DELTA APPAREL, INC
Form 10-Q
February 07, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended December 31, 2011
OR

o 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 Incorporation or Organization)	(I.R.S. Employer 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 þ No o

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 þ No o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ

As of February 2, 2012, there were outstanding 8,450,125 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)

	December 31, 2011	July 2, 2011
Assets		
Current assets:		
Cash and cash equivalents	$355	$656
Accounts receivable, net	51,389	76,821
Inventories, net	182,917	159,209
Income tax receivable	6,736	—
Prepaid expenses and other current assets	4,869	4,059
Deferred income taxes	4,810	2,931
Total current assets	251,076	243,676
Property, plant and equipment, net	39,427	39,756
Goodwill	16,812	16,812
Intangibles, net	7,101	7,405
Other assets	3,912	4,216
Total assets	$318,328	$311,865
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$46,508	$55,554
Accrued expenses	15,634	23,708
Income tax payable	—	969
Current portion of long-term debt	3,286	2,799
Total current liabilities	65,428	83,030
Long-term debt, less current maturities	117,222	83,974
Deferred income taxes	3,583	2,877
Other liabilities	147	19
Total liabilities	186,380	169,900
Commitments and contingencies	—	—
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 8,450,125 and 8,421,863 shares outstanding as of December 31, 2011 and July 2, 2011, respectively	96	96
Additional paid-in capital	59,681	59,750
Retained earnings	84,095	93,277

Accumulated other comprehensive loss	(81)	(14)
Treasury stock —1,196,847 and 1,225,109 shares as of December 31, 2011 and July 2, 2011, respectively	(11,843)	(11,144)
Total shareholders' equity	131,948	141,965
Total liabilities and shareholders' equity	$318,328	$311,865

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended		Six Months Ended	
	December 31, 2011	January 1, 2011	December 31, 2011	January 1, 2011
Net sales	$105,486	$104,722	$229,009	$212,639
Cost of goods sold	105,345	82,844	197,613	164,851
Gross profit	141	21,878	31,396	47,788
Selling, general and administrative expenses	20,182	20,076	44,744	42,971
Change in fair value of contingent consideration	—	(1,530)	—	(1,530)
Goodwill impairment charge	—	612	—	612
Other (income) expense, net	(52)	95	(59)	152
Operating (loss) income	(19,989)	2,625	(13,289)	5,583
Interest expense, net	992	601	1,885	1,202
(Loss) income before (benefit) provision for income taxes	(20,981)	2,024	(15,174)	4,381
(Benefit) provision for income taxes	(7,389)	608	(5,996)	1,315
Net (loss) income	$(13,592)	$1,416	$(9,178)	$3,066
Basic (loss) earnings per share	$(1.61)	$0.17	$(1.09)	$0.36
Diluted (loss) earnings per share	$(1.61)	$0.16	$(1.09)	$0.35
Weighted average number of shares outstanding	8,465	8,500	8,458	8,512
Dilutive effect of stock options	—	256	—	257
Weighted average number of shares assuming dilution	8,465	8,756	8,458	8,769

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)

	Six Months Ended December 31, 2011	January 1, 2011
Operating activities:		
Net (loss) income	$(9,178)	$3,066
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,642	3,573
Amortization of deferred financing fees	180	140
Excess tax benefits from exercise of stock options	(529)	(100)
(Benefit from) provision for deferred income taxes	(1,173)	794
Loss on disposal of property and equipment	45	65
Non-cash stock compensation	1,043	456
Change in the fair value of contingent consideration	—	(1,530)
Goodwill impairment charge	—	612
Inventory write down	16,195	—
Changes in operating assets and liabilities, net of effect of acquisitions:		
Accounts receivable	25,432	11,615
Inventories	(39,904)	(21,605)
Prepaid expenses and other current assets	(811)	(1,164)
Income taxes	(7,176)	(2,074)
Other non-current assets	124	1
Accounts payable	(9,046)	6,699
Accrued expenses	(8,073)	(2,774)
Other liabilities	61	(80)
Net cash used in operating activities	(29,168)	(2,306)
Investing activities:		
Purchases of property and equipment, net	(3,054)	(3,804)
Cash paid for business, net of cash acquired	—	(9,884)
Net cash used in investing activities	(3,054)	(13,688)
Financing activities:		
Proceeds from long-term debt	302,878	246,401
Repayment of long-term debt	(269,143)	(230,081)
Repurchase of common stock	(2,289)	(1,060)
Cash used, net of proceeds, from net settlement exercise of stock options	(54)	217
Excess tax benefits from exercise of stock options	529	100
Net cash provided by financing activities	31,921	15,577
Net decrease in cash and cash equivalents	(301)	(417)
Cash and cash equivalents at beginning of period	656	687
Cash and cash equivalents at end of period	$355	$270
Supplemental cash flow information:		
Cash paid for interest	$929	$1,017
Cash paid for income taxes	$2,308	$2,611

