face of macroeconomic headwinds and continued supply chain disruptions, our broad channels of distribution allow us to continue to work together with large retail and global brand partners who seek the value-added services we can uniquely provide.

Over the last several months, we have managed our commitments for July based cotton contracts to reduce the amount of high priced cotton that would eventually flow through to our cost of sales. We have already decreased our production output and have reduced our planned operating schedule until late fall when lower priced cotton will be available in the marketplace. We expect these actions will reduce our units on hand to service the undecorated activewear market. Now, let me turn the call over to Simone, who will review our third quarter financial results, and then I will rejoin the call prior to our opening for questions. Simone.

Simone Walsh

Thank you, Bob.

For our fiscal 2022 third quarter, we delivered sales of $126.9 million, a 7% increase over the prior year third quarter. The performance was driven by growth across both of our business segments, with the Delta Group segment up 3% and the Salt Life Group segment up 30%.

During the third quarter, Delta Group net sales grew to $106.0 million compared to $102.6 million in the prior year third quarter. This growth was driven by Global Brands, achieving an increase in revenue and units sold. In our on-demand digital print business, DTG2Go, sales and unit growth both increased from the previous quarter as we continue to make progress with our digital first strategy. Average selling prices are increasing due to expanded service levels and more expensive garments. We expect these trends to continue in the fourth quarter and into the next fiscal year.

The Salt Life Group third-quarter revenue grew 30% to $20.9 million compared to $16.1 million in the third quarter of 2021. The segment's growth was driven by over 40% increase in wholesale sales, combined with continued Salt Life branded retail store sales growth.

Gross margins at Delta Apparel declined from the prior year fiscal third quarter by 130 basis points to 24.2% for the third quarter of fiscal 2022. This decline was driven by inflationary cost pressures, including rising prices of cotton, energy and continued labor cost pressures. In the Delta Group, gross margins were 19.1% for the June 2022 quarter, a decline from the prior year June quarter margins of 21.7%. Gross margins were most negatively impacted by higher cost inventory flowing through cost of sales. These costs include the rising cost of cotton, energy, dyes and chemicals, freight and wages.

At DTG2Go, we expect to realize improved gross margins as we complete new digital print equipment installations and build production output and efficiencies as we move into subsequent quarters.

The Salt Life Group segment's gross margins improved to 50.2% in the third quarter of fiscal 2022 compared to 49.6% in the prior year third quarter resulting from a favorable mix of sales, including increased Salt Life branded retail store sales.

Net sales for Delta Apparel for the first nine months of fiscal 2022 were $369.3 million, an increase of 14.7% over the same period last year.

For the Delta Group, net sales for the first nine months of fiscal 2022 were $323.3 million, an overall 14% increase over same period in the prior year.

For Salt Life, in the first nine months of fiscal 2022, net sales were $46.0 million, up $8.4 million or 22% from the prior year net sales of $37.6 million in the comparable period.

Gross margins in the Delta Group for the first nine months of fiscal 2022 declined to 19.6% of sales from 20.2% of sales in same period for the prior year.

In the Salt Life segment for the first nine months of fiscal year 2022, gross margins grew to 51.6% of sales from 47.9% in the prior year, driven by sales channel mix and higher selling prices.

Selling, general, and administrative expenses ("SG&A") were $22.4 million in the third quarter of fiscal 2022, or 17.7% of sales, compared to $19.9 million, or 16.8% of sales, in the prior year third quarter. Selling expenses increased during the quarter driven by sales channel mix in our Activewear business combined with a rise in travel and trade show cost as compared to the same period last year when travel was still depressed. The addition of new Salt Life retail stores has also increased SG&A costs year-over-year. Within our distribution centers there is sustained pressure on wages where we are seeing a double digit increases in the costs of hourly associate wages and incentive compensation. The timing of issuance of specific stock-based compensation awards this year has also led to equity compensation expenses being elevated over the same period of last year. Other income for the third quarter of 2022 was $1.0 million. This is substantially made up of valuation changes in our contingent consideration liabilities of $0.8 million associated with the acquisition of DTG2Go. In addition, we also recognized profits related to our Green Valley Industrial Park equity method investment in other income.

Interest expense was $2.0 million in the third quarter of fiscal 2022, up from the prior year third fiscal quarter expense of $1.7 million due to higher debt levels. In June 2022, we completed the renewal of our Seventh Amendment to our Credit Agreement with Wells Fargo, extending the term for 5 years to expire in June 2027.

For the nine months ended June 2022, our effective tax rate was 17.2 percent, down from 23.1 percent in the third quarter of fiscal 2021. We anticipate our tax rate for the full year to be approximately 18%.

Operating profit in the third quarter was $9.3 million, down from the prior year third quarter with $11.9 million of operating profit.

We achieved net earnings for the June 2022 quarter of $6.2 million, or $0.88 per diluted share, as compared to $8.2 million, or $1.14 per diluted share, in the prior year.

