FINAL TRANSCRIPT

Diamond Estates Wines & Spirits Inc.

Fiscal 2018 First Quarter Financial Results Conference Call

Event Date/Time: August 24, 2017 — 9:00 a.m. E.T.

Length: 29 minutes

CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Bob Gibson
PI Financial — Analyst

Vay Jonynas
Altus Securities — Analyst

Tom Burke
Canaccord Genuity — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Sylvie (phon), and I will be your conference coordinator for today. At this time, I would like to welcome everyone to the Diamond Estates Wines & Spirits Fiscal 2018 First Quarter Financial Results Conference Call.

Note that 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. And if you would like to withdraw your question, please press *, and the number 2. Thank you.

Mr. Souter, you may begin your conference.

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

Thank you, Sylvie, and good morning, everyone. Welcome to the Diamond Estates financial results conference call for the fiscal first quarter ended June 30, 2017.

As stated by Sylvie, my name is Murray Souter and I'm the Diamond Estates' President and Chief Executive Officer. I'm joined today by Alan Stratton, our Chief Financial Officer, and I'll start this call by providing an overview of our results in the quarter and other key developments at the Company. Alan will then discuss the financials in depth, and I'll conclude with some comments on our strategy going forward. After that, we will be pleased to answer any questions you may have.

Before we 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 this morning for more information.

Q1 was a very solid quarter for the Company, reflecting continued growth in our core business versus 2016. That growth could have been even better had we not faced inventory shortages due to the poor harvests of 2014 and 2015. While we made every effort to maximize the profitability of our inventory by orienting our production towards the export and grocery channels, the 5.3 percent sales increase over Q1 2016 could have been double that if we hadn't faced that supply constraint.

Our strong sales performance was largely driven by the export and LCBO channels, which increased 23 percent and 32 percent respectively year over year.

The export business continues its robust growth, particularly in China where we have a strong strategic position in the marketplace. China is well on its way to becoming the world's second largest wine market in a few years, and we're pleased to see the Chinese demand for our products remains extremely strong.

We also continue to make progress in the LCBO channel, where our McMichael, FRESH, and EastDell brands are performing exceptionally well.

As many of you know, Diamond has benefitted from our strong position in the Ontario grocery stores. Every single grocer that currently sells wine in Ontario is carrying our products, and as a reminder, grocery stores are obligated to show strong support for local wine. Half of the locations are carrying 100 percent VQA, and the other half are carrying 50 percent VQA. As a leading VQA producer, we're ideally positioned to capitalize on this opportunity.

Diamond Estates has a substantial market share in the grocery channel, significantly above our overall share. As more store licences to sell wine are obtained and Canadians become accustomed to the convenience of buying wine through this channel, we are very well positioned to continue market gains.

We're also pleased with our financial result in the quarter. We reported revenue of $9.6 million in Q1, up 5.3 percent from the prior year despite the inventory supply issues.

Our EBITDA rose 11.5 percent to $1.4 million. The higher EBITDA increase reflects the operating leverage we are generating through sales increases. Our net income for the quarter of 0.9 million represented a 23.5 percent increase from last year. Alan will provide more details on the results in a few moments.

Now let me turn to some of the important corporate events in the quarter. The most significant occurred on March 5th when we completed a $4.4 million acquisition of a 49.99 percent minority interest in our agency business, Kirkwood Diamond Canada or KDC. This interest was previously owned by our joint venture partner Kirkwood Brands Limited, and as a result, we now own 100 percent of this business unit.

The transaction gives us ownership of a business with a seasoned cross-Canada sales force and significant unrealized potential, given the strong domestic and international brands we represent.

KDC sells more than 1.4 million cases of alcoholic beverages per year and is the fifth largest independent sales agency in Canada. Since we started the partnership with Kirkwood in 2014, the business has grown every year on both a case and a dollar basis.

By bringing this division under full ownership, we are confident that we can improve profitability through better focus and by capitalizing on the inherent efficiencies in the business. For example, we're currently in the planning stages of a new vision for the agency division that will leverage our regional expertise as we develop a national strategy in our approach to grocery and on-premise accounts.

