

# **Indigo Books & Music Inc.**

## **Annual Information Form**

**For the fiscal year ended April 2, 2011**

**May 31, 2011**

## TABLE OF CONTENTS

<b>CORPORATE STRUCTURE .....</b>	<b>1</b>
Name, Address and Incorporation.....	1
Principal Subsidiaries.....	1
<b>GENERAL DEVELOPMENT OF THE BUSINESS .....</b>	<b>3</b>
Three Year History.....	3
<b>DESCRIPTION OF INDIGO .....</b>	<b>4</b>
<i>Overview of Business</i> .....	4
Description of the Retail Business .....	5
Description of the Internet Business .....	6
Description of Kobo Inc. ....	15
<b>RISK FACTORS.....</b>	<b>20</b>
<b>DIVIDENDS .....</b>	<b>23</b>
<b>CONSTRAINTS.....</b>	<b>24</b>
<b>MARKET FOR SECURITIES.....</b>	<b>24</b>
<b>DIRECTORS AND OFFICERS.....</b>	<b>24</b>
<b>AUDIT COMMITTEE.....</b>	<b>29</b>
Composition of the Audit Committee and Relevant Education and Experience of the Members .....	29
Pre-Approval Policies and Procedures .....	30
External Auditor Service Fees.....	31
<b>TRANSFER AGENT AND REGISTRAR .....</b>	<b>31</b>
<b>EXPERTS .....</b>	<b>31</b>
<b>ADDITIONAL INFORMATION.....</b>	<b>31</b>

# Indigo Books & Music Inc.

## CORPORATE STRUCTURE

### Name, Address and Incorporation

Indigo Books & Music Inc. (“Indigo”, the “Company”, “we”, “us” or “our” as the context requires) was formed upon the amalgamation of Chapters Inc. and Indigo Books & Music, Inc. under the *Business Corporations Act* (Ontario), pursuant to a Certificate of Amalgamation dated August 16, 2001. Subsequently, Indigo was amalgamated with Chapters Online Inc. (“Chapters Online”) under the *Business Corporations Act* (Ontario) pursuant to Articles of Amalgamation dated April 3, 2004, and with CCBC Holdings (2001) Inc. and 1526656 Ontario Limited under the *Business Corporations Act* (Ontario), pursuant to Articles of Amalgamation dated April 3, 2005. Previously, Chapters Inc. was formed upon the amalgamation of Coles Book Stores Limited and FICG Inc., under the *Business Corporations Act* (Ontario), pursuant to a Certificate of Amalgamation dated April 11, 1995. Indigo’s head and registered office is located at 468 King Street West, Toronto, Ontario, M5V 1L8.

Chapters Online was incorporated under the *Business Corporations Act* (New Brunswick) by Certificate of Incorporation effective July 23, 1999. In August and September 1999, Chapters Online went public on the Toronto Stock Exchange (“TSX”), with Chapters Inc. retaining a 69.9% ownership stake. On October 27, 2001, Indigo acquired all the issued and outstanding shares of Chapters Online not already owned by Indigo. This transaction resulted in the issuance of 750,193 common shares of Indigo to the holders of equity interests of Chapters Online. Thereafter, Chapters Online became a wholly owned subsidiary of Indigo. Immediately following the acquisition, Chapters Online’s business was incorporated into Indigo’s business. Pursuant to this transaction, Chapters Online filed Articles of Continuance in Ontario on November 5, 2001. On April 3, 2004, Chapters Online was amalgamated with Chapters Inc. and the online business is now integrated into the overall business.

### Principal Subsidiaries

The following table sets forth the names of the principal subsidiaries (including limited partnerships) of Indigo as of May 31, 2011, the percentage of voting shares (or interest) owned by Indigo and the jurisdiction of incorporation or continuance of each such subsidiary (or limited partnership).

<u>Name of Subsidiary</u>	<u>Percentage Owned</u>	<u>Jurisdiction of Formation, Incorporation or Continuance</u>
Calendar Club of Canada Limited Partnership.....	50.0%	Delaware, USA
Kobo Inc. ....	51.4%	Ontario, Canada

Kobo Inc. (“Kobo”) was incorporated in August 28, 2009 under the name Shortcovers Inc. under the *Business Corporations Act (Ontario)*. On December 4, 2009, the Company completed a name change from Shortcovers Inc. to Kobo Inc. On December 14, 2009, Indigo transferred the net assets of Shortcovers to Kobo Inc. in exchange for common shares of Kobo. Kobo’s corporate headquarters is located at 135 Liberty Street, Suite 101, Toronto, Ontario, M6K 1A7. Kobo’s corporate website address is [www.kobobooks.com](http://www.kobobooks.com).

## FORWARD-LOOKING INFORMATION

This document contains forward-looking information within the meaning of Canadian provincial and territorial securities laws. All statements other than statements of historical facts included in this Annual Information Form, including statements regarding the prospects of the industries in which the Company

operates, future plans, expected financial position and business strategy of the Company may constitute forward-looking information. The words “believe” “intend” and “expect” and other expressions of similar import, or the negative variations thereof, and similar expressions of future verbs such as “will” are predictions of or indicate future events and trends and identify forward-looking statements. Forward-looking information is based on the reasonable assumptions, estimates, analysis and opinions of management made in light of its experience and perception of trends, current condition and expected developments, as well as other factors that management believes to be relevant and reasonable at the date that such statements are made. The forward-looking information contained in this Annual Information Form is presented for the purpose of assisting the Company’s security holders in understanding its financial position and results of operation as at and for the periods ended on the dates presented and the Company’s strategic priorities and objectives, and may not be appropriate for other purposes. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, such statements involve risks and uncertainties, and undue reliance should not be placed on such statements. Certain material factors or assumptions are applied in making forward-looking statements, and actual results may differ materially from those expressed or implied in such statements. Information about material factors that could cause actual results to differ materially from expectations and information about material factors or assumptions applied in making forward-looking statements may be found in this document under “Risk Factors” as well as under “Risks and Uncertainties” in the Company’s Management Discussion & Analysis (53 weeks ended April 3, 2010 to the 52 weeks ended April 2, 2011) (the “MD&A”) and elsewhere in the Company’s filings with Canadian securities regulators. The Company does not undertake any obligation to update publicly or to revise any of the forward-looking information contained or incorporated by reference in this document, whether as a result of new information, future events or otherwise, except as required by law.

## **GENERAL DEVELOPMENT OF THE BUSINESS**

### **Three Year History**

It has been 14 years since Indigo launched its first superstore with a commitment to enriching Canadian's lives through books and complementary products. Much has changed since then in both our industry and the larger media environment that serves our customers. The online channel has expanded dramatically, offering consumers an increased number of titles at a lower cost than a traditional bookstore. More recently, the digital channel has provided consumers with a completely new reading platform with instant accessibility, huge selection and lower costs.

