Destination XL Group, Inc.

First-Quarter 2014 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's first-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, John Kyees, our Interim Chief Financial Officer, and Peter Stratton, who was announced this morning as our new Chief Financial Officer effective June 1st. Peter has been with DXLG since June 2009 and is currently Senior Vice President, Finance, Corporate Controller & Chief Accounting 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 are off to a strong start in fiscal 2014. For the first quarter, overall comparable sales increased by 3.4%, driven by our DXL stores. This is impressive given the challenging environment that just about everyone in retail has been facing.

Much like other retailers, February and March were difficult months for us. The severe winter weather, particularly in the Northeast and the Midwest, kept many customers out of the stores, and we even had 120 locations that were closed for at least one day. Sales momentum returned in April with an overall 6.8% comp for the month, which more than offset the weakness that we saw earlier in the quarter. This positive momentum has continued in May. In the first quarter, our DXL stores continued to deliver strong results with a 12.8% comparable sales increase for the 52 stores that have been open at least 13 months. I'm proud to report that we now have four consecutive quarters of double digit comparable sales at our DXL stores under our belt since we started our national advertising campaign. DXL sales for the first quarter more than doubled to $36.2 million compared with $17 million in the first 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. We grew the end-of-rack consumer by 8.3% and increased our penetration from 37.3% last year to 40.4% in Q1 this year. We expect this growth to increase as we communicate more specifically the sizes that we carry.

During Q1, we opened 7 DXL stores and closed 10 Casual Male XL stores. We now have 109 DXL stores open across the country and are represented with at least one store in every major metropolitan area.

Our current DXL roll-out strategy calls for us to open approximately 40 DXLs and close approximately the same number of Casual Male 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. We plan to open approximately 35 of the 40 stores in the first three quarters of this year. In comparison, we opened only 25 of the 51 stores last year in the first three quarters.

The overall DXL store square footage at year end fiscal 2014 is expected to approximate 1.2 million, or a 34% increase from the end of fiscal 2013. Last year, DXL sales per square foot were approximately $147. We project this to increase to $160 by the end of fiscal 2014. The roll-out of 215 to 230 DXL stores is scheduled to be completed by the end of fiscal 2017. In addition, we'll be opening a number of stores with a smaller footprint of 5,000 to 6,000 square feet in select smaller markets and in larger markets where an additional presence is warranted. For example, in Orange County, we closed three stores and added one DXL store in Irvine. However, the new Irvine DXL store cannot service the entire county, so we will be looking to open a 5,000 square foot DXL store in a location that is convenient to those regional customers who are furthest away from the Irvine location. With the addition of the 5,000 to 6,000 square foot models, the total number of DXL stores eventually could be higher than our estimated range.

Turning to our direct business… Our direct business in the US is improving over trend with a 1.0% increase without any support from catalog circulation. However, the challenges of our direct business in Canada had a significant negative impact on our direct sales. As a result, our overall direct business declined 1.6%. As a reminder, in the second half of fiscal 2014 we will anniversary the elimination of our catalog circulation. We should begin to see year-over-year improvement in our direct sales at that time.

As a key element to our growth plan, we are continuing to escalate our conversion of Casual Male customers to DXL. For stores that we have opened since November, we have increased the conversion of Casual Male customers to DXL by 24% year over year. In each closing Casual Male store, we have elevated the visual messaging of DXL at least six months prior to its closing. This included expansive DXL displays at the point of purchase, DXL shopping bags, and a variety of signage throughout the store promoting DXL's benefits. Through direct mail, we have improved our targeting of consumers most likely to convert and increased our communication to this customer. Additionally, we are providing more frequent promotional incentives to entice customers to experience DXL stores. We know that once we get a consumer to experience DXL, they are more likely to come back. In fact, our customer retention rate in DXL stores is 18% higher than in Casual Male stores.

Our national advertising has continued to have a positive impact on brand awareness in the marketplace. In the Spring of 2013, prior to any national DXL advertising, our aided brand awareness was at 13% and we have seen that awareness increase to 30% in the Spring of 2014. This can be attributed to the significant impact of advertising and a larger overall store footprint. In April, we launched our latest national marketing campaign on cable, network TV, radio and digital mediums. The theme of our new campaign is “You’re Looking Good.” If you haven’t seen it already, I encourage you to check it out on our website. The television ad delivers on the DXL experience, the breadth of designer brands, and most importantly, the confidence that can be achieved by shopping in our stores. In this campaign, we included a call to action by offering promotional pricing on select private label merchandise. While it is too early to discuss campaign results, we have seen higher conversion rates on-line and in-store. We are now seeing a more informed customer because the ad showcases the DXL store and its lifestyle offerings for men of size.

Our results this quarter further demonstrate that the transformation to the

DXL concept is the right strategy for our Company. During the next few years, we expect to increase our top line, improve profitability, generate cash flow, minimize early lease terminations, and grow sales per square foot and four wall contributions. Prior to implementing the DXL strategy, we had 445 Casual Male XL stores that were producing $279 million in annualized sales. For comparison, as of the end of fiscal 2013, we had 99 DXL stores producing $118 million in annualized sales. Once our planned 230 DXL stores reach maturity, we expect to deliver approximately $410 million in annualized sales. These figures do not include the potential for additional smaller footprint DXLs.

Before I turn the call over to John for the financial review, I'd like to offer him our sincere gratitude, on behalf of the board and the entire company, for stepping in as our Interim CFO during the past few months. John's contributions were invaluable and we greatly appreciate his commitment and dedication to the Company. John will continue to act as a resource regarding our financial strategies going forward and, of course, he will continue his contributions as a member of our Board of Directors.

