FINAL TRANSCRIPT

Diamond Estates Wines & Spirits Inc.

Fiscal 2018 Second 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 the Diamond Estates Wines & Spirits Fiscal 2018 Second 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. And if you would like to withdraw your question, please *, then the number 2. Thank you, everyone.

Mr. Souter, you may now begin your conference, sir.

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

Thank you, Sylvie, and good morning, everyone. Welcome to Diamond Estates' fiscal results conference call to discuss the financial results for the second quarter ended September 30, 2017. My name is Murray Souter, and I'm the 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 results in the quarter and other key developments at the Company. Alan will then discuss the financial results in depth, and I'll conclude with some comments on our strategy and the broader market. 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.

While we are disappointed with the Company's financial results for the second quarter of fiscal 2018, we are confident that our recent operating challenges are short term in nature. We have implemented significant measures to improve performance in the second half of the fiscal year and beyond, assisted by the return to more normal levels of finished goods.

This was a challenging quarter for Diamond Estates. The performance in both our winery and agency businesses was below our expectations. We reported revenue of 8.9 million in Q2, down 13.2 percent from the prior year; EBITDA declined to 800,000 from 1.4 million last year; and net income was slightly positive compared to 0.8 million in Q2 2017.

The challenges in our winery division relate back to the winters of 2014 and 2015. In February of both those years, there were severe bouts of cold weather in the Niagara region that caused significant damage to the vineyards in the region that ultimately led to reduced grape harvests. While one year of reduced harvest is manageable, the nature of these back-to-back shortages severely impacted both us and the industry in general.

Recognizing that this was going to be a challenge for us to manage growth in the face of insufficient supply, we implemented a short-crop strategy. Strategically, we analyzed our business channels and product categories based on how each supports our long-term strategic vision for the Company and on their long-term profitability.

The strategy was to allocate our lower-than-normal inventory to our most profitable brands and products and priority sales channels in order to maximize profitability in the short and long terms. Our analysis clearly indicated that priority should be given to our export and our emerging grocery channels.

The grocery channel is in its infancy and is showing significant promise as the retail channel of the future in Ontario. We believe grocery will eventually become the preferred sales channel for consumers in this province. We decided it was essential to establish a strong market share in grocery right at the beginning.

With respect to the export channel, we have a significant established position, and see continued growth as our partners expand their distribution base. This channel currently represents a significant portion of the Company's sales volume, and it is anticipated that it will continue to grow and strengthen in the future.

Ensuring adequate supply to these two channels required us to slow our growth in other channels. Recognizing that we could not turn water into wine, we implemented a strategy or program to slow sales in other sales channels, including the LCBO and our on-premise channels.

This included voluntarily withdrawing several products from distribution through the LCBO and temporarily converting some of our on-premise VQA products to International Canadian Blends, or ICB, products. Additionally, we scaled back significantly on promotional programming within the LCBO channel, and implemented price increases on select products to slow growth.

In the end, we were very successful in achieving our objectives of slowing demand; in fact, too successful, as these products slowed significantly versus their prior years' performance. The net impact of these actions in the second quarter was that sales declined 33 percent versus the prior year.

While our short-crop strategy ultimately had a more negative impact on our financial results than we anticipated, I'm very confident that we have resolved these issues and will return quickly to our growth curve.

Our grape harvests in 2016 and 2017 were much stronger than the prior two years, and some of those wines are now beginning to reach maturity. As a result, we have already reintroduced many of the delisted products into the LCBO, and have also increased our LCBO programming activity in the third and fourth quarters of our fiscal year.

We anticipate that these efforts should lead to significantly stronger sales compared to the second quarter.

The first phase of our capacity expansion was substantially completed on time and under budget this past quarter and added 600,000 litres of capacity to the winery, all of which is being fully utilized at the moment. As you saw in the press release, we processed a record tonnage of grapes this year, and our winemakers are very pleased with the quality and quantity of this year's harvest.

Our agency division also encountered numerous supply chain challenges in the quarter, largely originating from third-party logistics suppliers in Western Canada and offshore supply partners who are unable to ship orders in a timely manner. The result was that some orders moved from the second quarter to the third quarter. We have addressed those issues, and anticipate a return to more normal supply logistics for now and into the future.

