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FINAL TRANSCRIPT

Indigo Books & Music Inc.

Financial Year 2023 Q1 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

David McFadgen
Cormark Securities — Analyst

Bill Nasgovitz
Heartland — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Indigo Books & Music Inc. Financial Year 2023 Q1 Analyst Conference Call.

This call is being recorded on Thursday, August 11, 2022.

I now would 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 2023 first quarter results. My name is Craig Loudon, and I'm the Chief Financial Officer. Joining us from Indigo today are the Chief Executive Officer, Heather Reisman; and the President, Peter Ruis.

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 August 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.

This quarter, we delivered strong sales growth, posting revenues that exceeded the first quarter results in any of our three preceding fiscal years. Specifically, sales were $205 million, a $33 million increase over last year and a $12 million increase from Fiscal 2020. Worth noting, this growth was delivered notwithstanding that retail traffic, though very much improved over last year, has yet to come close to pre-pandemic levels. The double-digit growth was achieved in both our print business and our general merchandise business.

Our print business has benefited from a few things, including the sustained engagement of a younger demographic, very much influenced by support for reading on TikTok.

On the general merchandise side of our business, it is worth noting that our top proprietary brands, OUI, NÓTA™, and LOVE & LORE®, continue to be key pillars of growth for Indigo, contributing over 30% of general merchandise growth overall. We believe this demonstrates the value of our investment in this area of our business.

Unfortunately, much of the financial benefit of this strong growth has been blunted, as Indigo, like the retail industry as a whole, has been impacted by a uniquely challenging macroeconomic environment. Significant increases in fuel prices and challenges throughout many supply chains have continued to exert inflationary pressures on costs and negatively impact the timing of product deliveries.

A few other things I will note, though, on the horizon. We are looking forward to the upcoming launch this fall of our fully redesigned and advanced digital platform. The new indigo.ca/.com will allow us to provide our customers with an exceptional shopping experience and better showcase our thoughtfully curated, much expanded assortment.

We will also, as promised, be publicly sharing our initial advances toward our goal of being a net zero company. We are early in our journey, but determined to achieve our ambition.

In closing, let me just share that Indigo is approaching an important milestone. This year marks our 25th anniversary. We have some exciting initiatives planned, and we look forward to experiencing this milestone with all of our stakeholders.

I'd like to now ask Craig to provide a more detailed financial perspective on the quarter.

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

Thank you, Heather.

The results we are discussing are for the 13 weeks ended July 2, 2022. Comparative figures reference the 13 weeks ended July 3, 2021.

In the first quarter, the Company generated revenue of $205 million compared to $172 million for the same period last year. This represents an increase of $33 million or 19%. This exceeded the Company's top-line first quarter performance compared to the preceding three fiscal years, driven by success in the omnichannel business and double-digit growth across both the print and general merchandise categories.

As Heather discussed, the print business has continued to benefit from a resurgence of reading, leveraged through the Company's recent partnership with TikTok Canada to further capitalize on the popularity of reading from #BookTok.

From a general merchandise perspective, we continue to be pleased by the success of our proprietary brands, which have been a lever for sales growth.

As COVID-19 restrictions eased compared to the prior year, we also noted an improvement in sales in our giftable lifestyle categories and paper products.

As a result of social distancing and the government-mandated capacity constraints in stores in the prior year, we believe that comparable sales are not currently meaningful to evaluate performance. Instead, we have focused on total revenue.

Sales in the retail channel, which is inclusive of orders fulfilled through omnichannel store pickup, increased by $54 million or 60% to $144 million for the quarter ended July 2, 2022, compared to $90 million for the same period last year. The Company's retail network benefited from easing pandemic conditions, as stores remained open for the full quarter compared to rolling closures in the same period last year. While traffic still remains below pre-pandemic levels, the Company has generated higher conversion and increased average transaction values in the channel, blunting some of this impact.

Online channel revenue decreased by $23 million or 30% to $52 million for the quarter, compared to $75 million for the same period last year. The change in demand is impacted by the rebound of the retail channel. However, we continue to see sustained growth online, and sales in this quarter were 80% above pre-pandemic Fiscal 2020 levels. The online channel continues to be a key area of growth and investment for the Company.

