Destination XL Group, Inc.

Second-Quarter 2014 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's second-quarter fiscal 2014 financial results conference call. Today's call is being 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. On our call today is David Levin, our President and Chief Executive Officer, and Peter Stratton, our Senior Vice President 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.

Our results for the second quarter of fiscal 2014 are impressive, particularly given the challenging retail environment this past quarter. Destination XL's strong results were driven by the continuing success of our DXL concept. In fact, this quarter marks our fifth consecutive quarter of double-digit comparable sales increases for DXL stores. What is particularly noteworthy is that the strong performance at our DXL stores was driven by increased traffic and higher conversion rates of store traffic. This shift is a strong indicator of the success of our in-store marketing at our Casual Male XL stores to transition shoppers to the DXL stores. These are very important metrics to the long term success of our strategy.

DXL store sales for the second quarter almost doubled to $41.5 million compared with $21.5 million in the second quarter of fiscal 2013. Another very positive metric this quarter was our penetration of the end-of-rack consumer – those with waist sizes between 40 to 46 inches. Since the launch of our marketing program in Q2 of 2013, the DXL stores have grown the end of the rack customer from 39.2% at the end of Q2 2013 to 42.2% for the DXL stores this quarter. We expect even greater growth in this consumer category as we more proactively communicate the sizes that we carry as we go forward.

There are two new metrics we have identified that are encouraging in the DXL strategy. First, in DXL stores that have comped, the average DXL store has 65% more customers in its active data base than the average Casual Male XL store. Second, again in DXL stores that have been open greater than 13 months, DXL stores on average have maintained a 26% higher retention rate of customers than the average Casual Male XL store.

While we are working hard to redirect our Casual Male shoppers to the DXL stores, those Casual Male XL stores that remain open also are performing well. Customers that are not yet aware of the DXL stores continue to return to Casual Male XL stores to shop. Earlier this year, we slowed the pace of our store closings and, today, Casual Male XL stores are serving as ambassadors to direct customers to the new DXL stores nearby by enticing them with coupons and other DXL marketing materials. As I mentioned, this has been a very successful strategy for us, as we saw growth in our Q2 DXL traffic and conversion rates. In the second quarter, our conversion rate of transferring Casual Male XL customers into a DXL store increased 18%, compared with the same quarter a year ago. As part of our marketing strategy, we significantly increased promotional offers to improve our conversion of existing Casual Male XL customers into DXL shoppers. For example, promotions included a free Harbor Bay polo shirt, followed by a $50 gift card if they did not convert. We sent these customers an Experience Book to introduce the DXL concept and, as a result, one in three recipients visited a DXL store and made a purchase. This had the highest response rate of any direct mail piece we have done in the past.

At the end of April we launched our latest DXL marketing campaign on cable, network TV, radio and digital mediums. You have probably seen our "You're Looking Good" ad that showcases the in-store experience and depth of the brands we offer. Our ad last year was about increasing DXL brand awareness. This year's ad is really about bringing customers into our stores to shop. And so far, it is working. In store traffic is up by 6.5%, transactions grew 13.1% and our conversion rate increased 6.2%. Also, our web traffic conversion improved by 8% in Q2 2014 compared to Q2 of 2013. In addition, traffic on our destinationxl.com website was up 9% compared to last year. Another positive metric was our conversion rate from our mobile visitors was up 67% compared to last year.

While the increased investment in these promotional marketing activities had a slight adverse affect on merchandise margins in the second quarter, it is clear that they are proving successful in terms of traffic, conversion and sales growth. We believe these investments will ultimately translate into long-term profitable growth for our business.

This fall, we'll launch the next flight of our comprehensive marketing campaign. In an effort to align our media presence with our key selling weeks, we will be moving our fall advertising closer to the peak holiday selling periods. Last year, we launched our marketing campaign in late September and it ran until Thanksgiving week. This year, we will launch our initial advertising in mid-October. We will air additional television and radio commercials around Thanksgiving and through mid-December. We know that our marketing strategy works and, while running, it drives more traffic and transactions at our stores and online. Therefore, with this shift in the timing of our advertising, our sales in the third quarter of fiscal 2014 could be lighter than the same period of 2013, but we would expect to more than make of up for any loss in sales in Q3 and see stronger sales during the key holiday season of Q4.

In regard to the Casual Male XL business, last year when we decided to accelerate the Casual Male store closings, we also reduced some Casual Male XL stores' operating hours. During the first quarter of fiscal 2014, we returned to standardized operating hours for all Casual Male XL retail stores, which has positively affected business at many locations. As a result, the 7.1% increase during the quarter for our Casual Male XL retail stores, outlets and Rochester Clothing stores, was primarily driven by the comparable sales increase for our Casual Male XL retail stores.