Non-cash financing activity—issuance of common stock	$142	$98

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
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 for complete financial statements. We believe these condensed consolidated financial statements reflect all adjustments (consisting of only normal recurring accruals) considered necessary for a fair presentation. Operating results for the three and six months ended December 31, 2011 are not necessarily indicative of the results that may be expected for our fiscal year ending June 30, 2012. 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 fourth fiscal quarter generally being the highest and sales in our second fiscal 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 July 2, 2011, filed with the Securities and Exchange Commission ("SEC").
"Delta Apparel", the "Company", and "we", "us" and "our" are used interchangeably to refer to Delta Apparel, Inc. together w our domestic wholly-owned subsidiaries, M.J. Soffe, LLC ("Soffe"), Junkfood Clothing Company ("Junkfood"), To The Game, LLC ("To The Game"), TCX, LLC ("TCX") which was merged into Soffe effective January 1, 2012 (See Note M, The Cotton Exchange Acquisition in Item 1), Art Gun, LLC ("Art Gun") and our international subsidiaries, as appropriate to the context.
We have made certain reclassifications to the presentation of the prior year results in order to conform to the current year presentation. In our Condensed Consolidated Statement of Cash Flows for the six months ended January 1, 2011, we reclassified the amount of amortization expense associated with our deferred financing costs as well as the amount of excess tax benefits from the exercise of stock options. These reclassifications had no impact on our results of operations or financial position.
Delta Apparel, Inc. is an international design, marketing, manufacturing and sourcing company that features a diverse portfolio of lifestyle branded activewear apparel and headwear, and produces high-quality private label programs. We specialize in selling casual and athletic products through a variety of distribution channels. Our products are sold across distribution tiers and in most store types, including specialty stores, boutiques, department stores, mid-tier and mass channels. From a niche distribution standpoint, we also have strong distribution at college bookstores and the U.S. military. Our products are made available direct-to-consumer on our websites at www.soffe.com, www.junkfoodclothing.com, www.saltlife.com and www.deltaapparel.com. Additional products can be viewed at www.2thegame.com and www.thecottonexchange.com.
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 Amex under the symbol "DLA". We operate on a 52-53 week fiscal year ending on the Saturday closest to June 30.

Note B—Accounting Policies
Our accounting policies are consistent with those described in our Significant Accounting Policies in our Form 10-K for our fiscal year ended July 2, 2011, filed with the Securities and Exchange Commission.

Note C—New Accounting Standards
In December 2010, the Financial Accounting Standards Board ("FASB"), issued Accounting Standards Update, ("ASU"), 2010-28, Intangibles - Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts ("ASU 2010-28"). ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity must consider whether there are any adverse qualitative factors indicating an impairment may exist. ASU

2010-28 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. ASU 2010-28 was adopted on July 3, 2011, and the adoption had no impact on our financial statements.

In December 2010, the FASB issued ASU No. 2010-29, Business Combinations (Topic 805) - Disclosure of Supplementary Pro Forma Information for Business Combinations ("ASU 2010-29"). This standard update clarifies that, when presenting comparative financial statements, SEC registrants should disclose revenue and earnings of the combined entity as though the current period business combinations had occurred as of the beginning of the comparable prior annual reporting period only. The update also expands the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. ASU 2010-29 is effective prospectively for material (either on an individual or aggregate basis) business combinations entered into in fiscal years beginning on or after December 15, 2010, with early adoption permitted. We adopted ASU 2010-29 on July 3, 2011.

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DELTA APPAREL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(CONTINUED)

We expect that ASU 2010-29 may impact our disclosures for any future business combinations.

