FINAL TRANSCRIPT

Diamond Estates Wines & Spirits Inc.

Fiscal 2019 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 Diamond Estates Wines & Spirits Fiscal 2019 Second 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 number 1, on your telephone keypad. And should you like to withdraw your question, please press *, then number 2. Thank you.

Mr. Souter, you may begin.

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

Thank you, Sylvie. And good morning, everyone. Welcome to the Diamond Estates Conference Call to discuss our financial results for the fiscal second quarter ended September 30, 2018. I am Murray Souter, Diamond Estates' President and Chief Executive Officer, and I'm joined by Alan Stratton, our Chief Financial Officer.

I'll start this call by providing an overview of our Q2 results and other recent developments at the Company. Alan will then review our second quarter financial performance in depth, and I'll conclude with a discussion of our strategy and outlook. After that we would be pleased to answer any of your questions.

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.

The second quarter was highlighted by improved domestic sales performance in our winery division and major progress in the ongoing turnaround of the agency business. However, our financial results were negatively impacted by two factors that we had previously discussed, the lower export sales in our winery division and the loss of a key supplier in our agency.

We reported revenue of 8.2 million, a decline of 8.3 percent from 8.9 million in the second quarter of fiscal 2018. Gross margin was 37 million, down marginally from a similar number of 3.8 million last year. And EBITDA was $300,000, down from $800,000 in Q2 2018. We reported a net loss of $400,000 compared to a slight positive net income last year.

While we aren't happy with those overall numbers, we had some major accomplishments in the quarter. We achieved a number one market share position in the Ontario grocery channel with a 14-share market, and this has been a major focus for us as grocery sales will become increasingly important in the province as more stores get licensed to sell wine. I'll speak more about this later in the call.

We also generated strong sales growth in the LCBO channel. As we had previously discussed, we temporarily delisted several products in the LCBO last year and reduced marketing activity in the channel because of short-term inventory challenges. It took some time for us to reintroduce products and recapture sales momentum we previously had, but our recent efforts to engage directly with the stores to increase listings and improve shelf placements have been very successful. Overall, we generated a 17 percent increase in sales in the LCBO channel, which includes grocery, as compared to Q2 last year.

On the other hand, we were disappointed by the decline in the export sales during Q2. This relates to an issue with our key distributor in China, which is experiencing delays opening new stores. As a result, they continue to work through their excess inventories and have reduced new purchases. We are confident that this is a temporary issue as we've been recently advised that they have opened approximately 16 new stores, which were originally scheduled to open in calendar Q1.

Our distributor has been able to work through many of the issues associated with the delay, and we anticipate that they will renew their growth cycle in the near future. Our partnership with this distributor is a major competitive advantage for Diamond Estates, and we are certain that China will continue to be an important market for us.

On the agency side, we rebranded the division during the second quarter, changing the name from Kirkwood Diamond Canada to Trajectory Beverage Partners. This new name reflects the projected growth and new sales and marketing activity in this business. Trajectory continues to focus more of its resources on brand building and will form stronger relationships with a select group of partners in the beverage alcohol industry. This major strategic approach is expected to drive strong growth over time and minimize duplication and internal competition within the portfolio.

We also moved the agency into a new, renovated head office in Oakville during the second quarter.

We previously noted that we are forming new partnerships in the agency business to replace lost business from the supplier that ended its relationship with us. We are seeing solid revenue growth from these new relationships, and over time, we believe that they will more than offset any lost business. We also believe Trajectory's new business model will lead to better retention of key suppliers over the long term. Relationships are often transitory in this industry and we want to change that.

Overall, while there was a mixture of positive and negative news in our second quarter results, we believe we are on the right strategic path. The first half of 2018 was a transitional period for the Company with a lot of key developments, including the Backyard Vineyards acquisition and the rebound in LCBO listings. We believe we have strengthened our competitive position, paving the way for stronger profitability in the longer term.

I'll now invite Alan to review the second quarter financial results in more detail. Alan?

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

Thank you, Murray. Revenue in the fiscal second quarter was $8.2 million, a decline of 8.3 percent from the $8.9 million reported in Q2 last year. As Murray discussed, the decline was due to the lower export sales in the winery division and the loss of the large supplier in the agency division, which has been a common theme this year.

