Destination XL Group, Inc.

Second-Quarter 2013 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's second-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 second-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.

The second quarter was very important from a strategic perspective for our company, as we implemented our first national marketing campaign for Destination XL. The campaign was a success from many perspectives. We launched the six-week campaign on May 5th to define the DXL brand more clearly, expand market awareness and grow our active customer base.

The comprehensive marketing campaign included TV advertising as well as a radio and digital marketing mix. Our TV ad, which emphasizes the problems big and tall men have in finding a broad selection of styles and that Destination XL offers them a convenient one stop shop solution, aired on cable networks. These included ESPN, USA, TBS, and Comedy Central to name just a few.

Let me share with you some data points in a few key areas to give you a sense of just how successful the campaign was.

First, let’s look at comp sales. Our overall DXL store comp sales jumped to 28.8% in Q2 of 2013 from 17% a year ago. Looking specifically at DXL stores that had been open for more than a year, our comp was an impressive 16.5%. Given that for the past several quarters our comp in that category had been relatively flat, our 16.5% comp demonstrates the effect that the marketing campaign had on our retail stores. We’ve said many times on prior calls that we were pleased with the performance of our DXL stores given the lack of marketing. Now that we have a sufficient number of stores to rationalize a national marketing campaign, we are starting to see how these stores can really perform.

I’d like to note that our TV ad had no promotional call to action to prompt any short-term purchase behavior. We achieved our strong comps on pure brand building. In fact, market awareness of DXL jumped from 13% to 18% year over year. Now, while this is an impressive increase, the fact that we only have 18% brand recognition demonstrates the opportunity that we still have before us.

On our last call we mentioned that while our new marketing campaign would put DXL on customers' radar, we did not expect them to rush out to our stores right away. Our customers typically only shop about two times each year – so we didn't expect an immediate reaction. The campaign ran four weeks in May and two weeks in June. However, our store comps for July were even stronger than they were during the campaign. This tells us that our supposition was correct: not all of our customers came right in to shop after seeing the ad. But we did create sustained awareness so that they came into the store and purchased at a later date.

Compared to last year, traffic into the average DXL store was up 7.5% in the quarter, and new customers were up 26.1%. We're seeing our new customers spending more than our legacy customers because an increasing number of them fit into the "end-of-the-rack" category– a younger, smaller-waisted, more brand-conscious customer. The percentage of sales to customers with under a 46 inch waist increased to 40.5% of sales in the second quarter compared with 36.3% of sales for full year 2012.

Another important metric is our average transaction size at DXL stores, which is up 23% over the second quarter a year ago and up 37% compared with Casual Male stores this year. Two positive factors are behind this growth. First, units per transaction are up due to the much wider product selection available at DXL stores and the superior customer service professionals on hand to satisfy our customers. And second, one of our strongest selling categories has been in dress clothing, comprised of suits, sports coats, dress shirts and ties, which has a higher average ticket than our sportswear assortment.

Our branded assortments continue to resonate with attracting new customers and also offering our existing customers an alternative to our private label product. As I mentioned on last quarter's call, we have a number of exciting brand launches for the fall season. You may have noticed that Brooks Brothers is already being sold through our DestinationXL.com site and this brand will be at our DXL store locations for the fall. We also have an exclusive launch with True Religion to offer their brand in big and tall sizes. And for the first time we'll be carrying Peter Millar, Bill's Khakis and Adidas Golf as well.

The direct business fell short of our expectations during the second quarter due to softer catalog sales and the lower-than-expected effect from the marketing campaign on web sales. While traffic was up on the web by 80%, most of that appears to have been due to a curiosity factor as the vast majority of those visits were not converted. So we believe that while people were curious about DXL and visited the site, they didn't buy online. Through web analysis we have found that 20% of web traffic searched the store locator page.

For more than 5 years, the majority of our marketing spend has been catalog mailings to our current customers. This form of marketing has a high cost and a diminishing and low return on investment. We had not prospected for new customers by any means over this time period. The early success of the brand awareness program indicates we should be spending a majority of our marketing dollars on the program and attracting new customers. Therefore, going forward, we are eliminating our 120+ page catalogs, and will be replacing them with smaller 16-page brand mailers that will announce new seasonal offerings.

As we've discussed before, our goal with the direct business is to improve profitability, and eliminating the catalogs altogether at this point is another positive step in that direction. Considering circulation for Q2 was down 81% and impressions were down 85%, direct sales were only down 9.8%, and we improved direct operating margins by 130 basis points over Q2 2012. So this is purely a top-line issue at the direct business. Going forward, we're going to be putting the money we're saving on the catalogs to work where it can be most effective, and that's in promoting our DXL concept and increasing brand awareness. More specifically, we'll be expanding the scope of the second flight of our national marketing campaign scheduled for this fall.