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS ("ASU 2011-04"). The new guidance results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between accounting principles generally accepted in the United States ("U.S. GAAP") and International Financial Reporting Standards ("IFRS"). Additional disclosure requirements in ASU 2011-04 include: (a) for Level 3 fair value measurements, quantitative information about unobservable inputs used, a description of the valuation processes used, and a qualitative discussion about the sensitivity of the measurements to changes in the unobservable inputs; (b) for the use of a nonfinancial asset that is different from the asset's highest and best use, the reason for the difference; (c) for financial instruments not measured at fair value but for which disclosure of fair value is required, the fair value hierarchy level in which the fair value measurements were determined; and (d) the disclosure of all transfers between Level 1 and Level 2 of the fair value hierarchy. ASU 2011-04 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and applied on a prospective basis. ASU 2011-04 is therefore effective for our fiscal year ending June 29, 2013 and we are currently evaluating the impact on our financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220) - Presentation of Comprehensive Income("ASU 2011-05"). This new guidances gives companies two choices on how to present items of net income, items of other comprehensive income and total comprehensive income: Companies can create one continuous statement of comprehensive income or two separate consecutive statements. Other comprehensive income will no longer be allowed to be presented solely in the statement of stockholders' equity. Earnings per share would continue to be based on net income. ASU 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and applied on a retrospective basis. ASU 2011-05 is therefore effective for our fiscal year ending June 29, 2013, and we do not expect the adoption to have a material effect on our financial position.

In September 2011, the FASB issued 2011-08, Intangibles - Goodwill and Other (Topic 350), Testing Goodwill for Impairment. The Board decided to simplify how companies are required to test goodwill for impairment. Companies now have the option to first assess qualitative factors to determine whether it is more likely than not (likelihood of more than 50%) that the fair value of a reporting unit is less than its carrying amount. If after considering the totality of events and circumstances a company determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it will not have to perform the two-step impairment test. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. If a company has not yet issued their financial statements for the most recent annual or interim period, the company may choose to perform the qualitative assessment. ASU 2011-08 will be effective for our fiscal year ending June 29, 2013, and we are currently evaluating the impact on our financial statements.

Note D—Inventories

Inventories, net of reserves, consist of the following (in thousands):

	December 31, 2011	July 2, 2011
Raw materials	$21,861	$20,970
Work in process	41,953	34,599
Finished goods	119,103	103,640
	$182,917	$159,209

Raw materials include finished yarn and direct materials for the basics segment and include direct embellishment materials and undecorated garments and headwear for the branded segment. We regularly review inventory quantities on hand and record reserves for obsolescence, excess quantities, irregulars and slow moving inventory based on historical selling prices, current market conditions, and forecasted product demand to reduce inventory to its net realizable value. During the fiscal 2012 second quarter, selling prices declined in basic, undecorated tees while high cost cotton remained in our inventory costs. We determined we would not be able to recover our cost of inventory based on this selling price decline. As such, we recorded a markdown of inventory, including firm purchase commitments, of $16.2 million in the quarter ended December 31, 2012.

Note E—Debt

On May 27, 2011, Delta Apparel, Soffe, Junkfood, To The Game, Art Gun and TCX entered into a Fourth Amended and Restated Loan and Security Agreement (the "Amended Loan Agreement") with the financial institutions named in the Amended Loan Agreement as Lenders, 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. In connection with the Amended Loan Agreement, Israel Discount

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Bank of New York was removed from the syndicate of lenders under the credit facility, and Bank of America, N.A. was added to the syndicate of lenders.

Pursuant to the Amended Loan Agreement, the maturity of the loans under the previously existing credit facility was extended to May 26, 2016 and the line of credit was increased to $145 million (subject to borrowing base limitations), which represents an increase of $35 million in the amount that was previously available under the credit facility. Under the Amended Loan Agreement, 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 Agent's ability to secure additional commitments and customary closing conditions.

At December 31, 2011, we had $109.7 million outstanding under our credit facility at an average interest rate of 2.2% and had the ability to borrow an additional $28.2 million. Our credit facility includes the financial covenant that if the amount of availability falls below an amount equal to 12.5% of the lesser of the borrowing base or $145 million, 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. At December 31, 2011, our availability exceeded the requirements in the financial covenant and there was $11.8 million of retained earnings free of restrictions to make cash dividends or stock repurchases.