Revenue in the winery division was $4.9 million, a decline of 0.1 million from Q2 2018. Export sales dropped by 0.8 million because of our Chinese distributor's lower-than-planned new store growth, but this was partially offset by increased sales through our LCBO and grocery channels and 0.5 million of revenue from Backyard Vineyards in British Columbia, which we acquired in late June 2018.

Agency division revenue was $3.4 million in the second quarter, a decline of 0.6 million year over year. The lost supplier we discussed had contributed 0.8 million of revenue in the second quarter of fiscal 2018. Q2 2019 agency revenue also included severance of $0.2 million related to a separate supplier that concluded its agency relationship with us.

Gross margin in Q2 2019 was $3.7 million, a slight decline of 0.1 million or 1.5 percent compared to Q2 of last year, and this was partly related to the accounting for the Backyard Vineyards acquisition, as the inventory on that acquisition was recorded at fair value rather than cost, which is in accordance with IFRS rules. Accordingly, there was only a margin of 15 percent on that $0.5 million of sales the Backyard contributed during the quarter. This significantly impacted gross margin in the winery division. The overall gross margin in the division was $2.1 million, down 11.4 percent year over year. Gross margin percentage was 42.6 percent compared to 46.7 percent in the prior year. Normalizing for the impact of the acquisition accounting, gross margin in the winery division would actually have been 46.5 percent, which is similar to Q2 2018.

The lower gross margin in the winery division was partially offset by increased gross margin in the agency division. For that division, gross margin was $1.7 million, an increase of 14.2 percent from Q2 2018. As a percentage of revenue, that gross margin hit an all-time high of 50 percent in the quarter compared to 37.2 last year. And that increase was due in part to the loss of that major supplier relationship as margins tied to business from that supplier were only 17.3 percent in Q2 last year. In addition, the severance revenue we recorded improved agency gross margin in Q2 2019 by 3.9 percent.

Our total operating expenses were $3.4 million in the second quarter, an increase of 0.4 million from the $3 million reported last year. Employee compensation and benefits increased by 0.3 million year over year due in part to bonuses paid to certain executives following a review by the compensation committee as well as the acquisition of Backyard Vineyards that resulted in overall wage increases of approximately 0.1 million compared to Q2 of last year.

EBITDA was 0.3 million in Q2 2019 compared with 0.8 million last year. And after stripping out the acquisition costs and the costs of goods sold adjustment for the fair value of inventory sold from Backyard Vineyards, we had adjusted EBITDA of 0.5 million compared to 0.9 million last year. And that reflects a margin of 6.3 percent of revenue in Q2 2019 versus 9.9 percent in the prior-year period. Net loss was $0.4 million for the quarter compared to slightly positive net income in Q2 of last year.

Now turning to our balance sheet. Our working capital has increased to 15.1 million at the end of the second quarter, up by 1.5 million from 13.6 million at March 31, 2018, which was our fiscal year-end. And that was due in part to the Backyard Vineyards acquisition as well as the seasonality of our business as sales in our fiscal fourth quarter, which covers the January to March period, are typically lower than the first and second quarters of the fiscal year.

Now during the second quarter, the Company's directors exercised options that raised gross proceeds of approximately 0.5 million for Diamond Estates. A total of 2 million options were exercised at a price of $0.20 a share. An additional 500,000 options were exercised at a price of $0.25. Management was pleased to see directors increasing their financial commitment to the Company and demonstrating their support for our strategy.

Our debt to equity ratio as at September 30 was 1.21:1, similar to the 1.22:1 as at March 31. Increased debt from the Backyard acquisition was offset by the increase in share capital issued as part of that transaction as well as the exercise of stock options.

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

Murray Souter

Thanks, Alan. This is a very exciting time for our business with a number of catalysts that are expected to drive profitable growth in the future. Let me talk about a couple of them now.

We are pleased that the new Ontario government wants to modernize the rules around beverage alcohol sales. As many of you know, last week the government announced a plan to increase LCBO hours, expand the sale of wine in corner stores, grocery stores, and big box stores based on, and I quote them: "market demand as opposed to government decree." We're obviously still waiting clarity on this, but the government has promised to consult with industry prior to implementing any changes, which is a very positive announcement.

