Destination XL Group, Inc.

Fourth-Quarter 2012 Conference Call Prepared Remarks

Operator:

Good day, ladies and gentlemen. Welcome to Destination XL Group's fourth-quarter 2012 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 fourth-quarter results conference call. As most of you are probably aware, in February we officially changed the name of the company to Destination XL Group to better reflect our identity as we expand the Destination LX concept and rebrand the company. 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.

Our financial results for the fourth quarter were essentially in line with our initial expectations. Revenue and net income growth would have been stronger but were negatively impacted by mild winter weather and some delays in DXL store openings.

Despite those Q4 headwinds, the performance of our DXL stores and e-commerce website demonstrate the excellent potential of the DXL concept. Our DXL comparable store sales increased 15% for the fourth quarter and 15.6% for the year, and DXL stores represented 18% of our total store sales for the fourth quarter and 13.6% for the year.

Our direct business is down year-over-year due to lower catalog sales; however, our e-commerce platform, destinationxl.com, is performing exceptionally well. Sales from the website increased approximately 13% for the fourth quarter and 11.2% for the year. Total direct sales are now approaching approximately 20% of total company sales. With web sales growing at an accelerated rate, we are shifting more marketing dollars to digital strategies and cutting back on our catalogue circulation.

On our last call, we announced that we are accelerating the opening of our DXL stores and closing all Casual Male XL stores. We are going to complete the transformation in the next three years. At the end of the third year, our Casual Male XL retail stores will no longer exist and we will have 215 to 230 DXL stores across the country. When complete, we will have approximately 25% more square footage, but with about 150 fewer stores.

Our Casual Male XL Outlet stores will remain and will be used to help liquidate product from the DXL stores. We also plan on keeping 3-4 of our most profitable Rochester Clothing stores.

By accelerating our DXL strategy, we will be able to realize the benefit of the DXL concept much earlier than we initially anticipated. In fact, with the substantial investments we are making this year in the strategy, we expect to report improved profitability and cash flow beginning next year.

Our DXL stores and e-commerce platform accounted for 28% of our total business for fiscal 2012 and by the end of next year we project it will account for almost 50%. It is important to note that we reached that level of sales at our DXL stores with no marketing support. As we more rapidly expand our footprint across the nation, we are now launching a comprehensive marketing campaign to define the DXL brand more clearly, expand market awareness and grow our active customer base. Because we now have a significantly greater number of DXL stores in operation, our new marketing campaign should have a much greater effect on our performance in 2014 and beyond.

We started the process of developing an effective marketing campaign with a comprehensive research study. The study gave us insights into how our customers view our stores, and we were able to identify specific emotional triggers that drive their behavior. From this research, we began the process of building key brand attributes that would further connect our customers to the DXL brand. Finally, we developed and tested an advertising campaign that would foster brand awareness and deliver new customers.

This past fall, we conducted a six-week test to determine the most effective marketing combination for our national campaign. We tested our campaign in five markets: Memphis, Minneapolis, Denver, Atlanta, and Oklahoma City. In each market, we launched different combinations of digital, radio and television strategies. Going into the test, brand awareness for DXL stores open one year or more within our target audience was only about 17% – definitely room for significant improvement.

Before I get into the test results, let me tell you a bit about the actual campaign. The concept was designed to attract new and younger customers into our stores. We are targeting “end-of-the-rack” guys – those with 40-46 inch waists. This customer represents 65% of the total big and tall market. In the past, we had not been successful in getting this customer into our stores. He can’t shop at traditional retailers, because they don’t carry quality selections in his size. But he didn’t want to shop at a Casual Male XL because he had the impression it was for older men. He feels like he is in “no man’s land” when he goes shopping. So that became our theme. Through our marketing campaign, this customer will understand that there is an ideal place for him to shop with a vastly greater selection and better cache brands.

The test results showed that TV and radio were the most effective mediums to deliver greater brand awareness. The awareness increased by as much as 100% in newer markets like Minneapolis, which opened in Fall 2012, and 38% in established DXL markets like Memphis, which opened in Summer 2010.