At quarter end, inventories were $227.7 million, up $66.0 million from September 2021 and $75.4 million from the prior June quarter end. Our increased inventory level is a reflection of increasing input costs including raw materials, transportation and labor costs combined with an increase in units on hand. As a reminder, at this time in the third quarter of last year we were continuing to build production and inventory levels were depressed. At Salt Life with the opening of additional retail doors, combined with supply chain delays on sourced product, we planned for higher level of inventories. We continue to work across the Delta Group on aligning our manufacturing output to balance with demand and appropriately manage on-hand inventory.

Total net debt increased $40.7 million from September 2021 to $162.4 million at June 2022. Cash on hand and availability under our U.S. revolving credit facility totaled $30.8 million at June 2022, a $14.6 million decrease from September 2021. This decrease in availability is principally driven by capital expenditures, share repurchases and working capital needs.

As we continue to grow, we will prioritize investments to support our business strategy. During the third quarter, we invested approximately $5.5 million in capital expenditures. This capital spending has been mainly focused on digital print equipment to support our DTG2Go business, retail store openings, and information technology initiatives. We have largely completed our manufacturing expansion projects for our Delta Group for fiscal 2022.

We plan to further invest in Salt Life retail location openings and complete focused manufacturing expansion projects during our fourth fiscal quarter and anticipate spending approximately $20 million in capital spending for fiscal 2022.

In the third quarter of fiscal 2022 under the previously announced share repurchase program, the Company purchased 33,934 shares for $1.0 million, bringing the total amount repurchased to $56.4 million over the life of the program. At the end of the third quarter of fiscal 2022, the Company had $3.6 million of remaining repurchase capacity under its existing Board authorization.

I will now turn the call back over to Bob for some final remarks.

Robert Humphreys

Thanks, Simone.

Delta Apparel's activewear and lifestyle brands, including Salt Life, Soffe and Delta, continue to demonstrate broad-based market appeal. The combination of our broad customer base, diversified channels of distribution, and vertical manufacturing platform, positions us to build additional revenue from unit growth and by providing expanded value-added services. Continuing demand for our digital first DTG2Go production model positions us well for growth in this exciting technology driven market. Throughout the entire company, we have maintained our focus on the current economic environment and changing landscape and remained mindful of labor shortages, inflationary pressures and supply chain disruptions. Looking out into last quarter of fiscal 2022, we are well placed for further top-line growth. On our last earnings call, we discussed our anticipated double-digit revenue growth for the full year. After our first nine months of fiscal 2022, we expect continued revenue growth during our fourth quarter and to exceed our original goal of 10% revenue growth for the year. And now Operator, you can open up the call for questions.

Operator

Thank you.

Our first question comes from Dana Telsey with Telsey Group. Please go ahead.

Dana Telsey

Hi, good afternoon, Bob and Simone. Would love to touch upon the Delta Group and parse apart the Delta Activewear business and Delta Direct to better understand the demand for each category and what you're seeing happen on the expense side. In addition, pricing, how are you thinking about pricing go forward? You were able to come in as expected on the gross margin side down 130 basis points. What do you see as the outlook going forward? Thank you.

Simone Walsh

Thank you, Dana, and good afternoon. Just before we turn over to questions, I'd just 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 and Form 10-Q. These documents identify 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 turn back to Bob to start your question talking about Activewear, parsing out Delta direct, and pricing. Thanks, Dana.

Bob Humphreys

Dana, I think what we saw in our basic Activewear business is pretty much what the headline news was in the marketplace, that in the mass channel, they feel over inventory or consumers are having to trade down to pay for food and fuel for their cars and what have you. We did see some pullback there. Seems to be building a little bit stronger since then, but there was a four to six week time.

It's certainly not back to the levels it was earlier in this year, but it appears to be kind of working its way through the system. Pricing has held steady. We continue to have higher priced dyes and chemicals, cotton, coming through our system. We'll continue to look at our pricing in the marketplace and remain competitive, but work to get our higher costs covered through higher prices for our products.

Dana Telsey

Got it, and then on the gross margin perspective, how are you thinking about that go forward?

Bob Humphreys

Well, I think it'll ultimately be determined on marketplace pricing. If we don't get higher pricing in the marketplace, then we do have higher cost that will be rolling out through cost to sales over the next quarter or two.

Dana Telsey

Got it, and then inventory levels, where are you on inventory levels for each of the divisions and how do you expect to end the fourth quarter?

Bob Humphreys

In Salt Life, I'd say we're just where we want to be. Business is growing, a nicely force, and we need enough inventory to service that well. In our Global Brands business and Retail Direct business, our inventories are in good shape. That product is generally sold as we are making it and embellishing.

I mean, it's already sold so when we have inventory, we've made it for a specific customer and we've always had excellent success in customers fulfilling their commitments. We wouldn't expect that to change in this situation. In our business that we make product to an inventory level, as I said, in my prepared remarks, we are reducing output of that and we have reduced our normal consumption of cotton and plan to do that until mid-fall when lower price cotton will be in the marketplace and available to us. Then we will really turn the spigot back up on our manufacturing to have a full inventory position for our spring business, but don't want to do that with the peak cost of cotton, which was the July contract this year.

