Destination XL Group, Inc.

Third-Quarter 2013 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's third-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 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.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 third quarter, especially given the soft retail environment. The first two months of the quarter were quite slow as uncertainty surrounding the government shutdown negatively affected consumer behavior, and unseasonably warm fall weather further hindered sales. We also had promotions in Q3 last year that did not anniversary. We then saw a very strong rebound in traffic and sales during October, which we attribute directly to the start of our fall national marketing campaign. And that was certainly the highlight of the quarter.

Like in the spring, we saw a dramatic and positive effect from the campaign, which started during the last week in September and is just ending now. When you look at our comps for October, we reported a 30.2% increase in sales across all DXL stores, and a 25.3% increase for those that have been open longer than a year. This compares with a 15.9% comp for all DXL stores in August and an 8.7% comp in September. So you can see how well these stores performed with the strength of the campaign behind them.

Looking at comp sales for the third quarter overall, our DXL stores reported an increase of 17.7%. For the 36 DXL stores that had been open greater than a year, the comparable sales increase in the quarter was 11.3%. Keep in mind that the marketing campaign only began at the end of September, so we only had about five weeks of benefit in Q3. By contrast, in Q2, the six week spring campaign took place during the first two months of the quarter, and then we saw a positive halo effect for about a month after the conclusion of the campaign. So looking at Q4, we'll benefit from a few weeks of the campaign in November, and then hopefully we'll see the halo effect again into December.

The fall campaign included an additional week of advertising than it did in the spring – for a total of seven weeks – and cost approximately $2 million more. Our "No Man's Land" ad campaign aired in October on network television to supplement our nationwide presence on cable. This included placement during NFL games and primetime television on CBS and Fox. As in the spring, the fall marketing campaign also included a radio and digital marketing mix.

The response to our commercial has been excellent. It appears to be connecting with our target audience, young and old. These guys are always challenged when attempting to put together a wardrobe. They could find an item at one department store and another item in a different store, but they could not go to one location and put it all together. They want to be able to shop like everybody else, so this "No Man's Land" concept really seems to resonate with our guys.

Given that it is just ending, we aren't able to provide the quantitative results from the fall campaign just yet. However, we continue to be encouraged by many of the metrics that we're using to gauge the successful execution of our DXL strategy.

Looking specifically at October when the national marketing campaign was taking place, traffic into DXL stores was up 11% compared with last year, and new customer penetration increased 34.6% over last year. Traffic in our stores increased noticeably while the ad was airing. While some of this increased traffic was no doubt a result of curiosity shoppers, this gives us a sense of the impact our ad campaign has on driving customers to our stores.

On past calls we've discussed how the DXL concept would help increase the dollar size of our transactions, and that expectation is coming to fruition in a significant way. In fact, average transaction size increased by 17.4% in the third quarter for three reasons. First, our DXL stores have well trained sales associates, and the continued improvement in their productivity is having a noticeable effect on sales. Second, we're selling a greater mix of higher-priced name brands as well as tailored clothing. And third, our new smaller waist customers are spending more per visit than customers with a waist size greater than 46".

The name brand selection we offer at DXL stores is unmatched by any competitor. Every store has a Polo Ralph Lauren shop, and other name brands such True Religion, Calvin Klein and Lacoste. Some of these brands were not even available in big & tall sizes until we opened Destination XL. We're pleased with the early customer response to our name brand offerings, which is reflected in our average transaction size.

As I mentioned, a higher mix of tailored clothing also is making a positive difference in our average transaction size. In every DXL store, we offer several hundred square feet dedicated to clothing. Our custom "made to measure" offering, which includes a robust selection of suits, sport coats, dress pants and shirts, is also progressing well.

With all these wardrobe options available, we're attracting a new category of customer that we call the "end-of-rack" shopper. He can shop at department stores, but his options are limited. He's younger, smaller-waisted, and more brand-conscious. Attracting the end-of-rack customer, which represents 65% of the total big and tall market and who tends to have a higher spend per transaction, increases our total available market. We've done well attracting this customer into DXL. As proof of that, the percentage of sales to customers with a 46 inch waist or smaller increased to 43.5% of sales in October during the campaign compared with 36.3% of sales for full year 2012 and 40.5% in Q2 2013.

Prior to the spring marketing campaign, we often said that we were pleased with the performance of our DXL stores given the lack of marketing. It's now clearly apparent that our market campaigns have had a positive impact on many of the metrics that we're using to track our success. It's too early to discuss our specific marketing plans for 2014, but we continue to expect to have a marketing spend of approximately 7% for next year.

