FINAL TRANSCRIPT

Diamond Estates Wines & Spirits Inc.

Fiscal 2019 First Quarter Financial Results Conference Call

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Bob Gibson
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PRESENTATION

Operator

Good morning. My name is Leonie, and I'll be your conference Operator today. At this time, I would like to welcome everyone to Diamond Estate Wines & Spirits' fiscal 2019 first quarter financial results conference call. All lines have been placed on mute to prevent any background noise.

After the speakers' remarks, there will be a question-and-answer session. If you would like to ask a question during this time, simply press *, then the number 1 on your telephone keypad. If you would like to withdraw your question, please press *, followed by 2. Thank you.

Mr. Souter, you may begin your conference.

Murray Souter — President & Chief Executive Officer, Diamond Estates Wines & Spirits Inc.

Thank you, Leonie, and good morning, everyone. Welcome to Diamond Estates conference call to discuss our financial results for the first quarter ended June 30, 2018. I'm Murray Souter, Diamond Estates' President and Chief Executive Officer, and I'm joined today by Alan Stratton, our Chief Financial Officer.

I'll start this call by providing an overview of our Q1 results, as well as other key developments at the Company. Alan will then review our first quarter financial performance in depth, and I'll conclude with some brief comments on strategy and the market outlook. After that, we would be pleased to answer any questions you may have.

Before I begin, I need to remind listeners that certain statements about future events made on this conference call are forward-looking in nature and are based on certain assumptions and analyses made by the Company. Please refer to the cautionary statement on forward-looking information in our news release of this morning for more information.

First quarter was highlighted by a major milestone for our Company, the acquisition of Backyard Vineyards for $2.8 million on June 28th. We have been talking about acquisition opportunities for a long time, so we were very pleased to announce this deal on June 28th.

One of our central goals at Diamond Estates has been to transition the Company from being a regional VQA producer to a truly national one. This acquisition accomplishes that goal. We've acquired an award-winning brand that operates a 10,000-square-foot winery, retail store, and warehouse in Langley, BC, from which we can launch our Diamond brands into Western Canada.

We are also in the early stages of our plans to co-develop the Naramata Bench property into a new Lakeview Cellars winery in the Okanagan Valley, which is a truly world-class wine region. This is a unique and exciting opportunity. I'll speak more about that later in the call.

For now, I'd like to address our first quarter results. We reported revenue of $8 million, gross margin of 3.7 million, EBITDA of 800,000, and net income of 100,000. As you saw, these numbers were weaker than Q1 last year. We faced some significant short-term challenges in both our winery and agency divisions, which impacted performance. We were pleased, though, that we remained profitable during the quarter, despite these temporary challenges.

On the winery side of the business, we had lower sales to both our export market and the LCBO channel. The export issue is related to our largest Chinese distributor who has experienced delays in opening new stores in China. Unfortunately, that is somewhat out of our control. As a result of these delays, that distributor has reduced purchases in the most recent quarter in order to work through their excess inventory, particularly in ice wine.

The Chinese market is a complicated place to operate and delays in business are not uncommon. Our distributor remains confident that they will open their new stores in the current and next fiscal years and be back on track. This distributor has been an outstanding partner for Diamond Estates for many years, and we are certain that they will return to strong sales volume growth in China.

The LCBO issues are a hangover—excuse the pun—related to the short crop strategy we introduced last year. As a reminder, we introduced this strategy in response to the weak grape harvest in the Niagara Region in 2014 and 2015 after these regions experienced severe cold weather in February of those respective years. As a result of those harvests, our inventory levels were significantly below what was required to support our existing business and growth. In 2017, we made the decision to allocate inventory strategically. We decided to prioritize the export and grocery channels, which are strategically important to us, while temporary delisting some products sold to the LCBO.

The grape harvest in subsequent years, 2016 and 2017, were much stronger than the prior two years. And in recent months, we have reintroduced the delisted products to the LCBO. These products were relisted in the LCBO warehouses toward the end of fiscal 2018, but getting them out of the warehouse and onto the store shelves turned out to be more challenging than it's expected. A combination of competitive pressure on listings at store-level distribution and a lack of available programming through the LCBO hindered the return to normal distribution levels.

