

DELTA APPAREL, INC
Form 10-Q
February 09, 2016
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended January 2, 2016

OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____
Commission File Number 1-15583
DELTA APPAREL, INC.

(Exact name of registrant as specified in its charter)

GEORGIA 58-2508794
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

322 South Main Street
Greenville, SC 29601
(Address of principal executive offices) (Zip Code)
(864) 232-5200

(Registrant’s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of a “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of January 27, 2016, there were outstanding 7,747,557 shares of the registrant’s common stock, par value of \$0.01 per share, which is the only class of outstanding common or voting stock of the registrant.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

Delta Apparel, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(Amounts in thousands, except share amounts and per share data)

(Unaudited)

	January 2, 2016	October 3, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$296	\$300
Accounts receivable, less allowances of \$2,969 and \$2,984, respectively	48,364	62,741
Income tax receivable	627	—
Inventories, net	159,208	148,372
Prepaid expenses and other current assets	6,603	4,124
Total current assets	215,098	215,537
Property, plant and equipment, net of accumulated depreciation of \$83,289 and \$81,376, respectively	41,057	39,653
Goodwill	36,729	36,729
Intangibles, net	21,830	22,162
Deferred income taxes	6,300	7,294
Other assets	3,403	3,528
Total assets	\$324,417	\$324,903
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$52,284	\$53,349
Accrued expenses	16,854	20,661
Income tax payable	—	87
Current portion of long-term debt	8,413	8,340
Total current liabilities	77,551	82,437
Long-term debt, less current maturities	97,768	93,872
Other liabilities	1,571	995
Contingent consideration	2,900	3,100
Total liabilities	\$179,790	\$180,404
Shareholders' equity:		
Preferred stock—\$0.01 par value, 2,000,000 shares authorized, none issued and outstanding	—	—
Common stock—\$0.01 par value, 15,000,000 shares authorized, 9,646,972 shares issued, and 7,758,965 and 7,797,166 shares outstanding as of January 2, 2016 and October 3, 2015, respectively	96	96
Additional paid-in capital	59,408	59,399
Retained earnings	108,396	107,715
Accumulated other comprehensive loss	(203	) (429
Treasury stock—1,888,007 and 1,849,806 shares as of January 2, 2016 and October 3, 2015, respectively) (23,070) (22,282

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Total shareholders' equity	144,627	144,499
Total liabilities and shareholders' equity	\$324,417	\$324,903
See accompanying Notes to Condensed Consolidated Financial Statements.		

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Delta Apparel, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
(Amounts in thousands, except per share data)
(Unaudited)

	Three Months Ended	
	January 2, 2016	December 27, 2014
Net sales	\$90,171	\$93,381
Cost of goods sold	71,292	78,055
Gross profit	18,879	15,326
Selling, general and administrative expenses	16,892	18,540
Change in fair value of contingent consideration	(200	) 65
Other income, net	(40	) (62
Operating income (loss)	2,227	(3,217
Interest expense, net	1,276	1,528
Income (loss) before provision (benefit) from income taxes	951	(4,745
Provision (benefit) from income taxes	270	(534
Net income (loss)	\$681	\$(4,211
Basic earnings (loss) per share	\$0.09	\$(0.53
Diluted earnings (loss) per share	\$0.09	\$(0.53
Weighted average number of shares outstanding	7,761	7,881
Dilutive effect of stock options and awards	193	—
Weighted average number of shares assuming dilution	7,954	7,881
See accompanying Notes to Condensed Consolidated Financial Statements.		

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Delta Apparel, Inc. and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income (Loss)

(Amounts in thousands)

(Unaudited)

	Three Months Ended	
	January 2, 2016	December 27, 2014
Net income (loss)	\$681	\$(4,211)
Net unrealized gain (loss) on cash flow hedges, net of tax	226	(4)
Comprehensive income (loss)	\$907	\$(4,215)

See accompanying Notes to Condensed Consolidated Financial Statements.

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Delta Apparel, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Amounts in thousands)
(Unaudited)

	Three Months Ended	
	January 2, 2016	December 27, 2014
Operating activities:		
Net income (loss)	\$681	\$(4,211)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Depreciation and amortization	2,342	2,427
Amortization of deferred financing fees	125	125
Excess tax benefits from exercise of stock options	(89)	—
Provision for deferred income taxes	994	657
Non-cash stock compensation	412	(66)
Change in the fair value of contingent consideration	(200)	65
(Gain) loss on disposal of equipment	(1)	11
Changes in operating assets and liabilities:		
Accounts receivable	14,377	16,577
Inventories	(10,836)	(13,427)
Prepaid expenses and other assets	(2,479)	(1,176)
Other non-current assets	—	9
Accounts payable	(1,644)	2,240
Accrued expenses	(3,826)	(1,055)
Income tax payable/receivable	(625)	(805)
Other liabilities	(240)	(200)
Net cash (used in) provided by operating activities	(1,009)	1,171
Investing activities:		
Purchases of property and equipment, net	(1,753)	(1,971)
Proceeds from sale of fixed assets	16	—
Net cash used in investing activities	(1,737)	(1,971)
Financing activities:		
Proceeds from long-term debt	118,629	133,124
Repayment of long-term debt	(114,660)	(132,673)
Repayment of capital financing	(36)	—
Payment of deferred financing fees	—	(25)
Repurchase of common stock	(1,117)	—
Payment of withholding taxes on exercise of stock options	(163)	—
Excess tax benefits from exercise of stock options	89	—
Net cash provided by financing activities	2,742	426
Net decrease in cash and cash equivalents	(4)	(374)
Cash and cash equivalents at beginning of period	300	612
Cash and cash equivalents at end of period	\$296	\$238

