FINAL TRANSCRIPT

Indigo Books & Music Inc.

Fiscal Year 2019 Q4 Investor and Analyst Call

Event Date/Time: May 29, 2019 — 9:00 a.m. E.T.

Length: 28 minutes

CORPORATE PARTICIPANTS

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

Heather Reisman
Indigo Books & Music Inc. — Chief Executive Officer

CONFERENCE CALL PARTICIPANTS

Bob Gibson
PI Financial — Analyst

David McFadgen
Cormark Securities — Analyst

Justin Scapeir
Private Investor

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Indigo Books & Music Fiscal Year 2019 Q4 Investor and Analyst Call. At this time, all lines in a listen-only mode.

Following the presentation, we will conduct a question-and-answer session.

If at any time during this call you require assistance, please press *, 0 for the Operator.

This call is being recorded on Wednesday, May 29, 2019, and 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 2019 results. My name is Craig Loudon, and I'm the Chief Financial Officer. Joining us from Indigo today is the Chief Executive Officer, Heather Reisman.

Regarding the materials for this conference call, we issued the press release after market close yesterday evening. It can be found at indigo.ca and on SEDAR. This 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 11:59 p.m. Eastern Time on June 5, 2019.

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 quarter and year.

I would now like to turn the call over to Heather Reisman.

Heather Reisman — Chief Executive Officer, Indigo Books & Music Inc.

Good morning, everyone, and thank you for joining us. Fiscal 2019 was a challenging year. We saw a shift in the very positive top- and bottom-line momentum we've sustained in recent years. We faced significant disruption to our online channel triggered by the Canadian postal strike in the second half of the fiscal year and felt the omnichannel impact of economic pressures on consumer discretionary spending in the fourth quarter.

In addition to these headwinds, ongoing renovations in the retail channel did hamper our historical revenue growth. Though it was a challenging year, we remain confident in the underlying strength of our business, our customers' deep affection for the brand, and our ability to advance the Company to its next chapter of transformation and growth.

As we've discussed in the past few quarters, we have executed on an ambitious capital investment plan to renovate retail stores and bring a reimagined retail experience to a greater number of customers. In the fiscal year, we delivered our new store concept to 17 locations, including the opening of our first store in the US.

For returning to sales and profit growth, we have initiated a few improvement initiatives. We have appointed a new Chief Creative Officer, Nathan Williams. Nathan was the founder and Executive Creative Director of the global brand, Kinfolk. Nathan will be returning from Copenhagen to Toronto, and he will be running Indigo's creative teams, including the development of Indigo's private label items. We are very excited to see his unique vision brought to our company.

We are laser focused on cost-cutting and productivity initiatives, and in line with this, we have made the decision to repatriate our global sourcing and product development functions from New York to our home office in Toronto. We have also made some organization changes, and we have issued a separate press release detailing these changes to our leadership team, all of which we feel will strengthen us moving forward.

I would now like to hand it over to Craig to speak to the financial results in detail.

Craig Loudon

Thank you, Heather. The results we are discussing are for the 52 weeks ended March 30, 2019. Comparative figures have been provided for the 52 weeks ended March 31, 2018.

Revenue was $1.05 billion for the full year, which was $32.8 million less than prior year. The retail channel was impacted by the strategic closure of a few low-performing stores as well as the disruptions due to store renovations throughout the period.

The online channel was negatively affected by the Canadian postal strike, with lagging impacts through the fourth quarter. In addition to these channel-specific drivers, the Company's fiscal results were impacted by softer consumer spending in the nonessentials market space and the mature general merchandise assortment generating lower demand. A onetime breakage revenue adjustment in the prior year, due to a change in accounting estimates, also contributed to lower revenues.

Total comparable sales, including online, decreased by 1.1 percent. Specifically, retail revenue was down 1.8 percent in superstores and up 1.2 percent in small-format stores. The General Merchandise business was negatively impacted in the superstore format by the factors previously discussed, which resulted in negative comparable sales, while small-format stores were merchandised with nonbook product in a more significant way in fiscal 2019, generating a sales lift.

Gross profit decreased by $48.6 million, driven by deeper discounting and lower full price sell-through in response to the downward revenue pressures discussed. Growth in lower-margin areas of the business, such as best-seller books and toy, also contributed to the gross profit decrease.