As we monitor the ever-evolving shopping behaviours of our customers, we see that Indigo customers are increasingly leveraging the Company's digital platforms at the beginning of their purchase journey for product discovery, impacting demand on the online channel and conversion for the retail channel, while we monitor and report on channel economics, we are increasingly evaluating the business as a whole at an omnichannel level.

Cost of sales increased by $21 million to $123 million for the 13-week period ended July 2, 2022. Excluding the impact of online shipping costs, cost of sales increased by $24 million to $113 million for the quarter. As a percentage of total revenue, this represents an increase to 55% compared to 52% in the first quarter of the prior year. Macroeconomic conditions throughout the quarter have had an adverse effect on cost of sales, resulting in higher freight costs stemming from the ongoing global supply train disruptions, as well as additional inflationary pressures.

Online shipping costs decreased by $3 million to $10 million for the 13-week period ended July 2, 2022. Despite higher than normal variable shipping costs impacted from elevated fuel costs, total shipping costs decreased in line with the change in demand of the online channel.

Overall, operating, selling, and administrative costs increased by $15 million to $84 million for the period. These costs were offset by external COVID-19 support of $1 million, markedly lower than the $7 million the Company was eligible for and recognized in net occupancy abatement and government rent and payroll subsidies in the first quarter of the prior year. Costs increased in response to higher sales volumes in the retail channel compared to the rolling closures in the first quarter last year.

The Company also undertook additional strategic investments in the quarter, investing in talent, marketing initiatives, and technology.

As Heather mentioned, Indigo looks to provide customers with a revitalized digital experience later this year as we build on the e-commerce momentum that has been generated.

Adjusted EBITDA changed by $4 million to a loss of $19 million for the 13-week period ended July 2, 2022, compared to a loss of $15 million in the same period last year. Excluding the impact of external COVID-19 support, Adjusted EBITDA improved by $2 million to a loss of $20 million, compared to a loss of $22 million in the prior year.

While Indigo noted strong sales growth in the quarter, adverse macroeconomic conditions had a negative impact on costs. This was furthered by the discussed additional investments made by the Company.

Net loss for the 13-week period ended July 2, 2022 was $25.4 million or $0.91 net loss per common share, compared to a net loss of $21.9 million or $0.79 net loss per common share for the same period last year, a change of $3.5 million. This is inclusive of the external COVID-19 support discussed.

The Company finished the quarter with a cash balance of $43 million and no outstanding debt. No advances were made on the available $25 million revolving credit facility.

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

Q & A

Operator

Thank you, sir.

Your first question will be from David McFadgen at Cormark. Please go ahead.

David McFadgen – Analyst, Cormark Securities

Yes. Hi. A couple of questions.

First, I'll start off with a question on the margins. I would have thought as the in-store revenue ramps, the margins would actually improve. That wasn't the case. I guess, is it solely due to all the inflationary pressures you're seeing on the cost inputs, and if so, is there any idea when these will sort of ease and margins can go a bit higher from here?

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

Yes. Good point, David. It is absolutely the inflationary pressures. The biggest one that has an impact on margin is the inbound freight costs. The inventory we were selling through in the first quarter still was at probably the peak pandemic freight rates where we saw containers from Asia costing five times traditional levels. That is dropping now.

Currently, when we're securing containers, we're seeing it at about two-and-a-half times historic levels, so it's not back to historically where it's been, but it is improving, so we expect that to start selling through at holiday, but—we are certainly impacted by those freight costs. And then, obviously, sometimes we report this in costs, we showed it both ways, but when shipping costs are in, we're obviously also getting hit in cost of sales by fuel surcharges; fuel surcharges also cost us a significant amount in the quarter given the Russian hostilities, although it does seem in the last week the oil markets do seem to be softening a bit, so hopefully, there may be some relief down the path on that.

David McFadgen – Analyst, Cormark Securities

But just to clarify what you said, you think that Christmas quarter you'll start to see an improvement in margins then as these cost pressures ease off. Is that correct?

