Xcel Brands, Inc

Third Quarter 2016 Earnings Conference Call

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CORPORATE PARTICIPANTS

Hunter Wells, *ICR Investor Relations*

Robert D'Loren, *Chairman and Chief Executive Officer*

James Haran, *Chief Financial Officer*

Seth Burroughs, *Executive Vice President of Business Development and Treasury*

CONFERENCE CALL PARTICIPANTS

Eric Beder, *Wunderlich Securities*

PRESENTATION

Operator:

Good day, and welcome to the Xcel Brands Third Quarter 2016 Earnings Conference Call. Please be advised that reproduction of this call in whole or in part is not permitted without prior written authorization of Xcel Brands. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Hunter Wells of ICR. Thank you. Hunter, you may now begin.

Hunter Wells:

Good evening, everyone, and thank you for joining us. We appreciate your participation and interest. With us on the call today are Chairman and Chief Executive Officer, Robert D'Loren; Chief Financial Officer, Jim Haran; and EVP of Business Development and Treasury, Seth Burroughs.

By now, everyone should have had access to the earnings release for the third quarter ended September 30, 2016, which went out today at approximately 4.00 p.m. Eastern time. In addition, the Company will file with the Securities and Exchange Commission its quarterly report on Form 10-Q for the quarter ended September 30, 2016, on November 14, 2016. The release and the quarterly report will be available on the Company's website at www.xcelbrands.com. This call is being webcast and a replay will be available on the Company's Investor Relations website.

Before we begin, please keep in mind that this call will contain forward-looking statements. All forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from certain expectations discussed here today. These risk factors are explained in detail in the Company's SEC filings. Xcel does not undertake any obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

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Finally, please note that on today's call, Management will refer to certain non-GAAP financial measures, such as non-GAAP net income, non-GAAP diluted EPS, and Adjusted EBITDA. Our Management uses these non-GAAP metrics as measures of operating performance to assist in comparing performance from period-to-period on a consistent basis, and to identify business trends relating to the Company's results of operations.

Our Management believes these financial performance measurements are also useful because they provide supplemental information to assist investors in evaluating the Company's financial results. These should not be considered in isolation or as alternative to net income, earnings per share, or any other measure of financial performance calculated and presented in accordance with GAAP. You may refer to the attachment to the Company's earnings release or to Part 1 Item 2 of the Form 10-Q for a reconciliation of non-GAAP measures.

Now, I'm pleased to introduce Robert D'Loren, Chairman and Chief Executive Officer. Bob, please go ahead.

Robert D'Loren:

Hunter, as always, thank you. Good evening, everyone, and thank you for joining us on today's call. I'll begin with a high level overview of our 2016 third quarter, then we'll provide some thoughts on our outlook for the remainder of 2016 and then provide some insights into 2017. Next, our CFO, Jim Haran will discuss our financial results in more detail. Finally, Jim, Seth and I will open up the call for Q&A.

So let me start by saying that we are pleased to report double-digit revenue growth of 14% over the prior quarter and 28% on a nine month year-to-date basis. EBITDA for the quarter and nine months was up 5% and 12%, respectively. This, despite one-time revenue concession earlier this year that we made in connection with the timing and startup of our Quick Time Response or QTR platform, and slower than expected growth in our interactive television business.

We believe that our continued investments in design, marketing, production techniques and the launch of our QTR platform earlier this year will differentiate our Company from traditional licensing companies and wholesale apparel companies, and more importantly will allow us to continue to grow our market share in all of our distribution channels.

November marks approximately eight month since we launched three of our brands at HBC's Lord & Taylor and The Bay Department stores in the US and Canada through our QTR platform. While still early, we're pleased with the results which have proven the ability of the platform to react to trends and customer feedback in order to drive more full-price sell-throughs. This is something many retailers struggle with and we now provide a solution.

We are focused on optimizing the platform and growing market share. Our designers and merchants are intensely focused on the quality and value proposition in our products. We are fine-tuning in-store merchandizing, sales staff training and marketing, particularly delivering to our customer the message that we are offering products exclusively and selectively to our designated retail partners based upon 52 seasons whereby our objective is to deliver new and exciting products each week reacting and responding to our customers and trends in real time.

We believe that our QTR platform solves many current industry problems caused by the disconnect in short-lead media cycles and long-lead production cycles. Our continuing investment in this platform is intended to benefit both our current and future retail partners by helping drive customer traffic in stores, increased full-price sell-throughs and enhance margin. We believe that our business and the strategic advantage we provide to retailers will enable us to capture increased market share and growth across our business in 2017 and beyond.

