Xcel Brands, Inc.

Fourth Quarter and Full Year 2016 Earnings Conference Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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PRESENTATION

Operator:

Welcome to Xcel Brands' Fourth Quarter and Full Year 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 call 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 quarter and full year ended December 31, 2016, which went out today at approximately 4:05 p.m. Eastern Time, and in addition the Company will file with the Securities and Exchange Commission its Annual Report on Form 10-K for the year ended December 31, 2016, before March 30, 2017. The release and the annual 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.

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 these measures adjust for certain costs and other events that Management believes are not representative of our core business operating results, and thus they provide supplemental information to assist investors in evaluating the Company's financial results. These non-GAAP measures should not be considered in isolation or as alternatives 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 II, Item 7 of the Form 10-K, for a reconciliation of non-GAAP measures.

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

Robert D’Loren:

Thank you Hunter. Good evening everyone and thank you for joining us. I'll start with an overview of our recent performance and then provide some thoughts on 2017. After that, our CFO, Jim Haran will discuss our financial results in more detail, and then we'll finish by opening up the call for Q&A.

Twenty sixteen was a year of transformation for Xcel, in which we achieved our third year of double-digit revenue growth and made significant progress with our strategic initiatives. The steps we have taken better position us for future growth as we work to become the solution to many of the challenges our industry is facing today. The retail industry continues to be challenged by an unprecedented cycle of change driven by technology and media, some of which impacted our business in 2016. Despite these headwinds, we are pleased with our ability to grow our top-line revenues, while making the necessary investments we believe are essential to achieving long-term revenue and profitability expansion.

At the beginning of 2016, we launched three of our brands at Lord & Taylor and Hudson's Bay department stores through our Quick Time Response, or short lead time, production platform. The launch of our pioneering QTR platform in 2016 was not without its challenges - change and innovation have never come easy. We invested over $5 million in our business in 2016 in order to achieve our goals - including $1 million of non-recurring expenses to set up and support the QTR platform launch; $2 million of revenue concessions, as we reported in previous quarters in connection with the QTR platform; and $2 million of capital expenditures for our new corporate offices and operations facility, which include our state of the art design and production studio.

Over the course of the year, we gained a great deal of intelligence on how to optimize and fine-tune the model. Speaking to you today, almost one year since the initial QTR launch, I am quite pleased with the initial results - which have proven the ability of our platform to react to trends and customer feedback in real-time, in order to help drive customer traffic in stores, and provide products the customer want when they want it.

While we believe it is important to fine-tune and adjust the model in order to adapt to on-going changes at our retail partners, we have begun to shift our focus to growing market share. Just earlier this month, we announced the launch of our H Halston brand at Dillard's. We are also actively working on developing a men's collection for two of our brands, and we continue to meet regularly with key decision makers at major department stores to explore new opportunities and ways to enhance the QTR model. Finally, we plan to fully develop our data analytics capabilities in 2017. This will better enable us to listen to our customers and design in to trends as they emerge. We believe that this business and the leading strategic advantage that we can provide to our retail partners will enable us to capture increased market share and growth across our business in 2017 and beyond.

Moving now to our interactive television business. Although our revenues from interactive television increased from full-year 2015 to 2016, revenues during the fourth quarter and year-to-date fell short of our expectations, given the strong headwinds experienced by QVC in the latter part of 2016. We are working closely with QVC to develop strategies to optimize our business, engage with our existing customers, and develop conversations with new customers. QVC remains a key strategic partner for us, and we continue to be optimistic about significant opportunities for growth and expansion in this business with our existing brands, and in new categories, both in the US and internationally.

Outside of interactive television, we continue to see opportunities for growth within our specialty retail business. Looking ahead to 2017, this will continue to be an area of focus for us as we seek opportunities for expansion. We are currently working on a number strategic initiatives in the home category with Bed Bath and Beyond, and in the beauty category with Revlon, both expected to launch in 2017.

In 2017, we expect that retail will continue to be challenged, but with that said, we seek opportunity in our interactive television business and expect to start to see returns on our investment in our QTR business.

In our interactive television business, we expect solid performance barring any unanticipated behavior changes in our customers or unforeseen external or non-controllable events. In fact, we are already off to a great start in Q1 in our core apparel business, with interactive television sales currently projected to be up over 18% from Q1 of 2016. We also look forward to launching new categories, including beauty.

