Casual Male Retail Group

Third-Quarter 2012 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Casual Male Retail Group's third-quarter 2012 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 Casual Male Retail Group's third-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.casualmale.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.

Before we get started, I want to reach out to all of our colleagues, customers, shareholders and the communities impacted by Hurricane Sandy. Our thoughts are with them during this difficult time of recovery.

Operationally, our stores in the Northeast continue to feel the effects of the storm and we expect our top line results for the fourth quarter to be lower than expected as a result. Customers in that region are currently focused on other priorities.   Dennis will provide more detail on our outlook later in the call.

On last quarter’s call, we discussed our Destination XL strategy, and how we are accelerating that strategy to capitalize more quickly on the significant financial benefits that the DXL concept provides to our bottom line for the long-term. We’re more aggressively opening DXL stores and closing our Casual Male XL stores.

As we execute against that strategy, we’re seeing some very encouraging signs that this is the right course of action. But we also understand that we have a long way to go before the full transition to the DXL brand. In the third quarter, our revenue and earnings were lower than we expected due primarily to the mild fall weather that affected sales of seasonal apparel, and lower direct sales as we transition catalog customers to our more profitable e-commerce platform. At the same time, our DXL retail stores and direct sales through destinationxl.com performed very well in the quarter with excellent comps.

Before I get too far into our results and strategic progress for the quarter, let me provide you with a quick review of what Destination XL is all about.

Destination XL combines the offerings of our Casual Male XL stores with the designer names and quality clothing of our Rochester Big and Tall stores. Customers who have shopped at a Destination XL absolutely love it. The stores are upscale and aesthetically pleasing, and most importantly, we designed them around the needs of our customers. It's essentially a new superstore concept that delivers the best shopping experience ever for big and tall men. A customer would have to visit at least two or three other stores to assemble the same wardrobe solutions that can be purchased at one DXL location.

DXL stores offer more than 2,000 styles (versus 600 in our traditional stores), more private label brands and more name brands. Very recently, we began selling Tommy Hilfiger with an exclusive launch in big and tall sizes at our DXL stores. The brand has already been selling quite well on DestinationXL.com.

Through DXL, our customers also have the opportunity to acquire name brands like Polo, Lacoste, Michael Kors, Robert Graham and many others. We're also offering a much greater selection of higher ticket price clothing than ever before, along with our "made-to-measure" custom tailoring service that provides an even broader variety of options for suits and dress shirts. One of the consistent results of the expanded selection and the higher ticket of our aspirational brands has been the average transaction at the DXL stores has been close to 40% higher than what our current Casual Males XL stores produce.

For all of these reasons, Destination XL stores have been performing very well since we opened our first few stores in 2010, and they continued to do so in the third quarter. Destination XL retail stores recorded a 13.8 comp compared with a flat comp for our Casual Male XL stores. The DXL stores that opened in 2012 were up 32% year over year, those that opened in 2011 were up 14% and those that opened in 2010 were up 6%. Those are very good numbers given the absence of a marketing campaign. And, DXL still only represents about 14% of our retail sales, so there is an incredible opportunity to increase our top line as we open more DXL stores and launch our new marketing campaign next year. I'll talk more about the development of that campaign for Destination XL in just a minute.

In addition to our retail stores, we have an excellent opportunity to drive growth through our direct channel. As a result of the transition going on in that channel, we've recently seen a short-term decline in overall direct sales. In Q3, direct channel sales were down 3% year over year, entirely due to a 33% decrease in catalog sales. Our more profitable ecommerce sales were up 11% over the same quarter last year and that is encouraging.

Even though our sales are down in the direct channel overall, our profit margins are 200 basis points higher as we have been focused on more productive marketing. During the past few years, we've been scaling back on catalog marketing by narrowing our catalog distribution. Our total circulation is down about 30% from a year ago, with fewer customers receiving catalogs, fewer catalogs going to each customer and fewer pages in each catalog. Next year we will streamline circulation further and we will become increasingly less reliant on the catalog as we build our direct business.

