Destination XL Group, Inc.

Third-Quarter 2014 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's third-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, sales per square foot, 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 third quarter of fiscal 2014 demonstrate that our plan is working and customers are becoming much more aware of the DXL brand. Our increase in revenues for the quarter was driven by 12.8% comparable sales growth at our 73 DXL stores that have been open at least 13 months. This metric is particularly impressive when you consider that it compares with an 11.3% third quarter comp from same-store sales growth in Q3 2013. This is our 6th consecutive quarter of double digit DXL store comps. We are pleased this comp trend has continued in the month of November.

Our decision to increase promotional efforts to drive customers into DXL stores and improve the conversion of existing Casual Male XL customers into DXL shoppers is paying off. We ran one promotional offer during the quarter. It was a coupon to save $25 when the customer spends $75 at DXL. With the assistance of the promotion, traffic at DXL stores increased by 4.4%, conversion of traffic to sales was up 8.4%, and we saw a substantial rise in the number of active DXL customers in Q3.

We are also seeing traction from our efforts to attract the “end-of-rack” guy to our DXL stores. This younger, smaller-waisted, and more brand-conscious customer can shop at department stores, but his options at those stores are limited. The end-of-rack target group accounts for approximately 65% of the total big and tall market, and tends to have a higher spend per transaction. The DXL model is ideal for the end-of-rack guy because we are giving him more brand and style selections. These customers generated 42.4% of our DXL sales, compared with 33% at our Casual Male XL stores, in Q3. We expect to see continued end-of-rack growth as we continue our marketing to this group of shoppers.

Also, three factors that are contributing to an increase in our customer base is that the average DXL store has 82% more customers than a Casual Male store and of those customers, we retain 30% more in our active database than we do of the customers in a Casual Male store. Lastly, we are converting more Casual Male customers to DXL. Since November of 2013 we have converted 17% more customers than last year.

At our Casual Male XL stores, we continue to see the positive effects of the return to standardized operating hours. In addition, for Casual Male stores that would historically have closed once the DXL store opened in the market, we now keep the Casual Male store open as a clearance store for several months and to serve as brand ambassadors to direct existing shoppers to the new DXL store.

In terms of marketing, this year’s comprehensive fall campaign, which includes television, radio and digital advertising, will run through the peak holiday selling period to mid-December, unlike last year when the campaign ended mid-November. In addition, we have secured higher quality ad placements within our media strategy. We are running ads during NFL and college football games, and pushing more towards the weekend when our guy is more likely thinking of taking a shopping trip. We also will be running a 15 second spot the week of Thanksgiving that is directed to promotional events that are occurring that week.

We are continuing to make progress in growing our sales per square foot in DXL stores, which increased 9% to $160 from Q3 last year. By the end of fiscal 2014 we expect DXL store sales per square foot to grow to $165 and our long term goal is to reach sales per square foot of $220, driven in part by opening stores with a smaller footprint. The economics of the smaller footprint store – typically less than 6,500 square feet – are similar to those of our larger DXL format stores. However, the smaller box allows us to penetrate markets where we previously thought we could not be profitable by leveraging improved sales per square foot, with lower occupancy and build-out costs. Today, we have seven of these smaller footprint DXLs in operation. We anticipate opening this size store in select smaller markets as well as in larger markets where geographical considerations warrant an additional presence, but not another full size DXL store.

As we've discussed in prior quarters, our company has been moving towards an omni-channel approach to managing our business. Shopping behavior for our customer continues to evolve across multiple channels and we are working diligently to meet his needs. Our goal is to provide a seamless customer experience whether he shops a brick-and-mortar store, via computer, smartphone, or tablet.

We are starting to see more transactions that begin online, but are ultimately completed in store. This past year we enhanced our web functionality by enabling stores to sell merchandise directly though our destinationxl.com website. If an item cannot be fulfilled from our distribution center, the order is routed to a store that has the item in stock and the sale is completed at the store level. Similarly, if a customer visits a store and the item is out of stock, the associate can order the item for the customer through our website. Our buy online, ship from store capability is now in approximately 300 stores. In Q1 of 2015, we plan to launch shop online, pick-up in store which we think will be a real game changer for us because many of our customers have last minute needs. This feature brings the guest into the store and provides our selling associates with a chance to recommend additional in-store items.

We're also seeing more customers shopping from their mobile devices. Our website has been optimized for mobile responsiveness to make for a seamless shopping experience on any device. As a result, the conversion rate from our mobile visitors was up 139% from Q3 last year. Mobile penetration of site visitors has increased from 30% from the end of 2013 to

40% currently . Also, 65% of all of our emails are opened on a mobile device.

Because omni-channel engagement is changing the boundaries of where a sale originates and where a sale is ultimately settled, the company no longer presents comparable sales for its direct business on a stand-alone basis. Direct Sales are included in our Total Comparable sales results, instead of providing Direct sales as a separate channel.

The omni-channel experience continues to evolve and we believe this paradigm shift will have a profound long-term benefit for the Company, our customers and our shareholders.

We are encouraged by our strong third-quarter financial results and positive key DXL performance metrics as we continue to execute on our strategy. As we enter the fourth quarter, we remain focused on driving top-line growth and improving profitability.

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

Peter Stratton:

Thank you David and good morning everyone. There are a few different topics that I'd like to talk about today. First, I'll start by highlighting the Company's results for the third quarter of fiscal 2014. I'll then give you a quick update on our new debt facilities that were signed in the third quarter. Finally, I'll provide a review of our full year guidance for fiscal 2014, which we reaffirmed in our news release today.