Supplemental cash flow information:

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Cash paid during the period for interest	\$982	\$1,182	
Cash paid (received) during the period for income taxes, net of refunds received	\$33	\$(385)
Non-cash financing activity - capital lease agreements	\$1,336	\$—	

See accompanying Notes to Condensed Consolidated Financial Statements.

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Delta Apparel, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note A—Basis of Presentation and Description of Business

We prepared the accompanying interim condensed consolidated financial statements in accordance with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles ("U.S. GAAP") for complete financial statements. We believe these Condensed Consolidated Financial Statements consist of normal recurring adjustments considered necessary for a fair presentation. Operating results for the three months ended January 2, 2016, are not necessarily indicative of the results that may be expected for our fiscal year ending October 1, 2016. Although our various product lines are sold on a year-round basis, the demand for specific products or styles reflects some seasonality, with sales in our June quarter generally being the highest and sales in our December quarter generally being the lowest. For more information regarding our results of operations and financial position, refer to the Consolidated Financial Statements and footnotes included in our Form 10-K for our fiscal year ended October 3, 2015, filed with the United States Securities and Exchange Commission ("SEC").

"Delta Apparel", the "Company", and "we", "us" and "our" are used interchangeably to refer to Delta Apparel, Inc. together with our domestic wholly-owned subsidiaries, including M.J. Soffe, LLC ("Soffe"), Junkfood Clothing Company ("Junkfood"), Salt Life, LLC (f/k/a To The Game, LLC) ("Salt Life"), Art Gun, LLC ("Art Gun"), and other international subsidiaries, as appropriate to the context.

Delta Apparel, Inc. is an international apparel design, marketing, manufacturing and sourcing company that features a diverse portfolio of lifestyle basics and branded activewear apparel and headwear. We specialize in selling casual and athletic products through a variety of distribution channels and distribution tiers, including specialty stores, boutiques, department stores, mid and mass channels, e-retailers, and the U.S. military. Our products are also made available direct-to-consumer on our websites. We believe this diversified distribution allows us to capitalize on our strengths to provide casual activewear to consumers purchasing from most types of retailers.

We design and internally manufacture the majority of our products, which allows us to offer a high degree of consistency and quality controls as well as leverage scale efficiencies. One of our strengths is the speed with which we can reach the market from design to delivery. We have manufacturing operations located in the United States, El Salvador, Honduras and Mexico, and use domestic and foreign contractors as additional sources of production. Our distribution facilities are strategically located throughout the United States to better serve our customers with same-day shipping on our catalog products and weekly replenishments to retailers.

We were incorporated in Georgia in 1999 and our headquarters is located at 322 South Main Street, Greenville, South Carolina 29601 (telephone number: 864-232-5200). Our common stock trades on the NYSE MKT under the symbol "DLA". We operate on a 52-53 week fiscal year ending on the Saturday closest to September 30. Our 2016 fiscal year is a 52-week year and will end on October 1, 2016. Our 2015 fiscal year was a 53-week year and ended on October 3, 2015.

Note B—Accounting Policies

Our accounting policies are consistent with those described in our Significant Accounting Policies in our Form 10-K for the fiscal year ended October 3, 2015, filed with the SEC.

Note C—New Accounting Standards

Recently Adopted Standards

In November 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes, ("ASU 2015-17"). This new guidance requires businesses to classify deferred tax liabilities and assets on their balance sheets as noncurrent. Under existing accounting, a business must separate deferred income tax liabilities and assets into current and noncurrent. ASU 2015-17 was issued as a way to simplify the way businesses classify deferred tax liabilities and

assets on their balance sheets. Public companies must apply ASU 2015-17 to fiscal years beginning after December 15, 2016. Companies must follow the requirements for interim periods within those fiscal years, but early adoption at the beginning of an interim or annual period is allowed for all entities. ASU 2015-17 was adopted for our fiscal year beginning October 4, 2015. The implementation of ASU 2015-17 was applied retroactively to the October 3, 2015, Condensed Consolidated Balance Sheet included in this Form 10-Q. As a result of this retroactive application, current deferred income tax assets of \$7.3 million have been netted with noncurrent deferred income tax liabilities of \$7 thousand and reclassified to noncurrent deferred income tax assets.