The success of our national marketing campaign also reinforces our decision to eliminate the catalog, which has been a drag on our direct business. For the third quarter, direct sales were down 6.4%, but we improved direct operating margins by 910 basis points over Q3 2012 as a result of the catalog elimination. We'll continue to maintain a traditional "snail-mail" element of our marketing plan, but it will consist of a lower-cost 16-page brand mailer that will feature new seasonal offerings. On the positive side, sales from our e-commerce website, destinationxl.com, were up 8% compared with last year. This is encouraging given that web sales were actually down 2.7% in Q2, but we still have work to do in transitioning legacy customers away from the catalogs to the web.

When we think about our marketing initiatives going forward, we will be allocating the money we're saving on the catalogs to promoting our DXL concept and increasing brand awareness through focused digital and media marketing strategies.

The DXL concept is beginning to demonstrate its true growth potential. We are pleased with the progress of our national marketing campaign and continue to believe that our transformation from Casual Male to Destination XL will yield excellent long-term results.

With that, I'll turn the call over to Dennis

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 third 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 some context around our updated guidance for 2013.

In the quarter, total sales were $88.2 million compared with $88.7 million for the prior year's third quarter. The decrease of $0.5 million in total sales was principally due to a decrease of $3.5 million related to the overall drop in sales from our Casual Male XL and Rochester Clothing stores that have closed since last year and have not been replaced with a DXL store and a decrease of $0.4 million due to the difference in comparable weeks. These factors were partially offset by a comparable sales increase of 4.4%, or $3.7 million – despite the difficult retail environment during the third quarter.

Let me briefly 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.

The comparable sales increase of 4.4% consisted of an increase in our retail business of 6.4%, or $4.4 million, driven by our 74 DXL stores that had a comparable store sales increase of $3.4 million, or 17.7%. This was mostly on the strength of the average dollars per transaction which increased 17.4% during the quarter. Our remaining retail stores had a comparable sales increase of $1.0 million, or 2.0%.

Our August comparable sales were 2.4%, but then fell to (1.6%) in September as the risk of a government shutdown drew near. As David mentioned, however, by mid-October with the end of the shutdown and the arrival of colder weather, we saw a significant increase in sales. Comparable sales for October increased 13.6%, with much of the increase occurring after Columbus Day weekend.

Looking specifically at DXL comps, we saw a significant effect from the fall marketing campaign. Comparable sales for our DXL stores were up 30.2% in the month of October, and the comparable sales for the DXL stores opened longer than a year were up 25.3% in October.

The comparable sales increase was offset by a decrease in our direct business of 4.5%, or $0.7 million. This was primarily driven by a decrease in our catalog sales of $1.5 million for the third quarter compared with last year's third quarter.

As a result of our decision to eliminate catalogs completely, catalog sales decreased 73.3%, or $1.5 million, compared with the prior year. As a result, total circulation, which includes catalogs and mailers, decreased 89.4% in the third quarter over the prior year.

While catalog sales have decreased, the profit margin from our direct business continues to improve. The operating profit margin for the third quarter increased 43%, from 21.3% to 30.4%, and is expected to approximate over 30% for fiscal 2013, up nearly 400 basis points from fiscal 2012.

The improvement in direct profit margin is primarily being driven by sales from our e-commerce business, which were up 7.9% for Q3. In the long-term, we expect our e-commerce business to replace the current shortfall in sales from our legacy brand catalogs.

Gross margin for the third quarter, inclusive of occupancy costs, was 44.5% compared with gross margin of 44.0% for the third quarter of last year. The increase of 50 basis points was the result of an improvement in merchandise margins of 90 basis points, partially offset by an increase in occupancy costs of 40 basis points. On a dollar basis, occupancy costs for the third quarter increased 1.6% 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 and lease exit costs. The improvement in merchandise margins of 90 basis points was the result of initial markups as well as a favorable markdown rate compared with the prior year.

In 2013, we are expecting our occupancy costs, on a dollar-basis, to increase by over $4.0 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. The occupancy costs for the first nine months of this year included $2.6 million in pre-opening and lease exit costs associated with DXL store openings. As a result, we expect occupancy costs will be approximately 100 basis points higher as a percent of sales in 2013 than in 2012. From a merchandise margin perspective, we are planning a continued improvement of approximately 100 basis points.

As a percentage of sales, SG&A expenses increased to 46.6% compared with 42.5% for the third quarter of 2012. On a dollar basis, SG&A expenses increased $3.4 million, or 9.1%, for the third quarter compared with the prior year quarter. During Q3, the Company incurred approximately $4.5 million in incremental costs which includes $3.0 million in marketing costs and other $1.5 million of costs related to DXL pre-opening payroll, store training and infrastructure costs with respect to the transition.

