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Derek Lessard
TD Securities

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RBC Capital Markets

Nick Warner
BMO Capital Markets

PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Thank you for standing by. Welcome to the Dorel Industries First Quarter 2019 Results Conference Call.

At this time, all participants are in a listen-only mode. Following the presentation we will conduct a question-and-answer session. Instructions will be provided at that time for you to queue up for questions.

If anyone has any difficulties hearing the conference, please press star followed by zero for operator assistance at any time.

Before turning the meeting over to management, please be advised that this conference call will contain statements that are forward looking and subject to a number of risks and uncertainties that could cause actual results to differ materially from those anticipated.

I would like to remind everyone that this conference call is being recorded today, May 10, 2019.

I will now turn the conference over to Martin Schwartz, President and CEO. Please go ahead, sir.

Martin Schwartz, President & Chief Executive Officer

Thank you. Good afternoon and thank you all for joining us for Dorel's Q1 earnings call. With me are Jeffrey Schwartz, CFO, and Frank Rana, VP of Finance. We will take your questions following our comments. As always, all numbers are in US dollars.

I'm pleased to say that yesterday Dorel entered into a commitment letter with an institutional lender for our long-term financing and Jeffrey will elaborate on this shortly.

After a slower Q1, we see a better year ahead. Much is being done by our teams to respond to the changing needs of consumers and to rebuild shareholder value and these actions are gaining traction with positive signs in all three of our segments.

Our greatest challenge has been Dorel Juvenile. The good news is that Juvenile has reversed the weakness for the past three quarters. There is improvement in Chile, where same-store sales have begun to recover and increased 15% at Dorel-owned retail locations, even though the store count is now lower due to closures. Dorel Chile's e-commerce B2C site is also growing, helping to offset challenges in the wholesale channel. Sales in Europe were at their highest level since last year's first quarter. In the US, POS revenue increased, but there were major customer reduced orders to lower their inventory, which decreased overall sales slightly below prior year. Dorel Juvenile's China factory sales increased to third parties. Sales were also up at Dorel Juvenile Columbia with the sale of inventory to a local distributor because of the decision to change the business model.

Turning to Dorel Sports, we're excited about its prospects with the Cannondale line demonstrating excellent momentum. CSG had a very good quarter, posting its fourth consecutive quarter of improvement, excluding impairment losses on intangible assets, restructuring, and other costs. This was driven by new products, increased sales of E-bikes in Europe, and growth in the US IBD channel. In Brazil, Caloi revenue grew double digits in local currency due to a better mix, sales through the country's bike-sharing program, and price increases implemented last year. Pacific Cycle had declined at mass, but this has already reversed in April with strong POS at all the retailers due to a particularly good Easter, which took place this year in the second quarter. This will be reflected in second quarter results as two-thirds of Q1 mass channel revenue loss was recouped. April is generally a reliable barometer of the season and last month was strong for all bicycle divisions.

Dorel Home continued its revenue growth with e-commerce, a consistent driver, growing strong double digits, more than replacing reduced brick-and-mortar sales. Online sales represented 59% of the segment's revenue compared to 50% last year. Branded product sales have continued to grow steadily and are becoming an increasingly important strategy of Dorel Home, setting it apart from online competition. Specifically, Novogratz and Little Seeds doubled their sales year over year and while there is no comp for CosmoLiving, sales which began late last year are growing very well. Sales are also trending up in Europe at Alphason, Dorel Home's new venture in the UK, where additional Dorel products began arriving in late Q1.

Jeffrey will now provide the restructuring update and the financial perspective. Jeffrey?

Jeffrey Schwartz, Chief Financial Officer

Thank you, Martin.

I'm going to talk a little bit about the debt. As Martin mentioned, we entered into a commitment letter yesterday with an institutional lender for issuance of senior unsecured notes in the amount of $175 million, of which $125 million will be drawn down on closing and the balance of $50 million can be drawn down after closing with consent of the lender. The proceeds from the first tranche will be used to repay the $120 million convertible debenture.

Closing of the senior unsecured notes is conditional upon a number of factors, obviously, a preparation of the definitive documentation that's acceptable to both Dorel and the institutional lender, the completion of the final due diligence to the satisfaction of the lender, and other standard conditions. Of course, Dorel cannot provide any assurance that the senior note transaction will be completed on a timely basis or even at all.

