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UFI - Q2 2017 Unifi Inc Earnings Call

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PRESENTATION

Operator

Good morning everyone. On the call today is Tom Caudle, President, and Sean Goodman, Vice President and Chief Financial Officer. During this call, management will be referencing a webcast presentation that can be found at Unifi.com. The presentation can be accessed by clicking the second-quarter conference call link found on Unifi homepage.

Management advises you that certain statements included in today's call will be forward-looking statements within the meaning of the federal securities laws. Management cautions that these statements are based on current expectations, estimates and/or projections about the markets in which the Company operates. These statements are not guarantees of future performance and involve certain risks that are difficult to predict. Actual outcomes and results may differ materially from what is expressed, forecast, or implied by these statements. You are directed to the disclosures filed with the SEC on the Company's Form 10-Qs and Forms 10-K regarding various factors that may impact these results.

Also, please be advised that certain non-GAAP financial measures such as Adjusted EBITDA, Adjusted Working Capital, Adjusted Net Income, and Adjusted EPS will be discussed on this call and non-GAAP reconciliations can be found in the schedules to the webcast presentation.

I will now turn the call over to Tom Caudle.

Tom Caudle - *Unifi, Inc. - President*

Thanks, operator, and good morning everyone. Thank you for joining us today. I will start today's call with an operational and strategic overview before turning the call over to Sean, who will take us through the financial details for the second quarter and first half of fiscal 2017.

Our financial results reflect continued success and strong execution against our global strategy to provide high-quality, innovative, and sustainable products for our customers around the world. In particular, we have significantly improved year-over-year results across our international operations in both Asia and Brazil, which has helped offset some persistent soft market conditions in our domestic business.

Let's start with Asia. Volume and margin growth remained very strong in the region during the second quarter. Our PVA portfolio continues to grow in China, and we foresee exciting opportunities in Sri Lanka and Vietnam. In both filament yarn and staple fiber, we continue working with key brand and retail partners to develop long-term PVA programs that will drive value throughout the supply chain.

In Brazil, our results reflect the continuation of strong performance achieved throughout calendar 2016. Our team in Brazil has been able to successfully capitalize on expansion of the synthetic fiber market under a favorable tariff environment for imported raw materials, shutdown of a competitor, plus a volatile economic and political operating environment.

So, let's spend a few moments on our US regional business. Looking at the apparel industry, calendar year 2016 marked the lowest growth in overall apparel sales for the last five years. As a result, our domestic yarn sales have declined accordingly. After 2016's warm winter, weak retail season and associated inventory accumulation, retailers and brands were very cautious with orders during the December quarter, especially as the apparel industry showed flat year-over-year performance leading up to the holiday season.

Looking at specific domestic market sectors, we experienced the following headwinds throughout the first half of our fiscal year. Nylon, particularly socks, is being cannibalized by lower cost polyester alternatives. Nylon ladies hosiery volumes remain weak on account of consumer preferences, and the intimates sector continues to struggle. Polyester bottom weight garment volumes are also down, especially in uniforms for military and workwear applications. In addition, we are seeing heightened price-driven competition from imports in various polyester commodity and industrial yarns, along with the increased utilization of polypropylene fibers in furniture from China and Vietnam.

However, notwithstanding these headwinds, we continue to benefit from positive trends, including a record year for automotive sales in calendar 2016 as certain interiors utilize our fabrics. The increased adoption of our REPREVE chip into non-woven applications like geotextiles and carpet tiles, continued market share growth of synthetic apparel in the CAFTA region, and recent strong volumes in winter-wear associated with cold weather in certain parts of the country.

As you've seen from some of the recent domestic headlines, store closures and reduced expectations at retailers, apparel sales were fairly weak during the most recent holiday season. Our business tends to lag the activity at retail and, as a result, we are likely to experience continued weaker Polyester and Nylon Segment volume moving into the third quarter. Therefore, our short-term outlook has become more cautious, which Sean will discuss with you in a few minutes.