Net loss for the third quarter was $(4.1) million, or $(0.08) per share, which compares with a net loss of $1.6 million, or ($0.03) per share, in last year's third quarter. The decrease in earnings was attributable to the increase in marketing costs related to our national marketing campaign, as well as pre-opening costs, such as payroll and occupancy, related to the opening of our

DXL stores and trademark amortization. In total, the $5.8 million of DXL transition and marketing costs represents $0.07 per share.

The Company used $38.2 million for capital expenditures for the first nine months of fiscal 2013. That was partially offset by approximately $6 million from tenant allowances from landlords. From a liquidity perspective, for the first nine months of fiscal 2013, we had $5.2 million in cash and cash equivalents, outstanding borrowings of $27 million and $70.7 million of credit available under the Company's revolver facility. The Company's inventory levels at the end of the third quarter were up 3.0% compared with a year ago and unit inventory levels were 1.2% higher than year-ago levels. Unit inventories in branded apparel have increased as we open more DXL stores and this inventory has a higher carrying cost.

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

As most of you probably know, we are in the process of completely transforming our retail channel to the DXL concept. Across the country, we have opened 74 DXL stores and closed 168 Casual Male and Rochester stores to date. DXL store square footage has more than doubled since last year to more than 700 thousand square feet.

During Q3, we opened 9 DXL stores and closed 22 Casual Male XL stores. Our DXL stores continue to outperform our Casual Male XL stores and, as the chain becomes more fully converted, our top line sales growth should improve accordingly.

By the end of the fourth quarter, we expect to have opened 53 DXL stores and to have closed 102 Casual Male XL and Rochester Clothing stores. In fact, we opened 12 DXL stores just in the past 10 days alone. We expect the overall store square footage at year end to approximate 1.9 million, an approximate 5% increase from the end of 2012, of which nearly half will be DXL stores. Next year, we plan to open approximately 60 DXL stores, completing the roll-out with an expected total of 215 to 230 stores by the end of fiscal 2015.

As we have previously disclosed, this transition to the DXL concept will result in annual incremental SG&A costs of approximately $10.0 million on an annual basis, as a result of early store closures, as well as additional expenses to support the rollout. In addition, we expect to incur an additional $1.6 million in amortization costs in fiscal 2013 related to our Casual Male tradename, with the remaining $2.5 million amortized on an accelerated basis through fiscal 2018. The rollout is expected to be substantially completed by the end of 2015. The capital expenditures, incremental SG&A and other charges totaling approximately $150 million over these next three years are expected to be funded primarily from operating cash flows, equipment financings and borrowings under our credit facility.

And now turning to our guidance for the full year…

We continue to expect that we will be within the sales guidance range that we issued on our last call, but due to delays in some store openings, we expect to come in at the lower end of that guidance.

Revenues are expected to be approximately $395.0, which is based on comparable sales of approximately 5% for the year.

We expect gross margin to be constant to 2012 levels plus or minus 10 basis points at 46.5%. This is based on merchandise margins improving by approximately 100 basis points, offset by an increase in occupancy costs of approximately 100 basis points.

SG&A costs are expected to be approximately $166 million, or an increase of approximately $10 million from 2012 related to increased marketing expenses as well as DXL transition costs.

EBITDA is expected to approximate $15 million with an operating margin at about (0.8%).

In line with our narrowed revenue guidance, we now expect earnings per diluted share to be a loss of approximately $0.05.

Our capital expenditures for 2013 are expected to be approximately $45.1 million, after considering expected construction allowances contributed by our landlords on the new DXL sites. These expenditures will be spent largely on our planned opening of DXL stores as well as technology projects to improve the e-commerce site and the in-store customer experience. The 2013 net capital spend of $45.1 million will be funded from cash, EBITDA generated during the year, and reductions in working capital. Inventory levels at the end of the quarter were up 3% from twelve months ago, and only up 1.2% on a unit basis. We expect inventory levels to be approximately flat by the end of the year.

During the quarter, the Company supplemented its borrowing capacity under its $100 million revolver line of credit, with equipment notes for $13.9 million at an interest rate of 3.1% payable over four years. Over the next few quarters we expect to issue up to $16 million in additional equipment notes under the similar terms and conditions.

By the end of the year, the Company expects to have a net debt position (after any cash balances) of approximately $17-$18 million, with much of its $100 million line of credit available.

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. As always, 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.