Over the past three years, Indigo has invested directly into both of these high growth channels, but has also focused on advancing the core retail business through adapting our physical stores, improving productivity, and driving employee engagement.

The key strategies are outlined below.

#### *1. Adapting our Physical Stores*

To ensure that the offerings in our physical stores are rich and compelling, the Company is working to expand its product mix, is introducing full-line toy stores to its large format locations and is developing its own gift and lifestyle products to further expand its gift and lifestyle offering.

After successfully piloting the expansion of its toy offering Indigo began full expansion of the toy business in fiscal 2009. At the end of fiscal 2011, the Company had full-line toy stores in 53 of its large format stores with the remaining superstores showcasing expanded toy offerings.

Through fiscal 2010 and fiscal 2011, the Company took steps to establish its product development capability to expand its proprietary gift and lifestyle merchandise. This initiative is part of the Company's focus on providing customers with increasingly meaningful and life enriching merchandise while improving operating margins. To support this initiative, Indigo opened a new design office in New York in fiscal 2011, and proprietary merchandise developed by this team is scheduled to be in stores in fiscal 2012.

#### *2. Driving Productivity Improvement*

While a key focus in the Company's retail business is on evolving to meet the emerging needs of customers, the Company is also focused on driving productivity improvements. The challenge for the Company is to continually look for innovative ways to drive costs down while improving what we deliver to customers. For this reason the Company has implemented a number of key initiatives related to improving productivity. In particular, the Company has focused on two major supply chain productivity initiatives designed to further reduce costs, deliver improved operating margins and improve service to customers.

In fiscal 2010, a project was approved to open a new distribution facility and to deploy a new warehouse management system to serve as the fulfillment centre for the Company's online business. The 162,800 square foot facility opened in September 2010 and currently supports an increased assortment of books and general merchandise product for online customers.

The second phase of this project to upgrade the Company's existing retail distribution facility to more efficiently support the retail stores began in January 2011. The project scope will replace the warehouse

management system and upgrade the material handling equipment. This project is scheduled for completion in fiscal 2012.

### *3. Employee Engagement*

Indigo's strategic efforts over the past three years have included a focus on employee engagement. To help drive employee engagement over the last three years, Indigo invested in training and development, and has worked to improve overall communication throughout the Company. The Company will also launch a talent management software tool along with enhancements to existing human resources reporting tools in fiscal 2012. The Company realizes that sustaining high levels of employee engagement is a day in and day out, year over year responsibility and, accordingly, expects to continue to commit resources to specific initiatives designed to make Indigo one of the best places to work.

### *4. Digital Initiative*

Fiscal 2010 marked the true beginning of the digital age for books and Indigo is at the forefront of this new world. Shortcovers, Indigo's digital initiative, launched in February 2009 as a new digital destination, [www.shortcovers.com](http://www.shortcovers.com), offering online and mobile service with instant access to books, articles and blogs. On December 14, 2009, Indigo transferred the net assets of Shortcovers to a new company, Kobo in exchange for common shares of Kobo. The Shortcovers website was changed to [www.kobobooks.com](http://www.kobobooks.com). As at May 31, 2011, Indigo maintains a controlling interest in Kobo.

While books have been available in electronic form for many years, awareness of this format and the availability of new devices that enable eReading are growing. As Canadians begin to explore this new, electronic reading experience, Indigo intends to position itself as the go-to destination in Canada for eReading. Through its partnership with Kobo, Indigo provides an eReading experience to its customers, allowing them to purchase eBooks and read them on an evolving selection of smartphones and eReaders.

### *5. Online Development and Redesign*

Reshaping Indigo's offering to include expanded gift and lifestyle product, full line toy shops, and Kobo and Kobo accessories also involves the reshaping of our online experience. The online redesign includes changes in merchandising to add more gift, lifestyle and toy product and changes in the Company's approach to communicating online. The creative, architectural, and development work for the online redesign began in 2010 and will continue through 2011 and 2012.

To further improve the online customer experience, a new distribution centre dedicated to the online business, opened in September 2010.

## **DESCRIPTION OF INDIGO**

### *Overview of Business*

Indigo is the largest book, gift and lifestyle, and specialty toy retailer in Canada. Indigo operates in all provinces and sells books and book-related products, including newspapers, magazines, audio books, stationery, music CDs, videos, DVDs, educational and entertainment-oriented software, toys and gifts under the names Indigo, Chapters, the World's Biggest Bookstore, Coles, IndigoSpirit, SmithBooks and The Book Company, with one store under the banner, Pistachio. The online division, [www.chapters.indigo.ca](http://www.chapters.indigo.ca), features books, eBooks, toys, gift and lifestyle products. The Company also has a 50% interest in Calendar Club of Canada Limited Partnership, which operates seasonal kiosks and year-round stores in shopping malls across Canada.

Indigo is the majority shareholder of Kobo, a global eBook retailer.

The Company participates in a joint venture through a 50% equity ownership in the Calendar Club of Canada Limited Partnership to sell calendars, games and gifts through seasonal kiosks and year-round stores. Calendar Club of Canada Limited Partnership currently operates approximately 210 seasonal calendar kiosks and inline game stores each year.

### **Description of the Retail Business**

Indigo operates 97 superstores. Superstores are typically ten times the size of Indigo's small format stores, permitting them to carry a large title selection and provide an inviting ambience. Indigo opened one new superstore between April 3, 2010 and April 2, 2011, located at Erin Mills Town Centre in Mississauga.

Indigo operates 140 traditional small format stores under the banners Coles, SmithBooks, and The Book Company. In addition, there are nine small format stores which offer an expanded gift and paper selection, operating under the banner, Indigospirit and one new concept store under the banner of Pistachio. All small format stores are in shopping centres, street-front retail areas, airports, a hospital and shopping concourses throughout Canada. The small format stores are built on service, convenient locations and selection. Indigo continues to pursue a small format store rationalization program whereby, as leases come up for renewal, Indigo closes under-performing stores, as well as small format stores that will be impacted by the opening of a superstore in their markets. At the same time, it is management's belief that profitable opportunities exist within certain markets for the small format stores.