We recently took a more aggressive approach to our distribution relisting program, re-vectoring it to be more directly engage with the LCBO managers and assistants at store level. This has been extremely successful. In the past five weeks, we have achieved more than 130 new listings of our products in the LCBO stores, and we've negotiated better shelf placement for more than 170 listings. By the end of September, we expect to be back at the same level of distribution we had to prior to the first few listings. We are very confident that we are addressing this issue effectively.

In the agency division, our financial performance was impacted by the loss of a key supplier relationship during fiscal 2018, which we previously disclosed. The nature of the agency business is that supplier relationships can come and go. And while this is an important supplier for us, we are confident that we will replace the lost business and resume revenue growth.

We have established a number of new supplier relationships since the start of Q1, and we are starting to see revenues build from those new brands. We also expect to generate additional cost savings in the agency business that will drive stronger profitability.

While we are disappointed with our overall first quarter performance, we are confident that we have taken the appropriate actions to drive stronger profitability in future quarters.

I'll now invite Alan to review our Q1 financial results in more detail. Alan?

Alan Stratton — Chief Financial Officer, Diamond Estates Wines & Spirits Inc.

Thanks, Murray. Our first quarter revenue was $8 million, a decline of 16.9 percent from $9.6 million in Q1 of last year. As Murray discussed, the decline was due to lower-than-expected export sales, distribution challenges in the LCBO, and the loss of a key supplier relationship in the agency division.

Revenue in the winery division was $4.7 million, a decline of $0.8 million from Q1 2018. The export and LCBO issues each accounted for roughly half of that revenue decline.

Agency division revenue was $3.3 million in Q1 2019, also down by $0.8 million year over year. The lost supplier we discussed contributed $0.8 of revenue in the first quarter of last year.

Q1 2019 agency revenue also included severance of $0.2 million and a sale of inventory of $0.1 million at cost, related to another supplier that separated during that quarter. Normalizing for these items, the agency division's revenue was down by about $0.4 million or 10.9 percent compared with last year. That decline is due in part to some turnover in the sales team that has been addressed.

Gross margin in Q1 of 2019 was $3.7 million, down 16.1 percent compared to $4.4 million last year, primarily due to lower revenues. As a percentage of revenue, gross margin increased to 46.0 percent from 45.5 percent last year, and this was primarily driven by the loss of the low-margin distributor revenue associated with that supplier that terminated relationship with the Company in Q4 2018.

The agency division also recorded the nonrecurring severance revenue I just mentioned in the quarter, and that was largely offset by a provision of $0.2 million on excess inventory, primarily related to the termination of another supplier that was no longer a strategic fit within our portfolio.

Gross margin in the winery division was $2.3 million or 49.8 percent of revenue, while gross margin in the agency division was 1.5 million or 46 percent of revenue.

Total operating expenses were $2.9 million in the first quarter, down by 1.6 percent year over year. We achieved cost savings from the workforce reduction that was implemented in third quarter of fiscal 2018. These savings were offset by inflationary growth in wages and benefits costs to remain competitive as well as the creation of two strategic roles to support growth in the latter half of fiscal 2018; one being a vice president, people and culture and another a general manager of allied and specialty brands for our agency division. The net result has been a slight increase of 2.6 percent in overall employee compensation and benefits costs versus the prior year.

EBITDA was 0.8 million the first quarter compared to $1.4 million last year. After stripping out nonrecurring items, including acquisition costs, the warehousing cost recovery, and a Quebec sales tax recovery, adjusted EBITDA was 0.7 million in Q1 2019 versus $1.4 million last year. That reflects a margin of 9.3 percent of revenue in Q1 2019 versus 15.0 percent in the prior-year period.

Finally, net income was $0.1 million in the quarter compared to $0.9 million for last year.