Standards Not Yet Adopted

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, ("ASU 2014-09"). This new guidance requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. ASU 2014-09 is effective for annual periods beginning after December 15, 2017, for public business entities and permits the use of either the retrospective

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or cumulative effect transition method. Early application is permitted only as of annual reporting periods beginning after December 15, 2016. ASU 2014-09 is therefore effective for our fiscal year beginning September 30, 2018. We are evaluating the effect that ASU 2014-09 will have on our Consolidated Financial Statements and related disclosures.

In July 2015, the FASB issued ASU No. 2015-11, Simplifying the Measurement of Inventory, ("ASU 2015-11"). This new guidance requires an entity to measure inventory at the lower of cost and net realizable value. Currently, entities measure inventory at the lower of cost or market. ASU 2015-11 replaces market with net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured under last-in, first-out or the retail inventory method. ASU 2015-11 requires prospective adoption for inventory measurements for fiscal years beginning after December 15, 2016, and interim periods within those years for public business entities. Early application is permitted. ASU 2015-11 is therefore effective in our fiscal year beginning October 1, 2017. We are evaluating the effect that ASU 2015-11 will have on our Consolidated Financial Statements and related disclosures.

Note D—Sale of The Game

On March 2, 2015, we completed the sale of our The Game branded collegiate headwear and apparel business to David Peyser Sportswear, Inc., owner of MV Sport, Inc. for \$14.9 million. The business sold consisted of The Game branded products sold nationally in college bookstores and through team dealers. This transaction further strengthened our balance sheet and enables us to focus on areas of our business that are more strategic to our long-term goals. Our Salt Life business and corporate business, Kudzu, previously operated within To The Game, LLC (now Salt Life, LLC) were not included in the sale of the collegiate part of the business.

The sale included finished goods inventory of \$6.0 million, \$0.4 million in fixed assets, and \$0.1 million in other assets, along with the requirement that we indemnify up to \$0.3 million of legal costs associated with a particular litigation matter which was subsequently settled. The transaction did not include accounts receivable which we subsequently collected in the normal course of business and certain undecorated apparel inventory. We incurred \$0.4 million in direct selling expenses associated with the transaction. In addition, we incurred certain indirect costs associated with the transaction, including a \$0.8 million devaluation of the inventory not included in the sale and \$1.4 million in indirect incentive-based expenses.

The pre-tax gain on the sale of The Game assets, inclusive of the direct and indirect expenses, was \$5.6 million. The transaction and associated indirect expenses were recorded in our Condensed Consolidated Statements of Operations in our 2015 second quarter as follows: (i) proceeds of \$14.9 million less costs of assets sold and direct selling costs resulting in a gain of \$7.7 million recorded as a gain on sale of business; (ii) \$1.4 million in indirect expenses recorded in our selling, general and administrative expense; and (iii) \$0.8 million of indirect expenses recorded in our cost of goods sold. For income tax purposes, this gain and associated indirect expenses were treated as a discrete item and resulted in \$2.2 million in income tax expense being recorded in our 2015 second quarter.

Note E—Salt Life Acquisition

On August 27, 2013, Salt Life, LLC (f/k/a To The Game, LLC) purchased substantially all of the assets of Salt Life Holdings, LLC ("Salt Life Holdings"), including all of its domestic and international trademark rights in the Salt Life brand (the "Salt Life Acquisition"). The purchase price for the Salt Life Acquisition consisted of: (i) a cash payment at closing of \$12,000,000, (ii) a deposit at closing of \$3,000,000 into an escrow account to be held to secure indemnification obligations of the seller under the asset purchase agreement and to be held for a period of up to fifty-four months following the closing, and (iii) delivery of two promissory notes in the aggregate principal amount of \$22,000,000. An additional amount may be payable in cash after the end of calendar year 2019 if financial performance targets involving the sale of Salt Life-branded products are met during the 2019 calendar year. At acquisition, we recorded an accrual of \$3.4 million for the fair value of the contingent consideration associated with the Salt Life Acquisition. We financed the cash portion of the purchase price through our Fourth Amended and Restated Loan and Security Agreement, as amended on August 27, 2013. We expensed all acquisition-related costs,

totaling \$0.3 million, in the selling, general and administrative expense line item of our Condensed Consolidated Statements of Operations in the quarter ended September 28, 2013.

