FINAL TRANSCRIPT

Diamond Estates Wines & Spirits Inc.

Fiscal 2018 Fourth Quarter Financial Results Conference Call

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PRESENTATION

Operator

Good morning. My name is Sylvie, and I will be your conference Operator today.

At this time, I would like to welcome everyone to Diamond Estates Wine & Spirits Fiscal 2018 Fourth 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 questions, please press *, and the number 2. Thank you.

Mr. Souter, you may go ahead and begin the conference.

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

Well, thank you very much, Sylvie, and good morning, everyone. Welcome to Diamond Estates conference call to discuss the financial results for fiscal fourth quarter and the 12 months ended March 31, 2018.

As Sylvie said, my name is Murray Souter. I'm the President and CEO of Diamond Estates Wines & Spirits, and I'm joined by Alan Stratton, our Chief Financial Officer.

I'll start this call by providing an overview of our results for 2018, as well as other key developments at the Company. Alan will then discuss the financials in depth, including our fourth quarter performance, and I'll conclude with some brief comments on strategy and market outlook. After that, we would 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.

2018 was a transitional year for Diamond Estates. We achieved some very important milestones, most notably we acquired full ownership of our agency business, we completed the first phase of our Lakeview Winery expansion, and we opened our new retail store at that site.

We also had some challenges. The short crop strategy we implemented in response to the poor grape harvest in 2014 and 2015 impacted our performance earlier in the year, and we had some operating challenges in the agency division, which I'm happy to report have taken time to resolve but are now fixed.

I'm pleased to say that we delivered solid financial performance during the fiscal year, despite the challenges we faced. Let me provide a brief overview of our annual results.

Revenue was 34.3 million in fiscal 2018, equal to our total for fiscal 2017. Gross margins increased 9 percent to 15.2 million compared to 13.9 million last year. As a percentage of revenue, gross margin was 44.3 in fiscal 2018 compared to 40.6 a year ago. EBITDA was 2.5 million, which was slightly below last year's total of 2.8 million, but on an adjusted basis, EBITDA, which is EBITDA before restructuring items, increased 13 percent year over year to 3.7 million.

Our financial performance in fiscal 2018 got a boost from the capacity expansion we completed at the Lakeview Winery, which boosted our operating leverage. As well as our increased export sales, we increased sales significantly, relative to last year. Our results also benefitted from an improved product mix, lower spending on LCBO programming related to the short crop strategy, and an increase in commission-based sales in the agency division.

We believe we are now in an excellent competitive position. We had a record grape harvest of almost 2,900 tonnes in 2017, calendar, up 16.3 percent from the prior year. We believe the short crop issues are now firmly behind us. We also took the important and difficult steps required to restructure the agency business and position it for better financial performance going forward. Our leadership in that business is doing an excellent job, and I'm very optimistic about our prospects for the year ahead.

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

Alan?

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

Thanks, Murray. We reported revenue of $34.3 million in fiscal 2018, in line with last year. The higher export sales offset fewer sales of our bulk wine, and an early year decline in domestic sales relative to the short crop strategy. As a reminder, we implemented that strategy to ensure that we had sufficient supply for the new grocery channel and our export channel, which are both strategically important to us.

Revenue in the winery division was 17.3 million, a slight decline of 2.1 percent compared to last year. Revenue declined by 1.1 million in the retail licensing and LCBO channels, due to the short crop strategy, and by 0.8 million in contract sales. That was largely offset by the $1.8 million increase in export revenue.

In our agency division, revenue was $16.9 million for fiscal 2018, up 2.1 percent from last year. This was primarily due to higher commission sales to reflect growth in the Ontario market. We're confident that financial performance in this division will continue to improve during fiscal 2019.

Gross margin in fiscal 2018 was $15.2 million, or 44.3 percent of revenue, and that compared to $13.9 million, or 40.6 percent of revenue last year. This improvement is a result of better product mix and reduced programming spending in the LCBO, as well as the increase in commission sales in the agency division that I just mentioned.

We had a total gross margin of $8.1 million in the winery division, 7 million in the agency division. These totals were up 7.9 percent and 10.3 percent, respectively, compared to fiscal 2017.

