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Indigo Books & Music Inc.

Fourth Quarter 2023 Analyst 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

Hello everyone, and thank you for joining the Indigo Books & Music Fiscal Year ’23 Year End Analyst Call.

At this time, all lines are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. (Operator instructions.)

Remember that this call is being recorded.

I now have the pleasure of handing you over to your host, Craig Loudon, CFO. Please go ahead.

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

Good morning and thank you for joining us to review Indigo's fiscal 2023 results. My name is Craig Loudon and I am 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 July 5th.

This 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 related to this fiscal year.

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

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

Good morning everyone and thank you for joining us.

Indigo's fiscal 2023 financial results delivered strong top line performance with another year of over $1 billion in annual revenue. Amidst a continuously challenging economic climate and faced with a ransomware attack, we have remained steadfast in our commitment to deliver exceptional value to our customers. This was possible thanks to our hardworking Indigo teams. They have gracefully managed a turbulent environment and have worked tirelessly to operationally recover after the ransomware attack. This recovery is a testament to their hard work and unwavering dedication to our Company.

Through all of this, Indigo customers continue to show their loyalty to our brand. We learned that anyone can be vulnerable to attacks of this nature, and in the face of this extraordinary challenge we did not waver. I believe we have come out of this incident stronger together.

The general merchandise business delivered strong results this year, growing by six percent, fuelled by double digit increases in the Paper, Baby and Wellness categories. Baby and Wellness specifically were two categories in which the Company focused on curating assortment and we are thrilled to see how these categories have resonated with our customers.

The Print business was more adversely affected by the ransomware attack in the fourth quarter, which limited the Company's ability to replenish inventory of certain titles. Sales declined four percent compared to the prior year; however, the Print business remained above pre-pandemic levels. Books are the heartbeat of our organization and continue to be the central inspiration for all other products we offer.

This past fall, we celebrated Indigo's 25th birthday with the launch of our new brand platform: *life, on purpose*™, *la vie décidément*™. Through a national marketing campaign, we celebrated iconic Canadian authors and culture shapers, highlighting how they live their lives with intention. We were excited to commemorate this important milestone.

Like the broader retail market, Indigo continued to feel the impacts of the macroeconomic environment on consumer behaviour and costs, which compounded the headwinds from the ransomware attack.

Looking forward to fiscal 2024, we have a lot of excitement on the horizon, including the launch of our modernized digital platform and the opening of our new flagship store at The Well in Toronto. We remain focused on our long-term strategy, which includes generating sustainable and profitable growth and increasing 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 and Executive Vice President, Indigo Books & Music Inc.

Thank you, Peter.

First, I would like to give an update on the ransomware attack. As you are aware, on February 8th, Indigo was the victim of a ransomware attack, resulting in internal operational disruptions and service disruptions to both the ecommerce and retail channels. More specifically, our online channel was temporarily shut down. The full website was restored after four weeks. The retail network was unable to process electronic payments for approximately three days and experienced other operational limitations that impacted the Company’s ability to fulfill demand.

The complete and long-term financial impact of the ransomware attack cannot be reasonably estimated at this time, however, it has had a material detrimental impact on the Company's fiscal 2023 financial results. The Company maintains cyber insurance coverage and is in the process of working with its insurer to make claims under the policy for both the business interruption losses and the incremental costs associated with the attack. As noted in our financial statements, these incremental costs totalled $5.2 million as at April 1, 2023. We are working with third party evaluation experts to assist in determining the extent of the business interruption losses. Due to the complexity of cyber insurance coverage, there will be a time lag before the recovery of insurance proceeds, the extent of which we cannot yet reasonably predict.

Now I would like to speak to our fiscal 2023 financial results. The results we are discussing are for the 52 weeks ended April 1, 2023, and comparative figures reference the 52 weeks ended April 2, 2022. Some discussion also surrounds the comparable pre-pandemic period, being the year ended March 28, 2020.

Revenue for the full year was $1.058 billion compared to $1.062 billion in the prior year, a change of $4.6 million or 0.4 percent. Merchandise sales, the total of retail and online sales and excluding other revenues, increased by $4.6 million to $1.015 billion compared to $1.010 billion in the prior year. The growth was generated despite the headwinds of a challenging macroeconomic environment.

Year-to-date sales momentum was halted in the fourth quarter as the Company became a victim of the ransomware attack. This had a material impact on sales in the fourth quarter and in the fiscal year.