The other significant activity in the quarter within the agency division was the appointment of Chris Terrio, a highly experienced beverage alcohol executive, as president of the division in October. Under Chris' leadership we have already initiated actions to significantly improve performance, including a workforce reduction, and are implementing structural changes in how we operate to improve performance in the division.

We are confident that these actions and Chris' leadership will lead to significantly improved operating results for our agency.

Overall, the second quarter was a frustrating period for us. Our business had strong momentum going into Q2, and it was unfortunate that circumstances prevented us from maintaining it. However, I am very confident we have taken the appropriate corrective actions, and our performance will be stronger in the second half of the fiscal year.

I'll now invite Alan to review our Q2 2018 financial results in more detail.

Alan?

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

Thank you, Murray. Revenue for Q2 2018 was $8.9 million versus 10.3 million in the second quarter of 2017, which as Murray said, was a decrease of 13.2 percent, all attributable really to the impact of the short-crop strategy that Murray discussed in detail, as well as the supply chain challenges we experienced in our agency division.

In the winery division alone, total revenue was 5 million, down 17 percent from the prior-year period. However, export revenue was $2.5 million in the second quarter, which is up 8.1 percent from last year, and as Murray indicated, is one of the priority channels.

These figures reflected the impact of that short-crop strategy under which we temporarily delisted 10 stock-keeping units from the LCBO channel, and sold substantially less bulk wine to other wineries and food processors in order to protect our supply for our grocery and export channels.

Second quarter revenue in the agency division was weaker than expected coming in at $3.9 million, down 7.5 percent from the $4.3 million recorded last year. As Murray said, the business underperformed due to a combination of factors that are largely related to supply chain management by third parties.

Gross margin in the winery division was $2.3 million in the second quarter of fiscal 2018, down 11.6 percent from the comparable period last year. Gross margin as a percentage of revenue in the winery division increased to 46.7 percent in the quarter compared to 43.7 percent last year.

That significant improvement reflected the measures undertaken in the LCBO channel, as well as the reduced sales of bulk wine as part of our short-crop strategy.

Gross margin in the agency division was $1.6 million in the second quarter of fiscal ’18, down 11.5 percent from the comparable period in fiscal 2017. Gross margin as a percentage of revenue in the agency division declined to 40.2 percent compared to 42.0 percent last year. That decline is primarily due to remaining provisions taken in the second quarter to clear out excess inventory and destroy obsolete product in Western Canadian markets.

Excluding this onetime item, gross margin in the second quarter actually would have increased by 3.7 percent from the prior year, reflecting actions that were taken to improve margins this year through pricing initiatives, cost control, and product mix, partially offset by those reductions taken to clear out the excess inventory.

Total operating expenses were $3.1 million in the second quarter of fiscal 2018, up 4 percent compared to the prior year. Compensation and benefits were actually down versus Q2 last year due to costs related to the separation of three employees in Q2 2017.

EBITDA in the second quarter of fiscal 2018 was approximately 0.8 million, down from 1.4 million in the year-ago quarter. And net income was slightly positive in the second quarter, down from 0.8 million in the prior year.

With the strong 2016 and 2017 harvests, in addition to multiple changes at KDC, we are very confident of a return to growth in the short run.

Turning to the six-month period ended September 30th, we had revenue of 18.5 million, down 4.5 percent from the 19.4 million in the first half of fiscal 2017, again reflecting the effect of the short-crop strategy.

Overall, revenue in the winery division was 10.4 million year to date, down 4.7 percent from the prior-year period. However, export revenue of 5.1 million year to date was up 13.6 percent from last year.

Revenue in the agency division was $8.1 million year to date, down 4.2 percent from last year.

Our gross margin in the first six months was $8.4 million, down 0.7 percent from the prior year. Gross margin as a percentage of revenue increased to 45.1 percent in the first half of fiscal 2018 compared to 43.4 percent in the comparable period last year. That partially offset the impact of the decline in revenue.

Total operating expenses for the six months of fiscal 2018 were 6.1 million, up 7.3 percent year over year. Employee compensation and benefits expenses declined in fiscal 2018 relative to the year-ago period, largely due to those severance payments made in fiscal 2017.

As a result, EBITDA declined 17.7 percent to 2.2 million in the first six months of fiscal 2018 compared to 2.7 million in the comparable period last year. Net income declined to 0.9 million in the year-to-date period compared to $1.5 million last year.