On December 6, 2013, we entered into an agreement (the "IMG Agreement") with IMG Worldwide, Inc. ("IMG") that provides for the termination of the Salt Life brand license agreements entered into between Delta Apparel and IMG (as agent on behalf of Salt Life Holdings) prior to the Salt Life Acquisition as well as the agency agreement entered into between Salt Life Holdings and IMG prior to the Salt Life Acquisition. In addition, the IMG Agreement provides that Delta Apparel and Salt Life Holdings are released from all obligations and liabilities under those agreements or relating to the Salt Life Acquisition. Pursuant to the IMG Agreement, Salt Life and IMG entered into a separate, multi-year agency agreement, which has since been terminated, whereby IMG represented Salt Life with respect to the licensing of the Salt Life brand in connection with certain product and service categories. Salt Life agreed to pay IMG installments totaling \$3,500,000 to terminate these contractual arrangements. As a result, the above-referenced \$3,000,000 indemnification asset was released from escrow during the quarter ended December 28, 2013, and applied towards these payment obligations, along with additional amounts previously accrued for royalty obligations under the above-referenced Salt Life brand license agreements. During the years ended October 3, 2015, and September 27, 2014, we made payments of \$0.8 million and \$2.1 million, respectively, in accordance with the terms of the agreement. As of January 2, 2016, there were 2 quarterly installments of \$195 thousand remaining. We have recorded the fair value of the liability as of January 2, 2016, on our financials with \$0.4 million in accrued expenses.

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The Salt Life Acquisition continues our strategy of building lifestyle brands that take advantage of our creative capabilities, vertical manufacturing platform and international sourcing competencies. Prior to the Salt Life Acquisition, Salt Life, LLC (f/k/a To The Game, LLC) sold Salt Life-branded products under exclusive license agreements which began in January 2011. As such, the results of Salt Life sales have been included in our Condensed Consolidated Financial Statements since that time.

We accounted for the Salt Life Acquisition pursuant to ASC 805, Business Combinations, with the purchase price allocated based upon fair value. We have identified certain intangible assets associated with Salt Life, including tradenames and trademarks, license agreements, non-compete agreements and goodwill. The total amount of goodwill is expected to be deductible for tax purposes. Components of the intangible assets recorded at acquisition are as follows (in thousands, except economic life data):

Goodwill	\$19,917	Economic Life N/A
Intangibles:		
Tradename/trademarks	16,000	30 years
License agreements	2,100	15 – 30 years
Non-compete agreements	770	6.6 years
Total intangibles	18,870	
Total goodwill and intangibles	\$38,787	

Note F—Inventories

Inventories, net of reserves of \$8.7 million and \$8.4 million as of January 2, 2016, and October 3, 2015, respectively, consist of the following (in thousands):

	January 2, 2016	October 3, 2015
Raw materials	\$11,521	\$11,412
Work in process	18,194	19,071
Finished goods	129,493	117,889
	\$159,208	\$148,372

Note G—Debt

Delta Apparel, Soffe, Junkfood, Salt Life (f/k/a To The Game, LLC) and Art Gun are borrowers under the May 27, 2011, Fourth Amended and Restated Loan and Security Agreement, with the financial institutions named therein, Wells Fargo Bank, National Association, as Administrative Agent, Bank of America, N.A., as Syndication Agent, Wells Fargo Capital Finance, LLC, as Sole Lead Arranger, and Wells Fargo Capital Finance, LLC and Merrill Lynch, Pierce, Fenner & Smith Incorporated, as Joint Bookrunners. The May 27, 2011, Fourth Amended and Restated Loan Agreement (as subsequently amended, the "Amended Loan Agreement") was subsequently amended on each of August 27, 2013, September 4, 2013, September 26, 2014, and February 27, 2015.

Pursuant to the Amended Loan Agreement, the maximum line of credit under our U.S. revolving credit facility is \$145 million (subject to borrowing base limitations), and matures on May 27, 2017. Provided that no event of default exists, we have the option to increase the maximum credit available under the facility to \$200 million (subject to borrowing base limitations), conditioned upon the Administrative Agent's ability to secure additional commitments and customary closing conditions. In fiscal year 2014, we paid \$0.4 million in financing costs in conjunction with the September 26, 2014 amendment. No financing costs were paid in conjunction with the February 27, 2015 amendment.

As of January 2, 2016, there was \$84.2 million outstanding under our U.S. revolving credit facility at an average interest rate of 2.95%, and additional borrowing availability of \$17.2 million. This credit facility includes a financial covenant requiring that if the amount of availability falls below the threshold amounts set forth in the Amended Loan

Agreement, our Fixed Charge Coverage Ratio (“FCCR”) (as defined in the Amended Loan Agreement) for the preceding 12-month period must not be less than 1.1 to 1.0. We were not subject to the FCCR covenant at January 2, 2016, because our availability was above the minimum required under the Amended Loan Agreement. At January 2, 2016, our FCCR was above the required 1.1 to 1.0 ratio and therefore we would have passed our financial covenant had we been subject to it. At January 2, 2016, and October 3, 2015, there was \$6.6 million and \$7.3 million, respectively, of retained earnings free of restrictions to make cash dividends or stock repurchases.

