Destination XL Group, Inc.

First-Quarter 2013 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's first-quarter 2013 financial results conference call. Today's call will be recorded. At this time, all participants have been placed in a listen-only mode. There will be an opportunity for questions and comments after the prepared remarks. (Operator Instructions). I'll now turn the call over to Mr. Jeff Unger, the company's VP of IR, for opening remarks and introductions. Please go ahead, sir.

Jeff Unger:

Good morning, everyone, and thank you for joining us today for Destination XL Group's first-quarter results conference call. On our call today is David Levin, our President and Chief Executive Officer, and Dennis Hernreich, Executive Vice President, Chief Operating Officer and Chief Financial Officer.

During today's call, we will discuss some non-GAAP metrics to provide investors with useful information about our financial performance. Please refer to our earnings release, which was filed this morning and is available on our website at investor.destinationxl.com, for an explanation and reconciliation of such measures. Today's discussion also contains certain forward-looking statements concerning the Company's operations, performance and financial condition, including sales, expenses, gross margin, capital expenditures, earnings per share, store openings and closings, and other matters. Such forward-looking statements are subject to various risks and uncertainties that could cause actual results to differ materially from those assumptions mentioned today, due to a variety of factors that affect the Company. Information regarding risks and uncertainties are detailed in the Company's filings with the Securities and Exchange Commission.

I'll now turn the call over to President and CEO David Levin.

David Levin:

Thank you Jeff and good morning everyone.

We performed well in the first quarter as we continued to execute on our DXL strategy. In terms of the Q1 results, the quarter started off slow, with colder-than-usual weather in February and March delaying the sale of our spring apparel, such as shorts and t-shirts. As the weather warmed up, we bounced back in April and had a 7.4% comp for the month.

The strong sales in April were not enough to offset softness in the first two months of the quarter, resulting in a decline in quarterly sales and net income. The weather-related issue contributed to consolidated comps that were down by about a half percent.

More importantly, we made progress executing our accelerated three-year strategy to roll out the DXL concept. We now have 53 DXL stores in operation in comparable established markets, which generated first-quarter comparable sales of 17.7% and accounted for 22% of total comparable retail sales during Q1. We have opened one DXL store in a new market, for a total of 54 DXL stores in operation.

An important metric for the long-term growth of the DXL concept is dollars per transaction, which rose 17.6% in the first quarter to $154 from last year's $131. In comparison, dollars per transaction at our Casual Male XL stores during the quarter was only $110. This impressive year-over-year increase resulted not only from better sales productivity, but also improved sales mix toward higher end name brands and increased sales penetration in tailored clothing. Also, all DXL stores now have a custom made-to-measure department that offers a robust selection of suits and sport coats, along with dress pants and shirts.

It's important to point out that the traction we have made with the DXL concept has been accomplished with essentially no marketing.

But that is changing.

By now, I hope you have had an opportunity to catch our DXL commercial that is currently airing on popular cable networks such as ESPN, USA, TBS, NBC Sports, and Comedy Central to name just a few. The goal of the commercial is to express the challenges our customers face when shopping for merchandise that fits. We equate this challenge to shopping in no-man's-land, and DXL is the solution. In the ad, we highlight the Destination XL shopping experience, and the broad selection of styles and brands that we offer in one easy and convenient store. We believe the commercial will drive traffic to our DXL stores and ecommerce website, DestinationXL.com. The commercial is truly resonating with our customers and, given its humorous nature, people are sharing the video on various social networks, allowing us to reach an even larger audience.

The television commercial is just one element of a six-week national marketing campaign that we launched on May 5th to define the DXL brand more clearly, expand market awareness and grow our active customer base. In addition to TV, the comprehensive campaign consists of a radio and digital marketing mix.

If you haven’t seen our commercial on TV or heard it on the radio, I encourage you to visit destinationxl.com and click on the commercial. Here you also can see a sample of the digital concepts we are using to drive traffic on the web. On the website, we also have another video we developed to give customers a virtual tour of our DXL stores. These videos have already been viewed thousands of times on our website and on Youtube and have been shared and reposted by users on various social networks.

As you may recall, this national campaign is based on a successful test-campaign we conducted during the fall of 2012. The results of that test demonstrated that awareness increased by as much as 100% in newer markets like Minneapolis, which opened in fall 2012, and 38% in established DXL markets like Memphis, which opened in summer 2010. In addition, we conducted another six-week test in Dallas and Providence this winter that demonstrated a similar pattern of success in both markets.