I'll now turn to our balance sheet. Working capital increased substantially by 4.7 million to $13.1 million as at September 30th compared to 8.4 million at year-end March 31, 2017, and that was as a result of the new operating facility with Bank of Montreal being presented as a long-term liability because it is a commitment for a three-year term.

During the same period, our debt to equity ratio increased to 1.06:1 from 0.68:1, which is a result of eliminating the noncontrolling interest in our KDC division, as well as increasing the bank debt resulting from that acquisition in Q1, and the additional funds borrowed in Q2 used to fund the expansion of the winery facility.

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

I would especially like to highlight the importance of our new banking facilities that we consummated on September 29th with Bank of Montreal. Not only does it come at senior lender rates, it provides capacity for us to execute against our strategic growth plan by providing expandable facilities up to $30 million.

We retired a total of about $18.5 million in debt that was outstanding under loans from both CIBC and Meridian Credit Union, and we expect the new facilities will lead to annualized interest savings of roughly $100,000 as the lower cost of borrowing is partially offset by the assumption of additional term debt to fund the first phase of the winery's expansion, which we substantially completed in September.

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

Murray?

Murray Souter

Thank you, Alan. I am confident that our business is now on much stronger footing compared to the second quarter, and we are regaining our momentum as we speak.

Looking ahead, there are numerous reasons for us to be optimistic. Let me highlight a few of them now.

As Alan just noted, the first phase of our Lakeview winery expansion in Niagara-on-the-Lake is substantially complete. The expansion provides enhanced scale that allows us to generate increased operating leverage and profitability. Our capacity will increase from the current 5.1 million litres to approximately 6 million next year as phase two of the expansion gets built out. As I stated earlier, phase one was on time and under budget.

We're also pleased that the Ontario government has agreed to fund up to 600,000—6 million of that total cost of the expansion over the next three years.

On the grocery front, we're expecting the Ontario government to issue a new tranche of grocery licences in the near future. As a reminder, we are one of the top three suppliers in the grocery channel. Seventy stores are currently licensed, a number that will increase to as high as 300 by 2025. Half the stores will carry 100 percent VQA wine, and the other half will carry 50 percent.

We have the right products at the right prices to maintain a very strong position in this increasingly important channel.

We're also continuing to evaluate potential acquisition opportunities in our winery division. We're keen to add brands to our portfolio, and there are a number of producers in Ontario that are attractive to us. We recognize that our scale is a competitive advantage, and there are benefits to partnering with Diamond Estates.

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

Q&A

Operator

Certainly, sir. Ladies and gentlemen, if you do have a question, please press *, followed by 1 on your touch-tone phone. Note that your 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 ask that if you're using a speakerphone to please lift the handset before pressing any keys.

And your first question will be from Corey Hammill at Paradigm Capital. Please go ahead.

Corey Hammill — Paradigm Capital

Good morning, guys.

Murray Souter

Good morning, Corey.

Corey Hammill

I have a bunch. I'm just going to run through a few here. First, you talked about having to short ship certain channels, specifically the LCBO. Are there any ongoing negative side effects to doing that in terms of getting that shelf space back or those listings back?

Murray Souter

No. The LCBO, recognizing the channels for the industry, implemented a voluntary withdrawal or voluntary delisting program so that you could actually advise them, delist your product, and when back in inventory they would put it back—would buy … obviously buy up inventory and put it back on its shelf. So that's happening now.

Corey Hammill

Okay. So that's—it's a coordinated effort?

Murray Souter

It was.

Corey Hammill

You obviously weren’t alone in—I mean, we can go through the grape harvest, but everybody was faced with similar problems from those two—

Murray Souter

Yeah.

Corey Hammill

—difficult years. In terms of the—

Murray Souter

There was a number of—

Corey Hammill

In terms of the outlook for the second half of the year, now would you say that the impact is basically now done and we could get back to seeing growth on the revenue side in the winery business Q3 and Q4? You’ve had a string of quarters where revenues have been increased; this was a bit of an anomaly that revenue actually came down. So curious if it’s a one-and-done and we’re back on track? Or if this could linger a couple more quarters?