#### *Superstores*

Indigo operates its superstores under the names Indigo Books & Music, Indigo Books • Gifts • Life, Indigo Books • Gifts • Kids, Chapters, and the World's Biggest Bookstore in all ten provinces of Canada. These superstores are typically about ten times the size of Indigo's small format stores. In the 52 weeks ended April 2, 2011, these stores accounted for sales of \$667.6 million, representing 65.6% of total revenues. In the 53 weeks ended April 3, 2010, these stores accounted for sales of \$670.5 million, representing 69.2% of total revenues. Indigo superstores are designed to be a destination for book consumers, offering an environment that is conducive to browsing and that becomes a part of the local community. Management believes that, as a result of superior title selection, ambience, convenient hours (generally, 10:00 a.m. to 10:00 p.m., seven days per week), competitive pricing and knowledgeable staff, Indigo is well positioned to maintain its status as the leading book superstore operator in Canada.

**Large Title Selection.** Indigo believes that superstore sales are driven by actual customer browsing on-hand titles and by customers' expectations that a desired title or subject will be in stock. Indigo's superstores offer a large selection of book titles, covering major and obscure subjects. Indigo has computer kiosks in all superstores to give retail customers access to much the same inventory of books that is available to its online shoppers.

**Superior Store Design.** Superstores are designed to encourage browsing for extended periods, featuring wide aisles, comfortable seating, warm lighting and soft colours. Floor plans partition the stores into manageable areas and lead customers to popular categories such as "fiction", "kids" and "gift and lifestyle".

**Real Estate.** Indigo operates 97 superstores. The size of an Indigo superstore is dependent upon the size of the local population and the potential draw of such a store, the demographics of the market, and the availability of other locations. Currently, superstores range in size from 10,000 to 67,000 square feet,

with the majority being between 20,000 and 30,000 square feet compared to an average of approximately 2,600 square feet for small format stores. The total superstore selling footage is 2,235,430 square feet. All Indigo superstores are leased.

#### *Small format Stores*

Indigo operates its small format stores in all ten provinces and one territory in Canada under the names Coles, Indigo, Indigospirit, SmithBooks and The Book Company. These stores are typically located in retail shopping centres, street-front retail areas, major airports, a hospital and central business districts. Coles is the leading shopping centre bookstore chain in Canada in terms of both sales and number of stores. Indigo's small format stores generated combined sales of \$148.7 million in the 52 weeks ended April 2, 2011, representing 14.6% of total revenues. In the 53 weeks ended April 3, 2010, these stores accounted for sales of \$157.4 million, representing 16.3% of total revenues.

***Convenience Shopping.*** Indigo's small format stores typically carry approximately 8,000 titles, covering a wide range of book categories, including new releases, bestsellers, mass market paperbacks, trade books, bargain and remaindered books, audio books, calendars, newspapers and magazines. Stores are generally open during the operating hours of the shopping centres in which they are located.

Small format stores rely heavily on impulse and walk-in business. Indigo believes that its recognized national banner names are valuable in attracting walk-by traffic into its stores, and that its portfolio of locations in prominent shopping centres, street-front retail areas, airports, a hospital and other core retail locations across Canada is the most significant factor contributing to their ongoing sales performance.

***Real Estate.*** Indigo operates 140 traditional small format stores under the banners Coles, SmithBooks, and The Book Company. Additionally there are nine small format stores which have an expanded gift and paper offering, operating under the banner Indigospirit. There were four small format store closures and one small format store opening between March 30, 2008 and March 28, 2009, and five small format store closures and no small format store openings between March 29, 2009 and April 3, 2010, and one small format store closure and no small format store openings between April 4, 2010 and April 2, 2011

Indigo's management believes that many of Indigo's small format stores are located in geographic areas that are too sparsely populated to support a superstore and, accordingly, that Indigo's small format stores will continue to provide a significant source of revenue into the future.

#### *New Concept Stores*

During the fiscal year ended March 28, 2009, Indigo opened two new concept stores under the Pistachio banner. Pistachio offers a "good for you, good for the planet", environmentally friendly selection of kids and baby, home and lifestyle, and organic apothecary products for everyday use. During the fiscal year ended April 3, 2010, Indigo closed one of the stores operating under the Pistachio banner as the demographics of the location were not a match for the Pistachio offering. The Yonge & Eglinton, Toronto street front location remains open. Certain Pistachio products are also sold in Indigo and Chapters superstore locations.

#### **Description of the Internet Business**

Indigo operates [www.chapters.indigo.ca](http://www.chapters.indigo.ca), a leading Canadian destination for online shoppers. The site features a large selection of books, audio books, music CDs, DVDs, toys, and gift and lifestyle merchandise at Canadian prices, with a focus on products of interest to Canadians.



In February 2009, Indigo also launched Shortcovers.com, a digital destination offering both an online and mobile service to help booklovers find their next great read. Using the Shortcovers service, customers can sample or purchase books, chapters, articles and other content for immediate download to mobile devices they already own. On December 14, 2009, Indigo transferred the net assets of Shortcovers to a new company, Kobo, [www.kobobooks.com](http://www.kobobooks.com). For further information about Kobo, please refer to the section entitled “Description of Kobo Inc.”.

### *Attracting Customers to the Website*

Indigo uses a variety of different resources to attract customers to its website. The resources include: our large opt-in database; paid and natural search; and affiliate marketing.

Indigo’s affiliate program allows other website owners to link to Indigo’s website and direct their visitors to purchase products from Indigo. Each time a purchase is made by a visitor who has followed an affiliate’s link, such affiliate receives a referral fee. Indigo’s website is also designed to allow affiliates to establish links from their websites quickly and easily.

The online channel also supports our *irewards* loyalty program members. These members, who represent our most loyal and valuable book buyers, are attracted to and supported by the website through offers of additional discounts on books when shopping at our website. In early fiscal 2012, Indigo launched a free, points-based loyalty program (*plum rewards*) as an alternative to the fee-based *irewards* program. This new program is also supported by the online channel.

The Indigo Community, an online platform that combines the best of social networking with a set of user generated content tools designed specifically for booklovers, also attracts customers to the [www.chapters.indigo.ca](http://www.chapters.indigo.ca) website. Indigo Community members are drawn back to the site through triggered emails sent out in response to activity related to their participation in the Community, for example, when a friend recommends a book to them.

### *Building Customer Loyalty*

Indigo’s website promotes customer loyalty and repeat purchases by providing an online experience, including the Community platform, which encourages customers to return frequently. Visitors to the website are greeted with highlighted subject areas arranged in a simple fashion intended to enhance product search and selection. Indigo offers numerous forms of content to enhance a customer’s shopping experience, including cover art, synopses, annotations and reviews by other customers.

Other special features include bestseller lists, featured books, music and DVDs, themed presentations, highlighted books by Canadian authors, along with video, audio and digital content. Indigo’s search engine and sorting capabilities allow consumers to search or “browse” in an intuitive and easy fashion, grouping products according to keywords, titles, authors, artists, actors, and more complex and precise search tools. Indigo’s search engine is designed to produce accurate and meaningful results on virtually every search.

