

Indigo Books & Music Inc.

Fiscal 2022 Third Quarter Results

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Indigo Books & Music Inc. — Chief Financial Officer

Heather Reisman

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CONFERENCE CALL PARTICIPANTS

David McFadgen

Cormark Securities — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Indigo Books & Music Inc. Financial Year of 2022 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 this call you require immediate assistance, please press star zero for the operator. This call is being recorded on Friday, February 11, 2022.

I would now like to turn the conference call over to Mr. 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 2022 third quarter 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 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 18, 2022.

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.

Our strong sales performance with our print and general merchandise businesses, both in growth mode, delivered another quarter of revenues that exceeded both last year and pre-pandemic levels. Specifically, sales were \$430.7 million. This represents a \$65.3 million or 17.9% increase over last year and a \$47 million or 12.2% increase over fiscal 2020. Growth in our core print business is being driven by a renewed interest in reading and the popularity of reading on social media. This latter phenomenon, which is still gaining in strength, has been strengthening the Indigo brand with a key demographic.

On the general merchandise side, our lifestyle and kids businesses both delivered strong results, further insulating our overall business from being dependent on the existence of any one blockbuster book to make our season. This sales growth was delivered despite an endlessly disruptive set of pandemic conditions. The Omicron variant upended the recovery in retail, which had begun earlier in the fall. It brought another round of severe capacity restrictions in key markets, which blunted the incredible momentum we experienced in the first two months of the quarter. Most significantly, it impacted us in the critical days leading up to and including December 24th when our stores are typically chockablock and customers are concerned with ensuring product is in hand for Christmas morning.

While Craig will provide a detailed financial perspective, we are pleased to deliver an adjusted EBITDA of \$52 million despite heightened freight and logistics costs and minimal external COVID-19

support. These results are a testament to our meaningfully curated product assortment and strengthened operating model, which included greater sell-through of full-price goods, and of course the dedicated efforts of our exceptional teams. We are energized by the strength of our business and look forward to moving past this pandemic when we can fully realize our growth potential.

I will now pass it over to Craig.

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

Thank you, Heather.

The results we are discussing are for the 13 weeks ended January 1, 2022. Comparative figures reference the 13 weeks ended December 26, 2020.

We generated revenue of \$430.7 million, an increase of \$65.3 million or 17.9% from the third quarter last year. The Company experienced growth across its print and general merchandise businesses. As Heather discussed, the print business benefitted from a resurgence in reading. The Company's position as Canada's leading bookseller, combined with the effective mitigation of distribution delays experienced by the publishing industry, resulted in its ability to capitalize on the elevated demand, notably introducing the Indigo brand to a younger demographic.

The Company's proprietary brands and strategic inventory buys meaningfully contributed to the growth of the general merchandise business. As a result of social distancing and government-mandated capacity constraints in stores, we believe that comparable sales are not currently meaningful to evaluate

performance. Instead, we focused on total revenue, as discussed, as well as omnichannel fulfillment trends.

The retail channel, which is inclusive of orders fulfilled through omnichannel store pickup, increased by \$67.7 million or 29.4% to \$298.1 million for the 13-week period ended January 1, 2022. Retail revenue growth was driven by high conversion and full-price sell-through. While pandemic conditions softened and the Company's retail network performed stronger than in the same period last year, the emergence of the Omicron variant dampened the network's full recovery.

Online channel revenue decreased by \$3.5 million or 2.8% to \$122.0 million for the 13-week period ended January 1, 2022. The slight moderation in demand reflects the rebound of retail, as discussed. The online channel sustained sales levels at 86.3% above pre-COVID fiscal 2020 and continues to be central to the Company's growth trajectory.

Cost of sales increased by \$34.5 million to \$252.4 million for the 13-week period ended January 1, 2022. Excluding the impact of online shipping costs, cost of sales increased by \$32.4 million to \$229.8 million for the period. As a percentage of total revenue, this represents a decrease to 53.4% compared to 54.0%. While this was driven by the retail channel rebound, which typically has a higher margin profile, the strength of the Company's product assortment and a tighter promotional cadence delivered improvements in its merchandise margin. Notably, these improvements more than offset the adverse impacts of higher inbound freight costs triggered by global supply chain constraints. To provide further context, in the quarter pressures from the global supply chain cost of general merchandise business approximately 300 basis points in margin rate.