Total operating expenses in fiscal 2018 were 12.7 million, up 14.3 percent year over year. After normalizing for nonrecurring costs, including severance, restructuring costs, and onetime financing charges, operating expenses were $11.9 million, an increase of 4.9 percent from last year.

Employee compensation and benefits expenses increased, as we made some targeted new hires to support growth of our new business, including Chris Terrio, the head of our agency division. Advertising and promotion expenses were slightly higher in fiscal 2018, and G&A expenses increased by 7.9 percent due to investments in information technology as we upgrade our infrastructure and systems. We also incurred some legal fees early in the year associated with the acquisition of the noncontrolling interest in our agency division.

EBITDA was 2.5 million, down 11.9 percent from 2.8 million in fiscal 2017. However, after stripping out the nonrecurring items I just mentioned, our adjusted EBITDA of 3.7 million was up 13.7 percent—or, sorry, 13 percent from 3.3 million last year. And that reflects a margin equal to 10.9 percent of revenue in fiscal 2018 compared with 9.6 percent last year.

Net income was slightly positive compared to $0.5 million in fiscal 2017.

Now I'll turn to our fourth quarter results. It should be noted that our business is highly seasonal, and the January to March quarter is a typically slow period in which our sales are generally weaker than other quarters. Canadian wine consumption is lower in that part of the year, and winter conditions impact export sales.

But overall revenue in Q4 was $5.4 million, a decrease of 11.2 percent from 6.1 million last year. Revenue declined 29.3 percent to 1.9 million in the winery division. That was reflecting the decreased bulk wine sales and the impact of a temporary contract sale in Q4 last year.

The agency division revenue of 3.5 million was up 3 percent compared to last year. This was partly due to a sale of inventory related to a supplier that had terminated its relationship with us in Q3 2018.

Gross margin was 2.3 million in Q4 2018, which was similar to last year. Lower gross margin in the winery division was offset by higher gross margin in the [audio gap].

Operating expenses in the quarter were 3 million, up 8.9 percent compared to Q4 2017. The increase reflects severance expenses for an executive in the agency division, as well as some increases in salaries and benefits costs to attract and retain employees in a competitive environment. This was partially offset by a reduction in advertising and promotion.

The result is EBITDA was negative $0.8 million in the quarter compared to negative 0.5 million last year. Adjusted EBITDA was negative 0.5 million compared to negative 0.2 million a year ago. And we had a net loss of 1.4 million compared to a net loss of 1 million in Q4 2017.

And now, turning to our balance sheet. Working capital was $13.6 million as at March 31, 2018, an increase of 5.2 million compared to 8.4 million at the end of fiscal 2017. This was primarily due to the new operating facility with Bank of Montreal being presented as a long-term liability, because it is fully committed for a three year term.

During the same period, our debt-to-equity ratio increased to 1.22:1, up from 0.68:1. This was due to the elimination of the noncontrolling interest and increase in bank debt resulting from the acquisition of full ownership of our agency business in Q1 2018, and the additional funds borrowed from BMO in Q2 2018 to fund the expansion of the Lakeview Winery.

For your information, debt is defined as total liabilities less other current liabilities. And equity is defined as shareholders equity plus noncontrolling interest.

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

Murray Souter

Thank you, Alan. As I said earlier, this has been a transitional year for Diamond Estates that's had its share of challenges. But we are now well positioned to take advantage of the positive catalysts in the market and in our company. Let me talk briefly about a few of them.

Internally we continued our multiphase expansion of the Lakeview Winery. During this past calendar year—or sorry, during this calendar year we will expand capacity from 5.3 million to 5.8 million litres. This will provide additional operating leverage that will benefit both our top-line and bottom-line financial performance. Subsequent to 2018, we plan to increase capacity to 6.4 million litres over the following two years, so our operating leverage will continue to improve.

Externally, the Ontario grocery rollout is something we're watching very closely. While we can't predict timing, we do expect another tranche of licences to be issued relatively soon. The province, as you know, has committed to increasing the number of licensed stores from 70 today to 300 by 2025. And it will be interesting to see what the incoming government, to be sworn in on Friday at Queen's Park, decide if they're going to speed up the pace of that wine rollout, or in fact, if they will expand to grocery and convenience stores.