Sales in the retail channel increased by $73 million or 11 percent to $762 million for the year compared to $689 million in the prior year. The retail channel had a strong rebound as customers' desire to shop in-store drove sales in the second quarter above pre-pandemic levels and the channel delivered a record-breaking Boxing week, fuelled by strong holiday demand.

Revenue from the online channel decreased by $69 million or 21 percent to $253 million for the year compared to $322 million in the prior year. This decline was partially a result of a shift in channel demand as the retail network recovered from COVID-19 rolling store closures and capacity restrictions in the prior year. This was compounded by the temporary shutdown of the Company's ecommerce platforms as a result of the ransomware attack. Compared to pre-pandemic fiscal 2020, the online channel sustained year-to-date growth of 71 percent through January, reinforcing the continued strategic importance of this channel as a lever for growth.

As a result of social distancing and the government-mandated capacity constrains in stores in the prior year, we believe that comparable sales are not currently meaningful to evaluate performance.

Cost of sales increased by $22 million to $642 million for the year compared to $619 million in the prior year. Excluding the impact of online shipping costs, cost of sales increased by $28 million to $589 million for the year, compared to $561 million in the prior year. As a percentage of total revenue, this represents an increase to 56 percent, compared to 53 percent in the prior year.

The headwinds of the current macroeconomic environment heavily impacted the Company's current year cost structure. The inflationary environment drove an overall increase to cost of inventories and the Company noted a greater penetration of promotions compared to the prior year when full price sell through was elevated.

Incremental international freight was still high as we sold through inventory from peak container prices, costing an incremental $5.5 million compared to the prior year, or $20.3 million compared to pre-pandemic levels.

As seen industry wide, the Company was also challenged by higher shrink levels in the current year, causing an incremental $10.3 million of expense.

While the cost of fuel increased the variable cost of shipping, total shipping costs decreased compared to the prior year due to lower overall sales in the online channel.

Operating, selling and administrative costs increased by $20 million to $370 million for the year, compared to $350 million in the prior year. The increase in cost was primarily driven by reduced government grants and external COVID-19 support of which $3.3 million offset operating, selling and administrative costs in the current year compared to $12.9 million in the prior year. The Company also incurred additional spending to support the modernization of its ecommerce technology.

Adjusted EBITDA decreased by $53 million to a loss of $21 million compared to earnings of $33 million in the prior year. As discussed, this was heavily impacted by the ransomware attack which had a material effect on sales and costs in the fourth quarter and fiscal year as a whole. This was compounded by the adverse impacts of the current macroeconomic environment, including elevated cost of sales through higher inventory costs, additional international freight, elevated shrink and a higher penetration of promotions compared to the prior year. Additional costs were also incurred on enabling infrastructure to support a modernized ecommerce technology and higher amortization of the Company's right of use assets impacted by lease modifications recognized in the prior year. The Company also recognized reduced government grants and external COVID-19 support payments.

These incremental costs and ransomware impacts also affected the net loss position, which was $50 million for the year ended April 1, 2023, or $1.78 net loss per common share compared to net earnings of $3 million or $0.12 net earnings per common share in the prior year.

Fourth quarter results were heavily impacted by the ransomware attack, driving a decrease in revenue of $27 million to $194 million for the quarter ended April 1, 2023, compared to revenue of $221 million in the prior year. It's also accounted for the majority of the $19 million change in quarterly net loss position, which was a loss of $43 million compared to a loss of $23 million in the same period last year.

With regards to inventory, the Company finished the year with a balance of $244 million compared to $274 million in the prior year. The Company is focused on prioritizing our inventory health, while remaining promotionally disciplined, and has made a strategic decision to right size inventory to achieve this objective, most notably through a more conservative replenishment strategy. The ransomware attack also impacted inventory levels as the Company was limited in its ability to replenish inventory for part of the fourth quarter.

Subsequent to year end, Indigo received a binding commitment with respect to our revolving line of credit facility with a related party, Trilogy Retail Holdings, Inc. The credit facility is for an aggregate principal amount of up to $45 million, and with the consent of Trilogy Retail Holdings, Inc., the amount may be increased by up to $10 million. Credit facility will be used to finance the seasonal working capital and operational needs of the Company, will be issued on reasonable commercial terms, and will not be convertible directly or indirectly into equity or voting securities. The credit facility will be subject to the terms and conditions of the credit agreement anticipated to be entered into between the Company and Trilogy Retail Holdings, Inc. on or before July 31, 2023.

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

Operator

Thank you.

