Destination XL Group, Inc.

Fourth-Quarter 2013 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's fourth-quarter and fiscal 2013 yearend 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, and thank you for joining us today for Destination XL Group's fourth-quarter results conference call. On our call today is David Levin, our President and Chief Executive Officer, and John Kyees, our Interim 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.

Before I jump into the results, I'd like mention that I am here with John Kyees, our Interim Chief Financial Officer. John has served on our Board of Directors since 2010 and was CFO of Urban Outfitters from 2003 until his retirement in 2010. He also served as a senior financial executive at several other prominent retailers. John will play a valuable role on our senior management team while we conduct a search for a permanent CFO.

As you know from our preliminary results announcement in January, much like the majority of the retail industry, the fourth quarter was a challenging one for DXL. At the same time, we continue to be pleased with the performance of our DXL stores. I'll be discussing some very positive data from our most recent DXL marketing campaign and an update about our DXL rollout strategy on today's call.

But first, let me recap the results for the quarter. A few factors negatively affected Q4 sales of $108.5 million, which were lower than we had expected at the end of Q3. First, during the key selling weeks between Black Friday and Christmas, store traffic was down approximately 4% from the prior year. Also, adverse weather conditions in some geographies kept people from shopping during the latter months.

Nonetheless, we are pleased to report that same store sales for the 48 DXL stores opened greater than a year increased 13.6% and 12.3% for the fourth quarter and fiscal year 2013, respectively. In total, our comparable sales for the fourth quarter and full year increased 4.2% and 3.0%, respectively, from the prior-year periods.

In September we launched our fall marketing campaign for DXL. This time around, our ad campaign aired on network television to supplement our nationwide presence on cable, which included spots 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.

With these higher profile media spots, the results of the fall campaign were even better than our spring flight. DXL brand awareness nearly doubled following the fall campaign to 25%. In markets where we have opened a DXL store, awareness grew to 30%; and in markets where we don't have a store, awareness grew to 22%. Customer traffic at our DXL stores increased by nearly 10% overall during the seven week campaign, which ended right before Black Friday. In addition, sales in the bottoms category to the key "end-of-rack" guys with 40-46 inch waists increased by 31% during the fall campaign. As we've discussed before, this is a key new demographic for the DXL concept.

In 2014, we will launch a new marketing campaign that will build on our previous two. The objective of the new campaign will be to further reinforce the DXL brand, better communicate the products and services we offer and demonstrate why we are the choice retailer for our target customers. This time, the marketing will include a call to action, which was not present in our past two campaigns, and will have additional geographically targeted radio spots. We anticipate a similar marketing spend in 2014 as we had in 2013; however, we now have over 100 DXL stores in our portfolio and therefore expect a higher return on our marketing dollars. We will provide more details on this campaign on our Q1 call.

A good portion of our marketing dollars are being spent on digital initiatives. As we all know, Internet and mobile sales are growing at a rapid pace as consumers spend more time shopping online than at brick and mortar stores. We've made considerable efforts to improve our online storefront and the experience our customers have at destinationxl.com. As a result, in Q4 our strong online sales outweighed the decline in catalog sales, resulting in an increase of 1.2% for our direct business over last year. In the second half of fiscal 2014 we will anniversary the elimination of our catalog circulation and will not have the difficult comparison with last year.

Before I turn the call over to John to review our financials, I'd like to give you an update on our conversion plan for Destination XL.

During Q4, we opened 25 DXL stores and closed 40 Casual Male XL stores. We now have 102 DXL stores open across the country and are represented with at least one store in every major metropolitan area. DXL store square footage has more than doubled since last year to more than 915 thousand square feet. The DXL same store sales continue to dramatically outperform our Casual Male XL stores and, as the chain becomes more fully converted, our top-line sales growth should improve accordingly. In fiscal 2013, our DXL stores accounted for 25% and the direct channel accounted for 18% of our total business, compared with 11% and 18% respectively in fiscal 2012.

Our original plan for 2014 called for us to open another 60 DXLs and to close 100 Casual Male XL stores. The long term goal was to have 215 to 230 DXL stores opened and to have closed all of our Casual Male XL stores, excluding outlets, by 2016. We now believe that we should open approximately 40 DXLs and close approximately the same number of Casual Male stores in 2014, and extend the roll-out through the end of 2017.

During the implementation of a transformative strategy like our conversion to DXL, you learn along the way and you have opportunities to adjust the plan. The first thing that we've learned is that the conversion to DXL was certainly the right strategy for the Company. Our DXL comps, customer reaction and new store margins give us continued confidence in this strategy.

Since initiating the DXL roll-out nearly three years ago, we've made tremendous progress and have been able to analyze a significant amount of data with respect to the effectiveness of our store openings and closings. So what did we learn?