The Community tool set allows members; to build a virtual bookshelf, music shelf, or DVD shelf; join in or start up book clubs/groups; and create and comment on reviews, top ten lists, recommendations, and posts. Each Community member may customize their profile based on personal preferences, including the ability to restrict sharing information or content. This social networking community geared to booklovers enhances the customer’s experience and encourages members to regularly return to the site.

Customer service and support are critical to establishing and maintaining long-term relationships with customers. Indigo seeks to achieve frequent communications with, and feedback from, its customers in order to improve customer satisfaction. It offers an email address and a toll-free telephone number to enable customers to request information and to encourage feedback and suggestions. Indigo's customer service representatives are available by telephone five days per week year-round, and more frequently during the holiday season. In addition, Indigo has customer service availability via email.

Indigo has designed its systems so that all transactions on its website are simple and secure. It allows its customers to establish an account online, to store an address book, credit card information and shipping preferences, which can be automatically re-used by customers on repeat purchases. All sensitive customer information is encrypted, using advanced security systems, before it is sent to Indigo's secure server.

Indigo's online site enjoys the benefit of Indigo's large volume wholesale discounts from its "bricks and mortar" retail stores. The online business does not always match the prices of all its competitors, but merchandises effectively with a mix of price competitiveness and a wide selection of products, including many bestseller books in hardcover that offer up to a 45% discount from publishers' list prices. It denominates its prices in Canadian dollars, which provides Canadian customers with certainty in determining price.

#### *Efficient Execution of Customers' Orders*

The ability to deliver products to customers efficiently is a critical factor in achieving repeat customer purchases.

Consumers increasingly demand an assured in-stock position and fast delivery from online retailers. In conjunction with the new Indigo Online Distribution Centre and outsourcing agreements with other vendors, Indigo is able to provide a large number of books, music, DVDs, and toys, many of which are available for shipment within 24 hours. It operates a virtual warehouse, whereby customer orders are automatically transmitted to the Indigo Distribution Centre or other third party vendors, where they are packaged and shipped to customers in accordance with their delivery specifications. The Indigo Distribution Centre uses inventory control systems that update its inventory as orders are transmitted from the website. Each customer receives an e-mail after placing an order that confirms that the order has been received by Indigo and that lists details of their purchase. A second e-mail is sent to each customer, confirming shipping and tracking information.

In September 2010, we opened a new distribution facility dedicated to the online business. This facility is 162,800 square feet, and became operational ahead of our critical holiday season. This facility supports an increased assortment of general merchandise business for the online business, as well as books that we sell to our customers. Technology plays a key role in Indigo's ability to communicate with customers, as well as ensuring that orders are executed accurately and efficiently. Indigo expects to continue to invest in technologies that will enable it to offer its customers a convenient and user-friendly online shopping experience. Its website and e-commerce platforms use a component architecture design that is fully redundant and rapidly scalable, allowing it to increase capacity easily as well as quickly develop new applications, such as the Indigo Community and Indigo's touch screen in-store kiosk application. The Q9 Data Centre located in Toronto, Ontario, is the primary host location for Indigo's online operations. Indigo selected this facility because it is a best in class data centre facility, particularly in terms of availability and security.

## *eBooks*

The emergence of the eBook category will have an impact on traditional book sales. Indigo anticipates substantial growth in the eBook market in the coming years and expects to continue to invest in eBook-related products and services to mitigate the erosion of physical book sales that may result.

On May 1, 2010, Indigo began selling the Kobo eReader in many of its superstore and small format stores, and through its online and kiosk channels. While this device is an important part of an eReading experience, Indigo will continue to support eReading via the Kobo service on a variety of devices available to Canadians.

## GENERAL

### *Purchasing*

Indigo's category managers have significant book industry experience, each specializing in one or more subject areas, such as fiction, history, architecture and science. Indigo purchases its books from more than 25 major publishers.

Currently, Indigo has an active list of approximately 500,000 titles. Each year, Indigo's category managers are presented with 60,000 to 75,000 new titles for consideration, of which approximately 25,000 are chosen for addition to Indigo's title list, while approximately 20,000 to 25,000 titles are de-listed annually. In addition, Indigo offers up to 2 million titles online through [www.chapters.indigo.ca](http://www.chapters.indigo.ca) and, when requested by a customer, Indigo will special order any book currently in print.

Approximately 85% of all titles Indigo purchases are returnable to suppliers for full credit. Indigo is responsible only for transportation and labour costs associated with returning these books. Historically, it has returned approximately 25% to 30% of the books purchased under these arrangements.

In order to offset the erosion of physical book sales and to maximize the average transaction revenues generated from customers who visit either small format stores or superstores, Indigo is focusing on the expansion of its toy, gift and paper programs. While the sale of books and book-related products are expected to continue to be the single most important product line for Indigo, management believes that the expansion of these other product lines will effectively add incremental revenues to existing store sales.

The purchasing activities for non-book products sold in Indigo's retail locations and online at [www.chapters.indigo.ca](http://www.chapters.indigo.ca) are centralized at its home office in Toronto (Ontario). Pricing for non-book products is determined at home office.

With the exception of gourmet food products, the majority of Indigo's gift and lifestyle products are foreign-sourced. The majority of Indigo's toy product is sourced through North American vendors. Indigo's centralized purchasing team manages the sourcing process including product choices, the management of product flow, product quality control and vendor selection.

To expand its existing gift and paper program, Indigo has established a product development team to design and develop a proprietary product line. The product development team is based in New York. Purchasing continues to occur from the head office in Toronto. Each quarter, the product is presented to the merchant team via a line review that takes place in the Toronto office. The merchant team decides which product will be carried across each of the channels represented under the Indigo banner.

In addition to expanding its gift and lifestyle program, Indigo has built an educational toy business as an adjunct to its children's books business. Management believes this is a strong long-term opportunity

both in stores and online, and the Company expects to continue to add toy programs to existing stores and to expand the online toy business.

The music business, specifically the retail compact disc business, has faced significant competitive challenges over the last several years. Indigo has not been immune to this pressure. Indigo currently offers “full-line” music/DVD departments in less than one-fifth of its superstores. Management is actively seeking to reduce the Company’s exposure to this business. As part of the corporate strategy, Indigo expects to continue to decrease the number of stores with a music/DVD section.

Indigo’s business is highly seasonal and follows quarterly sales and profit (loss) fluctuation patterns, which are similar to those of other retailers that are highly dependent on the December holiday sales season. A disproportionate amount of revenues and profits are earned in the Company’s third quarter. As a result, quarterly performance is not necessarily indicative of the Company’s performance for the rest of the year.