The credit facility contains a subjective acceleration clause and a “springing” lockbox arrangement (as defined in Accounting Standards Codification 470 ("ASC 470"), Debt), 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 facility as non-current debt.

In March 2011, we extinguished our existing debt with Banco Ficohsa, a Honduran bank, and entered into a new credit facility with Banco Ficohsa. As of December 31, 2011, we had $5.8 million outstanding on the installment portion of this loan and $5.0 million outstanding under the revolving portion of the agreement. The new revolving Honduran debt, by its nature, is not long-term as it requires scheduled payments each six months. However, as the 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 criteria, the amounts have been classified as long-term debt.

Note F—Selling, General and Administrative Expense

We include in selling, general and administrative expenses costs incurred subsequent to the receipt of finished goods at our distribution facilities, such as the cost of stocking, warehousing, picking and packing, and shipping goods for delivery to our customers. Distribution costs included in selling, general and administrative expenses totaled $3.8 million and $3.4 million for the second quarter of fiscal years 2012 and 2011, respectively. Distribution costs included in selling, general and administrative expenses totaled $7.6 million and $7.0 million for the first six months of fiscal years 2012 and 2011, respectively. In addition, selling, general and administrative expenses include costs related to sales associates, administrative personnel cost, advertising and marketing expenses, royalty payments on licensed products and other general and administrative expenses.

Note G—Stock Options and Incentive Stock Awards

On November 11, 2010, the shareholders of the Company approved the Delta Apparel, Inc. 2010 Stock Plan (“2010 Stock Plan”). We will not be granting additional awards under either the Delta Apparel Stock Option Plan or the Delta Apparel Incentive Stock Award Plan. Instead, all future stock awards will be granted under the 2010 Stock Plan. 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 prior plans that are subsequently forfeited or terminated for any reason before being exercised. We expense stock compensation costs in the cost of sales and selling, general and administrative expense line items of our Condensed Consolidated Statements of Operations over the vesting periods of each grant.

Delta Apparel, Inc. 2010 Stock Plan ("2010 Stock Plan")

For the three and six months ended December 31, 2011, we expensed $0.3 million and $0.8 million, respectively, in connection with outstanding awards made under the 2010 Stock Plan. As of December 31, 2011 there was $2.2 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 1.67 years. During the quarter ended December 31, 2011, no stock awards were granted under the 2010 Stock Plan.

Delta Apparel Stock Option Plan ("Option Plan")

We expensed $43 thousand and $59 thousand during the second quarter of fiscal years 2012 and 2011, respectively, in connection with our Option Plan. We expensed $0.1 million in each of the first six-month periods of fiscal years 2011 and 2012. As of December 31, 2011, there was $0.1 million of total unrecognized compensation cost related to non-vested stock options under the Option Plan, which is expected to be recognized over a period of 0.50 years. During the quarter ended December 31, 2011, vested options representing 23,333 shares of our common stock were exercised, and the shares issued, in accordance with their respective agreements.

Delta Apparel Incentive Stock Award Plan (“Award Plan”)

All awards granted under the Award Plan have vested and been exercised, and no awards remain outstanding. As such, no expense was recognized during the second quarter of fiscal year 2012. During the second quarter of fiscal year 2011 we expensed $0.2 million in connection with the Award Plan. During the first six months of fiscal years 2012 and 2011 we expensed $0.1 million and $0.7 million, respectively.

Note H—Purchase Contracts

We have entered into agreements, and have fixed prices, to purchase yarn, natural gas, finished fabric, finished apparel and headwear products. At December 31, 2011, minimum payments under these contracts were as follows (in thousands):

Yarn	$16,853
Natural gas	772
Finished fabric	2,329
Finished products	18,419
	$38,373

Note I—Segment Reporting

We operate our business in two distinct segments: branded and basics. Although the two segments are similar in their production processes and regulatory environment, they are distinct in their economic characteristics, products 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 Soffe (which includes The Cotton Exchange as the bookstore division of Soffe), Junkfood, To The Game and Art Gun. These branded embellished and unembellished products are sold through specialty and boutique shops, upscale and traditional department stores, mid-tier retailers, sporting goods stores, college bookstores and the U.S. military. Products in this segment are marketed under our primary brands of Soffe®, Intensity Athletics®, The Cotton Exchange®, Junk Food®, and The Game®, licensed brands of Salt Life® and Realtree Outfitters®, as well as other labels. The results of The Cotton Exchange have been included in the branded segment since its acquisition on July 12, 2010.

