Indigo Books & Music Inc.

Financial Year 2023 Q3 Analyst Conference Call

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CORPORATE PARTICIPANTS

Craig Loudon
Indigo Books & Music Inc. — Chief Financial Officer and Executive Vice President

Peter Ruis
Indigo Books & Music Inc. — Chief Executive Officer

CONFERENCE CALL PARTICIPANTS

David McFadgen
Cormark Securities — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Indigo Books & Music Inc. Financial Year 2023 Q3 Analyst Conference Call.

This call is being recorded on Friday, February 10, 2023.

I would now like to turn the conference over to Craig Loudon. Please go ahead.

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Good morning and thank you for joining us to review Indigo's Fiscal 2023 Third Quarter Results. My name is Craig Loudon, and I'm the Chief Financial Officer of Indigo.

Regarding the materials for this conference call, we issued the press release yesterday. It can be found at indigo.ca and on SEDAR. The conference call will be recorded and archived in the Investor Relations section of the Indigo website. A playback of the call will also be available by telephone until February 17th.

The conference call may contain forward-looking statements, and to the extent that it does, we refer you to our cautionary statement regarding forward-looking statements in the press release and the MD&A for the quarter.

I would now like to turn the call over to our Chief Executive Officer, Peter Ruis.

Peter Ruis — President, Indigo Books & Music Inc.

Good morning, everyone, and thank you for joining us.

We are proud of what we have accomplished this quarter, despite facing a challenging external environment. For that, I would like to thank our loyal customers who continue to call Indigo their happy place, and of course, our hard-working Indigo teams who, after years of challenging pandemic constraints, are still working to manage the current macroeconomic environment while building a winning product strategy.

Like the broader retail market, we felt the adverse impact of inflationary pressures on consumer behavior this quarter. Customers were increasingly focused on price, and the tightening of discretionary spending was yielding a more value-oriented shopper. These headwinds have reduced impact from Black Friday onwards as the holiday gifting season reignited strong demand.

In the online channel, we had a record-breaking Black Friday; and in the retail channel, sales exceeded the prior year, and we also achieved a record-breaking Boxing Week. Our strength in the month of December demonstrates the power of our brand and Indigo's position as a key gifting destination for Canadians.

The general merchandise business delivered another strong quarter, led by double-digit growth in the baby, toys, and wellness categories. The ongoing success of this business underlines the value of the Company's carefully selected assortment and the strategic expansion of core product offerings to meet the evolving needs of our consumers.

The print business continued to show resilience, and despite a slight decline to the prior period, grew in both sales and market share compared to pre-pandemic levels.

The retail industry on a whole is operating in a challenging macroeconomic environment. As mentioned, our teams have been working hard to manage various pressures, including supply chain disruptions, significant increases in fuel prices, and higher cost of inventory amongst others.

From a profitability perspective, much of the benefits of Indigo's strong Black Friday and holiday performance has been tempered by these economic factors.

Moving forward, we continue to focus on our long-term strategy to increase productivity, generate sustainable and profitable growth, and increase overall shareholder value.

I would now like to ask Craig to provide a more detailed financial perspective on the quarter.

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Thank you, Peter.

The results we are discussing are for the 13 weeks ended December 31, 2022, and comparative figures reference the 13 weeks ended January 1, 2022. Some discussion also surrounds the comparable pre-pandemic period being the 13 weeks ended December 28, 2019.

The Company generated revenue of $423 million in the third quarter compared to $431 million for the same period last year. As Peter discussed, this reduction in sales reflects the impact of the current macroeconomic environment on consumer behavior, which was most heavily felt at the beginning of the quarter.

From Black Friday onward, the Company generated revenue growth compared to the prior year. As a result of social distancing and the government-mandated capacity constraints in stores in the prior year, we believe that comparable sales are not currently meaningful to evaluate performance. Instead, we have focused on total revenue.