First, our initial concerns about declining productivity and erosion of our customer base at the remaining Casual Male XL stores did not materialize. In 2013, we closed Casual Male stores, which contributed $16.2 million in sales last year and were not replaced by DXL stores. We are therefore slowing down the Casual Male closings, and will keep more Casual Male stores open for a longer period of time. The Casual Male XL stores that will remain open are not the one-for-one stores that were closed when a DXL store opened up in close proximity. However, most of the remaining Casual Male stores are still within driving distance of a new DXL store and can therefore serve as ambassadors for the DXL brand. Our Casual Male associates will educate their current customers about the benefits of shopping at the new DXL stores and where to find the nearest location. The remaining Casual Male stores also will be equipped with marketing kiosks that provide information about the nearest DXL store. We expect these efforts to improve DXL brand awareness and our customer conversion rate.

Second, by extending the completion date of our strategy, we can be more selective about real estate decisions -- for example the locations, timing and size of our new stores.

By accelerating the closing of our Casual Male stores, we were incurring unnecessary expenses related to early lease exit penalties. Immature DXL stores in certain geographies were not able to offset that expense and recoup the lost cash flow of the Casual Male stores.

This is especially true when a DXL was opened in the fourth quarter. Stores that open during a fourth quarter generally don't have enough time to sell through the fall/holiday inventory before it is put into clearance, thus negatively affecting a store's profitability. Therefore, going forward, DXL store openings will be weighted toward the first three quarters of the year.

We've also determined that the average size of the standard DXL box exceeds the square footage necessary for some of the smaller markets we currently occupy or that we plan to enter. Our standard DXL box calls for 8,400 square feet of space, but we are modifying our design to fit into spaces with a smaller footprint of 5,000 to 6,000 square feet. We plan to open this concept in several smaller markets this year. This will significantly reduce our net build out costs, improve our sales per square foot and increase the four wall contribution in these smaller markets. The stores will offer all the same styles and brands as our larger DXLs, but will hold fewer units of inventory.

I would like to be very clear that the number of full-sized DXLs that we intend to open remains the same. The 215 to 230 store openings that we previously quoted just move out to the end of fiscal 2017. And, with the smaller format stores now being introduced, the final number of DXL stores in our portfolio may increase. We now expect the overall store square footage at year end fiscal 2014 to approximate 1.2 million, an approximate 34% increase from the end of fiscal 2013.

To summarize, we remain very confident in our DXL strategy and now expect to complete the roll out by the end of 2017. After accelerating the roll-out during the past 18 months in order to capitalize on the benefits of the DXL concept and our marketing campaigns, we now have a critical mass of 102 DXL stores, 48 of which have been open for a full year. We've learned a tremendous amount from our experience in rolling out DXL. As a result, we have optimized our roll-out plan in order to grow our top line, improve profitability, increase cash flow, reduce early lease terminations, and improve our sales per square foot and four wall contributions. We expect these changes to help us achieve double-digit operating margins in three to five years.

This revised strategy enables us to be a stronger company from a financial and operating perspective both during the conversion to the DXL concept, as well as at the end of the process. We've known for a long time that we have a winning concept. And now, we're using the knowledge that we've gained along the way to adjust our strategy to better serve our customers and shareholders.

With that, I'll turn the call over to John.

John Kyees:

Thank you David and good morning everyone. I'm delighted to be back in the saddle, and look forward to working with David during this transition period. As you know, I have served on the board for more than three years and am deeply committed to and supportive of the Company's strategy.

I'll start by highlighting the Company's results and then provide some context around our guidance for fiscal 2014.

For the quarter, total sales were $108.5 million compared with $114.9 million for the prior year's fourth quarter. The decrease of $6.4 million in total sales was principally due to the challenging retail environment, shorter holiday selling season, and adverse weather conditions in certain regions. In addition, the fourth quarter of 2012 contained an extra week which contributed approximately $5.9 million of sales in that period. Furthermore, we experienced a decrease in the quarter of $4.5 million related to lost 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. These factors were partially offset by a comparable sales increase of 4.2%, or $4.3 million.

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. Direct businesses are included in the calculation of comparable sales since we are a multi-channel retailer. Going forward, due to the significant number of DXL stores that now have been opened for more than a year, beginning with Destination XL's first-quarter fiscal 2014 financial results, the Company's DXL store comp sales metric will no longer include sales from DXL stores that have been opened less than a year. Starting in Q1, we'll now be reporting same store sales in line with industry standards.

The comparable sales increase of 4.2% consisted of an increase in our retail business of 4.9%, or $4.0 million, driven by our 99 DXL stores that had a comparable store sales increase of $4.5 million, or 15.7%, including relocated stores. As previously mentioned, the same store sales increase for the 48 DXL stores opened greater than one year was 13.6%. Our remaining retail stores had a comparable sales decrease of $0.5 million, or (0.9)%.

The comparable sales increase included an increase in our direct business of 1.2%, or $0.3 million. Sales for our e-commerce business were up $1.0 million, or 6.1%, for Q4, partially offset by a decrease in our catalog sales of $0.9 million or, negative 59.1%.