### *Information Systems*

In the fiscal year ended March 28, 2009, Indigo deployed new kiosks into all of its superstores to make it easier to search for products in store and to enable richer merchandising. Additionally, Indigo deployed a new customer database to manage customer information and loyalty cards across all channels. Finally, Indigo became compliant with the industry standard known as ISBN 13 moving to 13 digit Industry Standard Book Numbers (“ISBN”).

In the fiscal year ended April 3, 2010, Indigo upgraded its enterprise resource planning (ERP) system and introduced support for Chip and PIN credit cards. Indigo also introduced a new marketing system to allow for personalized recommendations to be provided to Indigo customers, a continuation of the customer loyalty program. Finally, Indigo introduced a new workforce management system to better manage its retail workforce.

In the fiscal year ended April 2, 2011, Indigo invested in a number of Information Technology initiatives. These initiatives include the opening of a new distribution centre to support the growth in the Company’s online channel and the deployment of a new warehouse management system in that facility. To support the growth of both the kids & lifestyle categories, the Company launched a new consumer experience at [chapters.indigo.ca](http://chapters.indigo.ca) and also integrated its online and kiosk channels with Kobo to sell eBooks & eReaders. Indigo also launched a virtualization and consolidation program to reduce the footprint of its information technology assets. Finally, Indigo invested in two other significant initiatives, a new loyalty program and payment card Industry (“PCI”) compliance, both of which are expected to be complete in the fiscal year ending March 31, 2012.

### *Loyalty Program*

Indigo’s *irewards* customer loyalty program for which customers pay an annual fee, operates at its superstores, small format stores, and online at [www.chapters.indigo.ca](http://www.chapters.indigo.ca) to provide members with a discount on all book purchases. Indigo believes that the program is important in generating significant customer commitment and value. In addition, the transaction and demographic information provided by the program provides a means to understand customer behaviour and respond with a variety of sophisticated marketing and service strategies that generate measurable contribution to the business. The *irewards* program had a combined total enrollment of approximately 940,000 members at the end of March 2011.

In January 2011, Indigo began to pilot a free, points-based loyalty program (*plum rewards*) as an alternative to the fee-based *irewards* program in two markets. The goal of the free *plum rewards* program is to grow Indigo's known customer database in order to expand on the Company's existing marketing and service strategies to better know and thereby better serve our customers resulting in positive contribution to the business. Furthermore, plum rewards supports Indigo's evolution to a more diverse merchandise mix by offering benefits that apply across most products available in-store. The pilot was deemed successful, and in April 2011, the *plum rewards* program was rolled out to all stores. At the same time, the *irewards* annual fee was increased and its discounts were expanded to include non-book products in store.

### *Employees*

As at April 3, 2011, Indigo employed a total of approximately 6,700 people (on a full-time and part-time basis). The number of part-time customer experience representatives (CERs) employed by Indigo fluctuates based upon seasonal demand. In 2011, Indigo implemented Phase III of the employee scheduling system which allowed for labour cost optimization. The growth of the gift and lifestyle categories was supported by a general merchant talent acquisition strategy that resulted in new merchant hires at all levels including the appointment of Ray Camano as Chief General Merchant. Employee development has been focused on providing store employees with the knowledge and skills to support our key business initiatives in sales generation, eBooks, Kobo sales, our gift and lifestyle expansion, and our toy expansion.

Since May 22, 2009, Indigo has had no collective agreements in place.

### *Trade Names and Trademarks*

Protection of the Indigo and Chapters trademarks and associated design presentation is highly important to Indigo and the Company has established procedures to protect the trademarks integral to its business. It is Indigo's policy to defend all of its intellectual property vigorously where appropriate. The registrations of Indigo's trademarks are renewable. Procedures are in place to ensure timely renewals.

Indigo is the owner of numerous trademarks and trade names that are registered in Canada. The principal trademarks of the Company include: Indigo®; Indigo Books Music & More®; Indigobaby®; Indigo! Kids®; Indigolife®; Indigo Love of Reading Foundation®; Indigospirit®; Chapters®; Coles®; Cultural Department Store®; Pistachio®; Smithbooks®; The Book Company and design; and World's Biggest Bookstore®.

In addition, Indigo owns certain domain names, including [www.chapters.indigo.ca](http://www.chapters.indigo.ca), which are used in connection with its online business and presence.

### *Indigo Distribution Centres*

Indigo maintains a 306,600 square foot retail distribution facility in Brampton, Ontario. The facility is used for the distribution of retail products.

With the completion of the first phase of a supply chain project approved in June of 2009, Indigo moved the fulfillment for online operations from the retail distribution centre to the new online fulfillment centre which opened in Brampton, Ontario in September 2010. The new 162,800 square foot online fulfillment centre supports an increased assortment of books and general merchandise product for online customers. A new warehouse management system has been implemented in the online warehouse.

The second phase of the supply chain project is currently underway to upgrade the existing retail facility to more efficiently support the retail stores. The project scope will replace the warehouse management system and upgrade the material handling equipment. The improvements are expected to be completed during fiscal 2012.

## **Properties**

Indigo currently leases all its facilities. The average unexpired term under Indigo's existing small format store leases is approximately 2.8 years, and superstores have an average unexpired lease term of approximately 3.7 years. Indigo has commenced a shorter-term leasing strategy for its small format stores in order to maximize flexibility, hedge against the possibility of shopping centre deterioration, and facilitate the implementation of the rationalization strategy related to its small format stores.

Indigo leases its main headquarters at 468 King Street West, Toronto, Ontario, M5V 1L8. Indigo's headquarters are approximately 65,000 square feet in size. Indigo also leases approximately 7,000 square feet of space at 441 King Street West in Toronto, where it currently houses its real estate and online groups.

Indigo also leases approximately 1,700 square feet of space at 176-180 Grand Street, New York, NY, U.S.A. where it houses its design and product development office.

Indigo leases its retail and online distribution centre premises, which comprise approximately 306,600 square feet and 162,800 square feet of warehouse space, respectively, in Brampton, Ontario.

## **Sustainability**

Indigo's program has evolved to include a three-pronged approach to sustainability which focuses its efforts to: 1) improve the sustainability of its book and non-book product through responsible purchasing practices and policies; 2) reduce the Company's operational impacts on the environment; and 3) increase awareness of and build engagement among our employees and customers.

Many areas of the business have adopted new procedures that, in addition to improving environmental performance, employee engagement, and enhancing brand reputation, may also improve the bottom line by capitalizing on operational efficiencies.