In addition, on May 8, 2019 Dorel amended its revolving bank loan and term loan agreement to extend the maturity dates of the earlier of July 1, 2021 or July 31, 2019 if the convertible debentures have not been repaid or refinanced in cash or in shares of the company by that date. Given that the convertible debentures have not yet been repaid or refinanced, the convertible debentures and the revolving bank loans and term loans are all classified as current as at the end of the quarter.

Moving over to restructuring that we announced in March, we have a little more detail. In particular, Dorel Juvenile is revamping and simplifying operations in several markets to reassert its position as the world's leading Juvenile products company and to further build competencies in an omnichannel world where consumers are increasingly digitally engaged. So, although, there are a number of opportunities, a number of areas of opportunity, the main focus comes from Europe and plans there are to streamline the organization and better leverage the scale of the operation by adopting technologies and processes that allow us for more centralization of the activities. We are confident the measures this year and next will bring the desired results.

So, right now we're looking at a total of between $25 million to $30 million of spend, restructuring spend, that we're expected to incur this year and next year. The majority of the estimated costs are for employee severance and related costs. Of that $25 million to $30 million, we recorded $14.1 million in the first quarter and right now we believe the annualized cost savings are between $12 million and $15 million per year. And they are expected to start or to be fully realized by the end of 2020, but some of them are starting this year, of which we are expecting $5 million of savings this year.

If we turn now to some of the financials, first quarter revenue decreased by $16.7 million or 2.6%. Organic revenue actually improved by 0.3% after removing the variations of foreign exchange rate year over year. And then when we remove the impact of revenue related to the divestment of the performance apparel line of business in the second quarter of last year, organic revenues actually increased by 1.1%. So, where we're seeing some of that organic revenue growth is at Dorel Home, obviously through the e-commerce channel, and in Dorel Sports, mostly from CSG and the Cannondale brands. Offsetting that is lower sales in the quarter from Pacific Cycle and some of Dorel Juvenile's markets.

Gross profit from the first quarter declined 230 basis points to 20.8% from 23.1%. As we go down the statement I'll point out finance expenses increased $2.6 million to $10.3 million for the first quarter. In 2019 the amount of $2 million was recorded as interest on the lease liabilities as a result of the adoption of IFRS 16. Excluding this impact of adopting IFRS 16, finance expenses only increased by $600,000 from last year.

Our effective tax rate is a bit odd because of the loss and everything but our adjusted tax rate is 37.1% in the quarter versus 10.2% last year. As you know, that tends to be very volatile, that rate. The main cause, again, some non-recognition of tax benefits related to the tax losses and some changes in jurisdiction in which we generated the income. But right now we are forecasting our tax rate throughout the year to be between 28% and 32%.

For the first quarter the net loss was $8.3 million or $0.26 a share compared to net income of $4.7 million or $0.14 last year. When we exclude the restructuring, the adjusted net income was $5.8 million or $0.18 a share. Last year we did have the liquidation of Toys“R”Us in the first quarter, which resulted in an impairment loss on trade of other receivables of $12.5 million or $0.29 per diluted share. So, when removing the impact of the impairment loss last year, the adjusted net income would have been $14.9 million last year compared to $5.8 million this year.

Now we go into the various segments. Dorel Home's first quarter increased by $18.5 million or 9.6%, so one of our stronger growth quarters. Very little of that, maybe 20%, is related to price increases from tariffs. So, the majority of that is true growth. The total organic number is actually 9.9%. And for the first quarter e-commerce now represented 59% of the total gross sales versus 52%, so that trend continues to grow and grow.

First quarter gross profits declined by 360 basis points to 14.1%. A number of issues hit that. We did have a less favorable product mix. We rolled out a lot of new lower-margin products, folding furniture as an example. We had a new roll out to a new customer. So that pulled down the margins as well. We do have some higher warehouse and distribution costs due to the overall footprint but, most importantly, we had a temporarily higher inventory level as we purchased significant amount of goods in the end of last year to beat the expected tariff increase of January 1st. And that continued on through particularly January and eventually kind of faded away. So we had quite a different gross margin between January and March, as the gross margin grew significantly through the quarters and finished, obviously, at a higher rate than the 14.1% that it averaged.

Our operating profit declined $1.8 million to $14.5 million, from $16.3 million and then last year in the quarter we did have a charge of $2.1 million for the Toys"R"Us bankruptcy.