Turning now to our balance sheet. We had working capital of $14.6 million as at June 30, 2018. That represents an increase of approximately $0.9 million from $13.6 million as at March 31, 2018, which was our fiscal 2018 year-end. The financial position changed in part due to the Backyard acquisition. Accounts receivable also increased by $2.2 million in the first quarter due to the seasonality of our business, as sales in the fiscal fourth quarter are traditionally lower than our first quarter.

Our debt-to-equity ratio as at June 30 was largely unchanged at 1.21:1, similar to 1.22:1 at last year-end. Increased debt from the Backyard acquisition mostly offset the increase in share capital issued as part of that transaction.

On that transaction, the total purchase price for Backyard Vineyards was $2.8 million. The acquisition was funded by $0.75 million of cash, 1.5 million in common shares priced at $0.32 per share, and the assumption of 0.55 million in debt. We recognized approximately $0.3 million of goodwill on the transaction, reflecting the excess of the purchase price over the fair value of the net assets acquired. We've also recognized a liability for deferred income taxes in the amount of 0.5 million related to the difference between the fair value and the tax basis of the assets. However, we expect to negate the impact of this liability through the effective use of tax loss carryforward balances in our main operating entity.

I will now turn it back over to Murray for some closing comments. Murray?

Murray Souter

Thanks, Alan. This is a pivotal time for Diamond Estates, and we believe that we are on the cusp of significant growth. The integration of Backyard Vineyards has gone very smoothly. We are now working on a comprehensive marketing plan for Backyard, and preparing for the launch of our Diamond brands into British Columbia.

As we previously stated, the Backyard facility is only utilizing about half of its capacity, which gives us the ability to launch the Diamond brands without investing heavily in production infrastructure in the near term.

This will be a real milestone for us. In the longer term, we see tremendous value in building a new Lakeview Cellars winery in the Okanagan Valley. We have access to an outstanding parcel of land on the Naramata Bench near Penticton. I can tell you that parcels like this are very hard to come by in the region. The Okanagan generates a great deal of tourist traffic, and we can leverage the experience from our Niagara-on-the-Lake facility to develop the winery into a prime tourist destination.

Speaking of Niagara, I'm very pleased to say that our retail store at the Lakeview Winery is performing extremely well, and we expect that to continue. The launch of this facility last May was hampered by the very poor wet weather through much of the summer of 2017, so it took some time for us to raise the awareness amongst consumers of the new facility. It is now generating very strong results.

Direct sales from the store increased by more than 65 percent in Q1, compared to Q1 last year, and these are very high margin sales, which we look forward to continued growth as that store is now fully established as a premium retail facility and retail environment.

Perhaps the most important topic to discuss is the Ontario grocery channel. Our efforts to maintain a high market share in grocery have paid off. Our market share in this channel in Q1 was approximately 13.2 percent with total grocery shipments of 32.5 percent compared to last year. This translates into an additional $0.1 million in top line sales. As a reminder, only 70 grocery stores have received licences to sell wine so far.

The Ontario government has committed to issuing 300 licences by 2025. While I can’t predict the timing, of course, the new populous government of Doug Ford, now in power, continues to talk openly about more beer and wine in grocery. We hope this process will move forward more quickly than the previous government’s timetable. Based on the sales we have seen so far in the 70 licensed grocery stores, we are very confident that it will ultimately become the most important sale channel in the province, as it is in most of the developed world.

That concludes our remarks this morning. Alan and I would now be pleased to answer any questions you may have. Leonie, please open the line.

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 Nick Corcoran from Acumen Capital. Nick, please go ahead.

Nick Corcoran — Acumen Capital

Good morning.

Murray Souter

Good morning, Nick.

Nick Corcoran

Yeah. So I guess we're trying to get a hold of how much catch up there might be later in the year. So in the agency division you said there's a couple large suppliers that you lost late last year and early this year. Do you expect any new contractors to help offset that through the rest of the year?

Murray Souter

Yes. We've picked up, as I said in my remarks, we've picked up a couple of new suppliers who came on in Q1, so we're now building the revenue on those. They're companies like Malfy Gin out of Italy, Edinburgh Gin out of Scotland, Great Britain.