### *Greening our Operations*

The Company is continually working to identify, measure, and utilize opportunities throughout the business in order to achieve Company-wide sustainability. These opportunities include:

- The implementation of Indigo's Environmental Paper Policy. Indigo established a leadership role in the publishing industry encouraging better paper sourcing practices, increased use of recycled paper fibre and pursuit of Forest Stewardship Council (FSC) certification for books. Indigo also participates in the Boreal Business Forum comprised of leading corporations and investors with a strong interest in conservation of the Boreal Forest;
- Working to achieve reductions in packaging materials to improve efficiency and reduce costs;
- Continuing to work to identify material-specific waste reduction opportunities. From 2007 to 2009 Indigo realized a 41% increase in the amount of waste diverted through store recycling initiatives representing 7,710 tonnes of waste diverted from landfill;
- Compiling energy consumption data across retail locations to better manage energy consumption, helping to reduce both costs and the Company's carbon footprint. Indigo has engaged the services

of a third party energy management group to allow for consumption insight and targeted identification of energy reduction opportunities;

- Indigo's Book Product Donation Program, which allows unsold books designated for scrapping to be donated to charity, has continued to grow. In fiscal year 2011, Indigo donated approximately \$200,000 worth of products to six literacy focused charitable partners. This program also positively reinforces the brand with customers and employees and strengthens our ties to local communities; and
- Introduction of Indigo's National Plastic Bag Reduction Program resulted in a 53% decrease in plastic bag use in Indigo's stores across the country and also reduced Indigo's internal bag program costs. Funds collected from the five cent bag fee were directed towards a variety of internal and external sustainability initiatives.

### *Social Responsibility and Employee Engagement*

As Indigo continues to diversify its product mix and to source from Asian markets, Indigo conducts factory social accountability audits in accordance with international standard SA8000. This will continue to be a focus for Indigo as it continues to grow the business.

Indigo recognizes that our employees want to be more involved in the IndigoGreen program. As such, Indigo is launching the development of store Green Teams and an Indigo Green Guide during Environment Week 2011. This is part of Indigo's focus to increase employee perception of Indigo as an environmentally and socially responsible company.

Indigo's sustainability programs and policies have no material impact on earnings or capital expenditures.

### *Indigo Love of Reading Foundation*

In 2004, Indigo founded the Indigo Love of Reading Foundation to address the underfunding of Canadian elementary schools and the resulting literacy crisis. The goal is to stimulate provincial governments across the country to invest in public school libraries and promote early literacy through engaging and relevant books. Until then, it will continue to put books in to the hands of children through its annual Literacy Fund grant and grassroots Adopt a School program. To date it has committed \$10.5 million to more than 415 schools in Canada with the support of Indigo and its customers, employees and suppliers.

### *Regulatory Environment*

The *Investment Canada Act* regulates the acquisition by a non-Canadian of control of a Canadian business, including a business engaged in the publication, distribution or sale of books. Currently, foreign investments to acquire control of an existing Canadian-controlled book publishing, distribution or retailing business are generally not permitted. Acquisitions of a non-Canadian controlled business and indirect acquisitions are subject to review by Heritage Canada, the government agency responsible for determining whether the acquisition is likely to be of net benefit to Canada. As part of that determination, Heritage Canada will typically seek from the foreign investor one or more commitments, such as a commitment to the development of Canadian authors, a commitment to support the infrastructure of the book distribution system in Canada, accessibility of the company's Canadian marketing and distribution infrastructure to interested and compatible Canadian-controlled publishers, and a commitment to education and research through financial and professional assistance to Canadian institutions offering programs in publishing studies. In addition, where the business is Canadian-controlled, other Canadians must be given a full and fair opportunity to acquire the business. In practice, these provisions have not

generally been applied to businesses in which bookselling forms only an ancillary component of the business, such as mass merchandisers. A foreign investment to establish a book publishing, distribution or retailing business will generally not be permitted other than as a joint venture controlled by Canadians.

The Book Importation Regulations (the “Regulations”) to the *Copyright Act* (Canada) came into force on September 1, 1999. The *Copyright Act* (Canada) and Regulations limit the “parallel importation” of books legitimately produced in another country, which may be imported without the consent of the Canadian copyright owner or exclusive distributor. The Regulations establish notice requirements and distribution criteria that must be met by an exclusive distributor. Where the specified criteria are met, orders may be placed for books only through the Canadian exclusive distributor. The *Copyright Act* (Canada) provides that the parallel importation of books without consent of the Canadian copyright owner or through the exclusive Canadian distributor constitutes copyright infringement.

In April 2010, the Government of Canada issued a one-time ruling to allow U.S. online retailer, Amazon.com Inc., to operate a distribution centre in Canada. Amazon had previously operated in Canada via a third-party operated distribution centre.

Heritage Canada has initiated a regulatory review of foreign investment in the Canadian book industry. No recommendations in relation to this review have been put forth as of May 31, 2011.

#### *Tax Loss Transaction*

On May 30, 2011, Indigo purchased a company, the sole asset of which is certain tax losses, from a public company controlled by Mr. Gerald W. Schwartz, who is also the controlling shareholder of Indigo. Indigo acquired this company with \$96.0 million of non-capital tax losses in exchange for net cash consideration of \$5.1 million and a note payable of \$5.1 million. The note payable is non-interest bearing and will be due on March 31, 2012. The transaction was recorded at the exchange amount and included transaction costs shared between the two companies. As a result, the Company will record a future tax asset of \$24.3 million and the difference of \$14.1 million between the net cash consideration and the future tax asset will be accounted for under IFRS and recorded directly to retained earnings.

In April 2010, Indigo purchased a company, the sole asset of which is certain tax losses, from a public company controlled by Mr. Gerald W. Schwartz, who is also the controlling shareholder of Indigo. Indigo acquired this company with \$69.6 million of non-capital tax losses in exchange for net cash consideration of \$7.7 million. The amount included transaction costs shared between the two companies. This transaction was recorded at the exchange amount. As a result, the Company recorded a future tax asset of \$20.7 million and the difference of \$13.0 million between the net cash consideration and the future tax asset was recorded as a deferred credit, included in accounts payable and accrued liabilities. In connection with this transaction, the Company obtained an advanced tax ruling from Canada Revenue Agency.

Previously, in March 2009, Indigo purchased a company, the sole asset of which is certain tax losses, from a public company controlled by Mr. Gerald W. Schwartz, who is also the controlling shareholder of Indigo. Indigo acquired this company with \$23.1 million of non-capital tax losses in exchange for net cash consideration of \$2.9 million. In connection with this transaction, the Company obtained an advanced tax ruling from Canada Revenue Agency, and Grant Thornton LLP, an independent accounting firm retained by the Company’s Audit Committee, provided an opinion that the value paid by the Company for the tax losses was fair.

The transactions were unanimously approved by the Audit Committee, all the members of which are independent directors.