Of course, to begin growing the direct business again – which we fully intend to do, we need to continue to make progress on e-commerce. As I mentioned, in the third quarter, our e-commerce sales were up

11%. Even though that increase was not enough to overcome the decline in catalog sales, we expect our overall direct sales to begin to grow once we optimize the marketing of our digital presence. About a year ago, we launched our DestinationXL.com website, where customers have access to all of our brands and can shop by concept, brand, lifestyle, size or price point. Already, we've seen higher per customer transactions for those shopping on the DXL site than those shopping on the Casual Male XL site.

As we discussed on last quarter's call, we're undergoing a total transition from our legacy Casual Male XL retail, catalog and online presence to the DXL concept.

During the quarter, we began testing new marketing concepts and messaging around the DXL brand in five geographic markets, which include seven DXL stores. We're measuring our success through a combination of brand awareness, store and web sales, traffic, and new customers to the brand. These tests will help us to determine the right media and the right message to help us build our brand nationwide.

Our test marketing includes TV, radio and digital advertisements, as well as in-store promotions. The creative concept behind the advertising campaign is that with DXL, bigger men have an alternative to shopping in a "no-man's land" where there are extremely limited choices of brands and styles in their sizes.

I invite you to take a look at our TV, radio and digital concepts, which can be viewed at www.DestinationXL.com/marketing and on the Investor Relations tab of our website in the Featured Documents section. Our TV effort, which was played primarily during primetime network television in the geographic test markets, also focuses on the concept that bigger men have had to shop in a vast wasteland…until DXL.

Our radio marketing is designed to drive awareness through the use of 30 second ads, DJ live reads, testimonials and remotes hosted in our stores.

Our digital campaign includes general awareness banners, retargeting and key digital news sites. In addition, customers in all markets are being shown online video on sites like NFL.com and Yahoo.

In our DXL stores, we're updating window graphics as well as signage in key areas to further reinforce our brand and campaign messages.

Once we have the results back from these tests, we'll complete the formulation of a new marketing strategy. Next year, when we expect to have a DXL store in nearly every major metropolitan market, we plan to launch a national marketing campaign. Our advertising test markets are already showing promise. Based on the small sample we have, we are seeing some nice movement. For example, in those test markets we're starting to attract a smaller-waisted, "end of rack" customer. As we've mentioned before, attracting the 42-46 inch waist, younger customer is a great growth opportunity for us. Customers within that size range represent 65% of the total big and tall market, yet it only represents 20% of our business today.   To build on that program, we are adding a new smaller top size in the spring that has a better fit than traditional tops for the smaller waisted customer. We've seen an increase in new customers overall in our test markets, so we're pleased with the test marketing results thus far.

On the last call, I mentioned a few key statistics from a recent analysis of the DXL customer funnel that are quite compelling and bear repeating. Only 17% of potential customers in our addressable market of men with a waist of more than 40 inches had even heard of DXL. And of those who are aware of DXL, only 8% are visiting the store. However, of those who do visit a DXL store, 73% make a purchase, and 89% of those that make a purchase intend to return. So those that are aware of the benefits of DXL love the store and intend to be return shoppers. So we have a real opportunity to leverage an effective marketing campaign to increase the awareness of DXL, and in turn, grow sales volume and profitability.

We are excited about accelerating our DXL strategy. Our DXL stores continue to do extremely well and our DXL e-commerce platform also is showing great promise. Adding a strategic nationwide marketing campaign to the mix will enable us to generate a great deal more awareness among customers. As we execute on the openings of the new stores over the next three years, we plan to grow our share of the end-of-rack customers, increase our overall dollars per transaction, and expand our market share. And, ultimately, substantially grow sales and achieve double digit operating margins.

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

Dennis Hernreich:

Thank you David and good morning everyone. I'll start by reviewing our third-quarter results and then offer an update on our accelerated conversion to the DXL concept. I'll conclude with our updated guidance for the year.

For the third quarter of fiscal 2012, total sales of $88.7 million were essentially flat compared with the prior year. Comparable sales increased 1.5% vs. the same period last year.