Beginning the last week in September through the middle of November, our "No Man's Land" ad campaign will be back on the air nationwide. This time we'll be broadening our ad-buy to include network television to supplement our nationwide presence on cable. The fall campaign will also have an additional week than it did in the spring – for a total of seven weeks. The campaign will cost approximately $2 million more than our original budget, but again this is essentially a reallocation from what we would have spent on catalogs. With the marketing campaign, we know we are picking up a significant number of new customers -- in direct contrast to our recent experience with catalogs.

We've long said that Destination XL is the right concept to drive profitable growth at our company for the long term. During the past few years as we've rolled out an increasing number of DXL stores, we've been pleased with the response from our customers -- but the lack of marketing had held back the growth we knew we could achieve. Now, our marketing campaign is proving out our expectations for Destination XL. We still have a long road ahead of us until we've completed the full transition to DXL, but we certainly made excellent progress during the second quarter.

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 second 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 $97.6 million compared with $100.5 million for the prior year's second quarter. Comparable sales increase 3.8% overall, of which we had an increase of 6.9% from the retail stores, and a 9.8% decrease in the direct business. We expect to end 2013 with a store count of approximately 366 stores, after opening another approximate 39 DXL stores and closing another approximate 60 Casual Male and Rochester stores, which means we will have about 46 fewer stores than we had at the start of the year.

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.

With that said, sales from our retail business overall were up 6.9% for the second quarter compared to 0.8% in the first quarter. The 65 comparable DXL stores, which represented 26% of the retail business, experienced a 28.8% increase over the prior year, compared to 17.7% in the first quarter, with DXL stores opened for more than a year performing with a 16.5% comp, compared to 4.7% in the first quarter, while the comparable sales for all other retail stores increased by 0.8%, compared to negative 3.2% in the first quarter. The retail comps in the second quarter increased significantly from the first quarter as a direct result of the national marketing campaign. The DXL stores penetration of the retail business is expected to grow to 40% in the second half of 2013.

Sales from our direct business for the second quarter decreased 9.8% over last year. Our direct business consists of three primary channels: catalogs, orders placed from stores to fulfill an immediate customer need if not available in the store, and our website, DestinationXL.com. Sales from our catalogs were down 51.7% during the second quarter, while sales from our website were down 2.7%. We have been transitioning our customers away from our print catalogues to making purchases on our more profitable e-commerce website. Catalog impressions were reduced in the quarter by 84% from a year ago. As David mentioned, we have made the decision to eliminate the catalogs altogether in favor of much smaller occasional brand mailers. This will be much more profitable for us in the long run. As a result of the transition away from catalogs, the operating margin of the direct business has improved significantly from prior years and reached 26.2% in the second quarter from 24.9% last year, with the direct operating margins expected to reach 30% for the 2013 year, up over 400 bps from a year ago. However, we also expect that the top line sales in the second half of the year to continue to suffer, resulting a in our decision to lower sales guidance for 2013. We are forecasting the direct business will return to sales growth commensurate with the retail channel in 2014 as the business cycles through the elimination of the direct mail catalogs.

Also impacting the Company's overall sales during the second quarter was $4.8 million loss in sales associated with Casual Male store closings where either the DXL store had not yet been opened or no DXL store is planned to be opened in certain more remote areas. In addition, as you know, there was a shift in the 2013 retail calendar resulting from the 53 week period in 2012; the $1.3 million negative sales impact in the second quarter occurred due to losing one week of spring sales, a higher sales volume period, and gaining one week in summer sales, a lesser sales volume period. Together, the overall sales impact in the 2nd quarter amounted to $6.1 million, or 6.1%.

Gross margin for the second quarter, inclusive of occupancy costs, was 46.6% compared with gross margin of 46.4% for the second quarter of last year. The increase of 20 basis points was the result of an improvement in merchandise margins of 150 basis points, partially offset by an increase in occupancy costs of 130 basis points. On a dollar basis, occupancy costs for the second quarter increased 5.5% 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 150 basis points was the result of continued improvement in our initial markups as well as a favorable markdown rate from a reduction in pricing promotions compared with the prior year.

In 2013, we are expecting our occupancy costs, on a dollar-basis, to increase approximately $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 included $1.3 million in pre-opening and lease exist costs associated with DXL store openings. As a result, we expect occupancy costs will be between 100 to 120 basis points higher in fiscal 2013 than in 2012. From a merchandise margin perspective, we are planning a continued improvement of approximately 110 basis points. We are expecting gross margin constant to 2012 levels at 46.5%, within a range of plus or minus 10 basis points.

