Indigo Books & Music Inc.

Third Quarter Fiscal 2020 Financial Results

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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

David McFadgen
Cormark Securities Inc. — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Indigo Books & Music Q3 Analyst Call. At this time, all lines are 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 star zero for the operator.

This call is being recorded on Friday, February 7, 2020 and I would now like to turn the conference over to Craig Loudon, CFO. Please go ahead.

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

Good morning and thank you for joining us to review Indigo's third quarter fiscal 2020 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 yesterday. It can be found at indigo.ca and on SEDAR.

The conference call will be recorded and archived in the Investor Relations sections of the Indigo website. A playback of the call will also be available by telephone until 11:59 p.m. Eastern Time on February 14, 2020.

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.

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.

As I have noted previously, fiscal 2020 has been a critical year of rethinking and restructuring to re-establish Indigo's true growth trajectory. In this third quarter, we delivered higher year-over-year earnings achieved through higher margin rates and a lower cost infrastructure. This was done despite lower sales. We did not comp sales this quarter in large part due to deliberate actions we took to prioritize profitability over participating in many industry-wide promotional events. Interestingly, despite the overall decrease in sales, we enjoyed the biggest single retail day in our history through this holiday season.

In addition to cost discipline, this quarter we completed full repatriation of our design team from New York to Toronto. While the restructuring associated with this was costly, having our design team located here in Canada will reap major benefits moving forward. We are also very excited about plans to meaningful expand our proprietary product under the creative leadership of Nathan Williams. We feel strongly that proprietary product is critical to long-term growth, particularly in the age of Amazon.

Despite the numbers, I feel it is important to note that this quarter Indigo served over three million customers and over the last twelve months we have served over six million customers. Our focus is on evolving the role we play for these customers with whom I know we hold a valued, trusted position. The transformation we are working through is major and it is necessitated by many factors, but we are committed to regaining a profitable growth trajectory.

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

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

Thank you, Heather.

The results we are discussing are for the 13 weeks ended December 28, 2019. Comparative figures have been provided for the 13 weeks ended December 29, 2018. As a reminder, we began reporting under IFRS 16, the new leasing standard, in the first quarter. Our financials, on a reported basis and discussed today, include the adoption of IFRS 16; however, we have also provided certain metrics for fiscal 2020 that exclude the impacts of the new standard to assist with your analysis.

Revenue was $383.7 million for the quarter, which was $42.3 million less than the third quarter last year. The top line decline was in response to the Company’s strategic shift to be less promotional and eliminate unprofitable sales and was consistent with the industry decline in retail traffic. In addition to the planned revenue decrease, we experienced headwinds from the absence of a breakout product this holiday season, cycling over prior hits, Becoming and Educated, in print and LOL in general merchandise. The attachment typically associated with hit product sales further decreased top line.

Total comparable sales, including online, decreased 10.5%. Comparable retail store sales for the quarter decreased by 10.1% in superstores and 11.2% in small-format stores, primarily as a result of softer traffic and the Company's planned efforts to reduce promotions. The online channel sales decreased by 12.7% for the quarter. The impact of refining the online assortment to eliminate unprofitable SKUs and reducing the channel's reliance on promotional discounting, which historically drove traffic and sales at the expense of profitability, lowered sales in the quarter; however, this new strategy was effective in meaningfully increasing both margin rate and contribution dollars. The increase in profitability was significant enough to lift the channel's contribution dollars from a negative position to a positive contribution to earnings.

The margin rate for the quarter increased 2.8%, driven by rate improvements in all channels across both general merchandise and print. While focused efforts to eliminate unprofitable promotions and stronger management of inventory delivered increased margin dollars in the online channel, the strategy was less effective in retail where the volume loss was not offset by a higher margin rate.

Overall operating, selling and administration costs decreased by $31.2 million compared to last year. Excluding the IFRS 16 impact, these expenses decreased $14.6 million, primarily through productivity initiatives and the impact of lower sales volumes on variable costs in our distribution network. Disciplined strategic project spending and other cost-cutting initiatives also realized cost savings.

For the quarter, adjusted EBITDA increased by $24.7 million. Excluding the IFRS 16 impact, adjusted EBITDA increased by $8.1 million. Higher adjusted EBITDA was driven by the margin rate improvement along with the Company’s continued efforts to increase efficiency and streamline its cost base.

Net income for the third quarter was $25.8 million compared to net income of $21.5 million last year. The impact of adopting IFRS 16 for the quarter was an earnings improvement of $0.1 million for the reasons previously discussed.

Capital investment in the third quarter of fiscal 2020 was $0.8 million compared to $20.1 million for the same period last year. This decrease was driven by the completion of the Company’s capital investment program undertaken during fiscal 2019 which implemented changes across Indigo’s retail outlets, digital platforms, and supply chain facilities. Additionally, the Company expects to under-spend against its capital expenditure target of $20 million for this year, a significant reduction from prior years.

At this point we 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 star followed by the one on your touchtone phone. You will hear a three-tone prompt acknowledging your request. If you are using a speakerphone, please lift the handset before pressing any keys. One moment please for your first question.

Your first question is from David McFadgen from Cormark Securities. Please go ahead.

David McFadgen – Analyst, Cormark Securities Inc.

Hi. A couple of questions. So, you've done a fairly good job at reducing the costs in the business. I'm just wondering is there more to do there? Do you think you could continue to take out cost or you've done most of what you thought you could do?

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

Craig, you want to take that? For sure, I think there's more we can do. Go ahead, Craig.

