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UFI - Q1 2017 Unifi Inc Earnings Call

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CORPORATE PARTICIPANTS

Tom Caudle *Unifi, Inc. - President*

Sean Goodman *Unifi, Inc. - Vice President and CFO*

CONFERENCE CALL PARTICIPANTS

Chris McGinnis *Sidoti & Company - Analyst*

Marco Rodriguez *Stonegate Capital Markets - Analyst*

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 first-quarter conference call link found on the Unifi homepage.

Management advises you that certain statements included on today's call will be forward-looking statements within the meaning of 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, forecasted, or implied by these statements. You are directed to the disclosures filed with the SEC and the Company's Form 10-Qs and Form 10-Ks 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*

Thank you, operator, and good morning everyone. Thanks for joining us today. I will start today's call with a brief overview of the first quarter before turning it over to Sean, who will take you through the financial details.

We are pleased with our first quarter results, which reflect the success of our strategy of providing the highest quality innovative and sustainable products for our customers around the world. We are especially pleased with the performance of our international operations in both Asia and Brazil, where we experienced growth that offset soft market conditions in our domestic business. The quarter is a strong validation for the strategic decisions we've made over the last few years.

First, our expanding global footprint is allowing us to accommodate the dynamic sourcing needs of our customers, no matter what region of the world they occupy. Second, the global availability of our premium value-added yarns allow us to transition production volume around the world, balancing commercial volumes between the Americas and Asia, to respond quickly and effectively to customer supply chain preferences and market demands.

Quarter one saw a strong volume growth in Asia as our global PVA product portfolio continued to gain traction with brands and retailers. Some of the growth in Asia has been driven by the transition of PVA volumes from our Nylon Segment to meet customer supply chain requirements. We spend a great deal of time developing our capabilities in the Asian market, beginning with the REPREVE brand and expanding to other PVA technologies. As we expand our presence beyond China, the potential for growth remains substantial.

In Brazil, we also experienced strong performance in a favorable market environment for synthetic yarns. Compared to the prior year period, we saw both overall market growth and gains in market share. There are multiple factors that can impact our future performance in Brazil, including currency fluctuations impacting the relative attractiveness of imported versus domestically-produced yarn, changes in the competitive environment, and the political and economic situation.

Looking forward, we are watching the economic and political situation closely, particularly in regards to potential changes in tariffs on certain of our raw material inputs that may adversely impact our business. But again, overall, we like our competitive and growing position in Brazil and we are very pleased with the performance over the last two quarters.

Moving to our domestic results, sales volume for the Company's domestic operations declined this quarter compared to the first quarter of fiscal 2016. While retail sales of apparel on a dollar basis have been flat year over year, apparel sales on a unit basis declined for the first time in three years.

In addition, there continues to be excess inventory in the supply chain with inventory at the end of September being almost 2% higher than the prior year quarter. This higher overall inventory level coupled with the last two winter seasons being particularly mild and a number of major store closings this year, included Macy's, JC Penney's, Dillard's, Sears, Sports Authority, and Kohl's, has resulted in caution amongst brands and retailers which has negatively impacted apparel production levels in the region.

The decline in domestic sales is most notable in our Nylon division, where consumer demand for socks, sheer hosiery, and intimate apparel has been noticeably soft during calendar year 2016. In response, we are closely managing cost and production schedules at our Nylon division and working with our nylon joint venture partners to increase customer acquisition. Our development efforts and customer relationships remain strong in this division.

In terms of CapEx, we had a very successful grand opening of our REPREVE bottle processing center in early September. We are very proud of this plant, that will provide almost 90 new jobs in Reidsville, North Carolina. As we mentioned in previous calls, this facility will have the capacity to produce 75 million pounds of clear polyester bottle flake annually, providing a dependable source of high quality raw material for our REPREVE recycling center.

In addition to the obvious vertical integration benefits, we will explore additional revenue streams outside of our existing markets for textile products. I'll let Sean cover more financial detail around bottle processing in a moment.

Turning to our marketing initiatives, the Company will continue our REPREVE national mobile tour with an enhanced interactive experience for consumers to learn more about REPREVE and the brands that we work with. The 2017 tour launched with stops at the headquarters of Nike, Ford and Wolverine to further educate their employees on the benefits of using REPREVE.

Based on the success we've had in the past, Unifi will continue to invest in professional sports marketing. We'll also be working with key brands like Volcom, Haggar and others to increase co-branding at the point of sale.