This test also showed that the combination of TV, radio and digital as executed in Memphis – an established market - was the most effective mix to drive sales, traffic and new customers to the brand. To effectively measure the merits of the test, we examined the performance of Memphis six weeks prior to the test with the six weeks during the test. We also compared these results to the rest of the chain for control group purposes. In comparing the Memphis results to that of the DXL control group, we found that:

- Memphis comp sales were 15% higher than the control group;
- Traffic was 24% higher;
- New customer purchasing was 64% higher; and
- Web traffic was 84% higher, most likely due to the curiosity

factor of the DXL commercial. The goal of the commercial was to bring awareness of the new store. It did not contain any sale or promotional message. The aided awareness went from 26% to 38% after the 6 week media campaign ran, and today, 4 months later, Memphis comps continue to outperform the pre-advertising sales levels.

Those were obviously very impressive results.

In addition, we found that we were bringing in a smaller sized customer. Again, this is a key growth segment. The campaign results showed that sales in the bottoms category for 40-46 inch waists increased by 38% during this test period in markets like Memphis, Minneapolis and Denver.

We will be using the marketing combination from our most successful test market as the blueprint for our comprehensive national campaign. The goal of this campaign is to grow our total customer base by 40% from the current level of 1.5 million active customers over the next 3 years. We are talking about a total big & tall market that is approximately 40 million customers.

We plan to execute two major flights of the national campaign. The first flight is slated for late spring and the second is scheduled for late fall. In both flights, we will proceed with a mix of TV, radio and digital, and will leverage partnerships with our new PR and social media agencies to drive further awareness and brand enthusiasm, and ultimately, customer traffic and purchasing.

In addition to the advertising campaign, we are also ramping up our digital efforts. We see opportunities to increase our exposure in paid search, strengthening our natural search capabilities, and expanding our network of digital affiliates. We are also exploring major new digital providers to dramatically expand our reach into untapped customers in the big and tall space.

While our catalog plan for 2013 includes a 50% reduction in circulation as we move more aggressively into digital, we are working to ensure that we are more profitable in the catalog segment. To this end, we are teaming up with third parties to help us optimize our circulation and reduce redundancies in customer distribution across brands. The savings from the circulation reduction will place catalogs in the hands of only our most responsive and profitable customers and improve the profitability of our catalog business.

During 2013 we plan to more than double the number of DXL stores in operation to between 105 to 112 by opening between 57 and 64 stores. At the same time, we have an aggressive schedule to close between 110 and 119 Casual Male XL and Rochester stores. Again, because we will have a significantly greater number of DXL stores in operation by the end of this year, our new marketing campaign is expected to have a much greater impact on our performance in 2014 and beyond.

In summary, 2013 is a critical year for us in executing our long term strategy of transforming the business to the DXL concept. We will focus on four primary objectives during the year, including:

- Opening more DXL stores, ending the year with approximately 105-112 DXL stores in operation;
- Investing in our transformation with respect to real estate development, training and merchandising, along with adequate levels of SG&A additions and capital expenditure;
- Accelerating the closure of our Casual Male XL anchor stores; and
- Funding and fine-tuning the marketing strategy to define the DXL brand more clearly, expand market awareness and grow our active customer base.

By achieving these objectives, we expect to improve our financial performance significantly in the coming years.

With that, I'll turn the call over to Dennis to review our financial results for the fourth quarter.

Dennis Hernreich:

Thank you David and good morning everyone.

In my prepared remarks, I will first provide a synopsis highlighting for you the Company's results for the 4th quarter and the 2012 year; 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 the earnings and cash flow guidance for the strategically critical 2013 year. Since the Company is going through an accelerated transformation of its business from its legacy brands to its Destination XL concept on a nationwide basis, which started in 2012 and will continue through 2015, there is a lot to cover, but I'll highlight the major points.

For the fourth quarter of 2012, total sales increased to $114.9 million from $111.1 million for the prior fourth quarter. Comparable sales increased 0.5% for the quarter. For full year 2012, total sales were $399.6 million, compared with $395.9 million for full year 2011. Comparable sales for full year 2012 increased approximately 1.5%.

Let me quickly 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, unless we have opened a DXL store in a new market, of which we have 2 DXL stores like that today in brand new markets, a DXL store is considered a comparable store. 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 0.5% and 2.0% for the 4th quarter and the year. The 46 comparable DXL stores experienced a 15.0% increase over the prior year for the fourth quarter, which is primarily responsible for driving the growth in the Company's total comp sales for the quarter. For the year, DXL stores comp sales were 15.6%. Those 16 DXL stores that have been open for more than one year generated 7.6% comp sales in the fourth quarter which we expect will improve during 2013 as the Company raises market awareness of the DXL stores with its national marketing campaign.