Notwithstanding our caution in the short-term due to the domestic market, we continue to see long-term opportunities and our global strategy continues to position us well to grow the business.

Now, I'd like to take a few moments to talk about our product and market development activities. Our new bottle processing center is operating in line with our expectations. While start-up of this facility has put pressure on margins during the first half of fiscal 2017, we are very encouraged by the performance of the bottle processing facility and the quality of product we have been able to produce. We expect positive results and attractive returns in the future. To date, we have processed over 350 million bottles, and we expect to reach a run rate of around 42 million bottles per week by the middle of calendar 2017.

In terms of other exciting product developments, this month, we began manufacturing an advanced category of new performance fibers, known as Avra, in partnership with Eastman Chemical Company. These new fibers, which are complementary to our PVA portfolio, combine Unifi's quality yarn production and know-how with the advanced chemical technology expertise of Eastman to create a new level of performance enhancing fibers, with initial adoption in apparel. We expect modest earnings from this product during its early stages, but see upside potential in the next few years.

Recently announced, Unifi received significant recognition as Fiber Producer of the Year for the World Textile Awards 2016 competition, acknowledging the excellence in our execution of the recycled fiber platform. We recently surpassed 5 billion bottles recycled into REPREVE fiber. We are very proud of this milestone and the tremendous success REPREVE has enjoyed. There continues to be increased interest in our unique offering that combines eco-friendly fibers with enhanced performance characteristics.

Turning to our marketing initiatives, REPREVE continues to grow volume through new programs. For example, we worked with Ellery Homestyles to develop a new REPREVE cobranded window treatment product that is now available at Target under the ECLIPSE brand. In addition, New Era, a leading headwear brand, has adopted REPREVE for a line of co-branded hats that will be launched later in the year. Lastly, at the 2016 Belk Bowl, we partnered with Belk and Haggar to promote the eCLo Stria dress pant made with REPREVE. The adoption and recognition continues and we remain excited about the future.

Thinking about our strategic growth opportunities. As a first step to enhance our focus on the many opportunities within our core business, we made the decision to divest our 60% interest in Repreve Renewables, a miscanthus business primarily focused on providing poultry producers with animal bedding. The market for miscanthus products is in its early stages, and we believe that the Renewables business will require meaningful investments and resources to grow and prosper. Divestiture of this business will allow us to devote our assets to the nearer-term opportunities in our core business.

Before I turn the call over to Sean, I would like to spend a moment on Parkdale America. It is one of the largest and lowest-cost cotton producers in the region. The last few quarters have been challenging for Parkdale America for many of the same reasons that our domestic business has been weak. However, we continue to believe that Parkdale America is run by a strong management team that has invested properly in its assets, has a strong reputation with its customers, and subsequently is well positioned to capitalize on a market recovery. We remain confident in our investment that has had a multi-year history of delivering attractive results.

I would like now to turn the call over to Sean to review our financial results.

Sean Goodman - *Unifi, Inc. - CFO*

Thank you Tom, and good morning.

Looking at our presentation, on Slide 3, we see a high-level overview of the second-quarter net income. For Q2, we are reporting net income of $4.6 million and basic earnings per share of $0.25. This is $1.9 million or $0.11 per share lower than the prior fiscal year period. However, when comparing net income in Q2 of fiscal 2017 to Q2 of fiscal 2016, we need to consider a number of specific items. First, net income for the second quarter of fiscal 2016 included $400,000 associated with key employee transition costs. In Q2 of fiscal 2017, we had a $1.7 million loss associated with the sale of Repreve Renewables, comparatively weaker performance from Parkdale America of approximately $300,000, and approximately $300,000 of after-tax startup costs from the bottle processing facility. When one adjusts for these unique items, net income for Q2 of fiscal 2017 would be in line with the prior fiscal year second quarter.

Slide 4 of the presentation shows a high-level overview of the year-to-date results. For the first half of fiscal 2017, we are reporting net income of $14 million and basic earnings per share of $0.78. Adjusting for the same items that we discussed on the previous slide, being key employing transition costs incurred in fiscal 2016, loss on sale of Renewables, Parkdale America's performance, and start-up costs associated with the bottle processing facility, net income would have increased by approximately $3 million, or 20%, in the first half of fiscal 2017 compared to the prior fiscal year six-month period.