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Also, the market share gains in the QTR platform has stimulated momentum in our licensing business for ancillary categories under our brands. We recently executed five new licenses for distribution in the bricks-and-mortar channel and expect to execute additional category licenses in the future as we continue to expand the QTR business. Additionally, we expect to launch a men's collection for at least two of our brands in 2017. This is an exciting prospect we look forward to providing additional details on in future calls.

We could not be more excited for the potential of our QTR business to bring value to our shareholders as well as our retail partners. And long term, we believe that ultimately this fast-virtual vertical model has the potential to generate significant increases in retail sales of our products. Our investment in the QTR platform has us strongly positioned as a leader in the industry to bring a scalable fashion QTR model to market. Looking ahead, we expect to announce new partnerships in this channel of distribution for Spring 2017.

Now moving to our interactive television business, our revenues from interactive television continued to grow during the third quarter largely due to growth in our core apparel and accessories businesses. We have experienced headwinds in this channel resulting in growth lower than our initial expectations. Despite these headwinds, we're pleased with our overall performance and are working closely with QVC to develop strategies we believe will help optimize our business in 2017. We remain cautiously optimistic for the balance of the year and anticipate that the plans that are being implemented will boost sales as we head into '17, and we remain confident in our longer-term opportunities.

As I've stated in the past, we continue to seek white space opportunities within this channel. We are currently in the process of developing beauty and skincare brands for additional growth in interactive television. QVC remains a key strategic partner for us and we continue to be excited by the significant opportunities for growth in this business both in the US and globally.

Turning to our specialty retail business, we continue to see opportunities for growth. Looking ahead, this will continue to be an area of focus for us as we seek opportunities for expansion. We are confident there are substantial opportunities for us in home and beauty and expect to make announcements in these categories for 2017.

A few concluding thoughts before I turn the call over to Jim. Looking ahead to the remainder of 2016, we remain firm and on track to achieve another year of double-digit top line revenue growth. While we have made significant expenditures and investments in developing and optimizing the QTR platform during the current year, we're confident that this investment will generate substantial returns for our shareholders in the future.

Additionally, we believe we are strongly positioned for continued growth leading into 2017 and beyond, as we execute our strategic initiatives to drive value for our shareholders.

Now, I'd like to turn the call over to Jim to review our financial results for the quarter and nine months. Jim?

James Haran:

Thanks, Bob. I will briefly discuss selected financial results for the third quarter and the nine months ended September 30, 2016. Please note that our financial results are described more fully in our Quarterly Report on Form 10-Q, which will be filed with the SEC on November 14, 2016.

In the third quarter of 2016, revenues increased by 14% to $8.3 million compared with $7.3 million in the prior-year quarter. The increase in revenues from the prior-year quarter was primarily due to the combination of higher revenues from our interactive television business, higher revenues in our QTR platform and revenues recognized from new license agreements entered into in 2015 and 2016. These

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increases were partially offset by a decrease in revenues associated with the management and design of the LCNY brand for which our contract ended in July 2016.

While the increase in revenues was somewhat below our expectations, largely due to slower than expected growth we encountered in the interactive television channel and revenue concessions in connection with the startup and implementation of our QTR platform, we (inaudible) response judiciously in managing our operating expenses to offset and mitigate this impact as much as possible. Also, we have been working closely with QVC to implement strategies to optimize sales heading into 2017.

Net income for the quarter was approximately $120,000 or $0.01 per diluted share compared with net income of $30,000 or $0.00 per diluted share in the prior-year quarter. Non-GAAP net income for the current quarter was $1.3 million or non-GAAP diluted EPS of $0.07 based on approximately 19.1 million weighted average shares outstanding compared with non-GAAP net income of $1.4 million or non-GAAP diluted EPS of $0.08 based on approximately 18.3 million weighted average shares outstanding in the prior-year quarter.

Our Adjusted EBITDA in the third quarter of 2016 was approximately $2.3 million, representing an increase of approximately 5% from the prior-year quarter's Adjusted EBITDA of $0.2 million.

Overall, our results are a reflective of the strength of our brand portfolio and our judicious management of our operating expenses while at the same time making the necessary expenditures to invest in our business for future growth.