Online shipping costs increased by \$2.1 million to \$22.6 million for the 13-week period ended January 1, 2022, largely due to increased fuel costs and additional shipping costs incurred in response to the severe flooding experienced in British Columbia during the period.

Overall operating, selling, and administration costs increased by \$16.3 million to \$127.1 million for the period. Operating costs were offset by external COVID-19 support of \$1.2 million, markedly lower than the \$12.9 million the Company was eligible for and recognized in net occupancy abatement and government rent and payroll subsidies in the prior year. Operating cost also increased on the return of higher sales volumes in the retail channel.

Adjusted EBITDA improved by \$14.2 million to \$52.0 million for the 13-week period ended January 1, 2022. Higher adjusted EBITDA was driven by strong sales and merchandise margin performance and achieved against lower external COVID-19 labour support and the corresponding increase in retail operating expenses.

The Company recognized net earnings of \$45.1 million for the 13-week period ended January 1, 2022, or \$1.62 net earnings per common share, compared to net earnings of \$30.7 million, or \$1.11 net earnings per common share, for the same period last year, an improvement of \$14.4 million.

With no outstanding debt and cash of \$189.9 million, the Company is well positioned to see through the remaining COVID-19 uncertainty and the execution of a post-pandemic growth strategy.

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 star followed by one on your touchtone phone. You will hear a three-tone prompt acknowledging your request and your questions will be polled in the order they are received. Should you wish to decline from the polling process, please press star followed by two. If you are using a speakerphone, please lift the handset before pressing any keys.

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

David McFadgen — Analyst, Cormark Securities

Hi. Thank you. Yeah, just a couple of questions. I was wondering, can you tell us how many days in the quarter were impacted by COVID lockdowns?

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

Sure. I mean I can give you the dates. This is Craig, David. It varied by geography, but in Alberta we were down to only 33% capacity from October 26th onward. In Quebec we were down to 30% capacity from December 16th and then in Ontario 50% capacity from December 17th. Now I will say in Ontario, even, I would say, a week before the restrictions went into place you could see consumer behaviour change drastically. So I think the measures were announced but didn't go into place for a week, so even a week before they went into place traffic dropped considerably.

David McFadgen — Analyst, Cormark Securities

Okay. And do you guys, I mean you must have some idea what that cost you in terms of revenue.

Could you comment about that?

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

Go ahead. Go ahead, Craig.

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

Yeah, I mean earlier in that quarter, David, we were exceeding our expectations, but in terms of what were expectations in retail, we had hoped to achieve probably at least another \$30 million in that channel in the quarter. So it's a little bit of a guessing game, but if that gives you any sense.

David McFadgen — Analyst, Cormark Securities

Okay. And that's helpful.

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

You realize it has two impacts, it has three impacts, and I think Craig's point is valuable that, based on the momentum in October and November, had that momentum continued it would have been at least, I think, Craig, you'd say at least what you're saying. But I agree with you in any case. But I just think it's important to point out that it has a couple of different impacts, not just retail sales. But when you push to online, you just have to ramp up all the delivery costs, which Craig notes in his comments earlier in the

call. And then the other factor is in the last week or the last 10 days but particularly the last week, when online can no longer pick up, then you have the more significant impact.

David McFadgen — Analyst, Cormark Securities

Yeah, okay.

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

So it's a sales and a cost.

David McFadgen — Analyst, Cormark Securities

Right. There's a few dynamics.

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

Yeah, yeah.

David McFadgen — Analyst, Cormark Securities

Okay. And then just looking at the online revenue, I saw it was down. I was expecting it to be down, because the prior year was benefitting from COVID and all the lockdowns there. I mean I'm just trying to get a handle on what online revenue looks like going forward assuming everything opens back up and we kind of get back to normal. Any help there would be (inaudible).

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

Yeah, I think you should keep in mind that our view, and I think most people's view, is that the pandemic has fundamentally changed people's behaviour. So I think it's fair to say we are optimistic. Our online is doing extraordinarily well and we are optimistic that retail will grow. We're optimistic feeling that retail will start to come back more and more to pre-pandemic levels, but the online channel will continue to be very strong. And we picked up a lot of new to online. Over the course of these two years, we picked up a lot of new to online shoppers. New to us and maybe new to online in total. So we're feeling positive about the opportunity in online and it's running way over pre-pandemic levels. Way over.