The basics segment is comprised of our business units primarily focused on garment styles that are characterized by low fashion risk, and includes our Delta Catalog and FunTees businesses. Within the Delta Catalog business, we market, distribute and manufacture unembellished knit apparel under the brands of Delta Pro Weight®, Delta Magnum Weight®, Quail Hollow®, Healthknit® and FunTees®. These products are primarily sold to screen printing and advertising specialty companies. We also manufacture private label products for major branded sportswear companies, retailers, corporate industry programs, and sports licensed apparel marketers. Typically these products are sold with value-added services such as hangtags, ticketing, hangers, and embellishment so that they are fully ready for retail. The majority of the private label products are sold through the FunTees business.

Our Chief Operating Decision Maker ("CODM"), Robert W. Humphreys, and management evaluate performance and allocate resources based on profit or loss from operations before interest, income taxes and special charges (“Segment Operating Income”). Our Segment Operating Income 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 and six months ended December 31, 2011 and January 1, 2011, by operating segment, is as follows (in thousands):

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DELTA APPAREL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(CONTINUED)

	Basics	Branded	Consolidated
Three months ended December 31, 2011:			
Net sales	$57,555	$47,931	$105,486
Segment operating loss	(18,692)	(1,297)	(19,989)
Segment assets*	171,336	146,992	318,328
Three months ended January 1, 2011:			
Net sales	$56,228	$48,494	$104,722
Segment operating income	1,370	1,255	2,625
Segment assets*	138,121	135,438	273,559

* All goodwill and intangibles on our balance sheet are included in the branded segment.

	Basics	Branded	Consolidated
Six months ended December 31, 2011			
Net sales	$110,152	$118,857	$229,009
Segment operating (loss) income	(17,108)	3,819	(13,289)
Six months ended January 1, 2011			
Net sales	$105,769	$106,870	$212,639
Segment operating income	1,521	4,062	5,583

The following table reconciles the segment operating income to the consolidated income before provision for income taxes (in thousands):

	Three Months Ended		Six Months Ended	
	December 31, 2011	January 1, 2011	December 31, 2011	January 1, 2011
Segment operating (loss) income	$(19,989)	$2,625	$(13,289)	$5,583
Unallocated interest expense	992	601	1,885	1,202
Consolidated (loss) income before taxes	$(20,981)	$2,024	$(15,174)	$4,381

Note J—Income Taxes

We had an effective income tax benefit of 39.5% for the six months ended December 31, 2011 compared to an effective tax provision of 30.0% for the same period in the prior year and an effective tax provision of 23.6% for the fiscal year ended July 2, 2011. During the second quarter of fiscal year 2012, we recorded a $16.2 million writedown of our inventory value. We accounted for this one-time adjustment as a discrete item for tax provision purposes, thereby creating an income tax benefit in the second quarter and first six months of fiscal 2012. Excluding the effect of this discrete item, the effective tax rate on normal operations for the six months ending December 31, 2011 was 24.0% and we anticipate the effective tax rate for the third and fourth quarters of fiscal 2012 to approximate 24.0%. During the third quarter of fiscal year 2011, we further developed our tax planning strategies, allowing us to keep more profits in Honduras, a tax-free zone, thereby reducing our overall effective tax rate on a prospective basis.
We file income tax returns in the U.S. federal jurisdiction and various state, local and foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state, local or non-U.S. income tax examinations by tax authorities for our tax years before 2007. However, net operating loss carryforwards remain subject to examination to the extent they are carried forward and impact a year that is open to examination by tax authorities.

Note K—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.

On August 2, 2011, we entered into three separate interest rate swap agreements, effectively converting $30 million of floating

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DELTA APPAREL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(CONTINUED)

rate debt under our U.S. revolving credit facility to fixed obligations at available LIBOR rates. The $15 million interest rate swap agreement that had been entered into on March 1, 2010 matured on September 1, 2011.