Turning to our direct business we have begun to see a turning point in this piece of our business. During the first two months of the second quarter of fiscal 2013, the direct business still included sales from our catalogs, which we stopped sending in May 2013. This created a very difficult year-over-year comparison for the first two months of the second quarter of fiscal 2014. As a result, total U.S. direct sales for the fiscal second quarter of 2014 were only up slightly year after year. We expect those comps to continue to improve in the second half of the year, when we are no longer comparing to 2013.

We want DXL to truly be ***the*** destination for our customers and have taken steps toward becoming a true omni-channel retailer. During the quarter we improved the functionality of our destinationxl.com website and increased the frequency of our digital display marketing and promotional efforts. Also, customers who shop online have the convenience of having their order shipped to a DXL store location near them for easy pick up at no cost and with no minimum purchase. By providing more convenient and cost-effective shopping options, we can significantly enhance our customers' shopping experience at DXL and increase the likelihood that they will return.

We have mentioned in the past that our direct business with Sears Canada was having a negative impact on our direct sales. During the quarter, we notified Sears Canada of our intent to exit the business and began the process of an orderly wind-down, which we anticipate concluding in the fourth quarter of fiscal 2014.

Our DXL roll-out strategy calls for us to open approximately 40 DXL stores and close approximately the same number of Casual Male XL and Rochester Clothing stores in 2014. We are being more selective about the timing, locations and size of our new store openings. Store openings will be weighted toward the first three quarters of the year. As of August 2, we had 113 DXL stores open for business across the U.S.

We expect our overall DXL store square footage at year end fiscal 2014 to increase by about 34% from the end of fiscal 2013, and, at the same time, we are improving our sales per square foot. Last year, DXL sales per square foot were approximately $147. We project this to increase to $160 to $165 by the end of fiscal 2014 and that we could reach $220 in the longer term.

One initiative that will help us achieve this goal is our plan to open a number of stores with a smaller footprint of 5,000 to 6,000 square feet in select markets. These smaller-footprint DXL stores also increase our opportunity for continued store growth beyond the original projected 220 to 250 stores. The economics of the smaller 5,000 to 6,000 square foot store is similar to our DXL larger format. The smaller box allows us to penetrate markets where we previously thought we could not be profitable by leveraging improved sales per square foot, occupancy costs, build out costs and capex. Today, we anticipate opening 50 additional 5,000 to 6,000 square foot DXL stores in select smaller markets and in larger markets where geographical considerations warrant an additional presence, but not another full size DXL store.

Our DXL strategy continues to prove successful, giving us confidence that we are on track to further increase our top line, improve profitability, generate cash flow and grow sales per square foot and four wall contribution.

With that, I will now turn the call over to Peter.

Peter Stratton:

Thank you David and good morning everyone. I'll start by highlighting the Company's results for the second quarter of fiscal 2014 and then provide a review of our full year guidance for fiscal 2014, which we reaffirmed in our news release today.

David provided the high level discussion of our sales for the quarter, so I'll get right into the details. Our total comparable sales increase of 7.0%, or $5.6 million, included an increase in our retail business of 8.5%, or $5.5 million. The retail increase, which in turn, was driven by our 61 DXL comparable stores, had an increase of $2.4 million, or 11.3%. We are seeing an exciting shift in our DXL store metrics. In fiscal 2013, our comparable sales growth was primarily the result of an increase in dollars per transactions. This quarter, our store traffic, store conversion, and number of transactions are all up over last year. In fact, for Q2, dollars per transaction slightly decreased by 1.1%, while the number of transactions increased by 13.1% and our conversion rate of store traffic into transactions increased 6.2%, primarily as a result of our marketing and in-store promotional initiatives.

Comparable sales from our remaining Casual Male and Rochester stores increased 7.1%, or $3.1 million. This increase was driven by our Casual Male XL Retail stores, which have been performing very well since we returned to standardized operating hours at the end of Q1.

In our U.S. direct business, as David mentioned, sales improved slightly with an increase of 0.5%, but we're optimistic about stronger near-term growth for this business based on our results in July and that we will no longer have to compare with any catalog sales.

Gross margin for the second quarter, inclusive of occupancy costs, was 45.7% compared with gross margin of 46.1% for the second quarter last year. The decrease of 40 basis points for Q2 of fiscal 2014 was the result of a decrease in merchandise margin of 120 basis points, partially offset by a decrease in occupancy costs of 80 basis points. The decrease in merchandise margin was due to an increase in our promotional activity which we began in Q1 to encourage our Casual Male XL customers to visit one of our DXL stores. We continued with similar promotional programs and customer acquisition initiatives during the second quarter. This approach is helping to transition our existing customer base to our DXL stores as evidenced by our increases in DXL store traffic and conversion.

