FINAL TRANSCRIPT

Indigo Books & Music Inc.

2021 Q3 Analyst Conference Call

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CORPORATE PARTICIPANTS

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

Heather Reisman
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CONFERENCE CALL PARTICIPANTS

David McFadgen
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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Indigo Books & Music Inc. Financial Year 2021 Q3 Analyst Conference 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 the call you require immediate assistance, please press *, 0 for the Operator.

This call is being recorded on Friday, February 5, 2021.

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

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

Yes. Good morning, everyone. This is Craig Loudon, Chief Financial Officer of Indigo. I just wanted to point out, Heather is, unfortunately, unable to make this morning's call. However, given the potential for connectivity issues in this remote work environment, we did prerecord our remarks yesterday, so you will hear from Heather during those remarks, and then I will open the call for questions. But just to point out, I will be handling the questions today.

We will now begin the formal presentation.

Good morning, and thank you for joining us to review Indigo's third quarter fiscal 2021 results. My name is Craig Loudon, and I am 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 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, 2021.

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. Indigo continues to adapt through the massively disruptive impact of COVID-19. Fortunately, the strength of our brand and the tireless efforts of our team absorbed some of the headwinds faced from government-mandated closures in key provinces and extreme metering of guests in those provinces which were open this holiday quarter.

Double-digit revenue growth in the first seven weeks of the quarter had set us on a trajectory for meaningful growth for the quarter, suggesting the strongest holiday period for the Company in many years. In addition to extremely strong online performance, our retail stores were experiencing a steady recovery prior to the government-mandated closures and limitations; all of which impacted us during the most important six weeks of this quarter and, in fact, of our year, including the two weeks before Christmas and the early part of the Boxing Week period.

As you can imagine, this is massively disruptive to the financial performance of our business and, in fact, to everyone in the organization. It is, however, worth noting that the agility of our response to the pandemic and the consumer response to our newly launched rebrand and strong book sales did blunt some of this impact.

Our omnichannel experience is also worthy of note. When we last spoke, we had just launched an industry-leading click-and-collect express service and a partnership with Instacart. This enhanced omnichannel network did resonate and, again, helped to blunt some of the impact.

Just after the close of the quarter, Indigo launched its Well Said Podcast aimed at furthering engaging with our customers on key topics and issues of interest to them.

Finally, we're thrilled to announce the appointment of Peter Ruis as our new President. Peter brings a wealth of omnichannel experience, most recently as the Managing Director of Anthropologie at the Urban Group. We look forward to Peter's expertise as we pivot to a living-with-intention company, with books still very much at our core, providing our customers with the ideas, reading, experts, and products to help them in their quest to live with purpose.

With a clear focus, a healthy balance sheet, and no outstanding debt, we are confident in the foundation we've established, and we look forward to putting this pandemic behind us.

Craig Loudon

Thank you, Heather. The results we are discussing are for the 13 weeks ended December 26, 2020. Comparative figures have been provided for the 13 weeks ended December 28, 2019.

In the third quarter, we generated revenue of $365.4 million, down $18.3 million or 5 percent compared to the same period last year. This decline reflects the financial impact of government-mandated store closures and customer capacity restrictions in the last six weeks of the holiday sales season, which represented a significant adverse event in the third quarter.

As a result of temporary store closures from COVID-19 and strict social distancing requirements limiting capacity in stores and open markets, we believe that comparable sales, which in the past has been a key performance indicator, is no longer meaningful to evaluate performance. Instead, we're focused on total revenue, as discussed, as well as online growth and omnichannel fulfillment trends, which I will offer some colour on.

Demand for categories that lend themselves to the current climate remain strong, led by the success of Barack Obama's, *A Promised Land*. The Company also experienced double-digit growth in its Baby and Wellness categories and saw continued strength in its new proprietary OUI lifestyle brand, as Heather discussed.

At 92 percent growth, the online channel revenue nearly doubled for the 13-week period ended December 26, 2020 compared to the same period last year, sustaining a positive trajectory going on 10 months from the commencement of the pandemic and absorbing some of the COVID-19 disruption.

The online channel experienced triple-digit growth in October and November as a result of encouraging customers to shop early before moderating slightly in December. These results were driven by improvements in conversion and average order value.

The retail channel, which is inclusive of orders fulfilled through omnichannel express pickup, decreased by 27 percent for the 13-week period ended December 26, 2020 compared to the same period last year. This reflects the severe impact of government-mandated store closures, as Heather discussed.

I would like to add that these closures included the Toronto market on November 23rd, right ahead of Black Friday. Through the launch of industry-leading click-and-collect services and the Company's Instacart partnership, however, the retail channel was able to flex to meet the demand of customers and alleviated some pressure from the online fulfillment centres.

These evolved omnichannel capabilities peaked at 35 percent of e-commerce demand during a critical period of December sales and will continue to be a pillar of our omnichannel strategy amid COVID-19 uncertainty and as customer expectations evolve post-pandemic.

Cost of sales as a percentage of revenue increased 3 percent compared to the third quarter last year, which was primarily a function of increased shipping costs due to the higher penetration of online sales. However, improvements to the Company's online fulfillment processes, strong inventory management, and lower online promotional activity delivered meaningful online margin rate increases year over year.

Overall, operating, selling, and administration costs decreased by $8.4 million in the third quarter compared to the same period last year. The Company recognized $9.7 million in occupancy expense abatements from its negotiation efforts to share the financial burden of the pandemic with its landlords and $1.8 million in government payroll subsidies. These reductions were furthered by lower costs throughout the Company's store network in response to the year-over-year decline in traffic, partially offset by increased costs in the Company's online distribution network from the growth of *indigo.ca.*

Against significant COVID-19 headwinds, adjusted EBITDA only decreased by $5.5 million to $37.8 million for the 13-week period ended December 26, 2020 compared to the same period last year. I would like to reiterate that these results reflect the quality of work achieved by our teams, the quality of our distribution channels, and the strength of our brand.