We worked very hard to maintain a leading market position in grocery, as we believe it will ultimately become the preferred venue for purchasing wine in Ontario. We recently advanced to the top position in terms of overall market share in the Ontario grocery channel. And we own four of the top ten selling SKUs in that channel.

This past year saw our winery brands win numerous national and international wine awards, and we are pleased to report that for the first time in our history we have won a double gold medal trophy for Lakeview Vidal ice wine, which won one of only five trophies, and we were the only Ontario winery to receive such an accolade this year, which is quite an accomplishment for our winemakers.

We are also continuing to evaluate potential acquisitions. The Canadian industry is highly fragmented, as you know, and we are one of the few natural consolidators. We have identified a number of promising opportunities, and continue to work through them, but finalizing these transactions is never easy. We're working very hard at it.

More wineries understand the benefits of partnering with us and capitalizing on our economies of scale, so we think it's just a matter of time. We're optimistic that we can complete accretive transactions that will build significant value for our shareholders.

Finally, I'd like to note that the fundamentals of our business remain very strong. Statistics Canada recently revealed that Canadian liquor stores, agencies, and other retailers sold $7.2 billion of wine in the fiscal year ended March 31, 2017, and that sales were up 3.1 percent overall compared to the prior year, fiscal year, government fiscal year. And sales in Ontario were up an impressive 4.3 percent.

We're also pleased to see that sales of Canadian wines rose 6.9 percent across the country. By comparison, imported wines were up only 1.4 percent, and beer sales increased only 0.7 percent year over year. So wine has been growing at a much faster pace. As StatsCan put it, more and more drinkers are opting for the grape.

That concludes our remarks this morning. Alan and I would now be pleased to answer any questions you may have.

Operator, please open the lines for questions.

Q&A

Operator

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

And your first question will be coming from Nick Corcoran at Acumen Capital. Please go ahead, sir.

Nick Corcoran — Acumen Capital

Good morning.

Murray Souter

Morning.

Alan Stratton

Good morning, Nick.

Nick Corcoran

My first question just has to do with how your products are doing in the Ontario grocery channel. I'm wondering if you can give us any data points on where they're standing right now?

Murray Souter

Yeah. So most recent quarterly results, we're at number one with a 12.9 percent share of market; our closest competitor was 12.1 percent. And then the other measure we have is a 12-month basis, so we're number two at I think it's at 12.1, and the number one is actually 12.7 percent. But they've been trending down; they're now actually in third place at 12 months. The leading competitor is now in third place in the most recent quarter.

Nick Corcoran

And then I think in the last quarter, maybe it was the quarter before, you talked about how you used your short crop strategy and you pulled some SKUs out of the LCBO channel.

Murray Souter

Correct.

Nick Corcoran

How is reintroducing those SKUs going?

Murray Souter

They're back on shelf now. It's been a slower process than we anticipated, much to the chagrin, I think, of the industry. As you know, the LCBO actually serves as the wholesaler of record and the actual wholesaler for both the grocery channel and for themselves. And they've been much slower in reintroducing the voluntarily delisted product towards the end of the quarter. We've actually elevated that discussion as an industry and individually ourselves as a company to speed that process, which we're now back in stock, but we were out of stock on those brands longer than we should've been.

We're back on shelf, though.

Nick Corcoran

Great. And then the last question for me just has to do with China and your export strategy. And you showed really good year-over-year growth between '17 and '18. What should we expect going forward?

Murray Souter

Well, we don't generally give you forward-looking statements. I can tell you that the Chinese market for red wine, which is the most important aspect of it, it's 193 million 9-litre common cases, which is the largest red wine market in the world. The red wine market is still forecast to grow 40 percent over the next three years. That's not per year; that's over the next three or four years. And we're seeing that in our business. We are seeing red wines growing dramatically, table wines growing dramatically, so we're pleased with that. That's—from a consumer aspect, table wines are consumed, whereas ice wines tend to be less frequency and tend to be a little more of a gift item, a little bit more of a gift item, but the table wines we're seeing good solid growth. So that bodes well for the future.

Nick Corcoran

Okay. That's all for me. Thanks a lot.

Murray Souter

You're welcome. Thanks, Nick.

Operator

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

Bob Gibson — PI Financial

Good morning.

Alan Stratton

Good morning, Bob.

Bob Gibson

Let’s just continue on this China thing. In your press release you said you expect exports to China to be less robust this year.