We're also going to invest in new systems and the integration of the back-office functions to unlock cost synergies in distribution, sales, and brand management. We expect the agency business to represent growing, reliable, long-term cash flow generator that is complementary to our winery business.

Also in the quarter, on May 17th, we opened our new retail store at the Lakeview winery in Niagara-on-the-Lake. We now have a modern 25,000-square-foot space with attractive tasting area. We built this store in order to drive higher direct sales of our product at the winery, and all indications are that it is delivering as planned. Our winery is now one of the premier destinations for visitors to Niagara-on-the-Lake.

I'll now invite Alan to review our Q1 2018 fiscal results in greater detail. Alan?

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

Thank you, Murray. As Murray indicated previously, revenue in Q1 2018 was $9.6 million versus 9.1 million in Q1 2017, representing an increase of 5.3 percent. That increase was driven by growth in the export channel as well as the grocery stores, both in the winery division, and that therefore increased the proportion of revenue from that division up to 56.5 percent in Q1 2018 from 53.8 percent in Q1 2017.

Total revenue in the winery division grew 10.6 percent to $5.4 million in Q1 2018 from 4.9 million in Q1 2017. Export revenue increased 23 percent to $2.6 million as the Company continued to benefit from growth in demand from China.

Revenue from the Liquor Control Board of Ontario increased 32 percent in Q1 2018 over Q1 2017 as the Company continues to strengthen its position in that channel, which includes the grocery stores.

Partially offsetting growth in the export and LCBO channels were declines in revenue from bulk wine and licensee customers, driven by insufficient grape supply. As Murray indicated, we have allocated product to enable us to support our export and grocery customers, and as a result, several products have been temporarily discontinued, primarily affecting the LCBO and licensee customers.

This is an industry-wide problem in Ontario that is expected to ameliorate as grape supply improves. And as that supply permits, we intend to reintroduce the affected products back into the market.

Q1 2018 revenue in the agency division declined 0.9 percent to 4.2 million in Q1 2018. However, revenue in Q1 2017 did include an unusually high amount for contract severance from a supplier that we terminated a relationship with. Excluding that nonrecurring item, revenue in 2018 actually increased by 4.8 percent over Q1 2017, and that increase was driven by growth from several brands within the portfolio and across both Western and central Canadian regions, including Ontario.

Now excluding that nonrecurring severance revenue, the proportion of our revenue derived from commissions in Q1 2018 was up to 27.6 percent versus 26.1 percent last year. Note that a certain amount of movement between agents of suppliers is common in the industry and to be expected.

Now gross margin in the winery division increased 26.4 percent to $2.7 million in Q1 2018, representing almost half—49.9 percent of revenue—as compared to $2.1 million which represented 43.6 percent of revenue in 2017. And that improvement was driven by several factors, including lower spending on direct programming in the LCBO, some targeted price increases, operating leverage, improved product mix, and reducing sales of low-margin bulk wine to other wineries.

Now gross margin in the agency division was $1.7 million, representing 41.6 percent of that division's revenue. This was slightly higher than last year after excluding the severance payment in 2017 that I referenced a moment ago. And on that basis, the gross margin last year represented 40.8 percent of revenue. So the small increase does reflect actions taken to improve margins through pricing initiatives, cost control, and product mix, partially offset by margin reductions taken to clear out excess inventory.

Operating expenses increased 11.1 percent to $3 million, representing 31.2 percent of revenue from 2.7 million or 29.6 percent of revenue last year. The increase reflected higher personnel costs, in-store tasting programs in the grocery channel, advertising and promotional material related to the opening of the new retail store, promotional spending in support of the FRESH brand, and higher stores charges related to excess inventory balances in the agency division, which have been decreasing as excess product is sold through.

Q1 2018 EBITDA climbed 11.5 percent to $1.4 million from 1.3 million last year, representing EBITDA margins of 15.0 percent and 14.2 percent respectively. Net income rose 23.5 percent to 0.9 million in Q1 2018 from 0.7 million last year. As Murray highlighted, our EBITDA and net income growth is reflecting ongoing increased operating leverage across our business. As we continue to drive sales, our platform should continue to produce better profitability metrics.