In our QTR department store business, we expect strong double digit sales growth in 2017 as well as improvements in profitability. We anticipate continued momentum in retail sales of our propriety brands in Hudson's Bay and Lord and Taylor department stores, and are excited and optimistic about the launch of our H Halston brand in Dillard's this month.

Despite the current challenges in the retail sector, we believe that our business model is well-positioned to meet these challenges and provide innovation and flexibility to our retail partners across all channels of distribution.

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

James Haran:

Thanks Bob. I will briefly discuss selected financial results for the fourth quarter and the year ended December 31, 2016. Please note that our financial results are described more fully in our Annual Report on Form 10-K, which will be filed with the SEC by March 30th.

In the fourth quarter of 2016, revenues decreased by approximately 7% to $6.9 million, compared with $7.5 million in the prior-year quarter. This was primarily attributable to the Q3 and Q4 headwinds experienced by QVC, as Bob previously mentioned. In response, we have judiciously managed our operating expenses to offset and mitigate this impact as much as possible, while working closely with QVC to implement strategies to optimize sales in 2017.

Net income for the quarter was $2.8 million, or $0.14 per diluted share, compared with net income of $800,000, or $0.04 per diluted share, in the prior-year quarter. This increase was primarily attributable to a non-cash gain on the reduction of a contingent obligation associated with the acquisition of the Ripka Brand.

Non-GAAP net income for the current quarter was $300,000, or non-GAAP diluted EPS of $0.01 per diluted share, compared with non-GAAP net income of $2.1 million, or non-GAAP diluted EPS of $0.10

per diluted share in the prior-year quarter. Adjusted EBITDA in the current quarter was approximately $1.4 million, compared with the prior-year quarter's Adjusted EBITDA of $3.0 million. These decreases in our non-GAAP net income and our Adjusted EBITDA are mainly attributable to a combination of the aforementioned revenue decreases, as well as increased staffing and investments in our operations and infrastructure (including QTR) in order to support future growth in our business and enhance the value of our brands.

Turning now to the full year results; for full year 2016, total revenues increased by 18% to $32.8 million, compared with $27.7 million in the prior year. This was primarily driven by increased revenues from interactive television as a result of full-year revenues for the Halston and C. Wonder brands, which we acquired in late 2014 and mid-2015, respectively. In addition, there were increased revenues recognized from strategic license agreements related to our QTR program. These 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.

Net income for the year was $2.7 million, compared with $2.6 million for the prior year. Non-GAAP net income for the year was $4.9 million, or non-GAAP diluted EPS of $0.26 based on approximately 19.0 million weighted average shares outstanding. This compares to non-GAAP net income of approximately $6.3 million, or non-GAAP diluted EPS of $0.36 based on approximately 17.2 million weighted average shares outstanding, for the prior year. Adjusted EBITDA for the current year was approximately $8.5 million, compared with the prior year's Adjusted EBITDA of $9.3 million.

Overall, these results are reflective of increased staffing and scaling of our operations and infrastructure, including our investments in the QTR platform, in order to support future growth in our business and enhance the value of our brands.

Once again, as a reminder, non-GAAP net income, non-GAAP diluted EPS, and Adjusted EBITDA are non-GAAP unaudited terms. Our Earnings Press Release as well as our Annual Report on Form 10-K, which I indicated will be filed before March 30th, presents a reconciliation of these items with the most directly comparable GAAP measures.

Now to our cash position. As of December 31, 2016, the Company had total cash and cash equivalents of approximately $14.1 million, compared with total cash of approximately $16.9 million at December 31, 2015.

This approximate $2.7 million decrease in cash was primarily attributable to $5.5 million in scheduled principal payments on our term debts, $2.2 million of capital expenditures for our new corporate offices and operations facility, and $1.4 million for common share repurchases related to vested restricted stock in exchange for withholding taxes.

These cash outflows were largely offset by $7.9 million of cash generated from operating activities. Also contributing to the decrease in cash during the year was a $900,000 disbursement for a promissory note receivable, and $400,000 paid for contingent obligations associated with the Isaac Mizrahi and Judith Ripka acquisitions.

Now looking at our debt; at December 31, 2016, total liabilities were $44.9 million, which includes approximately $31.9 million of debt, and $6.9 million of net deferred tax liability. Debt consists of our $24.7 million senior bank term loan, $4.1 million of Seller Notes, and $3.1 million of contingent obligations. Of these amounts, $2.9 million of contingent obligations and $500,000 of Seller Notes are payable in stock or cash at the Company's option.