Overall, operating, selling, and administration costs increased by 25.7 million compared to last year, primarily due to the impact of legislated minimum wage increases across the country, increased occupancy from the addition of net new stores, and the other operating expenses associated with executing the Company's retail transformation as well as higher distribution costs associated with the Western distribution centre, which became operational in the fourth quarter.

For the year, adjusted EBITDA decreased by $74.3 million to a loss position of 19.1 million compared to earnings of $55.2 million last year. This was primarily driven by ongoing renovations in the retail channel, disruption to the online channel, a weaker economic environment, and deeper discounting in response to these revenue fluctuations. As mentioned, a change in accounting estimates for breakage, which resulted in EBITDA improvement for fiscal 2018, furthered the unfavourable year-over-year variance.

We ended the year with $128.4 million in cash and short-term investments, an 81.8 million decrease from last year while having no debt. This decrease in cash and cash equivalents was primarily a result of the planned capital investment program delivered in the fiscal year.

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

Q&A

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. Should you have a question, please press the *, followed by the 1 on your touch-tone phone. You will hear a three-tone prompt acknowledging your request, and questions are polled in the order received. Should you wish to decline from the polling process, please press *, followed by 2. One moment please for your first question.

Your first question is from Bob Gibson of PI Financial. Bob, please go ahead.

Bob Gibson — PI Financial

Good morning.

Craig Loudon

Morning, Bob.

Bob Gibson

I'd like to kind of focus on the fourth quarter if I could. And for starters, gross margin in the quarter wasn't as strong as last year, and I'm kind of seeing a trend in the last couple of quarters where your gross margin is not as strong. Can it get some colour on how come?

Craig Loudon

Sure. Well, first of all, I think, as we've said, margin was challenged throughout the year. But I think in Q4 you had additional softness in top line. But in any event, to answer your question specifically on margin, we had a year with many disruptions, as we've said. Many of the stores opened late, which generated—the new stores, our renovated portfolio, opened late. As a result, we had excess inventory.

The Canada Post situation had also added to that inventory issue where we had to move considerable inventory out of our online channel and out to stores. And so really, the challenge last year was that of discounting. There was more discounting than we would like to have seen and that impacted margin throughout the year, but mainly in Q3 and Q4. And we're certainly being very careful with inventory this year and have pulled back considerably to ensure that that doesn't continue.

Bob Gibson

Okay. And just top line, it looks like also that online sales weren't maybe as strong as they might have been versus a year ago.

Craig Loudon

Yeah. And certainly, we came into the strike situation just before holiday with double-digit growth in the online channel. And then once that disruption went into full swing we were in double-digit negative territory. It has been slow to recover. And in general though in Q4, I would say we are seeing different behaviour from consumers. I mean we are definitely a business of wants and not necessarily needs, and I think certainly we are seeing the consumer behaving differently. And certainly we've been talking to the banks and different people that see consumer spending on cards and whatnot, and they've certainly confirmed that at the start of the calendar year, there has been a significant pullback from what they're seeing in spending data.

Bob Gibson

Okay. And when I look at General Merchandise as sort of a percentage of your overall sales, it seems to have been flattening out. Any colour on that?

Heather Reisman

I can take it.

Craig Loudon

Sure. What Heather—

Heather Reisman

It's Bob. Right?

Craig Loudon

Yeah.

Heather Reisman

Hi, Bob. It's Heather.

Bob Gibson

Hi.

Heather Reisman

We had four almost five years of incredible growth in our General Merchandise business, like literally 20, 30 percent year-over-year growth in General Merchandise. And last year, we just hit a wall, just a combination of factors, we just hit a wall with it. And we did not see the level of growth; you're absolutely right.

Part of this lack of growth is the reason that we've decided to take a whole fresh look at the way we approach it and why we've made a change in creative direction. So it's not a big mystery. We had year after year after year after year of really big growth. And at some point we just needed to take a look at what was really driving that growth. And how do we have to look at it going forward? So not a big mystery.

But you're absolutely right. It did slow down, and we need to get it back juiced up. We know when it's right, the customer responds extremely well. But there's a real need for newness on a continuing basis, and that's our job.