On a dollar basis, occupancy costs for the second quarter of fiscal 2014 increased less than 1.0% compared with the prior year. As a percentage of sales, the 80 basis point improvement in occupancy costs is due to a decrease in lease termination costs as we slowed the pace of Casual Male XL store closures, with many of the stores staying open through their natural lease term. We are closing approximately 60 fewer stores in 2014 versus 2013.

As a percentage of sales, SG&A expenses for the second quarter of fiscal 2014 decreased slightly to 43.6% compared with 43.9% for the second quarter of fiscal 2013. On a dollar basis, SG&A expenses increased by $2.2 million, or 5.0%, for the second quarter of fiscal 2014 compared with the prior year's second quarter. The increase over last year includes higher marketing costs of approximately $1.1 million and an increase in payroll-related costs of $1.1 million due to the additional operating hours in our Casual Male stores. Pre-opening payroll, training and other incremental costs to support our DXL store openings were $0.8 million for the second quarter of fiscal 2014, compared with $1.3 million in the prior-year second quarter.

Net loss for the second quarter was $4.0 million, or $(0.08) per diluted share, compared with a net loss of $1.6 million, or $(0.03) per diluted share, for the second quarter of fiscal 2013. On a non-GAAP basis, assuming a normalized tax rate for fiscal 2014, the net loss for the second quarter of fiscal 2014 was $(0.05) per diluted share versus second quarter fiscal 2013 net loss of $(0.03) per diluted share. As a reminder, as a result of the valuation allowance against our deferred tax assets, we are not recognizing any income tax benefit on our operating losses in fiscal 2014.

During the second quarter of fiscal 2014, we notified Sears Canada of our intent to exit our business with them and began the process of an orderly wind-down, which we expect to complete by the end of fiscal 2014. As a frame of reference, Sears Canada represented less than 5% of our Direct business in fiscal 2013. Included in the net loss for the second quarter and first six months of fiscal 2014 is a loss from operations from our Sears Canada business of $1.0 million, or $(0.02) per diluted share, and a loss of $1.1 million, or $(0.02) per diluted share, respectively. The loss includes a charge, recorded in the second quarter of fiscal 2014, of approximately $0.8 million primarily related to inventory reserves and sales return allowances.

Capital expenditures for the first six months of fiscal 2014 were $18.9 million compared with $21.1 million for the first six months of fiscal 2013. The $2.2 million decrease is primarily related to the number of store openings during the first six months of fiscal 2014. As of August 2, 2014, we have opened 14 DXL stores compared to 17 DXL stores at August 3, 2013. We expect to open approximately 40 DXL stores and close approximately the same number of Casual Male XL and Rochester Clothing stores in fiscal 2014. In addition, the average square footage of a new 2014 DXL store is slightly less than the prior year, which will have a favorable impact on build-out costs.

From a liquidity perspective, at August 2, 2014 we had $5.6 million in cash and cash equivalents, total debt outstanding of $48.3 million, and $71.0 million available under our credit facility.

Our inventory levels at the end of the second quarter were up $8.1 million, or 7.5%, however, on a unit basis, inventory was down approximately 1.0% compared with year-ago levels. The increase in our cost basis is due to us carrying a greater percentage of branded apparel for our DXL stores, which has a higher carrying cost. In addition, we are making a concerted effort this year to take early receipt of merchandise to ensure that we are in a strong in-stock inventory position prior to key selling seasons.

And now turning to our guidance…

We are reaffirming our full year guidance for fiscal 2014 today. To reiterate, we expect:

Total sales to be in the range of $413 to $418 million.

A comparable store sales increase of between 13% to 15% for the 99 DXL stores that will have been open at least 13 months at year end.

Gross profit margin to range from 45.5% to 46.1%.

SG&A costs to be approximately $176.0 to $177.6 million.

Operating margin to be between negative 2.0% to negative 2.8%.

And we expect a net loss of $(0.21) to $(0.27) per diluted share, or a loss of $(0.12) to a loss of $(0.16) per diluted share on a non-GAAP basis, assuming a normal tax benefit of approximately 40%.

Our net capital expenditures for fiscal 2014 are expected to be approximately $36.4 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 continue to improve the e-commerce site and the in-store customer experience.

The fiscal 2014 net capital spend of $36.4 million, net of tenant allowances, will be funded from equipment financing notes, our revolving credit facility, and EBITDA generated during the year.

Borrowings at the end of fiscal 2014 are expected to be in the range of $35 to $40 million under the credit facility, with equipment financings of approximately $20 million.

We have adjusted our expected year-end borrowing levels to reflect our intention to take early receipt of spring merchandise at the end of the fiscal year to ensure that we are in a strong inventory position before the season. As a result, by the end of the year, we now expect to have a total debt position of approximately $55 to $60 million.

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