### *Normal Course Issuer Bid*

On November 2, 2009, Indigo commenced a normal course issuer bid (“NCIB”). Under the NCIB, Indigo was entitled to purchase up to 1,227,229 of its common shares, representing approximately 5% of its total outstanding common shares, with a daily maximum purchase of 2,571 common shares. All common shares purchased under the NCIB were cancelled and returned to treasury.

Indigo entered into the NCIB because it believed that its common shares had been trading in a range that did not fully reflect the value of the common shares. As a result, the Board of Directors of Indigo believed that the purchase of common shares from time to time could be undertaken at prices that made the acquisition of such common shares an appropriate use of Indigo’s available funds and an appropriate mechanism for returning capital to its shareholders.

The NCIB expired on November 1, 2010. Under this NCIB, Indigo purchased 59,613 common shares for an average purchase price of \$13.93.

All purchases made by Indigo under the bid were made in accordance with the rules of the TSX at market prices prevailing at the time of purchase.

A copy of the notice filed with the TSX with respect to Indigo’s NCIB can be obtained, free of charge, upon request, from Indigo’s Secretary at 468 King Street, Suite 500, Toronto, Ontario, M5V 1L8.

### **Description of Kobo Inc.**

#### *Overview*

In February 2009, Indigo launched Shortcovers ([www.shortcovers.com](http://www.shortcovers.com)), a new digital destination offering online and mobile service that provides instant access to books, articles and blogs. On December 14, 2009, Indigo transferred the net assets of Shortcovers to a new company, Kobo Inc. in exchange for common shares of Kobo. The Shortcovers website was changed to [www.kobobooks.com](http://www.kobobooks.com). As at May 31, 2011, Indigo maintains 51.4% ownership of Kobo Inc.

Kobo is a global eReading service with more than 2.3 million eBooks, magazines and newspapers available to its customers. Kobo offers an open, device-neutral platform that supports its belief that consumers should have the freedom to read any book on any device.

Kobo sells third-party digital content, including eBooks, newspapers and magazine content through its online store at [www.kobo.com](http://www.kobo.com) and its software applications for desktop and laptop computers, smartphones, tablets, eReaders and other devices. Kobo also supplies digital content to retail partners including Borders Group and REDgroup.

Kobo currently has distribution capabilities in Canada, the U.S., UK, European Union, Australia, New Zealand, Hong Kong and other territories

Kobo’s platform includes proprietary applications which support a wide array of tablet, smartphone and desktop devices on which customers can purchase and read their eBooks. Kobo also licenses its technology and platform to leading partner booksellers across the globe to allow them to establish their own branded eBook store and mobile applications “Powered by Kobo”.

Kobo also sells its own series of eReaders (devices dedicated to reading eContent). Kobo currently sells its eReaders directly through its [www.kobo.com](http://www.kobo.com) website, as well as directly through book and non-book retail partners in Canada, Australia, United Kingdom and the United States.

In the 52 weeks ended April 2, 2011, Kobo's revenues (after eliminating inter-company sales) were \$60.9 million, representing 6.0% of Indigo's total revenues. In the 31 weeks ended April 3, 2010, Kobo's revenues (after eliminating inter-company sales) were \$0.8 million, representing 0.1% of Indigo's total revenues.

## **Market**

The eBook and eReader markets have seen rapid growth in the last two years as a result of the rapid adoption of mobile media consumption and eCommerce. In addition to eReaders, multifunctional tablet devices such as the Apple iPad, Samsung Galaxy Tab and recently released BlackBerry PlayBook are rapidly gaining recognition and popularity among consumers.

The rapid growth of eReaders and tablets has driven corresponding growth in the eBook market, notably within the last three years. eBook sales are expected to grow significantly in the U.S. over the next five years. Growth rates in developed economies outside of the United States are expected to lag by approximately 1 to 2 years.

The periodical industry, including fully-illustrated (e.g. magazines) and text-oriented (e.g. newspapers and scholarly journals) content, remains an attractive segment for digital content distributors. Kobo entered these markets in October 2010, announcing the offering of a selection of some of the most popular newspapers and magazines in the world to its customers on a paid subscription basis through Kobo's eContent store.

Many major participants within the eBook industry have focused predominantly on the U.S., the largest market, and to a lesser extent the UK. While Kobo has developed a strong position within these key markets, it has also established a prominent position in other important markets including Canada, Australia and New Zealand.

The significance of multifunctional tablet computers to eReading should also be noted as tablets have significantly expanded the addressable market beyond frequent readers and have furnished content providers with a means to electronically distribute more graphic-rich content such as newspapers and magazines.

eReaders differ from other devices used for eBook consumption such as multifunctional tablets and smartphones in that they typically offer a superior eReading experience. eReaders often use screens manufactured by the E Ink Corporation which allow for outdoor reading and, because they are not backlit, reduce eye strain for readers. In addition, eReaders typically have longer battery lives and are lighter weight relative to tablets. Thus, eReaders and tablets target distinct markets, with consumers who adopt eReaders tending to be more frequent readers who prefer a dedicated device tailored to facilitating uninterrupted digital reading, as opposed to tablet buyers, who prefer a device with broader media and communications uses.

## **Competitive Conditions & Industry Trends**

Major competitors to Kobo in the eBook distribution market include Amazon, Barnes & Noble, Google and Sony. In addition, Apple with its iBookstore on its popular iPhone and iPad devices has also become a recognized player in the eBook market.

Although the eReader market has seen many choices of eReaders over the past few years, including competing brands such as the Amazon Kindle, Barnes & Noble Nook and Sony Reader, the market has experienced a substantial reduction in the number of hardware-only eReader competitors and some of the once-strong players are experiencing declining market shares. In addition, many early entrants including large, well-funded companies have been forced to exit the eReader market. These trends highlight the

importance of establishing a robust content offering and eReading ecosystem in conjunction with the eReader.

Along with its position as having one of the largest libraries of content for consumers, one of Kobo's other significant strengths relative to its major competitors has been its focus on innovating a better and more social customer experience, including integration of social elements (e.g. gifting, book clubs, recommendations, etc.), personalized reading capabilities and seamless and easy transfer of content between devices.

An important differentiator among eReader devices is eBook file compatibility, which varies based on the manufacturer's approach to digital rights management ("DRM"). Some manufacturers have chosen proprietary formats that can only be read on their devices and or with their applications. Kobo supports formats (e.g. DRM ePub) that are device-agnostic and can be read on numerous platforms, a philosophy that Kobo was one of the first in the industry to promote.

Fierce competition, combined with the introduction of lower-priced reading devices, and continually decreasing component prices have resulted in a notable downward trend in eReader prices.