For the third quarter, we are reporting an increase in total company comparable sales of 5.5% or $4.1 million. Leading the way are our 73 DXL stores that posted a comparable sales increase for the quarter of 12.8% or $2.8 million over third quarter last year. Our Casual Male stores, Rochester stores, and US Direct business had a combined comparable sales increase of 2.3% or $1.3 million for the quarter. Our store traffic, store conversion, and number of transactions are all up over Q3 last year. Store traffic increased 4.4% over third quarter last year in DXL stores open at least 13 months. Conversion, which we define as the percentage of visits that resulted in a transaction, increased 8.4% in DXL stores open at least 13 months over the prior year's 3rd quarter. Transactions, which are the product of Traffic and Conversion, increased by 13.1% for the third quarter over prior year third quarter. Finally, the Dollars per transaction metric for Q3 was flat to last year.

Gross margin for the third quarter, inclusive of occupancy costs, was 43.3% compared with gross margin of 44.2% for the third quarter last year. The decrease was the result of a 90 basis point decrease in merchandise margin. Occupancy costs as a percentage of sales were flat with last year. The decrease in merchandise margin was due to the increase in our promotional activity that David explained earlier. The free Polo shirt, the Experience book, and the October coupon all had favorable impacts on driving traffic to our DXL stores, increasing customer conversion and driving the top-line. Increasing our promotional activity 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 third quarter of fiscal 2014 increased less than 6% compared with the prior-year period. As a percentage of sales, occupancy costs remained flat. We have decreased 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 than in 2013.

SG&A expenses for the third quarter of fiscal 2014 decreased to 42.9% of sales, compared with 46.2% for the same period a year ago. On a dollar basis, SG&A expenses decreased by $0.8 million year over year, primarily due to the shift in the timing of our fall advertising campaign. Pre-opening payroll, training and other incremental costs to support our DXL store openings were $1.1 million for the third quarter of fiscal 2014, compared with $1.5 million in the prior-year third quarter.

Net loss for the third quarter was $6.2 million, or $(0.13) per diluted share, compared with a net loss of $4.1 million, or $(0.08) per diluted share, for the third quarter of fiscal 2013. On a non-GAAP basis, assuming a normalized tax rate for fiscal 2014, the net loss for the third quarter of fiscal 2014 was $3.7 million, or $(0.08) per diluted share, versus third quarter fiscal 2013 net loss of $4.1 million, or $(0.08) 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.

For the third quarter of fiscal 2014, EBITDA was $0.3 million, compared with a loss of ($1.8) million for the third quarter last year. We want to speak to this number because we believe EBITDA provides a good representation of the underlying business fundamentals and therefore is a meaningful indicator of financial performance. As we progress through the DXL transition, cash management is critical for us and we believe EBITDA is a key component in evaluating free cash flow. Therefore, we will be providing updates on this metric going forward.

Capital expenditures for the first nine months of fiscal 2014 were $30.8 million compared with $38.2 million for the first nine months of fiscal 2013. The $7.4 million decrease is primarily related to the slightly smaller square footage of our 2014 stores, which corresponds to a lower build-out cost. As of November 1, 2014, we have opened 29 DXL stores compared with 26 DXL stores at November 2, 2013. Our goal at the beginning of the year was to avoid opening any stores during the critical holiday shopping season. We're very pleased to report that as of today, we have successfully opened 41 stores this year compared to our original plan to open 40 stores in fiscal 2014. We now have a total of 140 DXL stores open across the country. Our next store opening will not be until Q1 fiscal 2015. We expect to continue with the pace of opening approximately 40 DXL stores and closing approximately the same number of Casual Male XL stores for the next two years.

Our inventory levels at the end of the third quarter were up $6.9 million, or 5.7% from third quarter last year. The increase in our cost basis is due to our carrying a greater percentage of branded apparel for our growing number of DXL stores. On a unit basis, however, inventory was down approximately 2% from year-ago levels. In addition, we are making a concerted effort this year to take early receipt of merchandise to ensure that we are in a stronger in-stock inventory position prior to key selling seasons.

Also noteworthy is the fact that our clearance merchandise is down 17% compared to Q3 of last year. Our clearance inventory now represents 9% of total inventory compared to 12% in Q3 last year. Earlier, we talked about our enhanced online inventory management technology that enables us to offer merchandise in the stores to our online customer. This has had a very favorable impact on the sell-through of clearance merchandise and, as a result, our clearance inventory position is much cleaner heading into fourth quarter than in the prior year.

In late October we announced that we increased our existing asset-based revolving line of credit with Bank of America by $25 million to $125 million and entered into a new agreement with Wells Fargo Capital Finance for a $15 million five-year senior secured second lien term loan. This was a very opportune time to increase our borrowing capacity on favorable borrowing terms. As you know, we're spending a lot of cash on building out new DXL stores and these agreements give us the flexibility to complete the roll out by the end of fiscal 2017 without having to worry about excess availability. Keep in mind these agreements did not increase our debt level, rather they just increased our capacity. The $15 million term loan proceeds immediately paid down the revolving line of credit thereby changing the composition of the debt, but not increasing our total debt level.

For the quarter, from a liquidity perspective, we had $6.1 million in cash and cash equivalents, total debt outstanding of $73.9 million, and $75.1 million in excess availability under our credit facility at November 1, 2014.

And now turning to our guidance…

We are reaffirming our full year EPS 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 12% to 13% for the 91 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.
- EBITDA in the range of $12.4 to $15.6 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 cash from operations, equipment financing notes, and our revolving credit facility.

Total Borrowings at the end of fiscal 2014 are expected to be approximately $55 to $60 million, consisting of a range of $20 to $25 million under the credit facility, $15 million under the term loan and approximately $20 million in equipment financings.

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.