Bob Gibson

Okay. Great. Now while I've got you, any colour on how New Jersey's doing?

Heather Reisman

It’s going to do okay. It’s not knocking it out of the park, but I do want to put it in a bit of perspective. The traffic in that mall has taken a pretty big dip this year. So interesting, right? We’re dependent on traffic.

The customers that come in love it, and they come back and come back and come back. And what is encouraging about it is that our margins are so much higher there than they are in our Canadian business. The reality is that our product, all of our proprietary product, we price the same price in the US as in Canada, and the customer is happy with it, really happy with it because we’re new and everything we’re doing is positive to them.

So our feeling is the basic orientation of our strategy is correct. I say that respectfully, given these numbers are nowhere near what any of us want them to be. What we’ve decided to do is to hold off any further growth this year, any new stores this year. We want to really put the effort into the overall evolution of the general merchandise product, the lifestyle product. As we just hired Nathan, it will take a couple of quarters for his impact to come on board. But as soon as we get that to where we believe it can be for the next big growth, we’re going to go back and look at the US strategy for sure.

Bob Gibson

Okay. So that sort of answers my next question. So no new stores this year?

Heather Reisman

No. We’re going to be extremely careful on capital this year. We spent a lot of money last year. We found it’s taken longer to absorb it and things that were a bit surprising to us. When we moved some stores, the customers took a little longer to find and come back than we would have anticipated.

Now it’s a bit strange because we opened new stores in the couple of years before, as you know, and the results were outstanding. So we just decided this year we want to absorb all the capital investments we've made, really get the assortment back to where we know it can drive the kind of we've experienced, and hold off on capital, be very, very, very careful with capital this year.

Bob Gibson

Okay. Great. Thank you so much.

Heather Reisman

Put a bit into digital. We'll put a bit into digital and, yeah. But primarily be very, very careful and make sure we get the business back on the growth track that we've experienced.

Bob Gibson

Okay. Thank you.

Heather Reisman

So it's a bit of a reset. That's where we are.

Operator

Thank you. Your next question is from David McFadgen from Cormark. Please go ahead, David.

David McFadgen — Cormark Securities

Hi. Yes. I have a few questions. So I was looking at the comparable same-store sales, in Q4, obviously, was down a fair bit.

Heather Reisman

Mm-hmm.

David McFadgen

Is that still the case for the first two months into this quarter? Has it improved at all?

Craig Loudon

I'll give you a rough idea. Obviously, we don't like providing forward guidance, David, but certainly, and also, I think it is very early and not much time. But I will say we are seeing some encouraging signs from the consumer. I think we're still in for a bit of a tough period, but certainly, compared to Q4, we are seeing some positive signs, particularly in physical retail.

David McFadgen

So some improvement, but it's probably going to be still tough. But maybe not as tough? I'm not trying to put words in your mouth. Just trying to—

Craig Loudon

Yeah. That's a fair statement.

David McFadgen

Yeah? Okay. So in the annual report, you talked about realizing about 20 million to 25 million of savings this year. I was just wondering, is that net of all these new hires and promotions that you've announced yesterday?

Craig Loudon

Yes. And I think, just to clarify, I think the 20 million to 25 million figure was over, I believe we said, the next two years. Realistically, it's probably 18 months type of time frame. And we are, I would say, at the moment halfway to our goal on that and pretty pleased with what we've been able to take out so far. And we are seeing other efficiencies in the business like in supply chain. A lot of our investments there are paying off. And we are getting money out of the supply chain and reinvesting it in other areas in addition to that number that's stated in the annual report. But yes. To answer your question, that would be net of those changes.

David McFadgen

Okay. So typically in order to realize that level of synergies would result in a restructuring charge, like a cash restructuring charge. Just wondering if you could give us an idea of what that would be.

Craig Loudon

Yeah, we did some. It was not substantial, so we didn't call it out specifically. I think part of it is that a big chunk of it was also related to we'd had a lot of project work ongoing. So it's not just people but related to the multiyear store investments that we've been working on. So we had a lot of project resources engaged in that activity. So I would say at least half of it came out with those type of requirements.