Ladies and gentlemen, we will now begin the question-and-answer session. (Operator instructions).

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

David McFadgen — Analyst, Cormark Securities

Yes, hi. A couple of questions. I think you talked about the fact that it's tough to, or impossible to predict or assess the impact from the ransomware attack going forward, but can you tell us what the impact might have been approximately in the quarter.

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

Sure. I think the closest comment I made to that, David, was that the change in net loss position in Q4—which is obviously when this event happened—of a decrease of $19 million; the majority of that is related to the cyber incident. I think that's the best direction I can give at the moment. Obviously, our analysis continues into whether there was any impact beyond Q4 and we're working on submitting that insurance claim.

That's the full amount I can comment on at the moment.

David McFadgen — Analyst, Cormark Securities

Okay. Then just when we look at the macro environment, you know interest rates keep going higher and probably discretionary spending is under some pressure. Are you seeing much impact in terms of the footprint in your store and the spending there?

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

I think certainly we've been seeing it since the fall and that consumers are definitely driven to the deal periods of time; so it can get quieter and then it surges when deals are on. I know on our last call we commented that we had a record-breaking Black Friday online and then Boxing Week, again, was off the charts; it was an all-time record for Indigo in physical retail. So, it is a bit of a roller coaster. That's what we commented on in Q3 and that's what we continue to see. Definitely, people are being more cautious.

David McFadgen — Analyst, Cormark Securities

Okay. Then, I was just wondering if you could give us an outlook on the potential to improve margins and are you undertaking any cost-cutting to effect that?

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

Yes, I think the biggest impact on margins this year will be that we're finally going to see some relief from the international freight. I did mention that in my comments, but those rates have finally come down with the volumes crashing out of Asia. They're back down to more historic levels, so we're going to have a benefit there compared to pre-pandemic levels of about $20 million, as I mentioned in my comments. So, that's going to help with margin.

We're also being very cautious with inventory purchases this year. With the supply chain improving – the global supply chain – it is possible to get inventory more quickly like it was historically versus the last few years where you had to take an early bet. We want to ensure that we don't get markdown pressure on margins.

Then, related to costs, we are working under a different operating model in our stores now, which we anticipate will take substantial cost out of that network to the tune of $15 million.

David McFadgen — Analyst, Cormark Securities

Okay. So, you think you'll realize $15 million in cost savings in the fiscal year you're in right now?

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

Yes. That's our plan.

David McFadgen — Analyst, Cormark Securities

Okay. Would we see that in the gross margin? Or no, probably the cost of operations, right?

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

Yes, you would see that in the cost of operations. My comment related to inbound freight would show up in margin.

David McFadgen — Analyst, Cormark Securities

Okay. When you talk about being able to source material, like, quicker, was that driving the improvement in the working capital? Because for the fiscal year you had an inflow of working capital of $34 million.

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

Yes, we're able to keep it tighter. The supply chain over the pandemic and then even up until last Holiday was so backlogged through the Port of Vancouver. It was taking ships anywhere from three and at its maximum six weeks to get a berthing position, and then there were rail delays of another three weeks in the West. So, those issues are now clearing up. I mean, there's always slight delays at Holiday, but it's faster to get reorders on product, and then also domestic suppliers have product readily available, when in the past couple of years they didn't always, and if you didn't take it up front, you wouldn't get it.

So, I think we are into more of a pre-pandemic model now where it is possible to replenish product without taking initial large positions on it.

David McFadgen — Analyst, Cormark Securities

Do you think it's possible that in the current fiscal year you could have once again another improvement in working capital where you could take some money out of the business?

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

Yes, our plan is to keep inventory lower than last year.

David McFadgen — Analyst, Cormark Securities

Okay. All right. Then lastly, you spent $24 million on intangible assets. That was up quite a bit versus the prior year. I was just wondering what's driving that and what's the outlook for that line in the cash flow statement.

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

Yes. The majority of that was related to our digital modernization that we've been speaking to for a number of quarters now, which we'll launch later in the summer. The intent this year is to spend about half that amount. That was an unusually high amount, but it was necessary to build our digital platform of the future.

David McFadgen — Analyst, Cormark Securities

Okay. All right, thank you.

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

Thanks David.

Operator

Thank you. (Operator instructions).

There are no further questions at this time. Please continue with closing remarks.

Craig Loudon — Chief Financial Officer and Executive Vice President, 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 first quarter results will be announced on or around August 10. Thank you again for your support and have a good day.

Operator

Ladies and gentlemen, this does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your lines.