As of December 31, 2016, total current liabilities were $10.4 million, inclusive of $6.4 million of the current portion of long-term debt. Our working capital, calculated as our current assets including cash less our current liabilities, was $11.5 million.

With approximately $14.1 million of cash and approximately $28.4 million of term debt, our year-end net debt to Adjusted EBITDA ratio was 1.7, and we continue to be positioned with one of the lowest leverage ratios of any of our industry peers. We anticipate that we will further reduce our current term debts by approximately $6.4 million in 2017, all paid through operating cash flow.

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

Robert D'Loren:

Thank you, Jim. In summary, as anticipated, 2016 was both a transformative and transitional year for us, and despite the challenges we faced in the fourth quarter, overall I am pleased with where we finished the year. We have continued to grow our revenues in the interactive television business, proven the capability and potential of the QTR platform, and laid the foundation to drive continued future growth across our portfolio of brands and across our ubiquitous distribution channels. We are very excited about the opportunities ahead in 2017, and look forward to sharing more results and information on future calls.

Our company vision is to re-imagine shopping, entertainment, and social as one. While at our core we are a working capital light licensing company, today we are truly much more than that. We are a media and brand management company that is strongly positioned as an innovator in the industry in bringing a scalable, fast-fashion vertical production QTR model to market. We provide solutions to our retail partners to address many of today's industry challenges.

Looking ahead, we are positioned to achieve improved top-line growth across our brands, expanded profitability, continue to please and delight our customers, and bring long-term value to our shareholders as well as our retail partners.

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

Operator:

Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speakerphone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Again, you can press star, one to ask a question. We'll pause a moment so that everyone has an opportunity to signal for questions.

We'll hear first from Eric Beder with Wunderlich Securities.

Bryan Caronia:

Yes, good afternoon all. This is Bryan Caronia on for Eric.

Robert D'Loren:

Hi Bryan. Good afternoon.

Bryan Caronia:

Good afternoon. So our first question or slate of questions has to do with the Quick Time Response model and in terms of any incremental costs or capital expenditures required to further build it out. So as it stands now, is the Quick Time Response model fully built out as it pertains to brands? Do you think that there's the opportunity to further add on brands to the Quick Time Response model as it stands now without any significant incremental cost? Then, certainly along that line as well, what is its capability to take on additional product lines? Obviously you alluded to the expansion for a few of your brands to men's apparel this year. Could you maybe point to any color pertaining to any sort of incremental investments for the platform?

Robert D'Loren:

That was a lot of questions all in one. I'll do my best. So to answer your question as it relates to the cost and the investment that we made in the QTR platform, I would say the majority of the heavy lifting is now passed us as it relates to the cost of setting it up. With regard to our plans to expand it and relating to your question about scalability, it is a very scalable platform at this point and we look forward to developing additional business with Dillard's and of course we are now actively speaking with other retailers about additional brand opportunities and what we can do for them with this platform.

So I hope that answered three of your questions.

Bryan Caronia:

No, I believe so. Thank you for the color. And then if we could delve in more specifically to QVC. You have—you spoke about the expansion into additional categories, particularly cosmetics through QVC, as well as you've spoken throughout 2016 about the expansion opportunities internationally. Can you sort of potentially give us an update in terms of your expectations in terms of the total addressable market there and growth opportunities both in the short term and in the near term through those two components of QVC?

Robert D'Loren:

Yes. We're looking beyond apparel in terms of growth with QVC and our plan for '17 is to launch a color cosmetics line that we expect will launch this fall. We've worked very hard over the last year to put together the supply chain for that product. We also anticipate that we will launch an anti-aging skin care line that is currently in clinical trials in spring of '18. So we see opportunity in beauty, we continue to look for additional opportunities in both anti-aging, skin care and color cosmetics and we are beginning to explore opportunities in food. We see an opportunity in food and hope that for 2018 we'll be able to introduce a food concept there at QVC as well.

With regard to international, we've seen good growth across our platforms, particularly with Halston in the UK, and in Germany in particular, and we look forward to continued growth with QVC's global platform.