Turning now to our balance sheet. Our working capital as at June 30, 2017 was $3.6 million, reflecting a reduction from March 31st, almost entirely attributable to the acquisition of the minority interest in our agency division, KDC.

Our debt-to-equity ratio was 1.05:1, up from 0.68:1 as at March 31, 2017 but still very healthy and again, reflecting the budget increase in bank debt resulting from the acquisition.

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

Murray Souter

Thank you, Alan. We're very pleased with the strong start to the year and are looking forward to the balance of fiscal 2018 and beyond. As we highlighted last quarter, we've broken ground on our capacity expansion at the Lakeview winery. This is a very important project as it will increase our processing and wine storage capability and capacity by approximately 3.6 million litres when completed.

This will give us significant economies of scale, lead to improved operating leverage and profitability. The capital cost of the current phase—of many phases—of the project is approximately $4.7 million and is expected to be completed in early calendar 2018. Construction is progressing on plan.

As I indicated earlier, we now have full ownership of KDC, and we're excited about the opportunities to improve results. We have undertaken a comprehensive review of the Company's operations and are implementing multiple initiatives to enhance capital and profitability.

Finally, we continue to explore opportunities to expand our winery business through acquisitions. The Ontario wine industry is highly fragmented with more than half of the market shares spread amongst approximately 150 smaller producers. We have a proven track record of success with the acquisition and integration of other wineries, and we're flexible enough to be able to move quickly when the right opportunities arise.

That concludes my remarks. Alan and I would now be pleased to answer any questions you may have. Sylvie, please open the line for questions.

Q&A

Operator

Certainly, sir. Ladies and gentlemen, if you do have a question at this time, please press *, followed by 1 on your touch-tone phone, and note that your questions will be taken in the order received. And if you should wish to withdraw your request, please simply press *, followed by 2. And we ask that if you're using a speakerphone, to please lift the handset before pressing any keys

And your first question sir, will be from Bob Gibson at PI Financial. Please go ahead, Bob.

Bob Gibson — PI Financial

Good morning, gentlemen.

Murray Souter

Good morning, Bob. How are you?

Bob Gibson

I'm okay. You note that you decreased spending on the direct programming in the LCBO. Can you give me a little colour on that and where you see that spending going in the future?

Murray Souter

We've had a long-term strategy of reducing what are known as off-price promotions—so limited time offers and bonus Air Miles—in order to generate sales. We believe that strong—that the brands need to have an investment, basically in below-the-line spending—advertisement, promotion, engaging with the customers. So we've been trending down over the past.

The most recent decline for the year was largely predicated on the basis that we had—we were short of bulk wine and inventory—finished goods inventory. So rather than promote it and sell it at a discount, we withdrew some of those programs. It'll settle out over the next—as product comes back into stock, starting with this fall—it'll settle out at probably slightly higher than where it is right now, but it won't return to the levels above.

Bob Gibson

Okay. Thank you. I know it's early days, but can you give me some colour on the new retail store? And how it's trending versus the old one?

Murray Souter

I can. It's doing very well. Now setting aside—as everybody knows in Ontario, it's been a rather wet May, June, July and August. But—and so we're seeing traffic down throughout the region. But we are matching against a year ago, which is extremely good, relative to our competitors.

What we are seeing is our average basket size is up significantly. And our average retail price has gone up, as have the margins within the store. So the margins in that facility, specifically were low 60s; they're now into the 70s. So we've seen both an upgrade in terms of the transaction value or the basket size, but also the individual items within that basket are higher margin goods. So all of that's very positive.

Bob Gibson

Excellent. And also early days. Any learnings on the agency business? And any colour on what you're going to do going forward?

Murray Souter

We're right in the midst of it, Bob, but I can tell you that we are—we see the—what we—what our—going in premise on opportunities, certainly around efficiencies and the ability to build the business are being proven correct. So that we anticipate that over the next several months, there'll be a number of revectoring exercise—or not exercises but activities that will bring that to fruition.