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

Yes. Now, we've got to see where all the other inflationary impacts happened on raw materials, etc., but we're trying to buy better. We're doing many things to overcome that, but certainly, the freight—inbound freight drag we saw in the first quarter, yes, it will be improved. It will not be back to historic levels, though, because we’re still seeing a premium of two-and-a-half times on those containers.

David McFadgen – Analyst, Cormark Securities

Okay, and then just on the SG&A, I noticed that went up a fair bit in the quarter. I thought that before you were going to hold SG&A here, but now it seems like you're investing again, so is this a new level for SG&A, or do you think this is going to go potentially higher even from here?

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

No. Well, I think probably what you're seeing in that are two things.

First of all, this quarter last year, in Toronto and most of Ontario, the stores were closed, so naturally, we do have higher labour with stores being open.

The other thing is, given the closures and also restrictions in other geographies—we mentioned this in the disclosure—we had $7 million of external support, given all those COVID impacts in the first quarter last year, that came from both the government programs and landlords who shared some of the closure pain with us, and that's the other thing you're seeing. Last year, the costs would have been artificially lowered by that amount.

David McFadgen – Analyst, Cormark Securities

Okay, and then just on revenue, there's obviously a concern that we could be going into potential recession; had two quarters of negative GDP. Just wondering if you're starting to see that show up on revenue that you're generating in store, say, like so far this quarter?

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

I wouldn't say we're seeing any change in that behaviour yet. I mean, we have noted in some of the disclosures that traffic is still, in physical stores, below pre-pandemic levels, but people are converting much higher and spending more when they come in; we don't see any indication of that yet.

The other thing I'll just note is historically in recessions, reading has held up, and also even on the GM side, we have some smaller price point items. We've held up reasonably well in those periods in the past, so—but again, we're not seeing any impact yet.

David McFadgen – Analyst, Cormark Securities

Yes. I know you guys don't like to provide guidance, I'm just wondering, do you think—I don't know if you can answer this, but do you think that your cash position in Q4 '23 will be the same or higher as Q4 '22?

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

I expect cash at year-end will be higher than it was last year.

David McFadgen – Analyst, Cormark Securities

Okay. Okay, great, and then can you give us sort of your target date for having the fully revamped digital platform that you're going to unroll in the fall?

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

It's probably in the October timeframe.

David McFadgen – Analyst, Cormark Securities

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

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

Thanks, David.

Operator

Your next question will be from Bill Nasgovitz at Heartland. Please go ahead.

Bill Nasgovitz – Analyst, Heartland

Yes. Good morning. Hey, congratulations on continued sales growth. That's fantastic.

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

Thank you.

Bill Nasgovitz – Analyst, Heartland

Looking at Factset here this morning, it looks as if your enterprise value is about CA$6 million market value less the cash. How do you feel about that, and what can be done to change it?

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

Obviously, we think it's greatly undervalued, so yes, look, obviously, there's—we think there's big opportunity here; that it's very undervalued. I think the last few years with the pandemic and everything that's happened has been a difficult period. I think, though, there's a broader market issue in play at the moment as well, but I obviously don't agree with the valuation, but I don't dictate that.

Bill Nasgovitz – Analyst, Heartland

Okay. Speaking of costs, what does it cost the Company to be a public company these days in terms of compliance and...

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

Hi. It's Heather Reisman speaking.

We don't break out the costs of doing this, but is there something behind your question? Is your question why is it public?

Bill Nasgovitz – Analyst, Heartland

Well, since you asked it, go ahead.

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

No. What is it you're trying to sort out here?

Bill Nasgovitz – Analyst, Heartland

Well, you're talking about increased costs. I'm just wondering what it costs to be public.

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

Yes, I don't know, probably a couple of million dollars by the time all the effort and cost and audit fees and whatnot, but I wouldn't say that's the drag on any valuation.

Bill Nasgovitz – Analyst, Heartland

Okay. Thank you.

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

Yes. Okay. Thanks very much.

Operator

Thank you.

At this time, Mr. Loudon, we have no further questions. 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 second quarter results will be announced on or around November 9th. Thank you again for your support, and have a great day.

Operator

Thank you, sir.

Ladies and gentlemen, this does, indeed, conclude your conference call for today. Once again, thank you for attending, and at this time, we ask that you please disconnect your lines.