Let me define what we mean by comparable sales. Comparable sales for all periods include retail stores that have been open for at least one full fiscal 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 comparable to all closed stores in each respective market area. Therefore, unless we have opened a DXL store in a new market, of which we have 4 DXL stores in new markets today, a DXL store is considered a comparable store. Direct businesses are included in the calculation since we are a multi-channel retailer.

With that said, sales from our retail business overall were up 2.5% for the quarter. Casual Male XL stores which are in close proximity to an existing DXL store location, however, continue to experience sales erosion, reporting negative comparable sales for Q3 of approximately 4%. The other Casual Male XL stores, on the other hand, generated an approximate 1% sales increase. The 31 comparable DXL stores experienced a 13.8% comparable store sales increase over the prior year, which is primarily responsible for driving the growth in the Company’s total comp sales for the quarter.

The success of our DXL stores is a great sign for our strategy in the long run, but a negative for our traditional Casual Male XL stores in the near term. An important part of the Company’s three year DXL rollout strategy is to accelerate the closing of Casual Male XL stores within DXL markets and maintain existing Casual Male stores until a DXL store enters the market.

Sales from our U.S. direct business decreased 3.0%. Our direct business consists of two primary channels: catalogs and our website, DestinationXL.com. The decrease in direct sales is being driven by the transitioning of our customers away from our traditional catalogs and toward our more profitable e-commerce website. This was demonstrated during the third quarter as sales from our catalogs and call center were down 33%, while sales from our website were up 11%.

While our long-term plan has been to eliminate our legacy brand catalogs gradually as our customers convert to digital mediums, we have been reducing our current circulation and page counts in existing catalogs and increasing our spending in digital marketing. In the third quarter, the Company's catalog circulation was reduced by 30% with an impression reduction of almost 50%. Although the decrease in our catalog sales has affected our direct business in the short-term, we expect our digital marketing efforts will make up for the top line shortfall in the long-term. In addition, as a result of decreasing our catalog circulation, we expect that our operating margins in our direct business will continue to benefit from this change.

In response to this new trend, we have intensified our digital marketing efforts that include emails, web searches, Internet banners, and affiliate sites. We recently made further enhancements to the DestinationXL.com shopping website introducing the acceptance of

PayPal, 1 page checkout, real-time customer feedback, improved merchandise assortment search by color and sports team. Other enhancements to the shopping experience are planned for 2013 including improved international customer servicing, custom dress shirts capabilities, and enhanced personalization. In addition, a mobile app is expected to be introduced in early spring.

For the third quarter of fiscal 2012, we reported a net loss of $1.6 million, or $0.03 per share, which was flat with Q3 of 2011. These results include incremental expenses of $3.0 million related to our DXL store growth initiative. The increased costs include approximately $0.2 million in pre-opening occupancy costs associated with our DXL store openings and approximately $2.3 million in SG&A expenses related to store openings, infrastructure and marketing costs. In addition, we had $0.5 million of additional amortization as a result of our "Casual Male" trademark's becoming a definite-lived asset.

Our gross margin rate, inclusive of occupancy costs, was 44% compared with gross margin of 45% for the third quarter of last year. The decrease of 100 basis points was primarily the result of a decrease of 40 basis points in merchandise margins plus an increase of 60 basis points in occupancy costs.

Our merchandise margin was negatively impacted by an increase of approximately 6.5% in clearance markdowns compared with the prior year's third quarter. However, our inventory at the end of the quarter has approximately 12% less clearance merchandise than at the end of the prior year's third quarter.

On a dollar basis, occupancy costs for the third quarter of fiscal 2012 increased 3.2% over the prior year. This increase is largely due to the timing of the DXL store openings and the associated pre-opening occupancy costs incurred.

From a liquidity perspective, at October 27, 2012, we had $5.2 million in cash and cash equivalents and outstanding borrowings under our credit facility of $7.6 million, with $64.4 million of available credit remaining.