Bryan Caronia:

Great, and if I could just add in one more. Obviously at the tail end of your prepared remarks you referred to how strong your financial leverage position is pertaining to your debt to EBITDA ratio. So as it pertains to that, what are you seeing in terms of the potential M&A market for brands that would fit in well to your long-term growth strategy as it stands now either from perhaps your competitors and their findings and their dealings as well as brands that might be looking to end up on your model?

Robert D'Loren:

So, as you can imagine in this current environment, there are a lot of companies that are struggling and we are looking at a lot of opportunities at the moment. We're being careful about what we look at and consider. That said, we do expect that in 2017 that we will develop a new brand acquisition that we hope will close this year.

Bryan Caronia:

Fantastic. I believe that's all I have, and best of luck in 2017.

Robert D'Loren:

Thank you.

Operator:

Thank you. We'll hear next from Ross Taylor of ARS Investment Partners.

Ross Taylor:

Yes. Robert, my household millennial tells me that Amazon is where her generation shops for clothing. What is it—or it would strike me as an Amazon relationship would be a natural fit for what you guys do. You have the ability to move quick to market and the like. Am I wrong in that or why hasn't something like that come to fruition yet?

Robert D'Loren:

Well you need to understand the demographic that a majority of our brands target. There's Isaac, Halston and Judith. We're targeting Gen-X and the baby boomer. So that doesn't really fit their sweet spot of targeting the millennial customer. That said, in 2016, we did launch Highline, which is targeted towards that millennial customer. We've had good results with it so far and as we get to know this demographic better we will explore those opportunities. I would agree with you, Amazon is natural. We have had conversations with them. The challenge with Amazon quite frankly from a production perspective is the way they buy. They tend to buy very light and shallow and that creates minimum order quantity challenges for us. But I'm confident that at some point we'll solve that and maybe find a way to do business with them.

Ross Taylor:

Yes. Obviously if you're able to develop I happen to be an owner of a air freight company where Amazon—and they worked out a deal where Amazon actually ended up taking a equity interest in the stock and bluntly in a tough space that stock has never looked back from there. So it strikes me this would be a very interesting way if it's able to be worked out to perhaps get them to buy into more than just treating Xcel Brands as a supplier but perhaps as part of their future.

Robert D'Loren:

We don't disagree.

Ross Taylor:

Also, I have another—I listened to your call, I listened to the fact that you talked about 2016 being a transformational year. You've accomplished a great deal. The stock looks inexpensive relative to your peers in a lot of measures. In the last 12 months though its lost almost half of its value, and I have to be honest, it frustrates me as someone from the outside to not see anyone inside buying stock when shares go for less than a happy meal.

Robert D'Loren:

I think of those and we tend to think of those strategies as synthetic measures to help the performance of the stock price. Management here is vested as you know. We own the majority of the Company; over 60% of the Company is owned by Management. That said, our strategy is to continue to perform and grow the business and quite frankly we believe that the stock price will take care of itself as the market in this sector rights itself.

James Haran:

And I think just to add one thing. I think it would benefit our shareholders if there was more liquidity in their stock. I think Management (inaudible)...

Ross Taylor:

Well...

James Haran:

... I think it goes the other way.

Ross Taylor:

... I actually will take—having done this for 34 years and been very successful at it, I will take great exception with that comment. Liquidity exists when demand exists. If people want to buy your stock, there's ample liquidity. I can find companies with fewer shares floating that trade like water and the problem really is I think that you need—to make the stock work there needs to be something that creates that feeling of demand, something that creates that feeling of interest and of upside. No one walks in in any given day needing to buy Xcel Brands. No one walks in at any given day needing to buy one of about thousands of other companies that trade. So while I understand you see it as kind of theatre, I think it's important theatre to your shareholders, and I think that it's a lot easier—it sends a clearer message of business success if your stock is going up than if your stock is going down, and I just think that there are easy ways to send that message and they're not getting sent and if you do send that message and you execute liquidity will take care of itself. I've never in this business seen a successful company with a value realization strategy for shareholders that hasn't had liquidity follow its success.

Robert D'Loren:

We would agree with that.

Operator:

Thank you. At this time, with no further questions in the queue, I'd now like to turn the conference over to Bob D'Loren for any additional or closing remarks.

Robert D'Loren:

Thank you Operator. Ladies and gentlemen, thank you for your time tonight. We greatly appreciate your continued interest and support in Xcel Brands. As always, stay fit, eat well and be healthy.

Operator:

Again, that does conclude our call for today. We do thank you for your participation, and you may now disconnect.