Murray Souter

Ice wine—well, the growth tends to be less robust. It should say—

Bob Gibson

The growth is—okay.

Murray Souter

Yeah—

Bob Gibson

So growth—okay. So not as robust on the growth. Perfect. And you did a lot of restructuring, eliminated a bunch of sales and marketing positions; maybe a little more colour on that? And are you going to have to replace anybody? Or, yeah, more colour.

Alan Stratton

When we bought out our minority partners, part of the reason we did it was saw that we could operate this business much more efficiently. We were a—or we are an operating company, so using common resources, accounts receivable consolidated, inventory management being consolidated, accounting functions being consolidated, financial reporting functions being consolidated, and that’s where really a lot of the restructuring came from.

There was also we probably had the wrong mix of sales operations in-field. We've corrected all of that, so we've consolidated a lot of the admin functions. We're going through that right now. We're investing in IT and data management for our decision-makers, which would be the marketing and sales folks in the organization. And all that is obviously—I don't want to use the word automation—but that's obviously freeing up more people to focus on the business, and we had some redundant positions. So that's really where the restructuring happened. We're through; we're completed that.

In terms of salesforce expansion or any other expansion will come with business growth as necessary, but we're investing a significant amount of money over the next two fiscal years in new ERP, which will support decision-making, will automate a lot of the finance functions, a lot of the reporting functions, make things less lumpy, and get us to a much smoother operation on that, those back office parts of the business.

Bob Gibson

Great. If Doug Ford changes how beer and wine is sold in Ontario, how might that affect you?

Murray Souter

Well, it's a big if. We're not quite sure what Premier-Designate Ford—at least he is for the next two days—is planning on doing, although he's made pronouncements about expanding grocery under the current AGCO guidelines and expanding to convenience and box stores or corner stores.

With the grocery side of it, we're very well positioned to take advantage of that. We have—if you do the math, we've got approaching 600 listings in those 70 stores. We're probably one of the top-listed brands or manufacturers in those stores. We've invested against trial in those stores. There's not a lot of things we can do within those stores. But as that expands, that capability and skill helps us expand our presentation into those stores, and it's going to be the same operators who are going to be opening up; Sobeys is going to double their number of stores or Loblaws is going to double their number of stores. So we're well-positioned for that.

The convenience store aspect of it, I think it's an unknown at this point, Bob. It's a very different business model than grocery. It's a different set of distributors who serve those retailers. They have different sets of wholesaler groups which we don't have a relationship with at this point, but it will be further out. My guess would be that there's a lot more work to do around the regulation of those stores, the monitoring of those stores, and that it will take some time for the government to get to that point. So I think that would be kind of the second domino to fall over.

Bob Gibson

Great. Thanks very much.

Murray Souter

You're welcome, Bob.

Operator

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

And at this time, Mr. Souter, it appears that we have no other questions. Oh, I do apologize. We have one more from Vay Jonynas at Hampton Securities. Please go ahead.

Vay Jonynas — Hampton Securities

Good morning. Good morning.

Murray Souter

Good morning, Vay. How have you been?

Vay Jonynas

Oh, confused, confused. Too much data. So one thing that's confusing me this morning, you just said that … referred to 600 listings in those 70 stores—

Murray Souter

SKUs.

Vay Jonynas

Who has 600 hundred listings?

Murray Souter

So the number of SKUs listed by the number of stores. So that would be an average of 10 or 11 per store. So—

Vay Jonynas

And that's your own? That's your own?

Murray Souter

That's our own. That's our own. So the average store in grocery has around—well, it depends on the number of footage, but anywhere from 100 to 150 listed SKUs per store times 70 stores would be somewhere north of 7,000 SKUs listed in the channel. And we have—

Vay Jonynas

Okay.

Murray Souter

—approaching 800 of those 7,000.

Vay Jonynas

Okay. Eight hundred as opposed to six hundred.

Murray Souter

Correct. Yeah. We're about … we're north of 750 right now.

Vay Jonynas

About 750. However, 70 stores? I thought beer and wine were allowed in more than 70 supermarkets across Ontario?

Murray Souter

There are 70—

Vay Jonynas

—seventy?

Murray Souter

Yeah. There's 70 licensed grocery stores. There's also the private wine stores called WRS, so winery retail stores, which are the ones owned by Peller, Arterra, and Colio.

