INDIGO BOOKS & MUSIC INC.
(TSX: IDG)

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***e*Research Corporation** is pleased to provide a **Portsmouth Equity Research** Initiating Report on: **Indigo Books & Music Inc.** (TSX: IDG).

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The Value Perspective
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INDIGO BOOKS & MUSIC INC.

TSX: IDG
Price (November 5, 2009): $13.25
52-Week High-Low: $14.49 - $10.51
Shares O/S: 24.54 million
Market Cap: $325.2 million

THE COMPANY

Headquartered in Toronto, Canada, Indigo Books and Music ("Indigo") is Canada's largest book retailer with 246 stores as of September 2009, and an online business at chapters.indigo.ca. The store count includes 91 superstores, and 153 small format stores located in 10 provinces and 1 territory. Indigo employs more than 6,500 people.

Superstores represent the majority of revenue with 70.5% of sales coming from these locations. Small format stores and the website represent 16.2% and 9.9% of sales, respectively.

Customer service at these stores is top-notch and the stores are always bustling with shoppers.

Based on the 5-year average of earnings per share, Indigo's market valuation is 10.78 times earnings. The price to book value ratio is 1.7 indicating a premium over net asset value. The 5-year average return on equity is 21.2%.

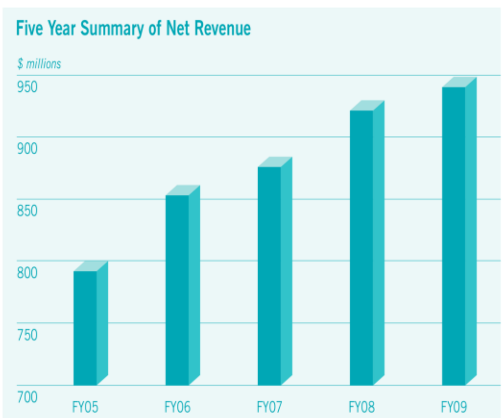
BUSINESS PROFILE

Indigo generates revenues through the sale of books, music, toys and other items. The retail operations include superstores (*Chapters, Indigo,* and *World's Biggest Bookstore*) and small stores (*Coles, Indigo, Indigospirit, SmithBooks,* and, *The Book Company)*. Indigo also has an online presence, chapters.indigo.ca.

The company has a focused strategy to ensure they are a enjoyable experience for consumers and that the physical store offering remains rich and compelling while offering new products and services to meet the needs of booklovers.

PERFORMANCE 2005 - 2009

Since fiscal 2005, revenues have increased by an average of 3.8% per year. As of September 2009, Superstores, Small Stores, and chapters.indigo.ca generated 70.3%, 16.2% and 9.7% of total sales, respectively. Comparable Same Store Sales Growth has averaged 3.8% at Superstores and 2.3% at Small Stores.



Operating Earnings have grown a cumulative 64% since fiscal 2005 – an average of 12.8% per year. The operating margin has averaged 7.1% and has steadily improved from 5.6% in fiscal 2005 to 7.7% in fiscal 2009.

Likewise, cash flows from operations have increased 144% since fiscal 2005 averaging nearly 3 times capital expenditure requirements.

Indigo's ability to generate more cash from operations than needed for growth has contributed to a significant reduction in long-term debt outstanding. Total debt in fiscal 2005 was $39.3 million or 44% of equity. At the end of fiscal 2009, total debt was $5 million or 2% of equity.

Successful operations have also ballooned Indigo's cash balance from $10.1 million (2.5% of assets) to $92.2 million (19% of assets). In turn, management introduced a $0.10 per share quarterly dividend for fiscal 2010 beginning to return cash to shareowners.

Indigo purchases much of their book inventory from publishers at a discount from the Canadian list price. These list prices are often determined several months in advance and therefore, exchange rate fluctuations are not reflected in the Canadian list price.

In 2007, the rapid appreciation of the Canadian made Indigo's products look expensive relative to American products and customers responded negatively. Management countered with price discounts for consumers bringing prices closer to their U.S. counterparts.

Today, a similar trend is emerging. The rapid depreciation of the USD in recent months suggests that Indigo may once again need to offer promotional discounts to consumers, who have the option of purchasing from U.S. retailers, either online or in-store. This suggests an impact on holiday season (Q3) earnings, which contribute more than 80% to overall profitability.

The Canadian book market is an estimated $2.8 billion dollar industry.