Turning to Slide 5, you can see the sales and gross profit highlights for the second quarter. The discussion here focuses on our core segments, which exclude ancillary operations. Refer to Slide 12 for the consolidated metrics.

Overall, revenue of $154 million was nearly flat compared to the second quarter of fiscal 2016. As Tom noted, our international performance, with sales growth of more than 50%, was offset by the soft domestic market. Consolidated sales volume, as measured by pounds of product sold, increased by 13%.

When looking at the performance of the individual segments, it's important to note that, in fiscal 2017, certain domestic PVA programs moved from the Nylon Segment to the International Segment to meet customer specific supply chain requirements. This reflects the successful execution of our strategy of providing a consistent product wherever in the world it is required. These sales were not lost; they simply moved from the domestic to the international business.

Tom reviewed the individual segment volume changes in some detail during his remarks.

In terms of pricing, the consolidated price decline of almost 14% is mostly attributable to changes in our sales mix. More specifically, looking at the Polyester Segment, within this segment, we experienced volume declines of a little more than 5% in the textured yarn business associated with the market conditions that Tom discussed in his remarks. This volume decline was more than offset by interest and associated volume growth in our recycled polyester Chip and POY products. Both of these products are relatively early in the value chain and carry a lower average sales price per pound than textured yarn products. This impacted our mix and led to a decrease in the average selling price for the polyester segment.

The recycled Chip growth was primarily driven by demand for recycled nonwoven products, while our POY growth was driven by capitalizing on a demand opportunity from a significant customer. The average selling price for polyester in Q2 of fiscal 2017 was also lower than the prior fiscal year due to the timing of our selling price adjustments in connection with raw material cost changes. In addition to the average selling price decline in the Polyester Segment, the consolidated price decline was adversely impacted by the relatively volume weakness of nylon, which carries a higher average selling price than polyester products.

Looking at gross profit, our total segment gross profit grew over the comparable period with a 60 basis points increase in gross margin rate offsetting the sales decline. Polyester gross margins declined due to the startup of our bottle processing facility, which negatively impacted the polyester gross margin by approximately 70 basis points in Q2. We do not expect bottle processing to be a drag on gross profit in the second half of fiscal 2017, and anticipate the facility beginning to make a positive contribution to our polyester gross margins by Q4 of fiscal 2017. Furthermore, polyester margins were adversely impacted by increases in raw material prices during Q2 as oil prices began to rise.

In the Nylon Segment, margins were adversely impacted by the transition of PVA business activity to the International Segment, as I described earlier. This impacted the nylon margin rate by approximately 250 basis points in Q2. Nylon segment margins were further negatively impacted by changes in the product mix and the significant volume declines.

The International Segment more than doubled gross profit with the substantial sales growth described earlier compounded by a strong increase in the margin rate driven by an increase in the PVA product mix. Foreign currency fluctuations improved net sales and gross profit in the International Segment by $2 million and $250,000, respectively, from Q2 of fiscal 2016 to Q2 of fiscal 2017.

On Slide 6, the six-month comparative results show similar trends to the three-month results. Sales declined by 1% with strength in the International Segment offsetting relative weakness in the domestic Polyester and Nylon Segments. Gross profit increased by 8%, driven by a total segment gross margin rate increase of 130 basis points largely due to the success of our international PVA portfolio. Global PVA sales remain in line with our expectation of 10% to 15% annual growth.

For the six-month period of fiscal 2017, foreign currency fluctuations improved net sales and gross profit in the International Segment by $3.3 million and $400,000, respectively, compared to the prior fiscal year period.