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The Amended Loan Agreement contains a subjective acceleration clause and a “springing” lockbox arrangement (as defined in FASB Codification No. 470, Debt (“ASC 470")), whereby remittances from customers will be forwarded to our general bank account and will not reduce the outstanding debt until and unless a specified event or an event of default occurs. Pursuant to ASC 470, we classify borrowings under the Amended Loan Agreement as long-term debt. In conjunction with the Salt Life Acquisition, we issued two promissory notes in the aggregate principal of \$22.0 million, which included a one-time installment of \$9.0 million that was due and paid as required on September 30, 2014, and quarterly installments commencing on March 31, 2015, with the final installment due on June 30, 2019. The promissory notes are zero-interest notes and state that interest will be imputed as required under Section 1274 of the Internal Revenue Code. We have imputed interest at 1.92% and 3.62% on the promissory notes that mature on June 30, 2016, and June 30, 2019, respectively. At January 2, 2016, the discounted value of the promissory notes was \$10.1 million.

In March, 2011, we entered into a credit facility with Banco Ficohsa, a Honduran bank. This credit facility is secured by a first-priority lien on the assets of our Honduran operations and the loan is not guaranteed by our U.S. entities. The installment portion of the credit facility carries a fixed interest rate of 7% for a term of seven years and is denominated in U.S. dollars. As of January 2, 2016, there was \$2.2 million outstanding on the installment portion of this loan. The revolving credit portion of the loan has an average interest rate of 8.0% with an ongoing 18-month term (expiring March 2019) and is denominated in U.S. dollars. The revolving credit portion of the loan requires minimum payments during each 6-month period of the 18-month term; however, the loan agreement permits additional drawdowns to the extent payments are made and certain objective covenants are met. The current revolving Honduran debt, by its nature, is not long-term, as it requires scheduled payments each six months. However, as the loan agreement permits us to re-borrow funds up to the amount repaid, subject to certain objective covenants, and we intend to re-borrow funds, subject to the objective covenants, the amounts have been classified as long-term debt. As of January 2, 2016, there was \$4.8 million outstanding under the revolving portion of the credit facility.

In October 2013, we entered into two new term loan agreements with Banco Ficohsa to finance our Honduran manufacturing expansion project. These loans are also not guaranteed by our U.S. entities and are secured by a first-priority lien on the assets of our Honduran operations. The first loan, an eighteen-month agreement for \$1.8 million, with a 7% fixed interest rate, is denominated in U.S. dollars, and has ratable monthly principal and interest payments due through the end of the term. As of January 2, 2016, this loan had been extinguished. The second loan, a seven-year agreement for \$4.2 million with a 7% fixed interest rate, was denominated in U.S. dollars and had ratable monthly principal and interest payments due through the end of the term. In November 2014, this loan was re-financed to a six-year agreement for \$3.6 million with a 7.5% fixed interest rate. As of January 2, 2016, there was \$3.1 million outstanding under this loan agreement. The carrying value of these term loans approximates the fair value.

In April 2015, we entered into a new term loan agreement with Banco Ficohsa to finance further capital expansion at our Honduran facilities. This loan is not guaranteed by our U.S. entities and is secured by a first-priority lien on the assets of our Honduran operations. The loan is a seven-year agreement for \$2.0 million with an 8% fixed interest rate, is denominated in U.S. dollars, and has ratable monthly principal and interest payments due through the end of the term. The first payment was due in June, 2015. As of January 2, 2016, there was \$1.8 million outstanding under this loan agreement. The carrying value of this loan approximates the fair value.

Note H—Selling, General and Administrative Expense

We include in selling, general and administrative (“SG&A”) expenses costs incurred subsequent to the receipt of finished goods at our distribution facilities, such as the cost of stocking, warehousing, picking, packing, and shipping goods for delivery to our customers. Distribution costs included in SG&A expenses totaled \$3.6 million and \$3.7 million for the three months ended January 2, 2016, and December 27, 2014, respectively. In addition, SG&A expenses include costs related to sales associates, administrative personnel, advertising and marketing expenses, royalty payments on licensed products and other general and administrative expenses.

During the fourth quarter of fiscal year 2014, certain strategic initiatives were implemented to improve net profitability. This effort included streamlining our administrative workforce, delaying our management structure and

streamlining decision-making and information flow, as well as reducing duplicative and excess fixed cost. During the fourth quarter of fiscal year 2014, we recorded a total of \$4.0 million in SG&A expense associated with these strategic initiatives. As of October 3, 2015, approximately \$0.5 million of these expenses were accrued and reported on our Condensed Consolidated Balance Sheets. During the first three months of fiscal year 2016, no additional expense was incurred in association with our strategic initiatives and \$67 thousand was disbursed during the first three months of fiscal year 2016, leaving approximately \$0.5 million remaining accrued on our January 2, 2016, Condensed Consolidated Balance Sheets.