VALUE ANALYSIS

Based on the current market price of $12.85 per share, the trailing 12-month PE is 11.27. If we expand this analysis to include the 5-year average of earnings from 2005 to 2009, Indigo is valued at 10.78 times earnings.

	FY09	FY08	FY07	FY06	FY05
Net Income (M)	30.6	52.8	30	25.3	11.7
EPS	1.215	2.079	1.194	1.016	0.483

The average PE ratio is useful for ironing out the ups and downs of the business cycle, including all special charges – good and bad. It emphasizes multi-year performance as opposed to recent performance.

Currently, the TSX is trading at approximately 21 times earnings.

We like, of course, that Indigo has had no earnings deficit in the past 5 fiscal years. However, there has been significant variation in the level of earnings, which reflects sensitivity to consumer behaviour and cyclical trends.

For any company, minimum per share growth in earnings of 30% over 5 years is attractive – at least in terms of sustainability. Indigo has grown quite significantly in recent years and it is prudent to expect that this is not sustainable in the long run. Earnings have nearly tripled since fiscal 2005 representing average annual growth of 32%.

This can also be reflected in the return on equity calculation, which has averaged 21.2% over the last 5 years compared with 13.81% in the trailing 12-months. The latter figure is closer to a reasonable number we would expect moving forward.

As of September 2009, the current equity value per share was $9.25 and the net tangible asset value was $7.38 per share. Comparing these with the market value of $12.85 per share, the price to book ratios are 1.4 and 1.7, respectively.

More than 60% of tangible assets are cash, accounts receivable and inventories. The reader may attribute the premium to a well-known brand and/ or Indigo's position as Canada's leading national book retailer.

At the end of fiscal 2009, Indigo introduced a quarterly dividend of $0.10 per share. The dividend represents an annual yield of 3.1% based on the recent market close.

Ideally, we like current assets to be at least twice current liabilities. In Indigo's case, current assets are 1.3 times current liabilities as of September 30, 2009. However, net current assets ($72.8 million) are sufficiently higher than long-term debt ($4 million).

As highlighted earlier, the capital structure has changed significantly since fiscal 2005. Total debt has been reduced from $39.3 million in fiscal 2005 (44% of equity) to $4 million (2% of equity), sufficiently better than our total debt to total capital maximum of 50%. Buoyed by high returns on equity, the equity value per share has increased from $4.77 in fiscal 2005 to $9.25 as of September 2009.

In recent years, earnings from operations have been quite sufficient to cover interest expenses and, from 2005 to 2009, the amount of money required for capital expenditures has averaged 36% of cash flow from operations. This suggests minimal requirements for debt or equity financing to fund growth.

INVESTMENT CONSIDERATIONS

1. Strengths

- Introduction of dividend; significant cash on hand (>15% of assets as of Sept. 2009);
- Low price relative to 5-year average of earnings;
- Only National retailer in Canada and the largest;
- Good balance sheet: low debt, sufficient working capital.

2. Challenges

- Expectation that earnings growth will slow-down;
- Exchange rate risk in the short-run;
- Short-dividend history;
- Highly dependent on holiday shopping season (Q3), when >80% of earnings generated.

3. Risks

- Economic environment: A decline in consumer spending could have a material impact on earnings;
- Dependence on the holiday season, which, in fiscal 2009, generated 35% of sales and more than 80% of earnings;
- Competition from specialty bookstores, independent bookstores, department stores, and other retailers;
- Foreign exchange risk due to currency fluctuations between Canadian and US dollar.

OTHER INFORMATION

- Gerry Schwartz, President & CEO, owns majority control: 17.2 million shares, or about 70%;
- In fiscal 2009, Indigo opened 2 *Pistachio* stores, an eco-friendly paper, gift, and apothecary concept;
- The company also launched *shortcovers.com,* providing readers with access to books, newspapers, magazines and blogs on their digital devices;
- Has a 50% interest in *Calendar Club of Canada,* an operator of seasonal kiosks and year-round stores selling calendars, games and gifts;
- Merged with Chapters in 2001;
- Earlier this year, acquired a company from major shareholder Gerry Schwartz for $2.9 million in exchange for $23.1 million of tax losses, which will reduce future income tax expense;
- In fiscal 2009, repurchased shares worth $2.5 million;
- Did not renew its $30 million line of credit, which expired October 15, 2009; and
- Website: www.chapters.indigo.ca

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