Turning to Slide 7 and looking at our equity affiliates highlights, at the end of the second quarter, the Company had approximately $116 million recorded for investments in unconsolidated affiliates. These investments consist of our 34% ownership in Parkdale America and our 50% interest in two joint ventures that supply raw materials to our domestic nylon operations. Our pretax share of Parkdale America's loss for the second quarter of fiscal 2017 worsened by approximately $400,000 compared to the same period last year. For the six-month period of fiscal 2017, our pretax share of Parkdale Americas results was approximately $2 million weaker than the prior fiscal year six-month period.

The nylon joint ventures also experienced pre-tax earnings declines in both the three-month and six-month periods associated with the soft nylon business that we saw in the previous two slides.

During the six-month period of fiscal 2017, we received a total of $1.5 million in distributions from our equity affiliates.

As Tom discussed in his remarks, during the second quarter, we divested our 60% interest in Renewables, which had a book value of $2.2 million as of the date of the transaction. As a result, we recorded a $1.7 million loss on the sale and our net debt decreased by $4 million. Renewables was a nascent business that was expected to incur a modest loss in the second half of fiscal 2017 of a little more than $500,000.

On Slide 8, we'll review the Company's balance sheet highlights. Adjusted Working Capital of $136 million was approximately $3.5 million below December 2015 and approximately $9 million above the level at the end of June.

As a percentage of annualized sales, Adjusted Working Capital was just under 22%. The increase from June 2016 is primarily related to growth in our international operations, the startup of our bottle processing facility, and the timing of holiday shutdowns in connection with our quarter ending on December 25.

Moving to net debt and total liquidity, we were pleased to execute our second principal reset on the term loan of our credit facility. Our balance sheet continues to support enhanced liquidity in a favorable interest rate environment. The Company ended the second quarter with around $135 million of debt principal and net debt of roughly $106 million, consistent with net debt at the beginning of fiscal 2017. As of the end of the second quarter, our weighted average interest rate for outstanding indebtedness was approximately 2.6%. Revolver availability and liquidity were $67 million and $95 million, respectively.

Before turning the call back to Tom, I would like to provide an update on the raw material tariff situation in Brazil and our outlook for fiscal 2017. Regarding the tariff situation in Brazil, we expect import tariffs on our raw materials to be restored to the favorable level seen during calendar 2016. However, we anticipate the earliest this is likely to happen is Q4 of fiscal 2017. This means that we anticipate margin pressure in the International Segment in Q3 of fiscal 2017. We expect the impact to be in the range of around 350 basis points for the International Segment.

Looking at the remainder of fiscal 2017, the guidance that we provided back in July called for low single digit percentage growth. However, we now expect to see a few more headwinds in the second half of fiscal 2017 than we originally forecasted, namely ongoing short-term demand uncertainty in the domestic polyester and nylon markets, margin pressure as polyester raw material prices increase faster than we can adjust selling prices, and import tariff-related margin pressure in Brazil. These headwinds are likely to be stronger in Q3 than Q4 of fiscal 2017.

While we will continue to manage our costs prudently, we will also continue investing in the product and process innovations, downstream marketing and branding that are drivers of our success, ensuring that we are well positioned to capitalize on global growth opportunities and the expected turnaround in the domestic market. Based on this, we are revising our outlook for revenue, operating income and Adjusted EBITDA for fiscal 2017 to be broadly in line with fiscal 2016. Anticipated capital project outlays for fiscal 2017 remain at around $40 million and we expect net debt at the end of fiscal 2017 to be in line with that at the end of fiscal 2016.

I will now turn the call back over to Tom.

Tom Caudle - *Unifi, Inc. - President*

Thanks Sean. While we are pleased with our fiscal 2017 results to date, the domestic market remains challenging. We again see the current weak domestic market conditions as temporary and we expect to be very well positioned to benefit when the environment improves, as it inevitably will.

For now, we are focused on optimizing our high-performing assets, executing on the completion of our multi-year capital expenditure plan, product and process innovations, and downstream business development to drive long-term growth and shareholder value creation. We continue to like our competitive position and we remain excited about our prospects.

I will now turn the call back over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Marco Rodriguez, Stonegate Capital.