Note I—Stock-Based Compensation

On February 4, 2015, our shareholders re-approved the Delta Apparel, Inc. 2010 Stock Plan ("2010 Stock Plan") that was originally approved by our shareholders on November 11, 2010. The re-approval of the 2010 Stock Plan, including the material terms of the performance goals included in the 2010 Stock Plan, enables us to continue to grant equity incentive compensation awards that are structured in a manner intended to qualify as tax deductible, performance-based compensation under Section 162(m) of the Internal Revenue Code of 1986. Since November 2010, no additional awards have been or will be granted under either the Delta Apparel Stock Option Plan

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("Option Plan") or the Delta Apparel Incentive Stock Award Plan ("Award Plan"); instead, all stock awards have been and will continue to be granted under the 2010 Stock Plan.

Compensation expense is recorded on the SG&A expense line item in our Condensed Consolidated Statements of Operations over the vesting periods. During the three months ended January 2, 2016, we recognized \$0.4 million in stock-based compensation expenses. During the three months ended December 27, 2014, we recognized a reduction in stock-based compensation expense of \$0.2 million resulting from an adjustment of the number of shares expected to vest under certain performance-based awards.

2010 Stock Plan

Under the 2010 Stock Plan, the Compensation Committee of our Board of Directors has the authority to determine the employees and directors to whom awards may be granted and the size and type of each award and manner in which such awards will vest. The awards available consist of stock options, stock appreciation rights, restricted stock, restricted stock units, performance stock, performance units, and other stock and cash awards. The aggregate number of shares of common stock that may be delivered under the 2010 Stock Plan is 500,000 plus any shares of common stock subject to outstanding awards under the Option Plan or Award Plan that are subsequently forfeited or terminated for any reason before being exercised. The 2010 Stock Plan limits the number of shares that may be covered by awards to any participant in a given calendar year and also limits the aggregate awards of restricted stock, restricted stock units and performance stock granted in any given calendar year. If a participant dies or becomes disabled (as defined in the 2010 Stock Plan) while employed by or serving as a director, all unvested awards become fully vested. The Compensation Committee is authorized to establish the terms and conditions of awards granted under the 2010 Stock Plan, to establish, amend and rescind any rules and regulations relating to the 2010 Stock Plan, and to make any other determinations that it deems necessary.

As of January 2, 2016, there was \$2.8 million of total unrecognized compensation cost related to non-vested awards granted under the 2010 Stock Plan. This cost is expected to be recognized over a period of 3.0 years. No awards were granted under the 2010 Stock Plan during the quarter ended January 2, 2016.

During the three months ending January 2, 2016, performance stock units representing 59,800 shares of our common stock vested upon the filing of our Annual Report on Form 10-K for the fiscal year ended October 2, 2015. Of these performance units, one half were payable in common stock and one-half were payable in cash and were issued in accordance with their respective agreements.

Option Plan

All options granted under the Option Plan have vested. As such, no expense was recognized during the three months ended January 2, 2016, or for the three months ended December 27, 2014. No options were exercised during the three months ended January 2, 2016. During the three months ended December 27, 2014, vested options representing 14,000 shares of our common stock were exercised, and the shares issued, in accordance with their respective agreements.

Award Plan

All awards granted under the Award Plan have vested and been exercised, and no awards remain outstanding.

Note J—Purchase Contracts

We have entered into agreements, and have fixed prices, to purchase yarn, natural gas, finished fabric, and finished apparel products. At January 2, 2016, minimum payments under these contracts were as follows (in thousands):

Yarn	\$28,339
Natural gas	222
Finished fabric	3,269
Finished products	26,569
	\$58,399

Note K—Business Segments

We operate our business in two distinct segments: branded and basics. Although the two segments are similar in their production processes and regulatory environments, they are distinct in their economic characteristics, products,

marketing, and distribution methods.

The branded segment is comprised of our business units focused on specialized apparel garments and headwear to meet consumer preferences and fashion trends, and includes the Salt Life, Junkfood, and Soffe business units as well as The Game business unit prior to its disposition on March 2, 2015. These branded embellished and unembellished products are sold through specialty and boutique shops, upscale and traditional department stores, mid-tier retailers, sporting goods stores, e-retailers, and the U.S. military. Products in this segment are marketed under our lifestyle brands of Salt Life®, Junk Food®, and Soffe®, as well as other labels.

The basics segment is comprised of our business units primarily focused on garment styles characterized by low fashion risk, and includes our Delta Activewear (which includes Delta Catalog and FunTees) and Art Gun business units. We market, distribute and manufacture

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for sale knit apparel under the main brands of Delta Pro Weight® and Delta Magnum Weight® for sale to a diversified audience ranging from large licensed screen printers to small independent businesses. We also manufacture private label products for major branded sportswear companies, retailers, corporate industry programs, e-retailers, and sports licensed apparel marketers. Art Gun produces custom private label garments using digital printing. Typically the private label products are sold with value-added services such as hangtags, ticketing, hangers, and embellishment so that they are fully ready for retail.