As a reminder to everyone, there are currently about 70 grocery stores licensed to sell wine with an additional 80 grocery stores that feature remodeled private wine store licences. Under the previous provincial government, the number of licensed grocery stores was expected to rise to about 300 by the year 2025. The current government has indicated they intend to make licences available to upwards of 5,000 grocery and convenience stores within the next short period of time. The million-dollar question is how quickly that will happen. We would be very pleased to see an acceleration of the licensing process, provided the government ensures some level of support for the Ontario industry. We're a very important economic driver in this province.

As I noted earlier, we now have the top market share in grocery, both for the most recent period, the most recent quarter, and the most recent 12 months. And based on very strong wine sales we've seen in this channel to date, market forces would suggest that more stores should be licensed in the short term to meet demand.

We're also very pleased with the performance of Backyard Vineyards since our acquisition in June. Sales from Backyard have been solid, and we are working hard to launch additional brands in BC by utilizing the spare capacity at the Backyard winery. In the longer run, we expect to generate major value in British Columbia from the development of a new winery in the Okanogan Valley. Additionally, we have recently expanded our Western Canadian leadership team with the hiring of a new Vice President General Manager in the region, who is extremely well known in the industry and experienced and who will supply much-needed leadership in this increasingly important market for us in the months and the years ahead.

As many of you know, the Niagara grape harvest for 2018 was completed around the end of October, early November. I am happy to report that while it was a very challenging harvest we were successful in fully utilizing the new capacity we added over the past two years. This bodes well for the availability of our products in subsequent years and will help us satisfy future demand.

Additionally, our new retail and tasting facility, which opened last year in Niagara-on-the-Lake, continues to perform very well with very strong sales results versus both plan and versus year ago.

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

Q&A

Operator

Thank you, Mr. Souter. Ladies and gentlemen, as stated, if you do have any questions, please press *, followed by 1 on your touch-tone phone. You will hear a three-toned prompt acknowledging your request. And should you decide to withdraw your question, you will need to press *, followed by 2. And if you're using a speakerphone, please lift your handset before pressing any keys.

And your first question, sir, will be from Amr Ezzat at Echelon Wealth Partners. Please go ahead.

Amr Ezzat — Echelon Wealth Partners

Good morning. Thanks for taking my questions.

Murray Souter

Good morning, Amr.

Amr Ezzat

Yeah. First off, congrats on your continued strong performance in the grocery channel. I just want to focus on a couple of things there. In the wine division, in general, when I'm thinking about the pace of sales going forward, how much more LCBO relistings is left to be done? Or is it now a completed process?

Murray Souter

No. It's not a completed process. And thanks for the question. We are always looking for additional listings. Distribution at retail is the single most important asset that a packaged goods company or consumer company can have. And having that access to the customer when their shopping is extremely important. So we are pushing that constantly. We are back close to where we were prior, but I think we've got 21 or 22 brands listed with the LCBO. Not all of them are to the level that we would want or where they were prior to our voluntary delistings. So we are pushing that, and it is a focus of our sales organization to get those back.

Amr Ezzat

Understood. Then maybe on China, just wondering if you had an update regarding the excess inventory your partner needs to work through? You mentioned in your prepared remarks that they opened or are opening 15 new stores. So I'm just wondering how far—

Murray Souter

Yeah.

Amr Ezzat

—are you (unintelligible)?

Murray Souter

Yes. Absolutely. And again, so the plan with our largest distributor in China was they were going to be at 200 stores in Q1 calendar. And it was a combination of their own owned stores, stores that they own, as well as stores that sub-distributors would own in other cities where they didn't have a presence. It was the sub-distributors who did not open stores, in fact in some of the cities, did not open any stores and were sitting or squatting is the term that they use, squatting on those distributor agreements.

Our partner has taken back those distributor agreements. They've cancelled them and have opened between 60 and 70 new stores. They're at 200 stores now, but they didn't happen until late—well, late being recently. So the inventory that they had purchased for that pipeline and retail sales last year, they've been chunking through fairly aggressively.

But we don't have a date when they—they are still ordering table wines. They're still ordering icewines to fill in. But we won't know when they're going to back to their kind of day-to-day purchasing. We anticipate it'll be soon, but it all depends on how well they do through their next big selling season, which, of course, is the lead up to Chinese New Year, which is early February.

Amr Ezzat

Switching gears to your agency division, you spoke to the loss of the supplier during the quarter. Is that the same one you spoke to Q1? Or is that a new one?

