

Indigo Books & Music Inc.

FY19 Q3 Investor and Analyst Conference Call

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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

PRESENTATION

Operator

Good evening, ladies and gentlemen, and welcome to Indigo Books & Music Inc. FY19 Q3 Investor and Analyst Conference Call. At this time all lines are in listen-only mode.

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

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

This call is being recorded on Tuesday, February 5, 2019.

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

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

Thank you. Good evening, and thank you for joining us to review Indigo's third quarter fiscal 2019 results. My name is Craig Loudon, and I am the incoming 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 this evening. It can be found at indigo.c (sic) [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 February 12, 2019.

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

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

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

Good evening, everyone, and thank you for joining.

As we discussed in the past few quarters, we are executing on a very ambitious capital investment plan to renovate our retail stores and to bring our reimagined retail experience to a greater number of our customers. While we remain convinced that the transformation will bring long-term success, the complexity of the renovation project has for sure had some short-term impact on sales and profitability.

As we move stores, some have been closed longer than we expected. To some extent, customers get disrupted, and it takes a little bit of time, not in all circumstances but in some, for those customers to reacclimate either to the new store or just to situations where we've moved. So there's still some impact here.

Another, and I think perhaps the most important temporal factor, which impacted us in this quarter—and it impacted sales, net margin, and cost—was the Canada Post strike. Indigo is hugely dependent on Canada Post in the third quarter as we are during the year, and the strike severely hurt our ability to serve customers in a manner that today's retail environment demands. As a result, to some extent, customers chose not to shop online. Or when they did shop online and we did send them to our stores to pick up the product, our cost to transfer the product was often quite high as we had to use a number of alternative carriers.

The combination of the lower sales and the increased costs were further exacerbated by the fact that the incoming trend, the incoming growth trend online, that we had anticipated for online influenced how much inventory we bought and, of course, we had to clear that inventory out through our system.

So you have the triple whammy. You have customers who don't get what they want. You have some customers who we satisfied through an alternative set of networks that was more expensive using our stores. And then we had the need to discount product that we fully expected to sell through our online channel that then had to go through retail. And of course, when you mark it down, you mark down all of the product. That, combined with some number of stores that opened later than we hoped, did have a big impact on the season.

Now there were also some notable external market headwinds as the Canadian retail industry faced a challenging December in particular. The sum of these downward pressures on performance resulted in comp sales for the quarter coming in essentially equal to last year, although we fully expected them to be up, both because of online growth and because of new stores that we would have hoped to be fully online much earlier than they were. And then in fact, so we were basically flat.

But the bigger impact was EBITDA. You had product sold, as I say, at margins less than we had hoped. And we had the impact of all of the costs that we did not anticipate, so the combination of the costs and the margin.

While some of these factors are temporal, we recognize that we are facing significant market pressures, and we will have to overcome these forces by leaning on our ability to be innovative, which has been the history of Indigo. And that basically is the story.

Do we think it's going to immediately pick up? No. But we can see the trend already starting to come back. It'll take a little bit of time, but we remain optimistic about our position in the market. What I will share is, in moments like this, we look very carefully at our customers, and we can see that the customers who we did dislocate, we can already see that they are starting to return. So that's the point we are right now.

Craig?

Craig Loudon

Great. Thank you, Heather. The results we are discussing are for the 13 weeks ended December 29, 2018. Revenue was \$426 million for the quarter, which was 7.3 million less than the third quarter last year.

The retail channel was impacted by ongoing renovations in seven stores and the closure of two low-performing stores, while the online channel was negatively affected by the Canadian postal strike, as Heather mentioned. A onetime breakage revenue adjustment in the prior period, due to a change in accounting estimates, also contributed to lower revenues.

Total comparable sales, including online, were essentially equal to last year sustaining the year over year comp growth achieved over the past two record holiday seasons. This is notable given the general Canadian retail market weakness and the downward pressure from the postal strike, which impacted the Company's primary growth channel.

Gross profit decreased by \$15.8 million, driven by deeper discounting in response to the sales disruptions discussed as well as increased shipping costs as the Company engaged higher cost shipping alternatives in response to the postal strike.

Overall operating, selling, and administration costs increased by 11.6 million compared to last year, primarily due to the impact of legislated minimum wage increases across the country and disproportion costs associated with the Company's opening its first US location during the period.

As a result of the factors discussed, adjusted EBITDA decreased by 27.4 million for the quarter, and net earnings for the third quarter was \$21.5 million compared to net earnings of \$42.6 million last year.

On a fiscal year-to-date basis, total revenue decreased by \$16.6 million, or 1.9 percent, to \$847.7 million compared to \$864.3 million for the same period last year. Year-to-date adjusted EBITDA decreased by \$59.4 million compared to the prior year for the reasons already discussed.

The capital investment in Indigo's long-term growth continues to have a temporary impact on profitability. However, based on the positive response to our new concept stores, our comparable sales, and the efficiencies expected from our enhanced supply chain, we are confident that these strategic investments will bolster Indigo's position as a valued retailer.

