Investment Summary: Chapters Indigo (TSX: IDG)
Toronto, Ontario
Established: 2001

Date prepared: May 14, 2010
Last updated: July 15, 2010

Please read in conjunction with the attached spreadsheets and the Company's annual and quarterly reports.

Conclusion

Returns on capital: 7/10
Returns on capital were higher than expected for this business averaging 22.9% for the period from 2006-2009.

This however is before making any adjustments for a normal rate of corporate tax and to reduce shareholders equity for the excess cash held in the business.

Earnings stability: 8/10
Earnings have been stable and growing over the period examined from 2005-2009.

Earnings history: 4/10
Company as it exists now has only been in operation since 2001. I have only examined as far back as 2005.

Growth potential: 3/10
Limited growth potential. See below.

Price: 8/10
See valuation; current price is ~$14 per share

Overall score: 7/10

Overall conclusion:

This is a good business with above average returns. The price is attractive. There is a great deal of cash on the balance sheet (~ $7 per share). The Company is possibly worthy of investment at a price below $20.00 per share.

I need to look back farther to get more historical data as well as to consider the future impact of online retail and ebooks.

Business description (from Company website)
"Indigo is the largest book retailer in Canada operating bookstores in all 10 provinces under the names, Indigo, Chapters, World's Biggest Bookstore, and Coles. Indigo also operates chapters.indigo.ca an online retailer of books, music, movies, and more. A

Canadian company based in Toronto, Ontario, Indigo provides consumers with inspiring retail and online environments for books and life enriching products & services."

Competitive/advantage, secret sauce

- Canada's leading bricks and mortar bookstore chain with dominant market share (28%); a clear leader in a fragmented market. Their brand is synonymous with books in Canada
- Canada's leading online bookstore – chapters.indigo.ca
- Company has strong in-store product merchandising abilities and user experience design
- Management is unusually strong for this size of business

Tidbits

- Indigo operates 249 stores including 96 superstores under the banners Indigo, Chapters and the World's Biggest Bookstore, and 151 small format stores under the banners Coles, Indigo, Indigospirit, SmithBooks and The Book Company and two new concept stores under the banner Pistachio
- The Company's Online sales represented 8.6% of revenue in 2009
- The Canadian book market is estimated at $2.8B; Company's share is around 28%
- Indigo product mix has been diversified to include a wide array of non-book products with higher margins.

Longevity and stability checklist

Longevity and earnings stability requirements have NOT been strictly met due to the Company's short operating history.

However, the industry is NOT new, highly cyclical, technology dependant, hit/breakthrough dependant, fashionable/cool, or commodity based. The Company has been doing pretty much the same thing since its predecessor Coles started in 1940.

Debt

The company employs minimal long term debt which significantly reduces the risk of financial distress in tough times. Almost half of the assets are financed through supplier AP and other short term liabilities. The remainder is financed through equity.

Usage of cash

The company seems to understand that the purpose of a business is to pay dividends to shareholders. They have been sitting on a pile of cash and recently started paying out dividends in 2010. All indications are that these dividends will continue and increase.

There is no indication that the company will squander the money made in the business on dubious acquisitions or questionable expansion; doesn't appear to have made any such moves in the past. Investments in new business ventures such as Pistachio and KOBO have been small and cautious.

Existence
If they disappeared tomorrow, would the world miss them?

Yeah, I think Canadians would miss Indigo. But other bookstores (maybe US chains) would take their place and offer virtually the same products and services. More sales would shift to Amazon's online store. They wouldn't be missed that much.

Management
Heather Reisman (and husband Gerry Schwartz – not officially part of management) are unusually strong for such a small company. They have strong operational abilities, a very deep base of contacts and unusual access to capital.

Salary for Reisman is a very reasonable $500k per year with no bonus or stock options. Reisman and Schwartz own 70% of the company's common shares. They think and act like owners (because they are).

Strengths, Opportunities, Risks
Strengths – company clearly dominates the bricks and mortar segment in Canada with almost no competition in any format (small or large stores). The brand is synonymous with books in Canada.

Opportunities – KOBO e-book format. Indigo owns 57.7% of this new venture. Looks poised for growth based on its device independent model which can be run on BlackBerry, iPhone, maybe even iPad. It may offer a viable alternative to Amazon's Kindle. This is a HUGE opportunity. But it is unclear who the winners and losers will be in the e-book race. So far Kindle is the clear winner.

Opportunities – chapters.indigo.ca – growth. Canada is geographically very large and not densely populated. The online store may help the company pick up sales in rural markets without opening new stores. However, the online channel has been stagnant as of late and growth may result in some cannibalization of in store sales.