Murray Souter

We are back—I mean, yes, we will continue to go back onto the growth curve, as we talked about in my remarks. The industry has faced this inventory shortage. I can only talk for us for our side of the equation. We are back in stock. We are now—the products that were delisted or were in short supply are now back in good inventory position, so we will start aggressively pursuing additional sales volume in that channel.

Corey Hammill

So the tough years were ‘14 and then ‘15 for tonnes of harvest. Can we assume that the bulk of what you’ve cellared from those years is now hitting the market and you’re starting to take advantage of what was a pretty good bounce-back in 2016? Is that how we should think of that as it’s working—

Murray Souter

Yeah.

Corey Hammill

—or it mostly works its way through?

Murray Souter

Yeah. We are coming to the end of bottling out our ‘15 vintage. There’s some ‘14 that’s floating around, but those are smaller volumes of reserve reds. We’re coming to the end of ’15, and we’ll be starting into ‘16. We’ve actually started into some of the early maturing varietals already, and we will—that will expand as we go through the year and we’re back into a good position in terms of—or better position in terms of inventories.

Corey Hammill

Okay. Just two more. On the agency side could you just be a little more specific about what actually happened specifically in Western Canada where you talked about not being able to get product? That was a bit of a surprise for me.

Murray Souter

Yeah. Well, it wasn't that we weren't getting product. It was product—it's the third-party logistics that are part of the buy-sell operations in Western Canada. They're controlled—they're licensed by the provincial liquor authorities in Alberta and BC. It was the BC third-party group that has had a significant number of employee turnover and were very delayed in getting orders fulfilled through that period.

Corey Hammill

Has that rectified itself? Or is it an ongoing problem?

Alan Stratton

They're working through it right now.

Murray Souter

Yeah.

Alan Stratton

They've hired a new manager and some new staff, and we've been pushing them hard on which orders need to get prioritized from our side. In addition, some of our foreign suppliers that failed to ship orders on time in Q2 we've been working with them to get their fulfillment cycle on track as well. So there were some stock-outs out west because of some product that didn't arrive in time.

Corey Hammill

Has that cost you any customer relationships at this point?

Alan Stratton

Well, the customers are the liquor boards, generally speaking. It doesn't—because they understand the nature of the industry, sometimes you end up with temporary supply disruptions, so they work with us on it.

Corey Hammill

Okay. And the last one I have is about the credit facility with BMO. So leverage in this quarter ticked up from where it's been. Can you remind us, are there any EBITDA leverage covenants on this? And given it's the first quarter you've had this and leverage ticked up, are they still … BMO still comfortable? And was this all part of the due diligence that they did? Were they aware that is was going to tick up before it comes back down?

Alan Stratton

Yes. We had worked closely with BMO, and obviously we're onside all the covenants. The notes to the financial statements do discuss them in detail. The EBITDA covenant is—or debt service covenant is 1.25:1, and so we were safely onside that in the quarter. And we don't anticipate there being any challenges meeting the covenants in the future.

Corey Hammill

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

Murray Souter

Thanks, Corey.

Operator

Thank you. Next question will be from Vay Jonynas at Wellington-Altus Securities. Please go ahead.

Vay Jonynas — Wellington-Altus Securities

Good morning. A couple completely unrelated questions. With respect to the crop problems that you had in 2014 and 2015, what's puzzling me is how it would all of a sudden impact your revenues in the September 30th quarter? Because there would seem to be a two-year time lag, and yet you expect those problems to be largely worked through the system in one quarter despite the fact that there seems to be a two-year time delay. And also my understanding is you've … you faced a shortage of grapes, yet which meant that you could not produce enough wine, although you do mention that the 600,000-litre capacity expansion, which was largely finished in September and you're now fully utilizing that capacity expansion despite the shortage of grapes to which you alluded. So it doesn't seem to me to add up. Could you comment on that?

Murray Souter

Yeah. That's a multipart question, but let me walk you through it. The harvest of 2014 and 2015, generally speaking, with red wine it's two harvests and potentially three harvests that we store the wine and allow it to age. So even though, for example, we've taken in wine—grapes this 2017 a record tonnage of 3,100 tonnes, it takes at least a year for white wines to mature to the quality level that we would bottle them out, and red wines at least two years. So 2014, calendar 2014, which is our 2015, those wines … the wines that were harvested at that point the reds would start to be available in calendar 2016. So it was towards after harvest last year that we would have started to bottle them out.