As our shareholders are aware, we continue to maintain a strong balance sheet position with \$249 million in cash and cash equivalents while having no debt.

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

Q&A

Operator

Thank you. Ladies and gentlemen, should you have a question, please press *, followed by 1 on your touch-tone phone. If you're using a speakerphone, please lift your handset before pressing any keys. One moment please for your first question.

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

Bob Gibson — PI Financial

Good afternoon.

Craig Loudon

Hi, Bob.

Bob Gibson

In your press release, Heather, you said Short Hills is resonating well. Can I get a little more colour on that and what you think your next steps might be?

Heather Reisman

So we set a what we thought was a fair budget for the first—I mean we opened in mid-October, so sort of third week in October. We set, I think, a reasonable budget for our first holiday, and we slightly improved on it. So, so far we feel happy with response of the customer, and we are being very careful about how that goes. But so far, we're happy.

Bob Gibson

Okay.

Heather Reisman

Anybody who's been, any customers who've been, anybody you've talked to, or anybody who's been to the store, we've had nothing but positive response.

Bob Gibson

Okay. Would you disclose how many store renovations you think you're going to have for this calendar year?

Heather Reisman

We're actually going to hold off on any major renovations. We have two stores to open, one in a couple of weeks and one at the end of the summer or very early in September. Those are the only major renovations we have planned. We will do some upgrading, a little bit of upgrading in some stores, but we are not planning to do the big renovation program that we did this year. We want to absorb a bit of what's happened and make sure that we are getting everything that we want out of what we did.

Bob Gibson

So CapEx will come down considerably, then?

Heather Reisman

CapEx will come down considerably as will operating costs associated with this. We took our strongest stores, and I think people will be very happy with how those stores all perform. But it was a lot for the Company to absorb, and we just want to take a bit of a breather.

Bob Gibson

Great. Thanks so much.

Operator

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

Your next question is from David McFadgen from Cormark Securities. David, please go ahead.

David McFadgen — Cormark Securities

Hi. Thank you. So I have a number of questions. So, Heather, can you just talk about the stores that you've renovated to date? Are they still performing well, as expected, with a fairly significant revenue increase compared with the prior store?

Heather Reisman

The majority of stores are performing well. In total, even the new stores—yes, so the majority of stores are performing well. We have a couple that have not reached their potential. For the most part, the ones that have not reached their potential, opened very late.

We had originally thought—I think I told you this in the summer. We had originally thought that our entire program would be completed by September. It turned out, for all kinds of reasons, there were so many unexpected things happened; developers who didn't finish what they had planned to do in time

for us to achieve what we wanted, just a series of things, a couple of things our teams learned along the way.

But the long and short is some of the stores opened as late as the second week in December. When you open a store at that time, you're not going to fully achieve what you want to do as opposed to opening in May, and you have some time to do it.

So the answer to your question is, the majority of stores are performing well, to our expectations, with a few that have yet to hit their stride. But we are very confident that every store that we invested in will deliver the return that we expected.

David McFadgen

Okay. So if we look in the next fiscal year as far as funding—

Heather Reisman

And you know the situations, Bob (sic), you have some situations that even you can eyeball here. We have a store in the Manulife Centre. I don't know if you've driven around the corner. We made a major investment in that store. The mall itself looks like a war zone. So, of course, our traffic in that store is down, I don't know, 20 percent. That renovation in the mall has to come back so that we can get the expected experience. But we're very confident in the long-term opportunity. And that is the case in a few places.

David McFadgen

Mm-hmm. Mm-hmm. So if we look to your next fiscal year or fiscal 2020, if you're only renovating two stores, the disruption should be down quite a bit. So the profitability, the EBITDA should really bounce back quite a bit. No?

Heather Reisman

Yes, it should. Yes, it should. I mean, we have to be careful about what we can project. Yes, it should. The larger issue is there is a general slowdown in the Canadian economy. For example, publicly reported results, which you can get at, in the month of December, overall toy sales in Canada decreased by—

Craig Loudon

Fourteen percent, the market shrank and—

Heather Reisman

The market shrank.

Craig Loudon

Similar in the United States, I think as well.

Heather Reisman

Right. Fourteen percent. We actually—I mean the fact that our sales, with all of what was happening, was flat, does say something to you about the customer commitment to us. But there are headwinds in the Canadian economy, and particularly for those items that consumers consider nonessential. And I think you can look at some of that.

So we are very respectful of that, and we know that we will have to absorb some of those headwinds. But there's a lot that happened this year: the costs that we laid in, all of which can come out; a number of things which happened that we don't anticipate happening; investments we made in our Calgary warehouse. We only get to turn on the online part of it this year. So there is a lot. When you invest this kind of capital, you know that some of it is to come.

Craig Loudon

Yeah.

Heather Reisman

So we have some things we can do, that we're very focused on, very focused on, and we still have to be respectful of what's happening in the market.

Craig Loudon

Yeah. And I think, David, just watching the Stats Canada numbers for the retail sector, we've gone from overall comparable sales growth of 5 to 7 percent that in the last three quarters it's dropped as low as half a point. And if you look at some of the discretionary categories, some of the year-over-year comparable sales have even gone into negative comp territory. So we're watching that very closely and being very careful, too, with our inventory levels.