David McFadgen

Okay. So there won't be, a least for the half, there won't be a restructuring charge?

Craig Loudon

We did announce the movement of our New York office that will close sometime prior to the end of calendar year. And there will be a charge associated with that. I would say it's not that material.

David McFadgen

Okay.

Craig Loudon

We would not move that below the line. That'll—

David McFadgen

Okay.

Craig Loudon

—just be into our regular costs.

David McFadgen

Mm-hmm. So, Heather, just a question.

Heather Reisman

Yes.

David McFadgen

When you look at your business, obviously, over the past few years, you're a much higher general merch business now compared with book. Do you think that your business is more economically sensitive now as a result?

Heather Reisman

Yes. I think that's absolutely true. Craig made the point that we are not a needs—we are not doing milk or cheese or—so we're not a full needs based business. We have a couple of things we're looking at that will improve that reality a bit. But yes, we are a book business and a gifting business under the larger lifestyle umbrella. And that's correct. We will be more sensitive to economic issues than we were when we were only books.

That said, I remain convinced, and I think I can say this easily with our entire executive team, that our future will be in making sure that our General Merchandise business is a strong and growing business. The future of the business is not in returning to books. It is the base, and we want to keep it as the base, but the real growth remains. So yes.

Craig Loudon

Yeah. And I think just to add one thing, David, to your point is that sure I think what you're saying has validity, and that right now when we see the consumer pulling back a little bit, books are certainly at the moment holding up a little better than general merchandise.

Heather Reisman

Mm-hmm.

Craig Loudon

And so I think it's still great to have the mix of the two.

Heather Reisman

Yeah. Oh, yes.

Craig Loudon

Yeah.

Heather Reisman

Oh, yes. We're not getting out of that business, for sure.

David McFadgen

Mm-hmm. So I think last quarter you indicated that you would be renovating, I think, two or three stores in this fiscal year. I was just wondering, is that still the case? Or are you not renovating any?

Craig Loudon

We just have one where we're doing a move of a store then creating a new concept store. So it'll be just one. There's a couple of very small ones where it's, frankly, more maintenance-related and potentially changing up a sign. But really, it's just one project this year.

Heather Reisman

And already accounted for.

Craig Loudon

Yeah.

Heather Reisman

Already accounted for.

David McFadgen

And, Heather, you said that—earlier on the call you said you were going to be extremely careful with capital this year.

Heather Reisman

Right.

David McFadgen

So would a $20 million CapEx approximate number make sense?

Craig Loudon

Yes.

Heather Reisman

Yes.

Craig Loudon

That's what we are holding it to. Yeah.

Heather Reisman

Exactly.

David McFadgen

Okay. And—

Heather Reisman

We have always had a focus on having a conservative balance sheet. This put a little bit of a dent in that. So, yes. We intend to build it back and be very careful.

David McFadgen

Yeah. Okay. So when I look at your results in fiscal 2018, you had probably a banner year in that year.

Heather Reisman

Mm-hmm. Mm-hmm.

David McFadgen

This year, obviously, a tough year from a profitability perspective. I would have thought or think that the business should, from a profitability perspective, rebound quite a bit this year. And I know you don’t like to give guidance, but I was just wondering do you think that’s a likely scenario?

Craig Loudon

Again, we’re not going to provide that guidance. However, I will say that I think it’s going to continue to be a bit challenging. Yes. Margin rate is going to improve. However, I think if you look at Q4 and some of the signs from the consumer, although yes, I said it’s coming back a bit, we’re still not anywhere near back to where we’d want to be.

And I think the other thing I didn’t mention earlier in my margin discussion, I focused mainly on general merchandise, but books, too, we have seen margin compression. And that one is tougher and more sustained. And that business has really shifted to a frontlist business where those titles are also in mass retailers and discounters. And we are forced down on price points on the best-selling books to 40 and 50 percent off, which we don’t like, but that does also put pressure on margins.

David McFadgen

Okay. All right.

Heather Reisman

But I think you can count on the fact that we're focused on the very things you think we should be focused on. We want to be conservative in what we share. But, yes, we are very focused on it.

David McFadgen

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

Craig Loudon

Thanks, David.

Operator

Thank you. Ladies and gentlemen, as a reminder, should you have any questions, please press *, followed by 1.