Additionally, we continue to grow volume with many brands and retailers such as Target, Levi, JC Penney, Express and more as they adopt new co-branded programs and expand their lines and place replenishment orders.

Before turning the call over to Sean, I would like to discuss our investment in Parkdale America. The soft domestic market conditions mentioned earlier coupled with higher cotton prices have created headwinds for Parkdale, and this comes after they recently completed some significant capital investment focused on future growth and production efficiency. While Parkdale has recently faced a challenging market environment, we continue to believe that it is well positioned as the low-cost supplier in the domestic market, and we remain confident that performance will improve with better market conditions.

With that as a backdrop, I'd like to turn the call over to Sean Goodman, our Chief Financial Officer, who will walk you through more detail around our financial results for the September quarter.

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Thank you, Tom, and good morning everyone. As Tom noted, we're pleased with the results for the first quarter, which shows strong growth across our key financial metrics and the success of our global PVA strategy.

On page three of our presentation, we show a high level overview of these results. For the quarter, net income increased by $1.4 million or 17% compared to the prior year first quarter. Strong consolidated operating results were further positively impacted by lower bad debt expenses and a lower effective tax rate. These benefits were offset by a decline in earnings from equity affiliates of approximately $2 million, primarily due to weaker earnings from Parkdale America as a result of the challenging domestic cotton market, coupled with accelerated depreciation associated with Parkdale's recent capital investment programs.

Turning to Slide 4, you can see the sales and gross profit highlights for the first quarter. Remember that the discussion here focuses on our core segments, which exclude ancillary operations. You can refer to Slide 9 for the consolidated metrics. First, let's look at sales.

Overall, we experienced a 1% decline in revenue, from $160.6 million in the first quarter of fiscal 2016 to $158.5 million this quarter. This was despite an 11% increase in volume, as measured by pounds sold. The decline in average selling price of 12% is mainly attributable to raw material cost in Q1 of fiscal 2017 being around 15% lower than Q1 of fiscal 2016. The remainder of the overall price decline is due to changes in the segment sales mix compared to the prior year first quarter.

We're pleased with the strong performance of our PVA portfolio, with sales growth this quarter at the top end of our expectations. And for the year, we're well on track to achieve our overall PVA sales growth goal of between 10% and 15%.

Tom provided a detailed look at the conditions in the NAFTA/CAFTA region, Asia and Brazil. I will add that currency favorability in Brazil benefitted revenue by about $1.7 million compared to Q1 last year, while the currency translation for China was unfavorable by about $500,000.

Moving to gross profit. Our gross profit margin on a segment basis increased from 13.1% in the first quarter of 2016 to 15% this quarter, resulting in a gross profit increase of approximately $2.8 million or around 13%. The International Segment achieved strong margin growth in both Brazil and Asia, with Brazil benefitting from increased production levels and a favorable PVA product mix. Also, currency favorability in Brazil added about $300,000 to gross margin over the comparable quarter. In Asia, margin gains were achieved as our PVA portfolio expanded in the region.

Polyester's gross margin rate remained consistent with the prior period, with the benefits from PVA product growth offset by costs associated with the startup of our new bottle processing facility. The nylon business experienced a significant decline in margin due to lower production volumes described earlier, coupled with the transition of certain PVA programs to the international operations in Asia.

Turning to Slide 5 and looking at our equity affiliates highlights, at the end of the quarter the company had approximately $117 million recorded for investments in the unconsolidated affiliates. These investments consisted of our 34% ownership in Parkdale America and our 50% interest in two joint ventures that supply raw materials to our domestic nylon operations.

Parkdale's pretax earnings for this quarter were $1.7 million lower than last year. The nylon joint ventures experienced pretax earnings declines associated with the soft nylon business that we saw on the previous page. During the three-month period, we received a total of $750,000 in distributions from our equity affiliates.

On Slide 6, we review the Company's balance sheet highlights. Adjusted Working Capital of $131 million was approximately $10 million below September 2015 and approximately $5 million above the level at the end of June. As a percentage of annualized sales, Adjusted Working Capital was 20.5% at the end of the first quarter. The increase from June 2016 is related to seasonal inventory increases, growth in our international operations and the startup of the bottle processing facility.

I'd like to take a few moments to talk about the bottle processing plant that commenced operations this quarter. Total capital spend on the project was approximately $30 million and we are expecting a three- to five-year EBITDA payback period. As anticipated, initial startup costs adversely impacted margins in the polyester division in this quarter by roughly 1%, and we would expect similar margin pressure in Q2.