Bob Gibson

Great. Thanks so much.

Murray Souter

You're welcome, Bob.

Operator

Thank you. As a reminder, ladies and gentlemen, if you do have a question, please press *, followed by 1.

And your next question will be from Vay Jonynas at Altus Securities. Please go ahead.

Vay Jonynas — Altus Securities

Good morning.

Murray Souter

Good morning, Vay. How are you?

Vay Jonynas

Good, good. Couple quick things. You were talking about your bulk wine, and then you mentioned your bulk wine with respect to promotional spending. Now I thought that bulk wine was being sold to other wineries, but when you mentioned it with respect to promotional spending, that seems to imply that you're also selling it to consumers. Could you explain that?

Murray Souter

No. Vay, so what I was mentioning in my remarks from Bob Gibson's question was that we hold our inventory not in a finished state, but we hold it in a bulk state. And our bulk inventories of wine, which we would then move into finished goods, were low because of the short harvests of 2014 and 2015. So we actually—we don't sell bulk wine to the public. It goes through a bottling stage, cold stabilization, filtration, and then into bottling, and is sold only in finished goods packaging.

Vay Jonynas

Okay. You also mentioned that your licensee sales were down. Licensees, does that not refer to bars and taverns? Or is there a wider definition?

Murray Souter

No. That includes anybody who has a liquor—under the AGCO—who has their liquor license and is allowed to sell spirits, beer, or wine to the consuming public.

Vay Jonynas

Okay. And finally, I think the last conference call you mentioned that your Chinese distributor had about 32 stores. Have they increased the number of stores? And do they—are they planning to increase the number of stores? What's happening there?

Murray Souter

Yeah. I can report that they are continuing to expand. They still have their 32 or 33 owned stores, so the stores that they own. They are also franchising the cap—well, obviously to reduce the capital expense. But they're franchising, and they have plans for—I believe it's 300 but that's just my memory—of ultimately of having 300 distributors, and they've started that rollout.

Our Vice President of Winemaking was over recently to China and participated in their sales meetings and distributor meetings in early July, I believe it was, and they're going gangbusters over there.

Vay Jonynas

Okay. Thank you.

Murray Souter

You're welcome.

Operator

Thank you. Once again, ladies and gentlemen, if you do have any additional questions, please press *, followed by 1 on your touch-tone phone.

And at this time, Mr. Souter, we have no—I do apologize. We have a question from Tom Burke at Canaccord Genuity. Please go ahead, Tom.

Tom Burke — Canaccord Genuity

Yes. Hi, guys. Great quarter.

Murray Souter

Thank you, Tom.

Tom Burke

Just I saw a very interesting article, I believe it was in the Financial Post, about the rosé category which has just caught fire. Are you seeing a big trend there as well? Because I thought it was quite interesting, and for anybody else on the call, I'd draw their attention to that article. I thought it was very interesting about where this category's come almost out of nowhere.

Murray Souter

Yeah. The rosé category—I don't know if you've been to Europe in the last 12 months. My CFO is actually headed there this evening for vacation. Rosés have exploded in Europe, and that tends to be where the consuming trends or the consumers' trends begin. We've seen a big lift in the US, and we're now seeing it in Canada. The rosés have been very strong.

And we also are doing very, very well with rosés, and to the point where we've run out of stock on some items—have gotten back into stock, obviously, but it's—the demand has been significant. It's a light drink. It's a summertime drink, although they tend to also consume them in the fall, and it's doing very well with the consuming public, particularly amongst the Millennials, the younger groups.

Alan Stratton

We have a general listing with the LCBO for an EastDell rosé, and that's been a very popular product in that channel. It's one of the ones that we were able to push through a price increase on this year because of the popularity. And it's a staff pick in the LCBO because it's such a high quality.

Tom Burke

Right. And it serves kind of a for—can you exploit this trend to as much as possible? Do you see this as kind of a longer term thing where rosé's kind of here to stay?

Murray Souter

Yup.

Tom Burke

Is it a seasonal thing? Is it—are the Asians buying it?