The goal is to grow our total customer base by 40% from the current level of 1.5 million active customers over the next 3 years. The total big & tall market is approximately 40 million customers, so there is a lot of opportunity for growth. While our new marketing campaign should put DXL on their radar, we do not expect them to rush out to our stores right away.

In fact, our customers typically only shop about two times each year. That said, in the first year of the campaign we expect to reverse the slow decline that we have experienced in our customer base during the past few years and to incrementally increase the number of active customers. We anticipate greater growth in our customer base in 2014 and 2015.

In addition to the current six-week flight of the national campaign, we plan to execute a second major flight in the fall. In both flights, we will proceed with a mix of TV, radio and digital, and will leverage relationships with our new PR and social media agencies to further drive awareness and brand enthusiasm, and ultimately, customer traffic and purchasing. It is important to note that our marketing strategy is about awareness and brand building. There's no call to action…no "Buy 1, Get 1" type promotion. We will be tracking results on a weekly basis, including traffic and sales, and we will be conducting a customer survey to measure awareness, purchase intent, brand perception and attributes.

Although it is far too soon to talk about results from the first flight of our national campaign, early response has been positive and we are anticipating results similar to those we experienced in the test markets.

In our direct business, catalog sales continue to decline. We are reducing circulation by 50% in 2013, including a 45% reduction in page count. Our print catalogues are being replaced with digital-focused direct marketing, including email, banners, paid search, display advertising, social media, affiliates and other online sales tools. In Q1, the web portion of our direct business was up 5.1%.

We see our website as an extension of our retail stores, as our customers are not single-channel shoppers. They are using each of our channels as a support to one another, whether it's starting at the store and visiting the website after, or researching products online and then heading to a store to make a purchase. For this reason, we have invested in the design and functionality of our e-commerce website. Using data and analytics to understand our customers better, we have developed a website where our guys can easily find what they are looking for and only see products that are relevant to them. For example, our website encourages visitors to fill out a size-profile, which allows them to enter their measurements and then ensures that only products available in their size are displayed.

We also use customer data for location-based marketing. Depending on the current temperature from where our customers log in, they will be presented with digital marketing banners that promote season-appropriate apparel. If it's warm, they'll see t-shirts and polos. If it's cold, they see jackets or sweaters. The ability to create and run campaigns that are targeted to customers experiencing certain weather in real time has been productive for us.

Another new feature we added to our website recently is the ability to create and purchase a custom dress shirt online. Customers can now design a dress shirt by selecting from over a 100 pattern and color combinations and choosing their preferred detail treatments from a variety of collar, cuff and pocket options.

We are just as focused on creating a great online experience as we are with the in-person visits to our stores. We believe these details really exceed the expectations of our customers and will ultimately result in greater conversion rates.

Moving on to our outlook for 2013 and beyond… We are on schedule with our DXL rollout plan. During 2013 we will grow the number of DXL stores in operation to between 105 to 112. We continue to focus on investing in our transformation with respect to real estate development, training and merchandising, along with adequate levels of SG&A additions and capital expenditures.

Now that our new marketing campaign has launched, we expect our performance to improve significantly in 2014 and beyond when we will have a greater number of stores in operation. We will continue to fine-tune our strategy to define the DXL brand more clearly, expand market awareness and grow our active customer base.

We plan to complete our transformation by the end of 2015. At that time, all of the Casual Male XL retail stores will be closed and we will have 215 to 230 DXL stores in operation. We'll still have about 55 Casual Male XL Outlet stores that will be used to help liquidate product from the DXL stores, as well as 3 to 4 Rochester Clothing stores.

By accelerating our DXL strategy, we will be able to realize the benefit of the DXL concept much earlier than we initially anticipated. In fact, with the substantial investments we are making this year in the strategy, we expect to report improved profitability and cash flow beginning next year. By 2016, we anticipate that this concept drives revenues of $600 million and operating margins that are greater than 10%.

With that, I'll turn the call over to Dennis to review our financial results for the first quarter.

Dennis Hernreich:

Thank you David and good morning everyone.

In my prepared remarks, I will first provide a synopsis highlighting the Company's results for the first quarter; then give you an update on the Company's progress and what's still to come with respect to the transformation to the DXL concept, and lastly provide the earnings and cash flow guidance for the strategically critical 2013 year.