The Company recognized net earnings of $30.7 million for the third quarter, or $1.11 net earnings per basic common share, compared to net earnings of $25.8 million, or $0.94 net earnings per common share, for the same period last year.

The Company recognized no income taxes as a result of deferred tax assets not previously recognized, compared to income taxes of $10.4 million in the prior year. This year-over-year change in income taxes drove the earnings improvement reported.

Coming out of the holiday season, we have $229.4 million in cash, with no outstanding debt and a clean inventory position.

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

Q&A

Operator

At this time, we would like to take any questions you may have for us today. To ask a question, please press *, 1 on your telephone keypad.

Our first question is from David McFadgen with Cormark Securities. Your line is open.

David McFadgen — Cormark Securities

Oh, hi. Hi, Craig. A couple of questions.

Craig Loudon

Hi, David.

David McFadgen

Maybe we could just focus on the General Merchandise performance. The revenue is down 11 percent. I know you guys have been reinvigorating that line. I was just wondering, is that decline of 11 percent solely due to COVID? Or how happy are you guys with your General Merch line?

Craig Loudon

We're very happy. We've seen a lot of strength, David. And in fact, we closed so early in Toronto, for example, November 23rd, which, to have that market closed during that period is unheard of. We believe that our revenue, when we look at the impact of those closures, would have been above last year in the quarter, had those closures not happened at Holiday.

So and then a few highlights in the areas we've been focusing on, such as OUI, which we've talked a lot about in our Wellness category. And then even in Baby, we've seen double-digit growth in the quarter in those spaces.

So we're thrilled with that and really looking forward to getting back open. This has been a long closure in Ontario. It'll probably end up being longer than the first one in the spring. So we believe we've got the assortment now and more to come. So really looking forward to getting open.

David McFadgen

Okay. And maybe if we could talk about your next fiscal year. I know you guys don't like to give guidance, but just a couple of benchmarks. Like do you think your CapEx, assuming the world goes back to normal and you can open up fully for the year, do you think your CapEx would be higher in 2022 versus your fiscal '21 year? Or are you going to keep it kind of the same?

Craig Loudon

It'll be a similar level, probably in the $15 million range, unless there's specific things identified that we want to invest in that have a quick payback. But certainly, the focus will absolutely be on digital. I think even post-pandemic, even though from what we saw in the spring with the stores recovering quickly, we still believe the future growth is going to come in the digital realm. So that will continue to be a big focus of investment.

And also, this whole environment with e-commerce really leaping forward, we've now really got critical mass in the channel, and we believe we're set up for success there. So that's certainly where we're going to focus our investments.

David McFadgen

And just following on that, when you talk about the growth being on digital, we obviously know the margin profile's lower on digital just because of the shipping costs and stuff. Do you think that you can continue to improve your gross margin on digital? I mean, it probably doesn't go back to the in-store margin, but just what's your thoughts there?

Craig Loudon

Yeah. No. Definitely. And in fact, yeah, we don't publish those selling margins. But in the online channel even this quarter, we had a five-point improvement in our selling margins. So it's absolutely been a focus.

Shipping costs obviously come with the territory. But on the other hand, it's a bit strange how these things get reported. It is an accounting requirement to include that in the margin, but it's a bit like in the retail channel saying, well, we'll include labour in margin but not store expenses. I mean, not to mislead; the overall contribution of the channel is a bit lower. But I think as long as it's real growth in that channel, it will work.

What has been challenging during the pandemic is you take volume from a fixed-cost network and put it into a variable network. That's where it's temporarily challenging because the fixed costs don't go away in retail. However, with retail recovering and then real growth in digital, then I think that sets us up for success.

And the other thing I just want to point out, operating in this environment has been challenging. In our distribution centres; we've had to adhere to social distancing. And actually, I'm quite proud to say we haven't had a single case of transmission in our Brampton or Calgary operations, in our DCs. Obviously, we have had cases from the community, but we've had no spread inside the buildings and have handled the cases and the cleaning appropriately so that there's no evidence of spread.

But that being said, with the distancing, it has lowered productivity. So as soon as that's not required anymore, we can have a productivity improvement there.

And then also on the carrier side, as everybody knows, all the carriers have been overwhelmed with volume. There's been pressure on rates, and consequently, really everything was operating at a kind of peak cost. And so certainly, I think there's opportunities there going forward as well.

David McFadgen

Okay. And this year, you guys have done a pretty good job at lowering your SG&A and cost of operations. And I was just wondering, assuming the world goes back to normal next year, do you think you can hold it at this level? Or it's just going to probably increase a little bit as the business improves?

Craig Loudon

No. We believe we can hold it at this level. Certainly, even pre-pandemic last year, we had talked about $20 million roughly that we got out of SG&A. We've got another $7 million to $8 million out now that I believe is repeatable. Obviously, there has been some rent relief and government programs in there that are not repeatable. However, those are really helping to cover a very large margin gap given the impact of lower sales during the first shutdown and then this subsequent second-wave shutdown.

David McFadgen

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

Craig Loudon

Okay. Super. Thanks, David.

Operator

We have no further questions at this time. I turn the call back to presenters for closing remarks.

Craig Loudon

Sure. Sorry. One second. 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 1st. Thank you again for your support and have a great day.

Operator

This concludes today’s conference. You may now disconnect.