Robert W. Humphreys, our chief operating decision maker, and management evaluate performance and allocate resources based on profit or loss from operations before interest, income taxes and special charges (“segment operating earnings (loss)”). Our segment operating earnings (loss) may not be comparable to similarly titled measures used by other companies. Intercompany transfers between operating segments are transacted at cost and have been eliminated within the segment amounts shown in the following table.

Information about our operations as of and for the three months ended January 2, 2016, and December 27, 2014, by operating segment, is as follows (in thousands):

	Basics	Branded	Consolidated
Three months ended January 2, 2016			
Net sales	\$61,516	\$28,655	\$90,171
Segment operating income (loss)	4,545	(2,318)	) 2,227
Segment assets	168,427	155,990	324,417
Three months ended December 27, 2014			
Net sales	\$57,681	\$35,700	\$93,381
Segment operating loss	(1,226)	) (1,991)	) (3,217)
Segment assets	181,445	170,884	352,329

The following table reconciles the segment operating earnings to the Company's consolidated income (loss) before provision (benefit) from income taxes (in thousands):

	Three Months Ended	
	January 2, 2016	December 27, 2014
Segment operating income (loss)	\$2,227	\$(3,217)
Unallocated interest expense	1,276	1,528
Consolidated income (loss) before provision (benefit) from income taxes	\$951	\$(4,745)

Note L—Income Taxes

Our effective income tax provision for the three months ended January 2, 2016, was 28.4%, compared to an effective tax benefit of 11.3% for the same period in the prior year and an effective tax provision of 19.9% for the fiscal year ended October 3, 2015.

We benefit from having income in foreign jurisdictions that are either exempt from income taxes or have tax rates that are lower than the United States. Based on our current projected pre-tax income and the anticipated amount of U.S. taxable income compared to profits in the offshore taxable and tax-free jurisdictions in which we operate, our estimated annual income tax rate for the fiscal year ending October 1, 2016, is expected to be approximately 28%. However, changes in the mix of U.S. taxable income compared to profits in tax-free jurisdictions can have a significant impact on our overall effective tax rate.

We file income tax returns in the U.S. federal jurisdiction and various state, local and foreign jurisdictions. Tax years 2011 through 2013, according to statute and with few exceptions, remain open to examination by various state, local and foreign jurisdictions. Tax years 2012 through 2013 remain open to examination by the Internal Revenue Service.

Note M—Derivatives and Fair Value Measurements

From time to time, we may use interest rate swaps or other instruments to manage our interest rate exposure and reduce the impact of future interest rate changes. These financial instruments are not used for trading or speculative purposes. Outstanding instruments as of January 2, 2016, are noted below:

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	Effective Date	Notational Amount	Fixed LIBOR Rate	Maturity Date
Interest Rate Swap	September 9, 2013	\$15 million	1.1700 %	September 9, 2016
Interest Rate Swap	September 9, 2013	\$15 million	1.6480 %	September 11, 2017
Interest Rate Swap	September 19, 2013	\$15 million	1.0030 %	September 19, 2016
Interest Rate Swap	September 19, 2013	\$15 million	1.4490 %	September 19, 2017

FASB Codification No. 820, Fair Value Measurements and Disclosures (“ASC 820”), defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Assets and liabilities measured at fair value are grouped in three levels. The levels prioritize the inputs used to measure the fair value of the assets or liabilities. These levels are:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 – Inputs other than quoted prices that are observable for assets and liabilities, either directly or indirectly. These inputs include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are less active.

Level 3 – Unobservable inputs that are supported by little or no market activity for assets or liabilities and includes certain pricing models, discounted cash flow methodologies and similar techniques.

The following financial assets (liabilities) are measured at fair value on a recurring basis (in thousands):

Period Ended	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest Rate Swaps				
January 2, 2016	\$ (330)	) —	\$ (330)) —
October 3, 2015	\$ (697)	) —	\$ (697)) —
Contingent Consideration				
January 2, 2016	\$ (2,900)	) —	—	\$ (2,900)
October 3, 2015	\$ (3,100)	) —	—	\$ (3,100)

The fair value of the interest rate swap agreements were derived from discounted cash flow analysis based on the terms of the contract and the forward interest rate curves adjusted for our credit risk, which fall in Level 2 of the fair value hierarchy.

The Salt Life Acquisition includes contingent consideration payable in cash after the end of calendar year 2019 if financial performance targets involving the sale of Salt Life-branded products are met during the 2019 calendar year. We used the historical results and projected cash flows based on the contractually defined terms, discounted as necessary, to estimate the fair value of the contingent consideration for Salt Life at acquisition, as well as to remeasure the contingent consideration related to the acquisitions of Salt Life and Art Gun at each reporting period.