Marco Rodriguez - *Stonegate Capital Partners - Analyst*

Good morning guys. Thank you for taking my questions. I was wondering if maybe you could provide a little more background detail on the tariffs there in Brazil, just kind of walk through, if you could, the rationale or the reason for the tariffs coming up, and then your confidence level when it comes to the Q4 2017 reversal of that, if you will.

Sean Goodman - *Unifi, Inc. - CFO*

We had a favorable tariff situation for our raw materials in Brazil during calendar 2016, at least during most of calendar 2016. The tariffs on the POY material that we import into Brazil had a tariff rate of 2%. That tariff rate has increased now. It was a temporary reduction in tariffs that we had from the Brazilian government. And that temporary reduction has now been lifted and the tariff rate is currently 18%. So, it's significantly higher than the 2% number that we had during most of calendar 2016.

The indications from Brazilian authorities is that the lower tariff rates will be implemented during calendar 2017. It's something that needs to be approved through the Mercosur organization in South America, and there is a meeting scheduled to approve that during our [fiscal] (corrected by company after the call) Q3. We anticipate approval, and that it will go into place in Q4 of this fiscal year.

Marco Rodriguez - *Stonegate Capital Partners - Analyst*

I'm sorry, that needs to be approved by who again?

Sean Goodman - *Unifi, Inc. - CFO*

Mercosur, the South American trade organization.

Marco Rodriguez - *Stonegate Capital Partners - Analyst*

Got you. And so there's supposed be a 350 basis point impact on your margins there in Q3, and the expectation is you go to a more normalized level that you were kind of running at before? Is that how I should understand that?

Sean Goodman - *Unifi, Inc. - CFO*

Assuming the tariff rates get revised to the lower level at the end of fiscal third quarter, we should expect to return to a more normal level in the fourth quarter.

Marco Rodriguez - *Stonegate Capital Partners - Analyst*

Got you. And then if you could just talk a little bit more on the Poly side, first off, where is your PVA as far as a percentage of revenues?

And then, in terms of the Poly segment, if you can just talk a little bit more about the mix inside there where you have more of your PVA stuff, which I would think would be showing stronger growth, you're talking about the 10 to 15 versus your non-PVA, and kind of give us some sort of additional color on the background as far as retail sales are concerned would be helpful.

Sean Goodman - *Unifi, Inc. - CFO*

Overall PVA sales growth during the quarter and during the first half were in line with the 10% to 15% growth expectations that we have for the global business. We are seeing the most significant PVA growth in the International Segment, but we continue to see PVA growth in the domestic segments as well.

To your question of PVA as a percentage of sales, we are very much on track to have PVA roughly at around 40% of sales for this fiscal year.

Marco Rodriguez - *Stonegate Capital Partners - Analyst*

And so do you know what the difference is in the growth rates on PVA versus international versus domestic?

Sean Goodman - *Unifi, Inc. - CFO*

The growth rates for PVA in international are higher than the growth rates for PVA domestically. And a large reason for this is, as I mentioned in my prepared remarks, that we have quite significant volume going from the Nylon Segment to the International Segment this quarter. So, this will really help the PVA growth rates in the International Segment, and adversely impact PVA growth rates in the domestic segments. So that's why we are going to see this higher growth in the international side than the domestic side, but it is influenced by this move, to support customer-specific supply chain requirements.

Marco Rodriguez - *Stonegate Capital Partners - Analyst*

Okay, got it. And last question and I'll jump back into queue. On your Nylon Segment, it sounds like it continues to see some pretty significant headwinds there, and obviously consumer preferences are changing. I'm just kind of wondering what your guys thoughts are on that particular business long-term. It kind of sounds like that business is flattish to maybe down for the next few years.

Sean Goodman - *Unifi, Inc. - CFO*

A couple of things on the nylon business. There is the impact of the PVA move to international that I just spoke about. We do expect, if we look into the second half of the year, the significant declines that we've seen in nylon in the first half to moderate, and we do not expect to see the 20% declines that we saw in the first half. That should moderate in the second half of the year.