Moving over to Juvenile, Juvenile's first quarter revenue declined by $13.1 million or 5.4%; however, organic revenues only declined by 0.6% after removing the impact of varying foreign exchange rates year over year. Gross profits in the quarter decreased by 170 basis points to 26.6 from 28.3 and the adjusted gross profit declined by 160 basis points. When we exclude the restructuring costs, the adjusted operating profit from the quarter was $7.3 million compared to $3.7 million last year but, again, last year we did have the Toys"R"Us impact. So if we add the Toys"R"Us impairment of $3.8 million, the comp would be $7.3 million this year to $7.5 million last year.

We did have some negative foreign exchange impact on the Juvenile segment in Q1 and that number ended up being close to $3 million, so it was rather significant. When we look at the quarter, although still not performing to where we want it to perform, a significant increase in our performance from the previous three quarters. As people remember, last year we had an okay first quarter and then everything kind of tailed off after that. We're pleased with where we are today at the first quarter and hope to continue to see the growth. As our new products hit the market, as our restructuring takes effect, we believe we're on track to improve.

Dorel Sports, first quarter declined by $22.1 million or 10.7%. When we exclude the impact of foreign exchange year over year and the divestment of the performance apparel business, which was Sugoi, in the second quarter, the organic revenue declined only 5.2%. Now, all of that decline is from the mass side of our business. They had a particularly tough quarter. We did see growth in both our CSG business and our Caloi business in Brazil. Gross profit declined in the quarter by 80 basis points. Again, all of that coming from Pacific Cycle.

Operating profit improved by $5.3 million to $4.5 million this year compared to a loss of $800,000 last year, but then if we exclude the impairment loss on trade receivables of Toys"R"Us, operating profit was $4.5 million compared to last year would have been $5.8 million. Again, all of that decline is coming from the Pacific Cycle. Now, normally we don't talk about a month from the current quarter, but April was such a significantly positive month for sales in our bike business particularly that I think we need to explain. We had a tremendous month in Pacific Cycle, making back almost 60% of our loss of revenue in the first quarter, we made it all back in just April, and then both Caloi and particularly CSG continue to have strong sales months. So we're pretty optimistic about the way our bike business is looking right now.

If we go just to the outlook quickly, we don't feel our first quarter results are necessarily indicative of our expectations for the full year, which is for higher sales and improved adjusted operating profits. Dorel Home will continue to see sales increases versus last year and margins are expected to improve in the second half.

Dorel Juvenile second quarter and full-year revenues and operating profits should exceed the prior year results with the most significant contributions coming from both Europe and Chile. And we're very much aware we have three very easy comps coming in the next three quarters for the Juvenile, so we'd like to see some significant improvements over the last year.

As I mentioned, April was a great month in the Sports business and the important thing about April too is it sets the tone for the important spring season. So having a strong April is more important than, let's say, a strong June because, you know, we saw the strength both in our shipping and at the POS at the retail level, so in some cases we've gotten some nice reorders this week and last week from accounts that probably wouldn't reorder if they had that type of sales in June. So the timing and the strength were both very welcome events.

So, we're confident in delivering improved and adjusted operating profit for the year, although we do have to point out there are two risk factors that do worry us. One is a stronger US dollar. We saw some of that in Q1, particularly in the Juvenile, so that's something that we have to keep an eye on. And then of course the uncertainty of the recently announced tariff increases will have an impact, we just don't know how much and to what extent, in some of our businesses. I mean we managed through the first round of tariffs fairly well, passing on most of those tariffs on through to the retailer and to the final customer. We did have more, I'll call, indigestion from trying to manage inventories at the end of the year last year than we did from the actual tariffs, so at this point there is no managing inventories as this was quite a surprise announcement.

With that, let's open up the lines for questions. Operator?

QUESTION AND ANSWER SESSION

Operator

Thank you. Ladies and gentlemen, we will now conduct the question-and-answer session. If you have a question, please press star followed by the number one on your touchtone phone. You will hear a tone acknowledging your request. Your questions will be polled in the order they are received. Please ensure you lift the handset if you're using a speakerphone before pressing any keys.

Your first question comes from the line of Derek Lessard from TD Securities. Please go ahead.

Derek Lessard, TD Securities

Good afternoon, gentlemen. Jeffrey, just maybe if you—I want to take maybe a 20,000-foot view and see what you think or how you think of Dorel? How does the company look a year from now after the restructuring versus, I guess, the last couple of years?