And your next question is from Justin Scapeir, from an investor. Please go ahead.

Heather Reisman

An investor?

Justin Scapeir — Private Investor,

Hi, guys. Great quarter. Question. What is your free cash flow estimate for the year?

Heather Reisman

Who are we speaking to? Could we know who we're speaking to?

Operator

The question is from Justin Scapeir, a private investor.

Heather Reisman

Okay. Go ahead.

Craig Loudon

We generally don't provide forward guidance on that, Justin. I mean, we're going to be careful with cash. I think we've covered that. We don't generally issue our full year financial plan, let alone a cash forecast.

Heather Reisman

Or a financial—

Justin Scapeir

And how is the New Jersey store performing?

Craig Loudon

We spoke to that earlier on the call. Question was asked.

Heather Reisman

We feel that the store is performing well; not knocking it out of the park as we might have hoped. But as I mentioned on the phone before, the customers who come into the store are loving it, shopping it, having a great time, and returning. The mall has experienced a very significant drop in traffic, and that does have an impact on the overall opportunity for us.

We are a business that does thrive where the traffic is there. But I think if you visited it or if you talk to anybody who goes, the customers who go have given us a very positive response; positive enough that we would want to do another store. We are just not going to do it this year.

Justin Scapeir

Right. Yeah. That makes sense. No. That's a huge growth opportunity, the US.

Heather Reisman

Yeah. That would be. And we always believed it was a growth opportunity for Indigo. It was why so many developers were and have been talking to us. We just want to wait until we advance the overall Lifestyle assortment through the course of this year before we do another one.

Justin Scapeir

But it's quite interesting that the books are holding up, though.

Heather Reisman

Yeah. The books—it's really interesting that books are not declining as much as people think. A bit of challenge with books is that there is pressure on margin, as Craig mentioned. A) they got bought online; there's almost no margin. And when they're bought in store, there is a tendency of the customer to want to buy front-list, which is more discounted.

So the sales are there. The margin is more challenged. And that's one of the things we're going to be discussing with our wonderful book partners, our suppliers. It will be high on our list of discussion points. Very high.

Justin Scapeir

Got it. Okay. Great. And is there a minimum cash balance that you feel comfortable with? How should we—I think, in this quarter, your marketing cap versus cash were essentially equivalent.

Heather Reisman

I'll get that.

Justin Scapeir

How do you think about that?

Heather Reisman

I don’t know how long you’ve been following us. We are, in essence, conservative in the sense that we have always wanted to maintain a strong balance sheet, and good for that strategy because we did not anticipate this challenging year. And in fact, we had it. And notwithstanding having had a challenging year, we’re in fine shape and can do the things we need to do.

So we are and always have been; we will continue to be conservative. And I think we mentioned earlier in the call, we have a much, much, much more modest capital spend plan for this year. So the way we think about cash is, of course, we want to earn a good return on our cash. But our first objective is to keep a strong balance sheet so that we know we can sustain through both growth opportunities and challenges. Retail is a challenging business these days and you need a very secure balance sheet.

Justin Scapeir

Excellent. Thank you very much.

Heather Reisman

Okay.

Craig Loudon

Thank you. I think David has a follow-up.

Operator

Thank you. Your next question is from David McFadgen. Please go ahead, David.

David McFadgen

Sorry. I just meant to ask one other question.

Craig Loudon

Sure.

David McFadgen

Regarding the fourth quarter, we've seen some other businesses that have been negatively impacted by some extreme weather over our winter, and I was just wondering was that the case with you.

Craig Loudon

I would say traffic, in line with everything else we've discussed, traffic was definitely more of a challenge in our fourth quarters. And with the holiday; holiday, we were pretty pleased with the traffic we saw in both channels.

But certainly, to your point, traffic was down in the fourth quarter. Part of that may well have been weather. We do look at that at certain parts of the country. But I think there was more to it than just weather.

David McFadgen

Okay. All right. Okay. Thank you.

Craig Loudon

Okay. Thanks, David.

Heather Reisman

Yeah.

Craig Loudon

So 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 7, 2019.

Thank you again for your support, and have a good day. Thanks very much. Bye-bye.

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.