Alan Stratton

It is a—well, there's seasonality to wine consumption period, depending on the varietal. Whites tend to be consumed more in the summer and less—and reds more in the winter. But rosé, we see it—we definitely see it sticking around. It's part of our—the method that we use to produce it is the Charmat method, and we plan on having our own in-house capability in the future on that, so we're making a significant commitment. We believe that rosés are here to stay.

Tom Burke

Great. And yeah, just one question on the general—the grape supply question. And is that necessarily a bad thing, that sometimes things are on allocation, you have this pricing power? And does this influence the general sort of pricing power in all the wine offerings? Because I think we've seen in history, be it in California or Australia, if there's a glut of grapes, is it a kind of careful-what-you-wish-for scenario at times?

Murray Souter

Well, it is. And we're—our—the Niagara region, which is where we are concentrated is, it's a rounding error in the world's grape production and wine production. We had a record in 2013 of 83,000 or 81,000 metric tonnes of grapes. And then '14 and '15, we didn't. And to be quite honest, I think that the quality of our product, the pricing of our product—we're able to compete on a world scale, but we can't do it without inventory.

So there would be no glut. If we had a 15 or 20 percent increase in tonnage or yield coming out of the fields, it would be consumed. We'd be able to—the industry would be able to use that through to the consumer, so. Australia, I know, they had many, many years of expansion in terms of vineyards and capacity, but they had declining sales in the two major markets they sell to, which were Europe and the United States. So they were authors of their own misfortune.

Even Bordeaux, when they have gluts, they—wine does pretty well over time. There's no best-before date for it, so. It survives very nicely as long as you continue to grow your demand, which we've been doing as an industry. VQA still—Ontario wines are still growing as are BC wines, so it's all very positive. I don't think we'd be suffering from a glut.

Tom Burke

Great. And just one final question on potential strategic acquisitions, that type of stuff. Are you guys still out there looking? Or do you feel you've got enough on your plate right now, in terms of some of your strategic initiatives and, of course, your capacity increases, et cetera?

Murray Souter

No. We're looking constantly, and we've been evaluating up until even very recently—and I mean very, very recently—opportunities, and we will continue. We're constantly looking in the marketplace.

Tom Burke

Great. Great. Hey. Look forward to some marketing at some point to get the Diamond Estates story out to a bigger retail audience. I think that's one of the missing links here a little bit, but great story and a very interesting story for retail investors.

Murray Souter

Great. Thank you very much, Tom.

Tom Burke

Yeah.

Operator

Thank you. Next is a follow-up from Vay at Altus Securities. Please go ahead.

Vay Jonynas

Okay. Now two months ago, you mentioned that you had the leading market share of facings in the supermarket channel. Is that still the case?

Murray Souter

Yeah. We have on average—I don't know if we had the leading—I don't know if I said the leading facings. We have about 700 SKUs listed in 70 stores, so we have an average of 10 facings per store, 10 SKUs per store. Facings are the number of bottles on the shelf. And that's still the case today; in fact, it's grown from two months ago. We still are top three. Our market share is about double what our industry market share is, so the channel for us is very well developed and continues to grow and perform very well.

Vay Jonynas

Okay. Also forgive my ignorance with respect to wine, but for whatever reason, I always associate rosés with sparkling wines. Is there some overlap there, or?

Murray Souter

Yeah. Rosés can be either/or. They can be a still wine or a sparkling wine.

Vay Jonynas

Okay.

Murray Souter

Rosé is—yeah. It's a wine—it's just a blush wine basically.

Vay Jonynas

Okay. Thank you.

Murray Souter

You're welcome, Vay.

Operator

Thank you. And at this time, Mr. Souter, we have no other question registered, sir. So I would like to turn the meeting back over to you.

Murray Souter

Okay. Well, thank you, everyone. That concludes our call this morning. Thank you very much for your interest in Diamond Estates and for listening to Alan and I through this morning. And we look forward to speaking with you again when we report Q2 towards the end of the calendar year. Thank you very much.

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 do ask that you please disconnect your lines. Have yourselves a great day.

*****