Accordingly, the fair value measurement for contingent consideration falls in Level 3 of the fair value hierarchy.

At January 2, 2016, we had \$2.9 million accrued in contingent consideration related to the Salt Life Acquisition, a \$0.2 million reduction from the accrual at October 3, 2015. The reduction in the fair value of contingent consideration principally resulted from the reduced remaining time to the measurement period. We still expect sales in calendar year 2019 to approximate the expectations for calendar 2019 sales used in the valuation of contingent consideration at acquisition. No contingent consideration is expected to be paid under the terms of the Art Gun arrangement.

The following table summarizes the fair value and presentation in the Condensed Consolidated Balance Sheets for derivatives related to our interest swap agreements as of January 2, 2016, and October 3, 2015:

	January 2, 2016	October 3, 2015
Deferred tax assets	127	—

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Accrued Expenses	(76) (184)
Deferred tax liabilities	—	269)
Other liabilities	(254) (514)
Accumulated other comprehensive loss	\$(203) \$(429)

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Assets Measured at Fair Value on a Non-Recurring Basis

Intangible assets acquired in connection with the Salt Life Acquisition are identified by type in Note E—Salt Life Acquisition. These valuations included significant unobservable inputs (Level 3).

Note N—Legal Proceedings

California Wage and Hour Litigation

We were served with a complaint in the Superior Court of the State of California, County of Los Angeles, on or about March 13, 2013, by a former employee of our Delta Activewear business unit at our Santa Fe Springs, California distribution facility alleging violations of California wage and hour laws and unfair business practices with respect to meal and rest periods, compensation and wage statements, and related claims (the "Complaint"). The Complaint is brought as a class action and seeks to include all of our Delta Activewear business unit's current and certain former employees within California who are or were non-exempt under applicable wage and hour laws. The Complaint also names as defendants Junkfood, Soffe, an independent contractor of Soffe, and a former employee, and sought to include all current and certain former employees of Junkfood, Soffe and the Soffe independent contractor within California who are or were non-exempt under applicable wage and hour laws. Delta Apparel, Inc. is now the only remaining defendant in this case. The Complaint seeks injunctive and declaratory relief, monetary damages and compensation, penalties, attorneys' fees and costs, and pre-judgment interest.

On or about August 22, 2014, we were served with an additional complaint in the Superior Court of the State of California, County of Los Angeles, by a former employee of Junkfood and two former employees of Soffe at our Santa Fe Springs, California distribution facility alleging violations of California wage and hour laws and unfair business practices the same or substantially similar to those alleged in the Complaint and seeking the same or substantially similar relief as sought in the Complaint. This complaint is brought as a class action and seeks to include all current and certain former employees of Junkfood, Soffe, our Delta Activewear business unit, the Soffe independent contractor named in the Complaint and an individual employee of such contractor within California who are or were non-exempt under applicable wage and hour laws. Delta Apparel, Inc. and the contractor employee have since been voluntarily dismissed from the case and the remaining defendants are Junkfood, Soffe, and the Soffe contractor.

On September 17, 2015, an agreement in principle was reached between all parties to settle the above-referenced wage and hour matters. Pursuant to that agreement, the defendants in the matters have agreed to pay an aggregate amount of \$300,000 in exchange for a comprehensive release of all claims at issue in the matters. Delta Apparel, Inc., Soffe and Junkfood have collectively agreed to contribute \$200,000 towards the aggregate settlement amount, which remains in our accrued expenses as of January 2, 2016. The settlement agreement requires the approval of the applicable courts before it can be finalized and the parties are currently seeking the necessary approvals.

Other

In addition, at times we are party to various legal claims, actions and complaints. We believe that, as a result of legal defenses, insurance arrangements, and indemnification provisions with parties believed to be financially capable, such actions should not have a material effect on our operations, financial condition, or liquidity.

Note O—Repurchase of Common Stock

As of January 2, 2016, our Board of Directors authorized management to use up to \$40.0 million to repurchase stock in open market transactions under our Stock Repurchase Program.

During the December quarter of fiscal year 2016, we purchased 68,330 shares of our common stock for a total cost of \$1.1 million. We did not purchase any shares of our common stock during the December quarter of fiscal year 2015. Through January 2, 2016, we have purchased 2,330,192 shares of our common stock for an aggregate of \$28.5 million since the inception of our Stock Repurchase Program. All purchases were made at the discretion of management and pursuant to the safe harbor provisions of SEC Rule 10b-18. As of January 2, 2016, \$11.5 million remained available for future purchases under our Stock Repurchase Program, which does not have an expiration date.

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The following table summarizes the purchases of our common stock for the quarter ended January 2, 2016:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Dollar Value of Shares that May Yet Be Purchased Under the Plans
October 4, 2015 to November 7, 2015	36,282	\$16.99	36,282	\$12.0 million
November 8, 2015 to December 5, 2015	22,479	\$15.51	22,479	