The nylon segment continues to be a profitable segment for us that operates off a relatively small asset base. We get a nice return from the nylon segment. We are addressing the demand weakness on two fronts. One, we are focusing on managing our assets and cost control, and two, continuing to work with our partners to develop specialty end uses for nylon. We are working on that to try and support the nylon business going forward.

Marco Rodriguez - *Stonegate Capital Partners - Analyst*

Got you. Appreciate it. Thank you guys.

Operator

Chris McGinnis, Sidoti and Company.

Chris McGinnis - *Sidoti & Company - Analyst*

Good morning. Thanks for taking my questions, and nice quarter. Can we just I guess start with maybe the international operations and the growth there? If you look at that, almost 57% growth. Can you maybe help us out with how much was Brazil of that and how much was China?

Sean Goodman - *Unifi, Inc. - CFO*

Actually, when we look at the growth for the International Segment, we are seeing, during the first half of the year, both Brazil and China growing at very similar growth rates. So you could expect, just in trying to separate between the two, very similar growth rates in those two areas during the first half of the year.

Chris McGinnis - *Sidoti & Company - Analyst*

All right. And I remember reading during the quarter, you talked about Vietnam, I think, even in your prepared remarks, a new relationship there. I think you've, over the last few years, have expanded internationally the same way you went with China. Can you maybe just talk about some of the developments on that side of the business? Can you maybe just give an update on Sri Lanka, the prospects for Vietnam, and just how quickly you think that they can ramp up here I guess?

Tom Caudle - *Unifi, Inc. - President*

This is Tom. We continue to be excited about our international segment. Sri Lanka, we are beginning to produce product there. We have a licensee in Vietnam now producing REPREVE product for us. We are evaluating our opportunities in that market, and we are going to, sometime in the near future, decide exactly what the future holds for Unifi there. But in general terms, we continue to be committed to the region and to our partners there in the region.

Chris McGinnis - *Sidoti & Company - Analyst*

Okay. And just because, honestly, there's a lot of talk about trade agreements and stuff. Any worries just with the change in presidency that maybe impacts on the business model, or your thoughts at least what could happen going forward?

Tom Caudle - *Unifi, Inc. - President*

I think, in general, anything that encourages domestic manufacturing is, in principle, good for us. TPP, although we had negotiated the best deal that we thought we could negotiate for us, it was still going to have a negative impact long-term on our business. So, it did give us a longer -- somewhat of a runway to make whatever adjustments we needed to make to be able to compete more favorably in a global market. But in general, we think it has the potential to be quite positive for us.

Chris McGinnis - *Sidoti & Company - Analyst*

And I guess just going off of that, have you seen any customers either talk more about bringing sales to you via the region? Has it changed the conversation with the customer base at all?

Tom Caudle - *Unifi, Inc. - President*

I think, in general, people began talking about it even before the current administration took office because of maybe some of the saber-rattling beforehand. But you know, it's early to know exactly what the full benefit or effects are going to be, but we don't see any short-term significant change happening.

Chris McGinnis - *Sidoti & Company - Analyst*

Okay. And I think just my last question, the board has been in place for a while now and pretty strong. And I'm just wondering. Can you maybe just talk about the benefits of having such a strong board and maybe the ideas for the Company going forward in terms of maybe branding some of the REPREVE brand possibly, or maybe thoughts around that?

Tom Caudle - *Unifi, Inc. - President*

Obviously, we have a more diverse board and more attuned to brands and consumer products than we've ever had before. I think everybody is getting very grounded now, and as we go forward, I think we will see more positive effects around those areas. So, it's probably early to make any major statements, but we continue to discuss it and they are very supportive of everything we are doing today in our business.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. Thank you, and nice quarter, and good luck in Q3, which seems to be a little bit tougher.

Operator

I'm not actually showing any further questions at this time. I would like to turn the call back over to our host.

Tom Caudle - *Unifi, Inc. - President*

Thanks, everyone, for joining us today.

Operator

Ladies and gentlemen, this does conclude today's presentation. You may now disconnect, and have a wonderful day.