Sales in the retail channel increased by $8 million, or 3 percent, to $306 million for the quarter compared to $298 million for the same period last year. This was driven by strong holiday demand, which drove December retail sales above the prior year. The channel also delivered a record-breaking Boxing Week. While traffic remains below pre-pandemic levels, it continues to rebound and was higher than the prior year, most notably when comparing to periods impacted by Omicron capacity constraints.

Revenue from the online channel decreased by $15 million, or 12 percent, to $107 million for the quarter compared to $122 million in the same period last year. This decline was largely a result of the shift in channel mix as the retail network recovered from last year's Omicron capacity constraints.

Consistent with the strength noted in the retail network, the online channel had stronger demand in the second half of the quarter and delivered record-breaking demand on Black Friday. It is important to note that while there was a decline to the prior year, the online channel has sustained sales at 63 percent above pre-pandemic levels. It continues to be a strategic lever of growth for the Company.

The impact of the current macroeconomic environment extended past softer customer demand and the associated top line decline, but also had a negative impact on costs. Cost of sales increased by $4 million to $256 million for the quarter compared to $252 million in the prior year. Excluding the impact of online shipping costs, cost of sales increased by $3 million to $233 million for the quarter compared to $230 million in the prior year. As a percentage of total revenue, this represents an increase to 55 percent compared to 53 percent in the prior year. This was driven by the inflationary impact to cost of inventories and incremental international freight costs.

The penetration of promotions, while still below pre-pandemic levels, has also increased since the prior year when the Company had elevated full price sell-through. Despite softened demand in the online channel, associated shipping costs increased, driven by the elevated cost of fuel and associated delivery surcharges.

Operating, selling, and administrative costs decreased by $3 million to $109 million for the quarter, compared to $113 million in the prior year. The decrease in cost was primarily driven by a reduction in labour incurred in the retail network, in addition to lower online volume costs from softened demand in the channel.

Adjusted EBITDA was $41 million for the quarter, compared to $52 million in the same period last year, a change of $11 million. As discussed, this was driven by the top line decline and compounded by the adverse impact of the current macroeconomic environment on costs. This included elevated cost of inventories, incremental freight, and a higher penetration of promotions in the quarter.

Additional costs were also incurred on enabling infrastructure to support a modernized e-commerce technology. The Company recognized net earnings of $34 million for the 13-week period ended December 31, 2022, or $1.23 net earnings per common share compared to net earnings of $45 million, or $1.62 net earnings per common share, for the same period last year, a change of $11 million.

With regards to inventory, the Company finished the quarter with a balance of $317 million compared to $275 million in the prior year. Last year, the Company was still measured in purchasing in response to uncertainty surrounding the impact of COVID-19 on consumer behavior.

This year, to support anticipated growth of the general merchandise business, to expand core product assortment and to mitigate supply chain risks, the Company increased inventory levels in advance of the holiday sales season. However, as sales were softer than anticipated, the Company finished the quarter with inventory levels above what was planned. This was compounded by the inflationary impact on product cost, which has also increased the value of inventory on hand. We are prioritizing our inventory health while remaining promotionally disciplined, most notably through a more conservative replenishment strategy.

I'd like to highlight that our general merchandise inventory is predominantly core assortment, which is relevant year-round. In addition, our print inventory is returnable to the publishers and therefore carries minimal risk. Overall, we are confident in our inventory management strategy.

With regards to our related party credit facility, Indigo repaid the amount in full during the quarter, and we have no other outstanding debt. We continue to deploy capital prudency to maintain a strong financial position.

Indigo experienced a cybersecurity incident commencing on February 8, 2023, resulting in internal operational disruptions and service disruptions to both the e-commerce and retail channels. The Company is working alongside third-party experts to resolve the situation and to understand if customer data has been accessed. Indigo's main priorities are to protect customer data, limit the operational and financial impacts of this incident, and safely resume full operations as quickly as possible.

Please note that while our press release and the transcript of this call will be available on our website, they will only be accessible there once this disruption is resolved.

At this point, we would like to open the call for any questions.