During the back half of the year, once we are over the initial startup phase, any margin pressure associated with bottle processing will be significantly less than during the first half of the year. The startup phase is progressing in accordance with our expectations, and we are excited about the benefits that this plant will bring to our business.

Moving to net debt and total liquidity. The Company ended the current period with $131 million of debt principal and net debt of $110 million. Net debt increased from the beginning of the year, driven by planned capital projects. The anticipated capital expenditures this fiscal year remains at around $40 million, which includes $10 million to $12 million of maintenance CapEx. We target a three- to six-year EBITDA payback period from capital projects. We expect net debt at the end of fiscal 2017 to be in line with that at the end of fiscal 2016.

At the end of the quarter, the Company's weighted average interest rate for its outstanding indebtedness was approximately 2.6%. Total revolver availability and liquidity was $60 million and $81 million respectively.

Before turning the call back over to Tom, I'd like to briefly address our outlook for fiscal 2017. On our last earnings call, we gave guidance for fiscal 2017 for low single digit percentage growth in sales and Adjusted EBITDA. While we are very pleased with the outperformance we achieved in the first quarter, we're still early in the year and we're not revising our guidance at this time.

I'll now turn the call back over to Tom.

Tom Caudle - *Unifi, Inc. - President*

Thanks, Sean. Our results for the September quarter mark a good start to our 2017 fiscal year and shows strong execution against our strategic plan. We are confident that our global strategy positions us well to respond to our customers' dynamic sourcing needs and deploys our resources in the best manner to return long-term shareholder value.

I'll now turn the call over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. (Operator Instructions). Chris McGinnis, Sidoti & Company.

Chris McGinnis - *Sidoti & Company - Analyst*

Good morning. Thanks for taking my question.

Tom Caudle - *Unifi, Inc. - President*

Good morning, Chris.

Chris McGinnis - *Sidoti & Company - Analyst*

Could we maybe just dig into the international operations? Obviously, significant gains there. Could you just walk us through what are new programs there and what's organic-based revenue coming out of, I would guess, more Brazil than China?

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Yeah, hi, Chris. It's Sean. So let's talk about Brazil first. In Brazil, we've had a couple of things happening in the Brazil market that have really helped our business there. Firstly, we invested a lot in our PVA capacity to produce PVA product in Brazil, and that investment is really paying off. We've seen significant growth in the PVA product portfolio in Brazil. At the same time, our market share has also expanded, particularly in the PVA product area.

But also, at the same time, the market for synthetic fibers in Brazil has expanded compared to the comparable quarter of last year. I think our comps versus Q1 in Brazil are relatively easy. Q1 was a relatively low point for the Brazil market, so we have seen the market expand from there.

What's also been happening in Brazil during this quarter, and we saw it in the fourth quarter as well, is the exchange rate environment was beneficial for the mix of products that we manufacture versus products that we import and then resell. And our margins on the products that we manufacture are higher than the margins on the products that we import and resell.

We also are running at a very high capacity in Brazil because of the high proportion of manufactured products and the high volume we're getting on the PVA products. Running at high capacity, we get efficiency from our manufacturing facility there as a result of that. So all of these things came together to result in a very strong performance in the Brazil market.

If you look at Asia, Asia continues to be a growth area for us. As you know, we have announced expansion into Sri Lanka, we continue to look at Vietnam. We're very encouraged by the interest that we see from global brands and retailers to supply our PVA product into the Asian supply chain. And Asia is essentially entirely a PVA market for us, so that's a higher margin market for us. We expect this market to continue to show growth for us during the remainder of the year.

So in the International Segment, we continue to see both Asia and Brazil performing very nicely this quarter as a result of the factors I just described.

Chris McGinnis - *Sidoti & Company - Analyst*

Sure. That makes sense. And I guess just thinking about for the rest of the year, that was really stronger growth than I would have thought. Do you think we see those similar growth rates for the remainder of the year, or do you think it's more of just kind of perfect timing, especially considering what's happening in Brazil?

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Yeah, so the way we look at it, let's think about Brazil first. I think we are going to see a continued strong volume in Brazil. We're very encouraged by the product mix and the market in Brazil and I think we will see continued strong volumes in Brazil. Remember, though, that our comparables in Brazil are much easier in the first half of the year than the second half of the year, because we did see a pickup in the Brazil market in calendar 2016.