Vay Jonynas

Okay.

Murray Souter

And those stores they also operate, but they're not grocery proper. They do have—53 of those stores are inside grocery, but they're operated by Arterra, Peller, and Colio.

Vay Jonynas

Okay.

Murray Souter

And we have an average of two listings, two to three listings with each of those stores as well.

Vay Jonynas

Okay. Now it was the policy of the previous Ontario government to expand from 70 stores to, what? 200 stores, or?

Murray Souter

Three hundred. Yeah. Three hundred stores.

Vay Jonynas

Three hundred over the next few years, but now we've got Doug Ford instead.

Murray Souter

Correct.

Vay Jonynas

So that could change; we don't know.

Murray Souter

My anticipation would be anything that was … that the Wynne government was involved in will change under the Ford government.

Vay Jonynas

Okay. Now another figure that you were mentioning, you said that the litre market share dropped down from 12.9 percent to 12.7 percent, and somebody had 12.1 percent. What were those precise figures that you just mentioned a couple moments ago?

Murray Souter

Yeah. Yeah. So our share in the most recent quarter—we measure the most recent quarter and the rolling 12-month basis. That's what we report on. We measure more than that, but that's what we report. So on the most recent quarter, we are about 12.9 percent share of market, which is above—

Vay Jonynas

Share of which market?

Murray Souter

Of the grocery market.

Vay Jonynas

Share of what market?

Murray Souter

Of the grocery market.

Vay Jonynas

Of the grocery market. Okay.

Murray Souter

Correct. And then on a rolling 12-month basis, we're about 12.1, I believe. Yeah. And then—

Vay Jonynas

So the most recent quarter you were 12.9 percent share of the grocery market.

Murray Souter

Correct.

Vay Jonynas

Okay.

Murray Souter

And the most … and over the most—the latest 12 months we're 12.1, so we're growing. That demonstrates we've—

Vay Jonynas

Okay.

Murray Souter

—gone from 12.1 to 12.9. And our leading competitor, who will remain nameless, has gone the opposite direction, so they've gone from number one to number three.

Vay Jonynas

Oh. And so you're now number one you'd say.

Murray Souter

Number one in the most recent quarter, yes.

Vay Jonynas

Okay.

Murray Souter

And number two, number two over the last 12 months.

Vay Jonynas

Okay. And finally, I saw that you lost Iceberg Vodka from your distribution channel. I still get the impression that you're having trouble with your distribution business. Have you addressed that?

Murray Souter

Yeah. Iceberg is no longer with us. They chose to go a different route to market. It wasn't performance-based. We were growing them at kind of 20, 25 percent. In the distributor business, you do tend to come and go. We didn't talk about it on the call, but Iceberg has left but we've picked up other businesses like Malfy and a number of other brands, Josh, the portfolio for the Deutsch Family Wines, which is the number-one selling California wine right now in the channel has … that's expanded.

We generally don't talk about those because they come and go on a regular basis; it just happens to be a part of the business. Most suppliers are with their distributors for three to five years before they change, and often it's not for any specific reason, other than they want a change.

Vay Jonynas

Would you anticipate that your distribution business would be relatively flat compared to the 2018 fiscal year, in the coming year, or?

Murray Souter

Well, we don't—

Vay Jonynas

You're hoping for some growth?

Murray Souter

Yeah. Vay, we don't—we often—we have planned for growth, but we don't comment on forward-looking statements.

Vay Jonynas

Okay.

Murray Souter

If you look back over the past year, we did grow the business, the agency side of our business, the distributor side of the business, and we grew it from the previous year to that as well. So we have good growth right now.

We would anticipate and we would plan for growth, but we wouldn't give you a number on that.

Vay Jonynas

Okay. Those are my questions.

Murray Souter

Great. Thank you, Vay.

Operator

Thank you. And at this time, Mr. Souter, we have no other questions registered, so I would like to turn the call back to you, sir.

Murray Souter

Well, thank you. Thanks, everyone, for joining the call. And that concludes my remarks for this morning.

Thank you for your interest in Diamond Estates, and we look forward to speaking with you again in August when we report our first quarter earnings.

Thanks 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.

Enjoy the rest of your day.

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