Murray Souter

Yeah. The one that we talked about in Q1 was a large supplier where we actually served as their distributor here in Canada. That's why the margins were quite low. So it was a very high volume, low profit distributor. The one that we lost moved—

Amr Ezzat

No. I'm not speaking about the very large one. I think like last quarter, you guys like mentioned obviously the large one, but there was also a severance payment that you got as—

Murray Souter

Okay. Sorry. Yes. Yeah there was, this is a different one. It's a much smaller supplier who chose to end a long-term relationship, largely because of their US distributor network as opposed to anything we'd done.

Amr Ezzat

Okay. So there's nothing systemic that we should read in loss of suppliers?

Murray Souter

No. Absolutely not.

Amr Ezzat

Okay. Then like on that division, I guess you delivered very impressive margins again, and even if I normalize for the severance payments you received, what do I think I guess, about these margins going forward in terms of sustainability? Or where do they go from here?

Alan Stratton

Gross margin?

Murray Souter

Yeah. Yeah. I'll let Alan answer that.

Alan Stratton

We normalize out for that stuff. That division should be able to generate margins in the low 40s.

Amr Ezzat

Okay. Then lastly on the greenfield opportunities you spoke to, any updates there in terms of plan about how you're going to go about it? Or it's still early days.

Murray Souter

Well, we're working through the amount of land that we're going to acquire. So we've got that more or less fleshed out now. We've done geological on the site and elevations. We are in the process of talking to architects for preliminary sketches so that we can start to cost out what the construction will look like. And there's municipal issues. Whenever you're doing something that generates traffic with a local municipality, there's acceleration, deceleration lanes that you've got to talk to them about and where you have your turnoffs and those sorts of things. But we're working through it right now.

We've had, I guess, four, five months now, and we'll be back out—our head of wine-making is headed out there in the very near future, and that will be part of the discussion as to what kind of gear we need to put in the building and capacity issues and how we step to capacity and those sorts of things.

So we're working hard on it, Amr. And we'll probably have some news for the market early in the new year.

Amr Ezzat

Great. Thank you very much, guys.

Operator

Thank you. Next question will be from Nick Corcoran at Acumen Capital. Please go ahead.

Nick Corcoran — Acumen Capital

Good morning.

Murray Souter

Morning, Nick, how are you?

Nick Corcoran

Pretty good. So I just have a quick question on the margin in the winery division. The Backyard, it sounds like you had a—just the IFRS compressing margins from those sales. Do you expect that to go forward? Or is that just a onetime thing?

Alan Stratton

Nick, it’s Alan. It will be a continuing theme for the next couple of quarters as we sell down the inventory that Backyard had on hand at the time we acquired it. But then by the end of the fiscal year, as we get into next fiscal, most of that inventory should have bled through the system.

Murray Souter

Yeah. And margins will go back up to normalized level in around—

Alan Stratton

Yeah.

Murray Souter

—40s to 50s.

Alan Stratton

Mid 40s to late 40s.

Murray Souter

Yeah.

Nick Corcoran

Okay. And then just on China, it sounds like your focus has been on icewine. It has been for a while. Is there any potential for red wine in that market?

Murray Souter

Actually, the market, a lot of our growth there through this quarter has been in red table wines that we’ve been shipping to them. The icewine is still a big proportion of it, but red wine is becoming a significant part of the portfolio into China.

And I did mention it in my remarks, but we’ve qualified a number of new distributors, who are looking for both icewine and for red table wines. China, as you know, is the largest red wine market in the world, and when they import, they don't buy cheap red wine. They buy, from us in particular, they buy our higher-end, higher-margin wine. So we're seeing growth on table wines much more than we're seeing growth in icewines over the near term. So it's very positive.

Nick Corcoran

Great. That's all my questions.

Murray Souter

Great. Thanks, Nick.

Operator

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

And at this time, Mr. Souter, it appears we have no other questions, sir.

Murray Souter

Okay. Well, thank you very much, everyone. That concludes our call this morning. Thank you for [audio gap]. As I've said in the past, if you have any questions or comments, please feel free to contact Alan or myself, and we look forward to speaking with you again in Q3, which will be February next year. Have a great holiday season and Christmas. Bye-bye.

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.