A negative trend has emerged among some of our traditional Casual Male XL stores that are in close proximity to the new DXL stores. The comp sales at these locations are below those of our other remaining Casual Male XL stores. Casual Male XL retail and outlet stores continue to experience sales erosion, reporting negative comparable sales for Q4 of approximately 4.8% and 2.2% for the year. This tells us that the success of our DXL stores is a negative for our traditional Casual Male XL stores in the near term. This was an important factor in our decision to accelerate the closing of our Casual Male XL stores while opening new DXL stores.

Sales from our direct business for the fourth quarter increased slightly over last year, with sales from the direct business increasing 0.6%. For the year, our direct business was down 1.0% over the prior year. Our direct business consists of two primary channels: catalogs and our website, DestinationXL.com. Sales from our catalogs and call center were down 49% during the fourth quarter, while sales from our website were up 13%. We are transitioning our customers away from our traditional catalogues to making purchases on our more profitable e-commerce website, so this is a positive for us in the long run. As David mentioned, in response to this shift in purchasing behavior, we decreased catalog circulation and impressions by approximately 70% in the fourth quarter, and are decreasing our catalogue circulation in 2013 by another 50% and impressions by almost 70% resulting in $3 million amount of savings being diverted to partially fund the national advertising campaigns and increasing our marketing spend in digital strategies. Although sales growth in the direct channel may have stalled as we work through this transition, the operating margin of the direct business has improved significantly from prior years and is approaching 25% from less than 20% in prior years, and is expected to continue to grow in 2013. We expect the Company's direct business will resume its revenue growth in 2013 on the strength of our digital marketing strategies, and our 2013 customer acquisition strategy to raise market awareness on a national basis, which should greatly benefit the e-commerce website.

For the fourth quarter, gross margin, inclusive of occupancy costs, was 47.5% compared with gross margin of 44.7% for the fourth quarter of last year. The increase of 280 basis points was the result of an increase in merchandise margins of 290 basis points offset slightly by a decrease of 10 basis points related to higher occupancy costs. The merchandise margins benefitted from improved initial markups, as well as less promotional activity in the fourth quarter, as well as fewer clearance markdowns. On a dollar basis, occupancy costs for the fourth quarter of 2012 increased 5% over the prior year due in part to higher costs for DXL stores.

Regarding the Company's SG&A levels, I'd like to note that the 53rd week in 2012 added $2.7 million in the fourth quarter, and the Company's DXL store opening activity also added to the SG&A level for the year. The Company expended approximately $9 million, or $0.11 per share, in DXL related transition costs, including items such as pre-opening costs, store closing expenses, and marketing related expenses throughout 2012.

Net income for the fourth quarter was $4.2 million, or $0.09 per diluted share, which compares with Q4 2011 adjusted net income of $3.1 million, or $0.06 per diluted share, which excludes a non-recurring income tax benefit of $42.5 million and a partial, non-cash impairment charge of $23.1 million against the "Casual Male" trademark. For the 2012 year, income from continuing operations was $8.1 million, or $0.17 per share during this DXL transition year, which compares to $0.22 per share in 2011 on an adjusted basis.

The Company’s $32.1 million in investing activities during the year was largely covered by operating cash flow of $29.9 million. From a liquidity perspective, at the end of the year, we had $8.2 million in cash and cash equivalents and no outstanding borrowings under our credit facility, which has $71 million of credit available at year end.

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

In Q4 2012, we opened 14 DXL stores and at year end we had a total of 48 DXL stores in operation. For the year, we remained on target by opening 32 DXL stores and closing 68 Casual Male XL and 2 Rochester stores. We now have at least one DXL store located in most major metropolitan cities across the U.S. The Company's total square footage increased 2.6%, but the DXL store square footage doubled to just under 500,000 square feet.

In 2013 we plan to double the number of DXL stores in operation to a range of 105 to 112 by opening another 57 to 64 locations. We have already selected sites for all of these new DXL stores, and are working towards finalizing lease arrangements, with more than half completed. We plan to close between 110 and 119 Casual Male XL and Rochester stores this year. We expect the overall store square footage to increase just over 5%, but the overall DXL square footage is expected to again double to just over 1,000,000 square feet.