Risk – limited growth – there has been almost no expansion in the number of stores or retail square footage in the five year time period examined. Also, in the overall market, there will likely be a continued shift from bricks and mortar to online. Online sales may provide some growth for the Company but some of it will cannibalize in-store sales.

Risk – competition – Amazon.ca is a formidable force in retail and ecommerce. Amazon is gaining an increasing share of the global book market. In comparison the chapters.indigo.ca website is second rate in terms of user experience, product reviews, product selection and price. Amazon has recently (April 2010) been given the green light to open a Canadian distribution centre. As well, changes in legislation limiting foreign competitors from operating in the Canadian book market appear to be going away; US chains may be able to open up shop in Canada.

Risk - technology – e-books such as Kindle, audio books (audible.com), and free illegal downloads of those products offer alternatives to conventional books. These alternatives, particularly e-books may result in a revolutionary shift from conventional paper books and books stores. This would have severe consequences for the business.

Risk – media and entertainment options have mushroomed in the last 5-10 years competing for customers' time. These include newspapers, magazines, blogs, email, websites, radio, tv, movies, video games, and free downloaded versions of the same. This reduces the consumption of books.

Risk - FX – The Company buys many of its products in USD and sells them in CDN. If the CDN declines versus the USD, margins (which are thin to begin with) will be affected. The Company does adjust prices accordingly but there can still be impact from this movement.

Risk – management – Company may be overly dependant on Heather Reisman for management ability.

Historical returns on the business

- Meets our minimum return on equity requirement of 15% per year. Over the period from 2006 to 2009, the Company's arithmetical average ROE was 24.9%. This is a very short period of time and a longer period needs to be looked at.

- Earnings and dividends history - the company has had positive earnings every year in the period examined (since 2005). This is a very short period of time and a longer period needs to be looked at. The Company has begun paying a dividend in 2010.

- Past growth has been mixed. Growth in revenue has been small averaging only 3.6% between 2005-2009. However, growth in EBITDA, net income and owner earnings have been very large at 10.4%, 21.2% and 14.7% respectively.

Is this a company we want to own?

Yes, at the right price.

Valuation

<u>DCF Valuation</u>

The approach that I used to perform the DCF was to discount the expected Owner Earnings from the business to today's value to determine a value for the shares.

Discount rate – I used a 15% discount rate. This rate can be varied depending on what you would like to earn on your investments.

Growth rate – I was conservative in my expectations of growth in Owner Earnings. Despite the strong growth seen in the past five years, for the base case valuation I used 4% for the next 5 years, 3% for the 5 years after that, 2% for the next five years and 1.5% thereafter. I believe that the Company's growth is limited as it already has a national footprint across Canada and little opportunity for meaningful increases in retail square footage. The US market is unlikely to offer growth opportunity. The online segment has been flat lately.

KOBO - The future results of KOBO are completely unknown. They could have a negligible or large impact depending on the success of the offering. I appears that KOBO is in also-ran in the race for e-book leadership with Kindle far in the lead.

Taxes – I made an adjustment to normalize past results to include a normal rate of corporate tax and remove the benefit of non-recurring loss carry-forwards

Excess cash - I made an adjustment for the extra cash in the business above and beyond what is needed for normal operations. The company had $203m in cash as at Dec.31, 2009. Assuming they need about $25m on hand to operate the business, this leaves $178m in excess cash or $7 per share.

Dividend yield

The Company's dividend yield is approximately $.40/$14 = 2.85%

The Company only started paying dividends in 2010. From an operational standpoint, dividends could have begun many years ago but the cash generated was used in the past to pay down the debt load brought on by the Chapters Indigo merger.

Private equity valuation

Based on an EBITA multiple approach used by a private equity buyer, the valuation would be between $22.03 and $27.94 per share. It is not clear whether the management who own a controlling stake in the business would be willing to sell it. More likely they could take it private themselves.

Comparable valuation

Based on comparable companies valuation using enterprise value to revenue, the valuation would be about $9.10 per share. If you add the $7 per share in excess cash, this would bring the comparable based valuation to around $16 per share. However, all of the comparables used in the analysis operate in the more competitive and less profitable US market resulting in a low valuation.

Sources

- Chapters Indigo public filings

- Yahoo Finance
- Stacey Muirhead Capital Management Ltd. presentation to the Ivey Business School (February 10, 2010)
    - http://www.bengrahaminvesting.ca/Resources/Video_Presentations/Guest_Speakers/Stacey.wmv
    - http://www.bengrahaminvesting.ca/Resources/Video_Presentations/PPT/jdstacey2010.pdf