Moving now to our year-to-date results. Our revenues for the nine months ended September 30, 2016 increased by 28% to $25.8 million compared with $20.2 million in the same period in 2015. As with our quarterly results, the increase in our current nine-month revenues was primarily due to higher revenues from interactive television and higher revenues in our QTR platform. These increases were partially offset by the decrease in revenues associated with the management and design of the LCNY brand.

Our nine-month 2016 net loss was approximately $20,000 or $0.00 per share compared with net income of $1.8 million or $0.11 per diluted share for the same period in the prior year. Non-GAAP net income for the current nine months was $4.6 million or non-GAAP diluted EPS of $0.24 based on approximately 19.1 million weighted average shares outstanding compared with non-GAAP net income of $4.2 million or non-GAAP diluted EPS of $0.26 based on approximately 16.5 million weighted average shares outstanding for the same period in the prior year.

Adjusted EBITDA in the first nine months of 2016 was approximately $7.1 million compared with $6.3 million for the first nine months of 2015, representing a year-over-year increase of approximately $800,000 or 12%. And again, as a reminder, non-GAAP net income, non-GAAP diluted EPS and Adjusted EBITDA are non-GAAP unaudited terms. Our Quarterly Report on Form 10-Q presents a reconciliation of these items with the most directly comparable GAAP measures.

Turning now to our cash position. As of September 30, 2016, the Company had total cash and cash equivalents of approximately $15.2 million compared with total cash of $16.9 million at December 31, 2015. The $1.7 million decrease in cash was primarily attributable to $4.6 million in scheduled principal payments on our debt, $1.9 million of capital expenditures for our new corporate offices and operations facility and $1.2 million for share repurchases related to vested restricted stock in exchange for withholding (phon) taxes. These cash outflows were largely offset by $6.8 million of cash generated from operating activities.

Also contributing to the decrease in cash during the quarter was $400,000 of restricted cash related to the sublease of our former office and $300,000 paid as final satisfaction of the earn-outs associated with the Isaac Mizrahi acquisition.

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Looking at our debt, at September 30, 2016, total liabilities were $49.9 million which includes approximately $36.4 million of debt and $6.7 million of net deferred tax liability. Debt consisted of our bank term loan and our seller notes totaling $29.8 million and $6.6 million of contingent obligations that are payable in stock or cash at the Company's option.

As of September 30, 2016, total current liabilities were $10 million and our working capital was $14.4 million. With approximately $15.2 million of cash and approximately $29.8 million of term debt, we continue to be positioned with one of the lowest leverage ratios of any of our industry peers.

With that, I would like to turn the call back over to Bob for his closing remarks. Bob?

Robert D'Loren:

Thank you, Jim. Ladies and gentlemen, in summary, our third quarter results reflect the successful execution of our key initiative to drive continued growth across our portfolio of brands and across our ubiquitous, diversified sales channels. As stated on previous earnings calls throughout the year, 2016 is both a transformative and transitional year for us and we are excited about our future prospects for growth as a result of our investments in brands, retail partnerships, people and processes.

Our Company vision is to re-imagine shopping, entertainment and social as one, while at our core we are a working capital licensing company. Today, we are in fact much more than that. We are a fast, virtual, vertical brand management and media company with vertical production capabilities built to provide solutions for many of today's retail industry challenges. We have grown our business by building upon our ability to provide innovative solutions for our retail partners and providing great products when our customers want them.

Our continued expansion with select new retail partnerships is a testament both to the success of our model as well as our growing reputation in the industry. Looking ahead, we're confident we will achieve improved top line growth across our brands, expanded profitability and in turn further increase long-term value for our shareholders.

That concludes our prepared remarks. Jim, Seth and I are now available to take questions. Operator?

Operator:

Thank you. The question-and-answer will be conducted electronically. If you would like to ask a question, please press star, followed by the digit one. If you are using a speakerphone, please make sure your mute is turned off to allow your signal to reach our equipment. Once again, star, one to ask a question. We'll pause for just a moment.

Our first question we'll hear from Eric Beder with Wunderlich Securities.

Eric Beder:

Good afternoon.

Robert D'Loren:

Hi, Eric.

Eric Beder:

Hi. You see now nine months into—excuse me, six months into the HBC rollout. As you are getting more data and the ability to react, how have you seen your ability to pick the trends and react to the trends better as you're getting kind of more data (inaudible) six months?