Dana Telsey

Thank you.

Operator

The next question comes from Jamie Wilen with Wilen Management. Please go ahead.

Jamie Wilen

Hi, fellas. On DTG2Go, you talked about improving gross margins in subsequent quarters, but could you talk a little bit more about the top line growth, the ability to pick up new customers? How's the relationship with Fanatics progressing, as well as adding capacity of added machinery, what is your capacity now for heading through the Christmas season, as well as the labor availability to help fulfill the orders?

Bob Humphreys

We now have all the equipment installed, that will be installed, for the rest of this calendar year. That's kind of up and running and been commissioned and what have you. The last of that just came on stream in the last few months. I think we continue to add new customers, particularly in our directed focus that are looking for the Digital First production, which is sold out for the foreseeable future.

On brand directs who are taking more of their product to their e-commerce sites themselves, those pieces of the business are growing. I think where this business started with the E-retailers, it's soft, but we still have a good business there, but it's our new technology, our new print quality, our new delivery mechanisms that's allowing us to drive unit and top line growth that DTG2Go. We think that's going to continue well into the future and the Fanatics relationship is good. I call it a partnership. Quite frankly, we work with them shoulder to shoulder on technology and quality and how to meet their customer's expectations and they share our results on that and give us excellent feedback. It's been a really enjoyable process so far and we expect that to continue.

We have had outside cost in that business as we started up this production and really developed this equipment. I think we've got a lot, if not, most of that, behind us now. We'll still be building productivity gains and efficiencies as we run it longer. Because of the seasonality of the business now, we are ramping up now and we'll continue to be ramped up through the holiday season.

I think one of the great things we have coming is a strong six month business instead of a strong six week business. We think that will continue around the sports calendar in the future driven by a lot of that Fanatics business. We believe good things to come.

There will be staffing separately or differently in prior years using some staffing techniques we've had in our manufacturing plants in the past that we think will allow us to ramp up more effectively and have a steadier workforce.

Jamie Wilen

But, you're sold out in your Digital First business, you've been adding a lot of equipment. How are we sold out for the foreseeable future, given that you've been selectively adding equipment where you needed it most?

Bob Humphreys

Well, with that new equipment coming on stream and growing production, my point is, we're not taking additional customers on that. We will have revenue increases, certainly from where we were this quarter, this past quarter, into our fourth quarter and first quarter of next year. My point being all of our capacity is spoken for.

Jamie Wilen

Right. Okay, and seasonality wise in DTG2Go, the December quarter should be the largest. Which is the second best quarter. Is it September?

Bob Humphreys

It's going to be September this year. Yes.

Jamie Wilen

Okay. On the Salt Life side, you have 20 stores now. What do you have planned for the remainder of this year and as you look into 2023?

Bob Humphreys

Yes. We have one more that is likely to open this fiscal year. It'll be close, but likely to open, and then we've got one more that the lease is signed on for this year that will not open this quarter, but first quarter. Then we'll open four to six next fiscal year, would be our expectation.

We have a lot of areas that we would like to put stores in and then is a matter of finding the right location in a town or locale that we know would be good if we can get the right location.

Jamie Wilen

Are the existing stores maintaining the productivity that they have? Some of your existing stores had incredibly high volumes that seemed high to surpass, but are they maintaining those volumes as they roll over from year-to-year?

Bob Humphreys

They are, and still, I think a pretty choppy economy out there. What we saw is maybe in the June timeframe, good sales, but not as strong as the prior year. Last week was the best week in our history same store sales. Stores that had been open a year in totality were up mid single digits.

We were 9% ahead of our business plan for the week, and I expect for this month, we'll have over $2 million of revenue through those 20 retail stores. Year-to-date—and you got to think about this with the seasonality, but year-to-date kind of GAAP operating profits, including lease start-up costs and what have you, has been in the 12.5% range.

Jamie Wilen

Wonderful. On the ecommerce side, that business has been slow because you've had to supply your retail and wholesale customers first. Now that we have additional capacity or I don't quite understand we're producing at lower levels, but do we have enough capacity and inventory for Salt Life and our ecommerce business to start to get back on track and grow again?

Bob Humphreys

Yes, and just in the last couple of months, we've gotten it back to its targeted level. We have a DC within our DC now dedicated to having product only for ecommerce so that wholesale orders don't come in and suck up our inventory. We've seen a dramatic improvement in our ecommerce sales in the last 60 days.

Jamie Wilen

Excellent. Thanks. I'll hop back into the queue to let someone else go.

Bob Humphreys

Now, I'll just say even while it's been depressed revenue, it's incredibly important to us and it's our highest margin piece of business in Salt Life.

Operator

As we have no questions at this point, I would now like to turn the conference back over to Bob Humphrey for any closing remarks.

Bob Humphreys

Operator, are you sure you have no more questions in the queue?

Operator

Nope. I don't see anybody in the queue.

Bob Humphreys

Okay. Well, thank you all for joining our call and I will look forward to updating you on our fourth quarter and full year results in the coming months. Thank you.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.