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

No, I think there is, David, for sure. I think, you know, we got a lot of operational costs out this year, out of supply chain, some out of the stores, a little bit out of home office, but I think there is more room there.

I think, additionally, one thing you're not seeing yet come through in the financials is the closure of our New York operation. We had severance in the year related to closing that and then also a period of about four or five months where we were operating both the New York design operation and the new Toronto operation. So, that closed in December, so in this quarter and as we get into next year, you'll see the benefits of that as well.

David McFadgen – Analyst, Cormark Securities Inc.

Can you quantify that for us, like what the savings would be?

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

I think at least there's probably another, well, what I just described related to New York would offer a pickup year over year of around $3 million, and then I think we have efforts planned at another $5 million, so probably something in the $5 million to $8 million range.

David McFadgen – Analyst, Cormark Securities Inc.

Okay. And how would you deliver that other $5 million or potential $5 million?

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

I don't think we need to go into all the details—

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

Yeah, I don't think we'll go into that.

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

—and a total amount maybe, additional, I don't think we need to go into the details on that. We have, as Craig was saying, we have plans, but we're not going to report on a line-by-line basis.

David McFadgen – Analyst, Cormark Securities Inc.

Okay. So, I know in the past you were talking about reinvigorating the general merch product line. I was just wondering where you're at on that.

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

So, we’ve been working assiduously since we sort of decided that we wanted to expand that area but working out of here. I have to say, it’s not all that wonderful to know that some of our product which is made in China will now be a little bit time affected and we’re working against that problem now, but we are very, very meaningfully engaged in expanding what we do on our proprietary product. It’s not just adding more, the reinvigoration; it’s looking to expand the amount of product that is proprietary. So we’re working on it now. You know me, David, I’m never going to give you an exact prediction, but you could imagine that we are working very, very hard on this.

David McFadgen – Analyst, Cormark Securities Inc.

Okay. I’m just wondering when we would start to see it show up in the stores.

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

Well, we’re hoping—our plan was this fall. We’re hoping to see it this fall. We are, like everybody else, impacted—we do a good amount of work in China and right now China is closed. So, I do think we will—we’re going to try and manage around that as best we can, but our plans were to see it start hitting the stores in the fall.

David McFadgen – Analyst, Cormark Securities Inc.

Okay. And we’ve seen a lot of discussion about retail just in general—

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

Yeah, of course.

David McFadgen – Analyst, Cormark Securities Inc.

—how tough retail is right now. Can you give us any idea on how just the traffic is at Indigo stores? Is it up? Is it down?

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

Well, the biggest challenge that we have, or change in trajectory, are the nights. I mean there's no question that binge watching and the amount of time people are spending on their technology, it's having an effect on night-time activity, and so that's where we've lost traffic that we have to try and pick it up at other times. And I don't think that that trend, you know, we can do some things, but it's very hard to reverse what is a very, very significant fundamental trend. So, we have a number of things we're trying to do to augment traffic on the weekends to make up for the traffic that we've lost in the night time.

David McFadgen – Analyst, Cormark Securities Inc.

Can you give us any idea of just, on an overall basis, the change in traffic? Like how much it's...

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

No. No, we don't report on traffic.

David McFadgen – Analyst, Cormark Securities Inc.

Okay. So, we saw the same-store sales growth was negative in the quarter. It's been negative for a few quarters. Do you have any idea when you think you might lap that and go positive?

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

Everything we're doing is to work on that. I mean this was, you know, we are being hit on all sides, not that it's not our responsibility to address it, which it absolutely is, but it is a combination. There was literally—it's the first year I've ever been in the business where there was not a single book, not a single book that gained any traction whatsoever.

So, just to give you some sense of what that means, between last year in the third quarter our top-two books accounted for several hundred thousand units, several hundred thousand units; our top couple of books all together didn't break 100,000 units this year. So, just think about that in terms of individual trips or individual online purchases and add the attachment rate that goes with that. The same thing in the toy business. You can look at the toy business, anybody's toy business anywhere across North America, there was nothing of significance, nothing that caught the sort of imagination of kids.

So, we had the combination of sort of general factors that affect us and, in a business that still does depend on having some amount of, a couple of hit things, as any business does, so we had that combination affect us. The question is how that evolves over the next little while will certainly affect things to some extent and then we are working harder on making those hits outside of what you can expect from the book or toy industry. That's the focus of the business.

David McFadgen – Analyst, Cormark Securities Inc.

Um-hmm. Okay.

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

It's a very hard challenge. I will not, in any way, underestimate it. But we are working hard on the things that we are doing and there's a lot of energy in the Company for what we are focused on. A lot of energy. Can't take that to the bank yet, but without it you can't do anything.

David McFadgen – Analyst, Cormark Securities Inc.

Yeah. And then I guess my last question would be, you talked about under-spending a normalized CapEx of $20 million. Can you give us an idea what that would be then?

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

Craig?

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

Sorry, David, what do you mean exactly? What it would mean, meaning in the year or—

David McFadgen – Analyst, Cormark Securities Inc.

Yeah, do you think you’re going to spend $10 million in the year, $15 million in the year?

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

I think it’ll probably be more in the $15 million range, yeah.

David McFadgen – Analyst, Cormark Securities Inc.

$15 million. Okay. All right, that’s it for me. Thank you.

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

Thank you, David.

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

Thanks, David.

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

Thanks.

Operator

Thank you. There are no further questions at this time. You may proceed.

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 May 28th. Thank you again for your support and have a good day.

Operator

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