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Robert D'Loren:

So generally speaking, Eric, the design process in this program is done in real time. So we're here designing on a weekly basis. But that said, the strategy is basically we design into three buckets; fashion, fashion core and core. All fashion very short lead and it's designed to be delivered in small batches where we test and if we see a positive reaction from the customer and the sell-throughs are at or above where we project them to be, then we get back into it quickly. So we cycle today—best case, or four weeks if we have the fabric position; worst case, if we're in the market with a fabric that we have but we have to print it, it could be eight weeks. On average, it's about a six-week cycle.

Eric Beder:

Are you seeing, and I know it's (inaudible) that the customer recognizes what's going on here and is coming back in more and driving the traffic and being more likely see the full price and traditional (inaudible) to a customer?

Robert D'Loren:

What we're seeing in the QTR piece is higher sell-throughs than we are in the entire floor set. So thinking about those three buckets; fashion is moving fast; fashion core, half of it fast, half of it is more long-lead; and then core of course is long-lead. So we set sell-through expectations for all three of those buckets and we're seeing sell-throughs in the fashion bucket when we're getting back into things at 2x to 3x where our long-lead product is selling through.

Seth Burroughs:

Eric, this is Seth. I think when you look at the customer response, the platform works because we're designing into what the customer is responding to. That being said, as we go into 2017, we're looking at a lot of ways we can try to optimize the program. As Bob mentioned, some of those ways are in-store merchandizing to better communicate to the customer about those new products every week. The product shows up on the floor every week. But it's also a function of marketing and of the sales people in the stores to do that. So we're looking at ways of being a little bit better at communicating to the customer now that we've shown how the structure of the program works.

Eric Beder:

Great. Am I right to assume with the men's will be also part of—will also be going out initially with HBC?

Robert D'Loren:

I'm sorry, Eric. We have interference on the line.

Eric Beder:

The men's rollout, am I right to assume, correct to assume that will also be in HBC initial rollout with them?

Robert D'Loren:

Correct. We expect initial shipments for Spring '17.

Eric Beder:

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How do—so you do a significant portion of this HBC rollout yourself. How do the new licensees fit into this mix? How are they providing—how are they structured in this role?

Robert D'Loren:

So Xcel is now set up to handle core sportswear and we rely on our licensees for all ancillary categories. So we're doing sportswear and denim collection. Our licensees do footwear, handbags, jewelry, outerwear, hosiery, all the ancillary categories that you would expect to see in a department store, eyewear and those products are not fast or they don't work on fast cycles the way the apparel does. And that's typical of fast fashion retail.

Eric Beder:

Got it. You have a great balance sheet, great numbers in terms of that. What is your appetite to add more brands to the mix to further expand in this Quick Time Response mechanism? What's your thought process on acquisition from what you see?

Robert D'Loren:

So I would say in 2016, we just could not focus on an acquisition. We were extremely focused on building out the QTR platform, getting the HBC business launched. Now that we've settled into the new headquarters, IT systems are up and working, the factory base is working and improving every day as we guide them through all of the changes that are necessary to operate this way. We're more confident looking into '17 about considering new acquisition. That said, we're always in the market looking for opportunities, brands that are synergistic with the expertise that we have here and that are serving the customer base that we know best, which is really that Gen-X and baby bloomer customer. We are now beginning to understand the millennial customer much better with our launch of Tie Line. So I would say that in '17 you can expect to see us out more aggressively seeking an acquisition opportunity.

Eric Beder:

Great. Final question, you mentioned the expansion of the QTR platform to another chain. Now when that happens, should we expect to see that margins will get significantly higher given that you're not—you're not going to recreate the infrastructure for this next partner, am I right? Is that how we should think about this?

Robert D'Loren:

Yes, that is correct. I would say that a significant portion of the current style to products under our brands that we're shipping will be similar. There will be some uniqueness related to another retail partner for geography and the individual customer demands within their stores. But for the most part it's very leverageable. If we take on another retailer and another brand, then of course there's some ramp up associated with that, but with the current brands that we have in the portfolio, it becomes very leverageable for us.

Eric Beder:

Great. Good luck in the holiday season.

Robert D'Loren:

Thank you, Eric.

Seth Burroughs:

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Thanks, Eric.

Operator:

At this time, there are no further questions. I would like to turn the call back over to Mr. Bob D'Loren for any additional or closing remarks.

Robert D' Loren:

Okay. Thank you, everyone, for joining us tonight. As we head into the homestretch, we remain focused on executing our strategy and look forward to sharing our results for the full year with you in Q1 of 2017. We greatly appreciate your continued interest and support in Xcel Brands. And as always, stay fit, eat well and be healthy.

Operator:

That will conclude today's call. We thank you for your participation.

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