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

Right. And what's giving Heather confidence in that is certainly, David, in the summer and the early fall when—

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

Exactly

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

—things were more wide open and people were more mobile, we did see retail in line with the pre-pandemic levels, but online still holding up. So we've seen that demonstrated. Now does that mean consumers change a little bit in the next two years? I mean no one has a crystal ball, but that's why we have confidence.

David McFadgen — Analyst, Cormark Securities

Okay. And, Craig, you talked about heightened freight and logistics costs. I mean do you expect these to ease off anytime soon, because we all know the inflationary pressures and supply side chain problems and stuff, or is this just going to be the way it is for a little while?

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

Well, it will be this way for a little while. The question is, what is a little while? We're not seeing them back off yet. In fact, I would say they're at the highest level they've been in the pandemic. I mean ocean containers that used to cost \$2,000 to North America are running \$25,000 right now. But over time that's got to adjust. Egregious rates like that bring on capacity, so it will adjust over time. I think you probably noticed in our materials that that did cost us \$6.9 million in the quarter. So we expect that to equalize somewhat over time, but not immediately.

David McFadgen — Analyst, Cormark Securities

Okay. And assuming the world gets back to normal, everything's open up at 100%, you guys have done a pretty good job at reducing your cost structure. Do you think you can hold it here or there's going to be more investments again in the cost structure? Just trying to assess what the ultimate profitability is to the business when things totally open up.

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

Yeah, I think I can go first, Heather. We can definitely hold it, David. I think what is encouraging is, you know, we see a future with both channels firing on all cylinders. Pre-pandemic, we had a very strong retail network and we believe we'll get back there, but our online business was a little smaller. So, frankly, when it wasn't Black Friday, the rest of the year, there were a lot of fixed costs that weren't necessarily well leveraged. I think now, with the scale in the online channel, and we see even further growth there, that as a percent of sales over time those operating costs should come down. Certainly hold and we believe there's opportunity to come down a little further. Not in dollar terms, but as a percent of sales.

David McFadgen — Analyst, Cormark Securities

Okay. And then I was just looking back at your results of, say, the last five years or so, and you hit a high watermark in the quarter ending December 2017 where you did about \$63 million to \$64 million of EBITDA. And I'm just wondering, do you think you can hit that high watermark or even surpass it now just...? I mean assuming we get back to normal and everything opens up 100%, do you think you can hit that level again?

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

Yes. We think we're going to hit that. Now I don't want to set your expectations that it's going to happen this year, because when we look at, you know, the traffic is still following a pattern of what it reduced due to Omicron. That has not come back yet. So I think we're probably going to be starting next year still a bit behind in that sense. We don't see the freight problem equalizing yet. And so I think we're still going to have some headwinds here, but we definitely see getting back to those levels of EBITDA, yes. The question is just on timing. And again, I didn't think this time last year we'd still be sitting here talking

about COVID, so really we need both channels firing on all cylinders and to be out of this before that happens.

David McFadgen — Analyst, Cormark Securities

Yeah. Okay. And so then just thinking about post-COVID era, if you're going to make some investments in the business, would they be retail driven, online driven, a combination? Maybe you can just give us an idea of what you're thinking longer term.

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

So, we have a couple of things on the plan. We're definitely going to continue to invest in digital, because we see it as a huge opportunity. We have some further plans for our stores but we have quite a thoughtful way of approaching that based on learnings from the last couple of years. So we will make the appropriate capital investments, we have a very thoughtful plan on them, and we're feeling pretty positive about the return on capital plan for the next couple of years.

David McFadgen — Analyst, Cormark Securities

But, you know, as you're talking about an investment in retail, you're not going to do anything like what you did a couple of years ago.

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

No, no. We don't have to. We don't have to. On two counts. We don't have to and, secondly, we remain a really desired brand by retailers and we're being encouraged, in the places we want to stay we're

not only being encouraged to stay but we're being offered renovation funds that we require for the most part.

David McFadgen — Analyst, Cormark Securities

Okay. Excellent. Okay, that's it for me. Thank you.

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

Okay. Thanks, David. You're always good. Anybody else?

Operator

There are no further questions at this time. Please 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 June 3rd. Thank you again for your support and have a great day.

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

Thank you. Bye-bye.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines. Have a great day.