As a reminder, we eliminated our catalogs completely in Q2 2013 and replaced them with more cost-effective direct mail pieces. Total circulation of our catalogs and mailers decreased 15.5% in the fourth quarter over the prior year. The operating profit margin for the fourth quarter increased slightly from 31.0% to 31.3%. While catalog sales have decreased, the profit margin from our direct business will continue to improve over time as we continue to drive sales from our more profitable e-commerce business. 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 fourth quarter, inclusive of occupancy costs, was

45.3% compared with gross margin of 47.5% for the fourth quarter of last year. The decrease of 220 basis points was the result of an increase in occupancy costs of 180 basis points and a decrease in merchandise margin of 40 basis points.

On a dollar basis, occupancy costs for the fourth quarter increased 7.1% over the prior year due to the associated pre-opening costs and timing of 25 DXL store openings during Q4, as well as the timing of our Casual Male XL store closings and lease exit costs. In fiscal 2014, we are expecting our occupancy costs, on a dollar-basis, to increase by approximately $1.8 million as a result of the 40 new DXL stores opening this year and the annualization of this year's store openings. However, we expect occupancy costs will be approximately 20 to 50 basis points lower as a percent of sales in 2014 than in 2013.

We are expecting that our merchandise margins, which have improved more than 170 basis points over the past 4 years, will remain relatively flat to a slight increase of 40 basis points in 2014.

As a percentage of sales, SG&A expenses increased to 44.1% compared with 37.7% for the fourth quarter of 2012. On a dollar basis, SG&A expenses increased $4.6 million, or 10.6%, for the fourth quarter compared with the prior year fourth quarter. During Q4, the Company incurred approximately $2.9 million in incremental transition costs related to DXL pre-opening payroll, store training and infrastructure costs, and $2.3 million of severance costs which were accrued at year-end.

Net loss for the fourth quarter was $(55.1) million, or $(1.14) per share, which compares with net income of $4.2 million, or $0.09 per share, in last year's fourth quarter. The net loss for the fourth quarter of fiscal 2013 includes a non-cash charge of $51.3 million to establish a valuation allowance against our deferred tax assets. During the fourth quarter of fiscal 2011, we reversed $42.5 million of our valuation allowance against our deferred tax assets, resulting in an income tax benefit for fiscal 2011. However, since our fiscal 2013 net loss resulted in a three-year cumulative loss position, we recorded this non-cash charge to establish a full valuation allowance against our deferred tax assets. For fiscal 2013, excluding the $1.05 loss due to the valuation allowance, a $0.03 loss due to executive severance, and a $0.02 loss due to fixed asset impairment charges our diluted earnings per share related to operating the business is a loss of $0.13. This number is less than the previous year EPS of positive $0.13 and is primarily attributable to lower than expected sales, the increase in marketing costs related to our national marketing campaign, and increased costs associated with our DXL growth. In total, we incurred $11.2 million, or

$0.14 per share in transition costs during fiscal 2013. This included $4.3 million in occupancy related costs associated with lease terminations and pre-opening rent, $5.3 million of DXL in SG&A costs and $1.6 million of amortization related to our trademark

The Company used $54.1 million for capital expenditures in fiscal 2013. That was partially offset by approximately $9.9 million from tenant allowances from landlords. From a liquidity perspective, for the twelve months of fiscal 2013, we had $4.5 million in cash and cash equivalents, debt of $25.7 million and $75.5 million of credit available under our revolver facility. Our inventory levels at the end of the fourth quarter were up 1.3% but unit inventory levels were down 6.9% than year-ago levels. We are carrying a greater percentage of branded apparel for our DXL stores and this inventory has a higher carrying cost.

And now turning to our guidance for next year…

We expect revenues for fiscal 2014 to be in the range of $405 to $410 million, which is based on a comparable sales increase of approximately 5.6% for the year for direct and sales on stores open greater than one year

A same store sales increase of between 12% to 15% for the DXL stores that will have been open for one year.

We expect gross margin to increase 20 to 90 basis points.

SG&A costs are expected to be approximately $175 to $177 million primarily related to an increase in operating costs associated with the greater number of DXL stores vs. Casual Male stores as well as pre-opening costs and payroll.

We expect earnings per diluted share to be in the range of a loss of $(0.21) to $(0.27). We will not recognize any income tax benefit in fiscal 2014 because DXL established a full valuation allowance in the fourth quarter of fiscal 2013. For comparative purposes, assuming a normal tax benefit of approximately 40%, the loss per diluted share for fiscal 2014, on a non-GAAP basis, is expected to be approximately $(0.12) to $(0.16).

Our capital expenditures for fiscal 2014 are expected to be approximately $36.0 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 $36.0 million, net of tenant allowances, will be funded from equipment financing notes, our revolving credit facility, and EBITDA generated during the year

Inventory levels are expected to be approximately flat with the prior year by the end of fiscal 2014.

By the end of the year, the Company expects to have a net debt position of approximately $50-$55 million, with $50 to $60 million in excess availability.

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.