For the first quarter of 2013, total sales decreased to $93.6 million from $95.5 million for the prior year's first quarter. We had 11 fewer stores in operation during Q1 2013, compared with last year, which was partially responsible for $1.5 million of the decline in year-over-year revenues. Comparable sales decreased 0.5% for the quarter. We expect to end 2013 with a store count of approximately 360 stores, which is about 52 fewer stores than we had a the start of the year.

As David mentioned Q1 sales started out slow due to the unseasonably cool weather, specifically in the Northeast and Midwest. Our comparable sales through the end of March were down approximately 3.9%; however, for April our comparable sales increased 7.4% once warmer weather emerged in those regions; April comparable sales in DXL stores increased +29.1%.

Let me quickly define what we mean by comparable sales. Total comparable sales for all periods include retail stores that have been open for at least one full year. Stores that have been remodeled, expanded or re-located during the period also are included in determining comparable sales. Most DXL stores are considered relocations and are comparable to all closed stores in each respective market area. Therefore, those DXL stores are considered a comparable store upon opening. If the DXL stores are opened in a new market, however, of which we have 1 DXL store like that today, such DXL store is not considered a comparable store until its one year anniversary. Direct businesses are included in the calculation of comparable sales since we are a multi-channel retailer.

With that said, sales from our retail business overall were up by almost 1% for the first quarter. However, our DXL stores continue to outperform our Casual Male XL and Rochester stores. As a result, the 53 comparable DXL stores experienced a 17.7% increase over the prior year, while the comparable sales for all other retail stores decreased by 3.2%. The DXL stores and direct sales represented 35% of the first quarter sales, and are expected to grow to over 40% of second quarter sales.

Sales from our direct business for the first quarter decreased 6.0% over last year. Our direct business consists of three primary channels: catalogs, orders placed from stores fulfill an immediate customer need if not available in the store, and our website, DestinationXL.com. Sales from our catalogs were down 60.6% during the first quarter, while sales from our website were up 5.1%. We are transitioning our customers away from our print catalogues to making purchases on our more profitable e-commerce website. So this transition away from print catalogs is a positive for us in the long run. As a result, the operating margin of the direct business has improved significantly from prior years and reached over 26% in the first quarter from 24% last year and is expected to continue to grow in 2013.

In response to this shift in purchasing behavior, we decreased impressions by approximately 70% in the first quarter. We will decrease our catalogue circulation by another 60% this year and impressions by nearly 75%, resulting in $3 million of savings being diverted to partially fund the national advertising campaigns and digital marketing spend. Given the early success of our national marketing campaign and digital strategies, we are optimistic that our direct business will resume its growth during this 2013 fiscal year.

For the first quarter, gross margin, inclusive of occupancy costs, was 47.5% compared with gross margin of 47.7% for the first quarter of last year. The decrease of 20 basis points was the result of occupancy dollar growth of 70 basis points, offset by an increase of 50 basis points related to merchandise margins. On a dollar basis, occupancy costs for the first quarter increased 2.6% over the prior year due to the timing of DXL store openings and the associated pre-opening costs, as well as the timing of our Casual Male XL store closings. The improvement in merchandise margins of 50 basis points was the result of continued improvement in our initial markups as well as a favorable markdown rate compared with the prior year.

In 2013, we are expecting that our occupancy costs, on a dollar-basis, to increase approximately $5.0 million as a result of the new DXL stores opening this year and certain lease termination costs associated with closing Casual Male XL and Rochester Clothing stores. As a result, we expect occupancy costs will be between 40 to 60 basis points higher in fiscal 2013 than in 2012. From a merchandise margin perspective, we are planning a continued improvement of approximately 40 to 60 basis points. Accordingly, we are expecting gross margin will be plus or minus 20 basis points in 2013 compared with a year ago.

As a percentage of sales, SG&A expenses increased to 41.0% compared with 39.5% for the first quarter of 2012. On a dollar basis, SG&A expenses increased $0.6 million, or 1.5%, for the first quarter compared with the prior year’s first quarter. During the quarter, the Company incurred approximately $1.6 million related to DXL pre-opening payroll, store training, infrastructure costs and increased marketing to support the DXL transformation effort.

This is a significant building year for us and as such, our SG&A expenses are expected to be noticeably higher than they have been in the past. We expect that our SG&A expenses will increase by $15.0 to $17.0 million and as a percentage of sales will be 220 basis points higher than 2012. This increase in dollars is primarily related to increased store payroll to support our planned new DXL store openings, incremental marketing costs associated with our effort to increase brand awareness, costs to close Casual Male XL and Rochester Clothing stores and other infrastructure-related costs.