Q & A

Operator

Thank you. Ladies and gentlemen, we will now be taking questions from stock analysts.

The first question comes from David McFadgen at Cormark Securities. Please go ahead.

David McFadgen — Analyst, Cormark Securities

Yes. Hi. Thank you. A couple of questions. You talked about increased promotions or discounting in the quarter. I was wondering if you would be able to quantify the increase year-over-year on what the impact would be on the gross margin?

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

I don't have those at my fingertips, David, but the interesting thing is, I would say, the impact of promotions is below pre-pandemic levels. Year-over-year, it is up because last year was very unusual, in that there was a product shortage last year still, with even more significant supply chain issues than were experienced this year. Everyone in the retail space was short of products. There was literally no discounting happening last year. I would say our markdowns and promotions are still, this year, below pre-pandemic levels. I wouldn't say it was substantial.

David McFadgen — Analyst, Cormark Securities

Okay. I'm just wondering what can be done—or it would be interesting to get your thoughts on what can be done to improve the gross margin going forward?

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Yes. Well, the first one is staying on top of inflationary impacts. There's no question this holiday period, the price of goods coming in was literally changing just before goods were shipping. Staying on top of inflationary impacts is important, and we're on it. We will start to see the benefit of freight coming down. International freight from Asia in particular was a real drag on margin this year. I think year-to-date, it's $6 million that dragged on gross margin.

Good shipping now—we are seeing much lower freight rates than we experienced during holiday. Now, all these goods take a little while to work through the system. But in future quarters, we'll see the benefit of a reduced freight on margins.

David McFadgen — Analyst, Cormark Securities

Okay. Can you quantify what that might be? Or is...

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Yes, I said year-to-date so far, it's $6 million. I'd estimate on the full year, it's something like $10 million.

David McFadgen — Analyst, Cormark Securities

Okay. Then just a clarification. The SG&A was offset by $1 million from the Canada Book Fund in the quarter and the cost of operations was also offset by $2.5 million from the Canada Book Fund in the quarter. Is that correct?

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Yes. Last year, we had other external support in the quarter, so there's a bit of offsets going both ways there. But yes, you're correct.

David McFadgen — Analyst, Cormark Securities

Are those nonrecurring? Do you think you can maybe get similar funds from those in the future?

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

We are certainly trying to apply for those, but obviously, there's no guarantees, and I can't really speculate on that. But it is a program where the Canadian government is trying to encourage Canadian authors and the sale of Canadian books.

David McFadgen — Analyst, Cormark Securities

Okay. Can you talk about how the demand is right now in this quarter?

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Yes. Certainly, January has been better than we'd anticipated, but I would say it's still a little softer than—since the first half of the year, there's no question in the second half that consumers are being far more careful, they're more deal-oriented. However, as we did note in some of our materials, October and November were very soft. Certainly, I know when speaking with other retailers, they experienced the same issues.

Then once we hit Black Friday, things came alive, got a little quiet, but we had a very strong final week into Christmas. Then Boxing Week, it was off the charts. As we noted in physical retail, we had a record Boxing Week. That demand has been good, and then I'd say that's carried into January that we've been either on or ahead of our forecast, whereas in October and November we were behind. We're certainly encouraged with what we're seeing at the moment. But again, no promises going forward. It has been a real roller coaster, I'd say, since September. Some weeks just way down and then other weeks really strong. I must admit it is a bit of a head scratcher at the moment.

David McFadgen — Analyst, Cormark Securities

Okay. All right. That's it for me. Thank you.

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Okay. Thanks, David.

Operator

Thank you. That concludes today's question-and-answer session. I'll turn the call back over to Craig Loudon for closing comments.

Craig Loudon — Chief Financial Officer, Indigo Books & Music Inc.

Thank you for your time and attention today. We appreciate you calling in and look forward to reconnecting on a quarterly basis. Our fourth quarter results will be announced on or around June 1.

Thank you again for your support and have a good day.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating, and we ask that you please disconnect your lines.