The outstanding financial instruments as of December 31, 2011 are as follows:

	Effective Date	Notional Amount	Fixed LIBOR Rate		Maturity Date
Interest Rate Swap	September 1, 2011	$10 million	0.7650	%	September 1, 2013
Interest Rate Swap	September 1, 2011	$10 million	0.9025	%	March 1, 2014
Interest Rate Swap	September 1, 2011	$10 million	1.0700	%	September 1, 2014

These agreements have been designated and qualify as cash flow hedging instruments and, as such, changes in the fair value are recorded in accumulated other comprehensive income/loss to the extent the agreements are effective hedges.

The following table summarizes the fair value and presentation in the Condensed Consolidated Balance Sheets for derivatives as of December 31, 2011 and July 2, 2011 (in thousands):

	December 31, 2011		July 2, 2011	
Accrued expenses	$—		$22	
Deferred tax liabilities	(51	)	(8	)
Other liabilities	132		—	
Accumulated other comprehensive loss	$81		$14	

Changes in the derivative’s fair value are deferred and recorded as a component of accumulated other comprehensive loss (“AOCL”) until the underlying transaction is recorded. When the hedged item affects income, gains or losses are reclassified from AOCL to the Condensed Consolidated Statements of Operations as interest income/expense. Any ineffectiveness in our hedging relationships, which currently is de minimis, would be recognized immediately in the Condensed Consolidated Statement of Operations. The change in fair value recognized in accumulated other comprehensive loss resulted in a loss, net of taxes, of $67 thousand and $29 thousand for the six months ended December 31, 2011 and January 1, 2011, respectively.

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 liabilities are measured at fair value on a recurring basis (in thousands):

	Fair Value Measurements Using			
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Period Ended	Total	(Level 1)	(Level 2)	(Level 3)
Interest Rate Swaps				
December 31, 2011	$132	—	$132	—
July 2, 2011	$22	—	$22	—

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

We use the projected cash flows, discounted as necessary, to remeasure the fair value of the contingent consideration for Art Gun at the end of each reporting period. Accordingly, the fair value measurement for contingent consideration falls in level 3 of the fair value hierarchy. The fair value of contingent consideration for Art Gun was determined to be de minimis as of December 31, 2011 and July 2, 2011.

DELTA APPAREL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (CONTINUED)

Note L—Legal Proceedings
We are party to various legal claims, actions and complaints arising from time to time in the normal course of business. While litigation is subject to inherent uncertainties, we currently believe that, due to legal defenses, insurance arrangements, and indemnification provisions with parties believed to be financially capable, such actions, individually and in the aggregate, will not have a material effect on our operations, financial condition, or liquidity.

Note M—The Cotton Exchange Acquisition
On June 11, 2010, we formed a new North Carolina limited liability company, TCX, LLC, as a wholly-owned subsidiary of M.J. Soffe, LLC. Pursuant to an Asset Purchase Agreement dated July 5, 2010, on July 12, 2010, TCX acquired substantially all of the net assets of HPM Apparel, Inc. d/b/a The Cotton Exchange, including accounts receivable, inventory, and fixed assets, and assumed certain liabilities. The total purchase price, which included a post-closing working capital adjustment, was $9.9 million. In fiscal year 2011, we finalized the valuation for the assets acquired and liabilities assumed and determined the final allocation of the purchase price. No goodwill or other intangible assets were recorded in conjunction with the acquisition of The Cotton Exchange. Effective January 1, 2012, TCX was merged into its parent entity M.J. Soffe, LLC for reasons of corporate simplification and no longer exists as a separate entity. The Cotton Exchange will continue to operate as the bookstore division of Soffe.

Note N—Repurchase of Common Stock
On August 17, 2011, our Board of Directors approved a $5 million increase in our Stock Repurchase Program, bringing the total amount authorized to $20.0 million. During the three months ended December 31, 2011, we purchased 49,948 shares of our common stock for a total cost of $0.9 million. During the six months ended December 31, 2011, we purchased 142,704 shares of our common stock for a total cost of $2.3 million, Since the inception of the Stock Repurchase Program, we have purchased 1,344,231 shares of our common stock for an aggregate of $13.9 million. All purchases were made at the discretion of our management and pursuant to the safe harbor provisions of SEC Rule 10b-18. As of December 31, 2011, $6.1 million remained available for future purchases under our Stock Repurchase Program, which does not have an expiration date.
The following table summarizes the purchases of our common stock for the quarter ended December 31, 2011:

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 2 to November 5, 2011	19,838	$16.47	19,838	