Jeffrey Schwartz, Chief Financial Officer

Well, again, mostly restructurings in Juvenile, right? So the Juvenile business is improving in many areas. I mean Chile, we had a big improvement so far this year. It's not quite there yet but I'm very happy to see where we're going. We're seeing all of our businesses improving. Obviously, we would love to see a big improvement in Europe, because that's where a lot of this is focused. We have more new products coming out of Europe than anywhere else. And with restructuring I think we can get back to maybe not peak areas by next year, but we can certainly get back by, let's say the end of 2020, to significantly higher levels than we were certainly last year and probably the year before. So I think that we've got to get the products to hit, we've got to have reasonably good success and be able to execute on this restructuring, and there's a lot of money there. And then like small, they're not huge improvements but if we can improve like we plan in Australia, the US, in Canada, China domestic, I call that, China domestic is what we call our sales into China. All of those are improving and going in the right direction at this point. So I think I like where we are in Juvenile.

In bikes, I'm very optimistic about Cannondale, because we've had some real good success now on the bottom line and the top line with the model 2019 bikes. So the market hasn't seen the model 2020 bikes or very little of the market's seen model 2020. We're very excited about model 2020. We've gotten some feedback from some places in the market and we think that will give us another boost. So the fact that we're starting with the 2019s and already in good shape, I think we're going to be in really good shape. And it's taken a while, as you know Derek, it's taken a long time to get to this point where actually things are really clicking, whether it'd be our product, or marketing, our operations are so much better. So you put all that together and I think we're going to see, in the next year, break out from there.

A little more cautious on the mass side, because it's still mass bikes. It's still weather-related. There's less distribution points. We are moving more and more towards online on those type of bikes, probably the leader on the mass side in online, but there's a lot of sort of more minefields to manage in that business as it's a tougher business.

And then Home, we're not planning for a lot of bottom-line growth this year as we're sort of refocusing some of our efforts. We're trying to move to the more higher-margin parts of the market like branding. We keep talking about branding because branding grows the names that we've given out. Those areas are growing at a faster-than-average rate with higher-than-average margins. So we're going to continue to invest in those, we call them lifestyle brands, as well as into some categories that do carry higher margins than just trying to do high-volume, low-margin products. We're still going to do that but I don't think that we can bet on the future of that, as those margins are kind of tight. So, we'll always keep them, they pay the bills, but to really grow the business we've got to continue to grow the higher-margin categories.

Derek Lessard, TD Securities

That's a good colour. Thanks for that. And maybe just one last one for me: In Juvenile, you did point to a single customer that reduced order, so just wondering how long before we start to lap that?

Jeffrey Schwartz, Chief Financial Officer

Well, it's a good question. I don't think it can go on. I don't know when it's going to stop but it has to stop soon, because they've done, it in the sense, right? So POS is—you don't want to get to the point, and I'm talking about not just us and them but us as partners, we both don't want to get to the point where POS suffers because you don't have enough inventory in the stores. So I don't think that's going to be a long-term issue. In fact, it might be over as of today, but it could last for another week or two. Certainly won't be going on much longer than that, because they've already reduced the amount of inventory they're carrying. So I don't have an answer but it won't be much longer.

Derek Lessard, TD Securities

Okay. Thanks, guys.

Operator

Your next question comes from the line of Sabahat Khan from RBC Capital Markets. Please go ahead.

Sabahat Khan, RBC Capital Markets

Thanks and good afternoon. Just on the Juvenile front, I guess you noted the restructuring, which is going to eliminate some costs. I guess through that process, how are you ensuring that you continue to get product, like kind of the right product into the right markets and so forth? And where exactly, I guess, within the Juvenile segment, are the restructuring activities? Is it front office in terms of marketing or sales or is it supply chain? Any colour there would be helpful.

Jeffrey Schwartz, Chief Financial Officer

Let's start with the first part. The product roadmap is already developed. We have the products for this year, for next year. We have significant amount of products this year because I'm going to call a bit of a catch-up year. We don't have certain products in certain niche categories within, let's say, the car seat business in Europe that are growing categories. So, we're caught a little bit behind over there, but I don't see that impacting very much of that, certainly not this year's stuff.

As far as where, a little bit early to actually get into too many details, other than we said we're looking at our processes and we're trying to centralize activities. We're in a lot of countries in Europe. So I can't, at this stage, get into too much more detail on that.