We've also picked up national distribution on a couple of our regional suppliers, where we only represented them in Ontario or on a regional basis. And those, we anticipate those will fill that gap very quickly through the balance of the year and into next fiscal year.

Nick Corcoran

Great. And then with the winery, can we expect any catch up in the Chinese exports through the back half of the year?

Murray Souter

Yeah. Let me give you a little colour on that. So last year, the contracts that we had with the largest distributor, we actually oversold them, or they actually bought additional inventory in anticipation of the opening of their store. Those stores did not open as planned. They were about 20 percent behind on their store count.

And so what's happened is they've worked through that inventory, that excess inventory in Q1. We generally ship to them Q1 through Q3, and it supports, in China, their big sales cycles, which start right about now with their Harvest Moon Festival, their Singles Day, and then finishes up with their Chinese New Year, usually in late January, early February.

So what's happened is they've adjusted their inventories for their sales peak through the Harvest Moon period, which is, I think it's September 24, so it's within three or four weeks from now.

We anticipate that we'll remain relatively buoyant in terms of our orders for the balance of the year. We can see the orders that we've got in-house. But we won't catch up quite in this fiscal year on those missing stores. So that little bubble is kind of moving out into the future a little bit.

Nick Corcoran

That's great. That's all for me.

Murray Souter

Okay. Thanks, Nick.

Operator

Thank you. Your next question is from Amr Ezzat from Echelon Wealth Partners. Please go ahead.

Amr Ezzat — Echelon Wealth Partners

Good morning, gents. Thanks for taking my questions.

Murray Souter

Hi. Thanks, Amr.

Amr Ezzat

Just want to circle back on the exports business. You're saying like a lot of it is due to the delays, and I understand that's out of your hands. But I'm wondering if you guys like have any metrics for existing stores? Like what's sort of the same-store sales? Or how are these stores performing relative to last quarter or last year, i.e. is it only a function of them having delays in opening the new stores?

Murray Souter

Yeah. Yeah. Our conversations, we've had meetings with them. They're a private company, so they—and typical of retailers they don't really share as much as they can. We know how many stores they have open, which we've agreed not to disclose. They're a private company, obviously. But they're same-store sales are growing. Sorry, they're, yeah, same-store sales are growing. And then we're seeing the addition of the incremental stores. So they have a plan to be at 200 stores about 12 months from now or 18 months from now. That's going to be a little bit delayed by about a couple of months just because of the delays that they experienced in the most recent quarter through first half of this fiscal year.

But their same-store sales are growing, and they're growing in as, if you read any of the literature out there, it's very consistent of what we see in the marketplace. Icewine sales continue to grow, but the real growth is coming out of table wines.

The Chinese market has very much embraced table wines. There's some other tailwinds that are helping us as well, not only the trade disputes with the US, but also the favoured kind of position that Canadian products tend to have in a Chinese market. We're seen as manufacturing very high-quality foods, of which wine as part of that. So we benefit from both of those.

Amr Ezzat

Understood. Then what I'm thinking I guess about how much excess inventory they need to go through? Are we talking a couple of quarters?

Murray Souter

No. They're pretty well through it now. We'll see us returning to the growth trend that we saw in the past or close to it over the balance of the year. There might be a little bit that's carried over into this quarter, but we can see the orders in this quarter already, and they're pretty significant.

Amr Ezzat

Great.

Murray Souter

The other thing that it does for us, and I probably should have mentioned this in my remarks, was we've never had excess inventory, particularly of icewine, for export. It's always been very tight inventories within sourcing here in Ontario, and this has actually opened up a little bit of an opportunity for us to both expand our supply, but also expand the number of distributors that we are engaged within other geographic areas.

So we have opened up a significant distributor in Great Britain. We're having shipments now. We have a distributor or retailer in the US who's picked up our product. And we're seeing significant interest out of Mexico and Vietnam and also through other Chinese distributors on a non-exclusive basis.