Third quarter free cash flow of $(12.9) million is largely the result of the seasonal increase in inventory. Our inventory levels at the end of fiscal 2012 are expected to be lower than last year's level by approximately $2 to $3 million.

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

Since the start of fiscal 2012 through Q3, we opened 18 DXL stores. We have already been opened 5 more stores since quarter end and plan to open an additional 9 DXL stores by year end, resulting in 32 stores opened in 2012 and a total 48 DXL stores in operation by the end of the year. By that time, we will have at least one DXL store located in most major metropolitan cities across the U.S.

We've done well in finding excellent real estate for our new DXL stores, and we plan to open another 63 locations next year, of which we have selected sites for 55 of these stores. Three of the new DXL stores that were slated for a late 2012 opening, will instead be opened just after year end in February 2013. We are continuing to target between 225 to 250 stores open by the end of fiscal 2015. To add to the Company's capacity to open DXL stores in accordance with our rollout plan, we have recently selected three outstanding national firms to assist us in the leasing, constructing and opening of DXL stores and the closing of Casual Male XL stores over the next three years, which will also enable our Operations group to stay focused on managing the Company's go forward retail stores. As we open more DXL stores, we will be closing existing Casual Male XL stores in each respective market area, virtually leaving in place only our outlet channel stores of approximately 50. For fiscal 2012, we remain on target to close 69 stores, and expect to close another 120 in fiscal 2013.

In the third quarter, DXL stores generated about 14% of our total retail revenue. We expect to approach 25% in the fourth quarter and reach nearly 50% of total sales by the end of fiscal 2013, on an annualized basis in our retail channel. We expect that the rollout will be mostly completed by the end of fiscal 2015 when we will see the full effects of a bottom line benefit from DXL with significantly greater top and bottom line growth in 2016. Sales per square foot in an average DXL store is expected to reach approximately $230 in 2016. This compares to sales per square foot for our total chain of $178 for 2011. This DXL rollout is projected to approximate $150 million in costs, which will be funded from operational cash flow, including the use of the Company's approximately $50 million in tax benefits.

With that, I'll give you our revised guidance for fiscal 2012.

As David mentioned at the outset of the call, mild weather and lower direct channel sales affected our sales for the third quarter. In addition, the impact of Hurricane Sandy on our Northeast business will have a negative effect on our fourth quarter revenues. We had 109 stores close for various periods of time for a total of 196 "store days" as a result of the storm in the Northeast, including some of our highest volume locations. Several stores were damaged, and we are still assessing the total impact that the storm will have on our Q4 results.

As a result, we are revising our guidance for full-year 2012.

We now expect total sales to be in the range of $400 to $402 million, which is based on a comparable sales increase of between 1.5% and 2.0%.

We expect gross margin to improve 10 to 40 basis points from fiscal 2011 to between 46.4% to 46.7%, based on merchandise margins improving by approximately 70 to 90 basis points with a 50 to 60 basis point increase in occupancy costs.

Selling, general and administrative costs are expected to increase by $3.0 million to $4.0 million to a range of $155 million to $156 million, primarily due to the additional store payroll and advertising costs associated with the planned DXL store openings and expected bonus accruals. Included in this increase is approximately $2.5 million for an additional 53rd week in fiscal 2012. As a percentage of sales, SG&A expenses are expected to increase over last year as a result of our DXL initiative by 30 to 50 basis points to between 38.7% and 38.9%.

Consolidated earnings per diluted share from continuing operations are expected to be in the range of $0.17 to $0.20 per diluted share.

We expect cash flow from operating activities of about $38 million, resulting in free cash flow of approximately $3.0 million. We anticipate our cash balances to increase to approximately $13.0 million by the end of the year, with no borrowings outstanding under our credit facility. Our capital expenditures for fiscal 2012 are still expected to be approximately $35.0 million. These expenditures will be spent primarily on our planned opening of a total of 32 DXL stores in 2012.

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. It's hard to grasp the opportunity we have with DXL until you've been in the store and can see for yourself what we offer our customers with this new concept. 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.