As a percentage of sales, SG&A expenses increased to 44.4% compared with 37.4% for the second quarter of 2012. On a dollar basis, SG&A expenses increased $5.7 million, or 15.1% for the second quarter compared with the prior year quarter. During the quarter, the Company incurred approximately $5.4 million in incremental costs including marketing costs related to the

National Marketing campaign and other support for the DXL transformation effort and costs related to DXL pre-opening payroll, store training, and infrastructure costs.

Net loss for the second quarter was $(1.6) million, or $(0.03) per share, which compares with net income of $1.2 million, or $0.03 per diluted share, in last year's second quarter. More comparable to last year is the Company's net loss from continuing operations of $(0.03) per share compared to last year's $0.06 per share in net income, which excluded the discontinued European direct business. The decrease in earnings was attributable to not only $5.4 million of DXL transition and marketing costs in SGA, but also another $1.3 million of pre-opening occupancy and lease exit costs that is included within the occupancy component of gross margin. In total, the $7.2 million of DXL transition and marketing costs represents $0.09 per share.

The Company used $21.1 million for capital expenditures for the first six months of fiscal 2013 partially funded by operating cash flow of $5.4 million. From a liquidity perspective, for the first six months of fiscal 2013, we had $5.1 million in cash and cash equivalents, outstanding borrowings of $12.3 million and $78.1 million of credit available under the Company's revolver facility. During the quarter, the Company and its Bank Group updated its credit facility to increase the size of the revolver facility from $75 million to

$100 million, at slightly more favorable rates. In addition, the Company expects to further bolster its balance sheet liquidity with a four year $20 million lease line to finance certain DXL store and other equipment, again at very favorable rates. The Company's inventory levels at the end of the quarter were up 4.1% compared to a year ago and unit inventory levels were 1.5% higher than year ago levels.

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

We now have 65 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 more than 600 thousand square feet.

Regarding our plans to open between 57 and 64 DXL stores in fiscal 2013, due to changes in the projected opening dates of these stores, we now expect 55 to 58 DXL stores to open in fiscal 2013 with the timing of the DXL new store openings shifting throughout the year causing a drop in the Company's sales guidance for 2013. We continue to identify excellent locations for our DXL stores, we are just not able to control the timing of the openings until after lease signing. Several DXL store openings that were anticipated for 2013 will instead open in the first half of 2014. Therefore, the Company is now expecting to open approximately 30 DXL stores in the first half of 2014 compared to 17 in the first half of this year. What's important is that when the DXL stores do open, taken as a whole, are performing as expected. Our original plan was to close between 110 and 119 Casual Male XL and Rochester stores in 2013, we now expect to close 100 to 105.

During Q2, we opened 11 DXL stores and closed 23 Casual Male XL stores. By the end of the year, we expect the overall store square footage to approximate 1.9 million, an approximate 4% increase from the end of 2012, of which almost half will be DXL stores.

And now turning to our guidance for the full year…

As a result of the projected store opening dates for some of our new DXL stores, and due to the underperformance of the direct business, we are lowering our revenue guidance to a range of $395.0 to $400.0 million, which is based on a comparable sales increase of between 6% and 7% for the year. This revised sales forecast for 2013 assumes overall second half sales to be between flat to plus 3%, with an overall comparable sales increase of over 10%, driven by the DXL new store openings as well as continued store comp sales from existing DXL stores, all in conjunction with the 7 week national marketing campaign commencing in early Fall.

We expect gross margin to be constant to 2012 levels at 46.5%.

SG&A costs are expected to be slightly lower than our initial guidance range as a result of lower variable costs related to fewer store openings. We now expect SG&A in the range of $167.0 to $169.0 million, or an increase of $11-$13 million from 2012 all related to increased marketing expenses as well as DXL transition costs. As a percentage of sales, SG&A expenses are expected to increase over last year as a result of our DXL initiative by 310 basis points to approximately 42.2% of sales. 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. This increase in dollars is primarily related to higher 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. Overall, we expect to limit our SG&A growth rates, except where necessary to support our growth activities or where there are unanticipated costs that are necessary to support our overall activities.

EBITDA is expected to be in the range of $17 to $18 million, and operating margins are expected to approximate -0.5%.

Earnings per diluted share are expected to in the range of a loss of $0.03 to $0.05.

Our capital expenditures for 2013 are expected to be approximately $45 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 million will be funded from cash, EBITDA generated during the year, and reductions in working capital.

Despite the lower-than-expected profitability, we're pleased to maintain our expectation for revolver borrowing at between $10 to $15 million by year's end.

As David mentioned, this was a milestone quarter for Destination XL, in what is a very important year in our strategy to transform the company. The implementation of the first wave of our marketing campaign was an important milestone that -- for the first time -- demonstrated the real potential for the DXL concept. While the direct business did not perform as we had expected, we're taking action to enhance sales and profitability in that business. We look forward to reporting continued progress to you in the quarters to come.

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.