Amr Ezzat

Great. Switching gears to your agency division, you delivered an impressive 46 percent gross margin there, 40 percent last year, and I believe like 30 percent last quarter. Understand that part of it is the severance revenue, but I'm just looking to get a normalized level going forward, and I'm assuming that level is going to be higher than your historical levels?

Murray Souter

Yeah. I'll let Alan talk to that, but it's largely mix and geography. But I'll let Alan respond.

Alan Stratton

Yes. So, Amr, as you know, the agency's kind of two halves of the business. There's the distributor business out west and then there's the agency, or principle business out east, where we are compensated on a commission basis that's 100 percent margin.

So that supplier that we lost last year was a unique situation where we were actually a distributor for them on a national basis. And so it was a disproportional amount of revenue, but it was an also low margin, 18 percent, 19 percent margin, on that business. So with the loss of that business, we're seeing probably a much more typical and favourable balance. While the top line's down, the overall proportion and sales mix will probably stay fairly consistent with what we had this past quarter. And so, therefore, the margins you're seeing now, we expect will be typical of what we should see moving forward.

Murray Souter

As well, just if I can add, the replacement business that we've picked up in Q1 will be at that higher margin.

Alan Stratton

Yeah.

Murray Souter

We won't be serving as a distributor, we'll be generating significant margins out of that business as well.

Amr Ezzat

Great. Maybe one last one on I guess like your last comment in your prepared remarks on the greenfield opportunity on the Naramata Bench. You spoke to, I guess, like a potential co-development opportunity in your PR, and I guess to the extent that you can, can you give us a little bit more details as to what sort of structure you're looking at there—

Murray Souter

Sure. Yeah.

Amr Ezzat

—for potential size and timeline for the project?

Murray Souter

Yeah. Absolutely. We purchased Backyard from a company called Azura Corporation. They're actually a property developer. They have about 160 acres of land in the Naramata Bench, which they are developing. The majority of that 168 is non-arable, is not arable, it couldn't be developed for vineyards, but there's about—there's 10 acres, which is absolutely perfect, and then there's another 28 acres that potentially could be developed as well for vineyards.

The plan would be to co-develop it with Azura, and at the end of the development, whether it be 10 acres or 38 acres, at the end of that we would either acquire their interest or sell both our interest to a third party and just lease back the facility from that third party.

So we want to do it as invest the least amount of capital that we can while generating as strong of margins as we possibly can. So that would be one of the models that we're looking at.

We're in the early stages of that, and the biggest thing is to scope it. And we've walked the property. We've got lots of drill tests on the property. We know what's there, and so it's a matter of starting the process of designing and developing it and figuring out which path we want to choose. And we'll do that fairly quickly over Q2 and Q3 here, this fiscal.

Amr Ezzat

Great. That's it for me. Thank you.

Murray Souter

You're welcome. Thanks, Amr.

Operator

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

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

Bob Gibson — PI Financial

Morning, gentlemen.

Murray Souter

Morning, Bob.

Bob Gibson

Can you give us an update on the winery expansion in Niagara?

Murray Souter

Yeah. We added in the second portion of phase 1, which was an additional half million litres of capacity, which is awaiting grapes as we speak. We anticipate our harvest will actually start within the next seven or eight days. It's going to be actually early this year, which is good. It's very positive. For those of us in Southern Ontario, we know it's been a good grape-growing year. And it is—those tanks are being connected and ready for operation.

Phase 2 will not happen for about another probably 18 months. We're actually going to be updating, as part of our planning in the fall, updating our capacity requirements and long-term forecast, and we'll get a more specific date at that point. It could be 12 months or it could be 18 months for the second phase of that expansion.

Bob Gibson

Great. Thanks very much.

Murray Souter

You're welcome, Bob. Thanks.

Operator

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

Murray Souter

Okay. Well, thank you very much, everyone. As I said, we're a little disappointed in the year or the quarter that we've had, but that concludes our call today. We thank you again for your interest in Diamond Estates, and we look forward to speaking to you again after our second quarter reporting. Thanks very much.

Operator

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

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