However, we would say that we would expect the margin rates in Brazil to be under some pressure in the remainder of the year relative to the margin rates that we saw in Q1, and the reason being is that now with a stronger Brazilian real, a more stable Brazilian real, the mix of product between domestically manufactured and the imported for resell product will shift a little more away from the manufactured products towards the resell products, and that will adversely impact our margins.

So in summary on Brazil, the volumes should continue to be strong. The margin rate, though, we'd expect that to decline versus the levels that we saw in the first quarter. We're also concerned in Brazil about potential changes in tariffs, I think Tom referred to these in his script, that could adversely impact our cost structure. So we're watching that. That could adversely impact our margins in Brazil.

When we look at Asia, with the Asian business, we think that the margin levels that we have in Asia should be fairly sustainable during the remainder of the year. Of course, it does depend on the mix of products there, but the margins in Asia should be sustainable during the rest of the year.

Chris McGinnis - *Sidoti & Company - Analyst*

Okay. And last question, and I'll jump back in the queue after this, could you maybe just talk about North America, how you guys feel positioned with the changing nature and maybe just a feel of how retailers and apparel manufacturers are thinking about heading into the prime season now for the holidays? Could you maybe just expand on that? Obviously, it seems a little weaker. Maybe your thoughts on what needs to change and what can maybe turn that segment around a little bit.

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Sure. So the domestic market and the NAFTA/CAFTA region performance for us has been relatively weak this quarter. We see a very uncertain retail environment, and the key issue for us there is the level of inventory. Level of inventory has remained at somewhat elevated levels versus historical levels, and this is creating some softness in our supply, that coupled with lower retail sales has impacted us.

In the medium to longer term, we do expect the region to continue to grow. We're optimistic about the region. We're seeing a trend towards more regional fast fashion and lean inventory and just-in-time inventory. We also do benefit from having diverse segments, from apparel to industrial to automotive, so that allows us to benefit as the region continues to expand. But right now, we are seeing weakness in the domestic market. A lot will depend on how the winter season goes. If we have a cold winter, that'll help us in the second half of the year. But it's a somewhat fragile environment at this point in time.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. Thanks for taking my questions.

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Oh, thank you.

Operator

Thank you. Marco Rodriguez, Stonegate Capital Markets.

Marco Rodriguez - *Stonegate Capital Markets - Analyst*

Good morning, guys. Thank you for taking my questions.

Tom Caudle - *Unifi, Inc. - President*

Good morning, Marco.

Marco Rodriguez - *Stonegate Capital Markets - Analyst*

I wanted to talk a little bit more about the poly side here in the quarter. Obviously, the volume's declined year over year, and you're also showing some year-over-year declines on the pricing and mix aspects as well. I just wanted to get a little bit better of a flavor here. On the volumes, if you can maybe talk a little bit about that. How much of that is the shifting, again, to more of the PVA stuff with lower weight, or just that soft retail environment? And also if you could talk a little bit more about the pricing and mix aspects, I wouldn't have expected that to come down so high on a year-over-year basis if we are pushing more PVA-type product.

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Yeah, sure, Marco. It's Sean. Let's just start on the pricing. When you look at the comparable period, you see that raw material prices in Q1 of 2016 were about 15% higher than they were in Q1 of 2017. And what happened during the course of last year, the 2016 fiscal year, is raw material prices were high in Q1 and they dropped down around 15% by Q2. So, just as you think about Q2 through Q4, our raw material prices we expect to be broadly in a similar range in 2017 to what they were in 2016. However, in Q1, we did have a significant raw material price decline of about 15% for virgin materials, and that is the predominant driver of price change in the polyester side.

When you look at this from a volume point of view, our volumes are down by about 4%. We wouldn't attribute that to a denier change associated with PVA. That is really related to the retail softness that we're seeing. You know, in some segments our volume is actually up, and in some segments our volume is down, but overall, the decline that we are seeing is in line with retail softness in the region.

Marco Rodriguez - *Stonegate Capital Markets - Analyst*

That's very helpful. And then shifting gears here to the nylon business, again, a fairly significant year-over-year decline on the volumes. You obviously have a fairly large client in there and you've pointed out the retail softness. I'm wondering if maybe you could talk a little bit more about any kind of conversations you may have had with your largest customer there, whether this is a competitive issue that perhaps they might be having, or is it just primarily the retail softness?