Net income for the first quarter was $1.0 million, or $0.02 per diluted share, which compares with net income of $2.3 million, or $0.05 per diluted share, in last year’s first quarter. This decrease is in line with our expectations.

The Company used $8.0 million for capital expenditures during the quarter and operating cash flow was negative $5.6 million. From a liquidity perspective, for the first three months of fiscal 2013, we had $6.1 million in cash and cash equivalents, outstanding borrowings of $11.6 million and

$61.2 million of credit available under the Company’s revolver facility. The Company’s inventory levels at the end of the quarter were flat with year ago levels but unit inventory levels were 4% lower than year ago levels.

Now I’d like to provide an update on the accelerated conversion plan for our Destination XL concept.

We now have 54 DXL stores in operation with at least one DXL store located in most major metropolitan cities across the U.S. DXL store square footage has more than doubled since last year to just over 500 thousand square feet.

We plan to open 57 to 64 DXL stores and close between 110 and 119 Casual Male XL and Rochester stores in 2013. During Q1, we opened 6 DXL stores and closed 17 Casual Male XL stores. We expect to open 12 DXL stores and close another 24 Casual Male XL stores in Q2. We have already selected sites for all of these new DXL stores, and are working toward finalizing lease arrangements for DXL stores to open late in the year. We expect the overall store square footage to increase at approximately 3%, but the overall DXL square footage is expected to again double to just under 1,000,000 square feet by the end of the year.

With that, we reiterate our guidance for 2013, which is a critical year in growing DXL store count across the chain, making significant progress in closing Casual Male XL stores, and significantly enhancing market awareness of the Company's DXL brand, which we expect will produce greater store and e-commerce traffic.

We anticipate total 2013 sales to be in the range of $415 to $420 million, which is based on a comparable sales increase of between 8.5% and 10.0% for the year. The critical factors in achieving this guidance are the DXL store expansion, along with the national media campaigns designed to increase DXL brand awareness.

EBITDA is expected to be in the range of $20 to $23 million.

We expect gross margin to be constant to 2012 levels at 46.5%, within a range of plus or minus 20 basis points.

SG&A costs are expected to increase by between $15.0 to $17.1 million, to a range of $171.4 to $173.5 million, primarily due to the $10 million in increased advertising spends for the national marketing campaign, higher corporate bonus expense, increases in DXL store opening and Casual Male XL store closing costs, training and travel costs related to new DXL stores and higher operating expenses to support the expected sales increase. As a percentage of sales, SG&A expenses are expected to increase over last year as a result of our DXL initiative by 220 basis points to approximately 41.3% of sales.

Earnings per diluted share are expected to be approximately breakeven.

Our capital expenditures for 2013 are expected to be approximately $45 million, after subtracting expected construction allowances contributed by our landlords on the new DXL sites. These expenditures will be spent largely on our planned opening of a total of 57 to 64 DXL stores in 2013 as well as technology projects to improve the e-commerce site and the in-store customer experience. The 2013 net capital spend of $45 million will be funded from cash, EBITDA generated during the year, and reductions in working capital. We expect free cash flow to be negative such that revolver borrowing should be between $10 to $15 million at year's end. Together with the Company's seasonal borrowing needs, we expect the Company's peak borrowing from its revolver to be in the neighborhood of $40 million during the year. Borrowing availability at year end is expected to be approximately $60 to $65 million. The Company is in discussions right now with its primary revolver facility lender to extend the existing facility to 2018, raise the credit limit to $100 million from the current $75 million limit, and lower the overall facility costs, which is expected to be completed in the second quarter.

At the end of this year, we will have a significantly greater number of DXL stores in operation and our Casual Male XL and Rochester store base will be reduced by more than half from what it was a few short years ago. In addition, we expect to have greater brand awareness as a result of our marketing campaign. Our turnaround plan is on schedule, which positions us for substantial revenue and operating profit growth beginning in 2014.

This concludes my remarks. We will now take your questions.

Q&A Session

Operator:

That concludes our Q&A session. I will now turn the call over to Mr. David Levin for any closing remarks.

David Levin:

Thank you all for being on the call. I'd like to end by inviting you to visit one of our DXL stores. Please give us a call if you would like to inquire about a store location or would like a tour.

We look forward to speaking with you next quarter.