David McFadgen

Mm-hmm. Mm-hmm. Okay. So can you quantify at all the impact from the Canada Post strike in the quarter? Just roughly?

Heather Reisman

Well, I can tell you, we had—I think what's fair to say is this. We had a healthy double-digit growth trajectory for the entire year. At the moment the slowdown and then the pretty-much-full strike happened, we saw a real hockey stick down.

Craig Loudon

Yeah. We went from double-digit growth to a double-digit decline. So it was very impactful. And then also, it drove a fair bit of cost too in terms of alternate operational arrangements.

David McFadgen

Yeah. So when you're talking double-digit growth or double-digit decline, you're talking specifically online only, right?

Craig Loudon

Correct. Yeah.

David McFadgen

Yeah. Okay. And then how long do you think it will take before you get the distribution centre out west optimized in terms of costs and—

Craig Loudon

Well, it was always our plan to bring it up in a phased manner. It is performing very well. For our holiday, we had it operating for all of the western Canada stores. And in fact, it was performing extremely well, with levels of productivity because it's better than our older operations, mainly because it has better equipment and a slightly higher level of automation.

And then it was always the plan this spring to bring online up. Just due to the IT complexity, we wanted to phase it out and ensure that we brought it up in a smooth manner. It was quite a successful launch.

David McFadgen

Okay.

Heather Reisman

So the good news was, we were in really great shape in the—I mean, there's no doubt, this was one of those years that you say, man, oh man, oh man. You have the labour raises, you have the postal strike, you have the larger softening just at Christmastime. But, but the customer is there. They're spending less. The customer continues to come to visit us. In fact, we had a slight uptick in customers. They're just spending less money.

David McFadgen

Mm-hmm. Mm-hmm. Okay. Do you think that—well, I think that there's probably a lot of costs in the business that could be taken out. Is there any initiative on your part to say, listen, our costs are up this high, and—

Heather Reisman

There is a very significant initiative already underway.

David McFadgen

To take out costs?

Heather Reisman

Mm-hmm.

David McFadgen

Okay. Can you quantify that for us?

Heather Reisman

No. You know I can't, Bob. (sic)

David McFadgen

No? No. Okay.

Heather Reisman

But you like to ask. I know you. You like to ask, but you know I can't.

David McFadgen

Okay.

Heather Reisman

There's no question that we're just about to roll off finishing the last work. As I say, we have a store, about to open another one underway, and we actually have an office move coming. But we are getting very close to being in that position, and we expect to go into the new year looking different.

David McFadgen

Mm-hmm. And how many stores actually did open during the second week of December? Was it just one or two? Or—

Craig Loudon

We had two in December and then four in November, so they'd—

Heather Reisman

And toward the end of November.

Craig Loudon

Yeah. Towards the end of it. So they did open much later than anticipated.

David McFadgen

Right. Okay.

Heather Reisman

And they were good-sized stores. So that you lose a lot of—

David McFadgen

Mm-hmm.

Heather Reisman

—potential third quarter.

David McFadgen

Mm-hmm. So can you give us an idea on what the CapEx might be? Like would it be—would 20 million be a reasonable number? Or that's too low for your next fiscal year?

Craig Loudon

I think it might even be less than that, David.

David McFadgen

Oh. Okay.

Craig Loudon

Yup.

Heather Reisman

Or that.

Craig Loudon

Yeah.

Craig Loudon

Yeah. It's certainly not going to—

Heather Reisman

It's in and about that area.

Craig Loudon

Yeah.

David McFadgen

Okay. All right. And then, I guess, lastly, what's sort of the plan for the US? I mean, so I take it that the revenue from that New Jersey store was about 1 million in the quarter because you said the revenue growth was driven from the New Jersey store.

Heather Reisman

We don't—Bob (sic), Bob (sic), you are a wonderful person to talk to. We never give that information.

David McFadgen

Okay.

Heather Reisman

And we can't give that information. I think your bigger question is how does this experience—what is the implication for the US? It was always our intention—I think we announced it right at the beginning—that we were going to launch this store. And by the way, it was an unbelievably smooth launch. Like I will say this, unlike what often happens to people, it was an unbelievably smooth launch into the US. We always said we were going to operate the store fully for a year, learn everything we could, and over the course of the year, understand what, if anything, we might want to adjust before opening more stores.

I can tell you that at our board meeting this morning, there was a whole discussion and energy in the board around we should start looking, but we have no plans at the moment. Our full focus is on really optimizing this experience and learning from the customer. We believe, if there is the opportunity we think with the brand, it's going to be more than a one-year opportunity. Like we're looking at something there will be growth in. And there are a number things we're already learning that we say would be small adjustments of what we might do moving forward. So we want this under our belt.

David McFadgen

Yeah. Okay. Well, that's it for me. Thank you.

Craig Loudon

Thanks, David.

Operator

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

Please proceed. There's no further questions.

Craig Loudon

Okay. I'd like to thank everyone for joining us on the call and have a great evening. Thank you.