Sabahat Khan, RBC Capital Markets

Okay, thanks. And then just on the reporting side, I guess in terms of the IFRS 16 impact above the EBITDA line, is about \$3 million to \$4 million a quarter a good estimate for the rest of the year in terms of the quarterly increase to your EBITDA?

Jeffrey Schwartz, Chief Financial Officer

No. It's actually—no. Okay. So what is the impact on EBITDA on a quarterly basis from IFRS 16? Is that your question?

Sabahat Khan, RBC Capital Markets

Yes.

Jeffrey Schwartz, Chief Financial Officer

Okay. If that's your question, the answer is a lot more than that. It's going to be \$11 million? Q1 was \$13 million

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Sabahat Khan, RBC Capital Markets

Okay. And then just on some of your, I guess, South American operations. In terms of just like as you go through the restructuring, how material is your sort of presence in South America to that segment as you look beyond the restructuring? Are there any additional markets that you could potentially exit over time? I just want to get an idea of that kind of geographic—

Jeffrey Schwartz, Chief Financial Officer

In South America we are, ah, we'll call Latin America, we are in Chile with our own operations. We're in Chile, we're in Peru, we're in Brazil and we're in Mexico. Brazil has done very, very well in the last few years despite the economy and we're going to continue to be there. We're arguably the number-one player today in Brazil in that business. Chile has had, as you know, lots of problems. We've been talking about it a lot. We are starting to see that recovery now. Same-store sales, like Martin said, in our own stores we're up 15%, which is tremendous. I think we are still the only sort of, the go-to place to go if you're going to shop at a brick-and-mortar place. We're going to be sort of the best and the last standing, so that's going to help. Peru is actually in great shape, which is kind of odd, because it's actually the same, management same everything as Chile but the country is different. So Peru continues to do well. And Mexico, we have a very small presence in Mexico but it's growing and we continue to see a lot of upside there. So that's kind of a future. All the other countries will be done through other distributors or not a lot of boots on the ground in the other countries.

Sabahat Khan, RBC Capital Markets

Thank you.

Operator

Ladies and gentlemen, if there are any additional questions at this time, please press star followed by the number one. As a reminder, if you are using a speakerphone, please lift the handset before pressing any keys

Your next question comes from the line of Nick Warner from BMO. Please go ahead.

Nick Warner, BMO Capital Markets

Hello and good afternoon. I just have a follow-up question relating to the IFRS 16 impact. Could you guys provide some details around the overall impact as it occurs on a segment-by-segment basis?

Jeffrey Schwartz, Chief Financial Officer

Well, at this point we're not doing it because the only impact we have... Of the 16? Yeah. Okay, hold on a second. It is in the notes. Which note is this? Note 16 of the Statement. So you're looking, I mean it's a lot of detail here. They'll be able to pull it out of the note. It'll be in Note 16 and in the details there. Why don't we leave it at that?

Nick Warner, BMO Capital Markets

Okay sure. Appreciate that then. My next question is how do you guys see Home margins evolving in Q2 and throughout the rest of the year?

Jeffrey Schwartz, Chief Financial Officer

It's a good question. So, we definitely feel like we're going to be above Q1. Last year there were some pretty high margins there. I don't know that we're going to get back on the gross margin. I mean one of the things right off the bat is causing some, I don't have a quantified but the fact that when we passed on the cost of the tariffs to our retailers, we didn't pass on a margin, we weren't able to pass on a margin on top of that. We were just able to pass to the cost pass-through. So that automatically sort of reduces some of your margin there. And like I said, as the year goes on I expect to be doing more and more in higher-margin product, so we do expect it to creep up.

But, as you can see, we're quite a bit off of last year's margin and some of that's competitive stuff, some of it is cost. I mean some of the cost last year that we bought product for was less than this year. Freight rates were less last year than this year. So there are a number of factors in there. And we are trying to grow that top line and make sure that we're doing it, so a number better than Q1 for sure and continuing to grow is probably the answer for this year.

Nick Warner, BMO Capital Markets

Okay, appreciate that. Thank you. That's all my questions.

Operator

Mr. Schwartz, there are no further questions at this time. Please continue.

Jeffrey Schwartz, Chief Financial Officer

Okay, I'll just take it from here. Thank you, everyone, for calling in.

Our annual meeting this year is on June 20th at the New Holiday Inn on Rene-Levesque at Lucien-L'Allier. We hope to see everybody there. Have a good weekend.

Operator

Thank you. Ladies and gentlemen, this concludes the conference call for today. Thank you for participating. Please disconnect your lines.