Of course your supply is based on also what your demand is, and we've been growing our business quite aggressively over the past two years, both domestically and export. And 9 or 10 months ago when we started matching up our demand with supply, it became evident that we were going to run out of feedstock, out of wine, bulk wine, well before the end of—'til before we got 2015 and 2016 harvested grapes into the bottles or into the position where we could produce them. So that's the time lag on that.

With respect to the capacity that we've added this year, the 600,000 litres of additional red fermenters which were put in place this year and what's being added next year, that will provide feedstock or bulk wine two years from now. So we'll start to draw that down for some of the Bordeaux styles in about this time in 2019.

Vay Jonynas

Okay. Completely unrelated question with respect to the grocery store channel. Now my local Loblaws store has a Wine Shop that migrated into the regular aisles. And you had mentioned that you weren't going to be getting into the Tetra Pak or cardboard boxes because it didn't seem to fit with the grocery store channel buying habits, yet at my local Loblaws store I see, if anything, an increase in the boxes and the Tetra Paks. In fact, I asked the lady working there and she says, oh, it's a very good seller. Their single-best seller was the Peller Estates Pinot Grigio and in the box, and she says that's what she buys herself. And then when I started to think about it, well grocery store channels are populated more solidly by women who are value-conscious buyers, much more so than men.

Now also in my local Wine Rack I find that they're expanding the boxes and the Tetra Paks into the Jackson-Triggs name brand and not just the Sawmill Creek. So are you reconsidering not packaging your wines in the Tetra Paks and the boxes? There does seem to be a market for it in grocery stores for that type of packaging.

Murray Souter

Okay. Thank you, Vay. What you're referring to is actually a private wine store that is owned by Andrew Peller. It's not the grocery licences which we participate in, although Peller and Arterra—

Vay Jonynas

Mm-hmm.

Murray Souter

—and Colio are required to carry competitive products on their shelves. Those are wine kiosks that used to be exterior to the store are now being moved inside and combined with a beer licence that the grocer owns. And they're required to carry—they can carry their own products, but they're required to carry 50 percent of their VQA product needs to be competitive product. So it's the government forcing them to open up their shelves.

We're not allowed to sell in that channel what you're referring to as cardboard or Tetra Pak, which is bag-in-box.

Vay Jonynas

Right.

Murray Souter

We are not allowed to sell those products in that channel. As well, we're not allowed to sell International Canadian Blends, ICB, product in those channels. It's only VQA that we can sell in those channels, which our competitors—literally competitors' licences.

So yes there is—and to your last comment—yes, there is a demand for bag-in-box product. It's largely controlled by a couple of the larger winery operations, Peller and Arterra and Colio. Pelee does have some entries into it. The LCBO has been very restrictive in terms of what's available on the shelf in those product categories, and we don't have a large ICB presence. We have a relatively small specialty brand located in that. And most of our product, in fact about 95 percent of our sales, are VQA.

Vay Jonynas

Now are you saying that the wines available in the box and bags and in the Tetra Paks are not VQA wines?

Murray Souter

That's correct. There's only two very small brands that the LCBO is trialling right now. One is Fielding Estate. I believe they're calling it the Weekend Wine Company or something like that.

Vay Jonynas

Mm-hmm.

Murray Souter

And the other one is a Pelee brand. The others are all controlled by Peller, and they are not VQA. Peller are not—

Vay Jonynas

They're—

Murray Souter

They're blended wines.

Vay Jonynas

They're blended wines. Okay. Yeah. Of course—

Murray Souter

If you look on—

Vay Jonynas

I wouldn't know the difference.

Murray Souter

Yeah. If you look—

Vay Jonynas

Mm-hmm.

Murray Souter

—Vay, if you look on the label it'll say—

Vay Jonynas

Mm-hmm.

Murray Souter

—produced from a blend of domestic and international wines.

Vay Jonynas

I see. Okay. Interesting.

Operator

Did you have any further questions, sir?

Vay Jonynas

No, I did not.

Operator

Thank you. Ladies and gentlemen, as a reminder if you do have any questions, please press *, followed by 1 on your touch-tone phone.

And currently, Mr. Souter, it appears that we have no other questions registered.

Murray Souter

Okay. Thank you.

Operator

Thank you, sir. Ladies and gentlemen, this does 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.

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