We expect that the rollout into existing markets will be mostly completed by the end of 2015 with between 215 to 230 DXL stores in operation. At that time, we should see the full effects of the top and bottom line benefit from the DXL format.   From a profitability stand point, 2013 will be the most challenging year, which I'll explain in more detail in just a minute, but we expect profitability to build quickly build in 2014 and 2015.

This DXL rollout is projected to approximate $150 million in costs, which will be funded primarily from operational cash flow, including the use of the Company's approximately $45 million in tax benefits and limited funding under our revolver during these transition years.

As the Company transforms its markets to DXL over the next three years, we will open approximately another 175 DXL stores and close approximately 300 Casual Male XL and Rochester stores, and raise market awareness with our target addressable market of 40 million men. As a result, we expect that our active customer base will increase by in the neighborhood of 40%, generating an approximate average annual 12% growth rate in the number of transactions. In addition, dollars per transaction from each customer visit to either to our stores or website are also expected to increase from a blended rate of $110 in 2012 to between $130 and $150 per transaction in 2016 as a result of three things:

(1) The private label vs. name brand assortment mix will shift from an approximate 75/25 mix in 2012 to 65/35 blend in 2016 raising the

average unit retail by approximately 15%;

(2) We expect to improve the Company's sales penetration in tailored clothing and related accessories, which has much higher average unit retail than sportswear. The DXL stores have the ability to properly display the widened assortment better than Casual Male XL can, and to better service the customer with better trained and more qualified sales associates. The current penetration approximates 15%, and we believe the penetration will exceed 25% in three years; and lastly,

(3) The Company's customer experience delivered in the stores, together with the expansive assortment available in any DXL store are hallmarks of the Company's DXL brand which we expect will produce greater sales productivity.

As the Company continues with the DXL transformation, we are forecasting significant sales growth in 2014 and 2015, reaching $600 million in 2016, producing gradually increased operating margins reaching over 10% in 2016.

With that, I'll give you our guidance for 2013, which is a critical year in growing DXL store count across the chain, making significant progress in closing Casual Male XL stores, and significantly enhancing market awareness of the Company's DXL brand across the chain, which we expect will produce greater store and e-commerce traffic.

We expect total sales to be in the range of $415 to $420 million, which is based on a comparable sales increase of between 8.5% and 10.0% for the year. The critical factors in achieving this guidance is the DXL store expansion, along with the national media campaigns designed to increase DXL awareness.

EBITDA is expected to be in the range of $20 to $23 million.

We expect gross margin to be constant to 2012 levels at 46.5%, within a range of plus or minus 20 bps.

Selling, general and administrative costs are expected to increase by between $15.0 to $17.1 million, to a range of $171.4 to $173.5 million, primarily due to the $10 million in increased advertising spends for the national marketing campaign, higher corporate bonus expense, increases in DXL store opening and Casual Male XL store closing costs, training and travel costs related to new DXL stores and higher operating expenses to support the expected sales increase. As a percentage of sales, SG&A expenses are expected to increase over last year as a result of our DXL initiative by 220 basis points to 41.3% of sales.

Earnings per diluted share are expected to be approximately breakeven.

Our capital expenditures for 2013 are expected to be approximately $45 million, after subtracting expected construction allowances contributed by our landlords on the new DXL sites. These expenditures will be spent largely on our planned opening of a total of 57 to 64 DXL stores in 2013 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 (a) the between $20 to$23 million of EBITDA, (b), with its beginning cash of $8 million and (c) another $5 to 10 million in reduced working capital; therefore we expect free cash flow to be negative such that revolver borrowing is expected to be between $10 to $15 million at year's end. Together with the Company's seasonal borrowing needs, we expect the Company's peak borrowing from its revolver to be in the neighborhood of $40 million during the year. Borrowing availability at year end is expected to be approximately $60 to $65 million.

At the end of 2013, the Company will have approximately 110 DXL stores opened, we will have reduced our Casual Male XL and Rochester store base by over half from what it was a few short years ago, and we will have made significant progress in raising market awareness of the DXL brand nationwide. Taken in total, this positions the Company for substantial revenue and operating profit growth beginning in 2014.

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. I'd like to end by inviting you to visit one of our DXL stores. It's hard to grasp the opportunity we have with DXL until you've been in the store and can see for yourself what we offer our customers with this new concept. 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.