We are also very pleased to announce today that Peter Stratton has been selected as our new Chief Financial Officer effective June 1. Peter has spent the last five years as our Senior VP of Finance and Chief Accounting Officer and has played an integral part in the development and execution of our DXL strategy. He has an excellent financial background and has demonstrated strong leadership skills throughout his tenure at DXL and we're looking forward to Peter's continued contributions in his new role. Peter will be covering the financial statements beginning on our second quarter call. But for now, I'll turn the call over to John to discuss our first-quarter results.

John Kyees:

Thank you David and good morning everyone. I'll start by highlighting the Company's results and then provide an update to our guidance for fiscal 2014.

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 3.4%, or $2.5 million, included an increase in our retail business of 4.7%, or $2.8 million. This was driven by a DXL comparable store sales increase of $2.2 million, or 12.8%, by the 52 stores open for at least 13 months. It is important to note that last year our DXL comparable store sales were driven by increased Dollars Per Transaction resulting from the increased mix of 3rd Party branded product. This year he DXL comparable store sales increase is being driven by increased transactions. Our remaining retail stores had a comparable sales increase of $0.6 million, or 1.4%. The comparable sales increase was slightly offset by a decrease in our direct business of 1.6%, or $0.3 million, as David discussed earlier.

As a reminder, we eliminated our catalogs completely during Q2 2013 and replaced them with more cost-effective direct mail pieces. Catalog sales for the first quarter of fiscal 2013 represented approximately $1.0 million of our direct sales first quarter last year. While catalog sales have been eliminated, the profit margin from our US direct business continues to improve as we drive sales through our more profitable e-commerce business.

Gross margin for the first quarter, inclusive of occupancy costs, was 45.4% compared with gross margin of 47.2% for the first quarter last year. The decrease of 180 basis points was the result of an increase in occupancy costs of 20 basis points and a decrease in merchandise margins of 160 basis points. The decrease in merchandise margin for the first quarter of fiscal 2014 was due to a higher level of year-end clearance and an increase in our promotional activity. The higher level of year-end clearance was primarily due to the fact that several of our DXL stores opened too late to capitalize fully on the Q4 holiday shopping season.

We expect that our merchandise margins, which have improved more than 170 basis points over the past four years, will decrease by 60 to 100 basis points as a result of our increase in promotional activity. This activity is geared towards converting our customers to our DXL stores and improving overall store traffic which we expect will lead to increased top-line and stronger profitability in the long-run.

On a dollar basis, occupancy costs for the first quarter increased 4.6% over the prior year due to the associated pre-opening costs and timing of seven DXL store openings during Q1, as well as the timing of our Casual Male XL store closings. In fiscal 2014, we are expecting our occupancy costs, on a dollar-basis, to increase by approximately $1.5 to $1.7 million as a result of the 40 new DXL stores opening this year and the annualization of last year's store openings. However, we expect occupancy costs will be approximately 50 to 70 basis points lower as a percent of sales in 2014 than in 2013.

As a percentage of sales, SG&A expenses increased to 43% compared with 40.6% for the first quarter of 2013. On a dollar basis, SG&A expenses increased $3.4 million, or 9%, for the first quarter compared with the prior year first quarter. The increase of $3.4 million includes incremental costs of approximately $0.9 million related to pre-opening payroll, training and store operations to support the new DXL stores, and a net increase of $0.6 million in the timing of marketing costs associated with the launch of our spring 2014 campaign. The remainder of the increase is primarily due to increased store payroll and increased health insurance costs and workers compensation claims.

Net loss for the first quarter was $(3.5) million, or $(0.07) per share, which compares with net income of $1.0 million, or $0.02 per share, in last year's first quarter. Because we maintain a full income tax valuation allowance, we will not be recording any income tax benefit on our pre-tax loss. Therefore, on a non-GAAP basis, assuming a comparable tax rate of 40%, the adjusted net loss for the quarter was $(2.1) million, or $(0.04) per diluted share.

Capital expenditures in Q1 were $11.1 million compared with $8.0 million for the same period last year. The $3.1 million increase is primarily related to the timing of cash outflow for new DXL store construction and management information projects during the first quarter of 2014. In fiscal 2013, our store opening and construction schedule was heavily weighted towards the back half of the year. In fiscal 2014, we are much more balanced with the majority of store openings planned in the first three quarters of the year.

From a liquidity perspective, at May 3, 2014 we had $5.6 million in cash and cash equivalents, outstanding borrowings of $51.8 million, and $67.9 million available under our credit facility.

Our inventory levels at the end of the first quarter were up 8% but unit inventory levels were down 6.5% compared with year-ago levels. We are carrying a greater percentage of branded apparel for our DXL stores and this inventory has a higher carrying cost. In addition, our inventory on a square foot basis is down compared with last year.

And now turning to our guidance for next year…

We are maintaining our guidance on full year earnings of a net loss of $(0.21) to $(0.27) per diluted share, or $(0.12) to $(0.16) per diluted share on a non-GAAP basis.

Our sales expectations have improved and we now expect revenues for fiscal 2014 to be in the range of $413 to $418 million, up from the prior guidance of $405 to $410 million. These revenue expectations are based on a total Company comparable sales increase of approximately 4% to 6%for the year.

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

Gross profit margin is expected to range from 45.5% to 46.1%, down from the original guidance of 46.2% to 46.9%

SG&A costs are expected to be approximately $176 to $177.6 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.

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

Our 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.

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

Borrowings at the end of fiscal 2014 are expected to be in the range of $30 to $35 million under the credit facility, with equipment financings of approximately $20 million.

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

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