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

So, thanks. Look, there is the retail softness, is one factor. But the nylon decline is more than just the retail softness. The nylon decline is also consumer preferences. We are seeing a decline in ladies' hosiery and casual clothing from nylon. There is that particular decline that we are seeing in the nylon market. We are also seeing a few segments where some nylon share has been passed to polyester. Polyester is a less expensive fiber.

Now, we're attacking the nylon situation from two fronts. One, we're certainly managing our assets to control our cost in that area. And two, we are working together with our joint ventures partners to develop specialty areas for nylon. But, as I say, going back to the beginning, nylon supply is more than just retail softness. There's other factors involved. And we're seeing that across the board with our customers in nylon.

Marco Rodriguez - *Stonegate Capital Markets - Analyst*

Got it. Very helpful. And last quick question and I'll jump back in the queue. In your prepared remarks, you guys talked a little bit about adding additional revenue streams, I think you said outside of what you guys currently are doing. Can you kind of expand on that and give some examples as far as what that might be, and then also if you could perhaps talk about any sort of strategy or strategic shift you might need to enter those markets and any sort of upfront costs that that might entail.

Tom Caudle - *Unifi, Inc. - President*

Yeah, Marco. This is Tom. That is mostly related to our bottle processing facility, and we were talking about going into maybe some food packaging and some other areas for our polyester flake coming from bottle processing, and also potentially some other uses for our recycled polymer at our REPREVE recycling center as well.

Marco Rodriguez - *Stonegate Capital Markets - Analyst*

And do you have any sort of timing aspect in regard to that?

Tom Caudle - *Unifi, Inc. - President*

You know, we're looking at those markets, and I think we're out seeding those markets right now with product, and that will be a gradual increase over time. And I guess another end use would be nonwovens as well, for our product.

Marco Rodriguez - *Stonegate Capital Markets - Analyst*

Got it. Okay, thanks a lot, guys. I appreciate it.

Tom Caudle - *Unifi, Inc. - President*

Thanks, Marco.

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Thank you, Marco.

Operator

Chris McGinnis, Sidoti & Company.

Chris McGinnis - *Sidoti & Company - Analyst*

Yeah. Hey, guys, just a couple more questions. I was just thinking about, Sean, I think your comments about Brazil and almost at full capacity. With the changes that were made or I guess the competitive landscape last year, would you guys consider maybe adding capacity in that region? You know, maybe where you're at in that thought process since you're performing so well. I guess thinking ahead of the tariff if something happens there negatively. Maybe just think about your thoughts for growth in that region?

Tom Caudle - *Unifi, Inc. - President*

Yeah, Chris, this is Tom. You know, I think we look at that market very positively. I mean, it's a difficult environment to do business down there because of all the issues that Sean and I have discussed previously. But certainly if market dynamics dictate, I think we would consider future expansion down there for sure.

Chris McGinnis - *Sidoti & Company - Analyst*

Okay. And in the current capacity you're at, sounds pretty positive. Are you close to full now?

Tom Caudle - *Unifi, Inc. - President*

We are. Currently, we're very close to full capacity. We've continued to, as Sean alluded as well, we've continued to invest in the capacity, adding PVA capabilities, which we've benefitted greatly from. And we will continue to do that as needed.

Chris McGinnis - *Sidoti & Company - Analyst*

Okay. Any developments on the Nike and Apollo, in speaking with Nike at all or working with Nike, any developments on your side of their thought process for investing in the region?

Tom Caudle - *Unifi, Inc. - President*

Well, I think Apollo and Nike, for us, at least on the surface, is positive. It's reinforcement that the brands and retailers are moving programs back to this region. And, with Nike and Apollo there are other potential entrants to this market coming back, and especially in knitting and weaving capacity that are potentially moving back to this region based on what they're hearing from the brands and retailers.

So we're encouraged about our business long term.

Chris McGinnis - *Sidoti & Company - Analyst*

Great. Well, thank you very much for the time today. I appreciate it.

Tom Caudle - *Unifi, Inc. - President*

Thank you, Chris.

Sean Goodman - *Unifi, Inc. - Vice President and CFO*

Thanks, Chris.

Operator

Thank you. At this time there's no other questions in the queue. I'd like to turn it back to Mr. Caudle for any closing comment.

Tom Caudle - *Unifi, Inc. - President*

Thank all of you for joining us today.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes your program. You may now disconnect. Everyone have a great day.