Kobo's low price eReader strategy was based on a differentiated business model in which eReaders are used as a channel through which to increase brand awareness and acquire customers to drive higher margin eBook sales. Thus, Kobo reduces its reliance on eReaders relative to other eReader vendors in favor of an eContent market with significantly higher margins and barriers to entry.

Shifts in the relationship between content providers and content distributors have reduced the incidence of content distributors competing on price on a substantial number of titles. This change has meant that content distributors such as Kobo and its competitors have had to identify other means of competing to attract customers, including focusing on the quality and selection of content available and differentiating the overall customer experience. These changes have significantly increased the barriers to entry for new potential entrants into the eBook market space.

Through its established relationships with top publishers, both in the U.S. and globally, Kobo is able to provide rich content through an attractive environment to its customers. The ability for new entrants to replicate this achievement and establish relationships with the top publishers has become significantly limited recently due to publishers' desire to limit the intellectual property risks associated with increased numbers of distributors, the difficulty for new entrants to develop reliable DRM that publishers can trust, and the additional administrative expenses and growing complexity required to manage these global content distributor contracts.

There are currently two methods by which Kobo works with book publishers to provide content to its customers. The first is the traditional reseller model. Under this model, publishers sell books to a bookseller, such as Kobo, at a specified recommended retail and set wholesale price, with the wholesale price typically around 50% of the recommended retail price. The bookseller may then sell the book at a discount to the recommended retail price.

In the U.S. publishers are moving to a newer agency model. Under the agency model, the publisher remains the "vendor" who then uses eBook retailers, such as Kobo, as agents to facilitate the sale of content to consumers. Under the agency model, the book publisher controls the book price and the bookseller sells the book for the publisher and then receives a commission. Commissions are currently generally 30% of the sale price.

Outside of the U.S., the agency model has been slower to take hold. In other key markets such as Canada, Australia and New Zealand, agency contracts are beginning to materialize. Until publishers adopt the agency model, the traditional reseller model is expected to remain in place in these other markets.

## **Products and Content**

### *eReaders*

eReaders, low-power devices with paper-quality screens for reading eBooks and other digital content, have recently experienced significant technological innovations in screen and form factors that have enabled readers to enjoy an electronic reading experience truly comparable to that of reading a physical book. In addition, the integration of wireless technology has made it easy and convenient for readers to quickly and efficiently download content.

In March 2010, Kobo introduced the first generation Kobo eReader, a single-purpose, easy-to-use device with a stylish design. The Kobo eReader was priced to provide readers with an affordable entry-point to eReading. The Kobo eReader was sold through Indigo, Borders U.S., Wal-Mart Canada, Borders Australia, Angus & Robertson and Whitcoulls.

In September 2010, Kobo introduced its second-generation eReader, the Kobo Wireless eReader. Built upon the success of the Kobo eReader, the Kobo Wireless eReader added wireless connectivity, upgraded hardware for faster performance, longer battery life and a sharper E Ink screen. The Kobo Wireless eReader allows consumers to purchase eBooks directly from their eReader. The device began shipping in October 2010. It is currently available at [www.kobo.com](http://www.kobo.com) as well as Indigo, Borders U.S., and Wal-Mart in Canada and the U.S and at other retail partners.

Kobo's first and second generation eReaders are preloaded with 100 free public domain titles, including *Pride and Prejudice* and *The Adventures of Huckleberry Finn*, providing first-time users the opportunity to test the Kobo eReading experience without having to purchase an eBook.

### *Content*

Kobo has one of the largest eBook libraries in the world with over 340,000 paid titles from major and independent publishers. Its catalog includes eBooks from over 2,200 publishers, including all of the top 50 publishers in the U.S.

Kobo has established close relationships with all of the world's major publishing houses and has also built relationships with a large number of smaller, independent publishers globally.

Kobo is currently focused on continuing to acquire content both for new markets, including Europe and Asia, and in new content categories for existing markets. In October 2010, Kobo announced the availability of subscription content from some of the most popular newspapers and magazines in North America.

Additionally, Kobo also maintains a focus on establishing a platform for self-publishers to convert and sell content through its store.

### *New Products*

The launch of the all new Kobo eReader Touch Edition was announced on May 23, 2011.

The new Kobo eReader Touch Edition is currently available for pre-order in store at Chapters, Indigo and Coles retail locations nationally and online at [www.chapters.indigo.ca/kobo-touch](http://www.chapters.indigo.ca/kobo-touch) and is expected to be available in-store and online in June 2011.

## **Specialized Skills & Knowledge**

Kobo has focused on building best-in-class technology capabilities. The well-educated, knowledgeable and experienced in-house team has provided Kobo with the expertise and means to

develop a variety of key technologies that the Company believes provide Kobo with significant competitive advantages and position it well for future growth.

The Kobo team has development expertise in a wide array of languages and platforms, including languages: C#, Java, Objective C, C++, OS; and frameworks: Windows, .NET, Apple's iOS, RIM Blackberry OS, RIM QNX OS, Android OS, Embedded Linux.

Kobo actively recruits junior talent from leading universities in Canada, including the University of Waterloo and University of Toronto. In addition, Kobo continues to actively recruit for its content acquisition team globally.

## **eReader**

### *Industrial Design*

Kobo, in conjunction with 3<sup>rd</sup> party design and innovation consulting firms, designed and owns the design for its eReaders.

### *Hardware/Software Integration*

Kobo developed and owns the eReader middleware and client software for its Kobo eReaders. These proprietary technologies provide the interface to the customer's content library and settings, as well as the link between the front-end customer environment and the hardware and operating system.

While Kobo owns the eReader designs and middleware, it has outsourced the manufacturing of components and assembly of the eReader through third-party relationships with key global suppliers.

## **Cycles**

Given Kobo's short operating history, there is no specific history from which to determine the seasonality of the business. Kobo expects its business to be seasonal and follow quarterly sales and profit (loss) fluctuation patterns similar to those of other retailers that generate a disproportionate amount of their sales in the holiday sales season.

## **Economic Dependence**

Indigo is not dependent on any Kobo contract.

## **Employees**

As at the fiscal year ended April 2, 2011, Kobo had 195 full-time equivalent employees.

## **Intangible Assets**

Protection of the Kobo trademarks, service marks, copyrights, trade secrets, proprietary technology, and similar intellectual is highly important to Kobo. Kobo relies on trademark, copyright, and patent law, trade secret protection, and confidentiality and/or license agreements to protect its proprietary rights.

Kobo has trademarks registered or pending in numerous jurisdictions throughout the world, including Canada and the U.S. Kobo's principal trademark is Kobo<sup>®</sup>.

In addition, Kobo owns certain domain names, including [www.kobobooks.com](http://www.kobobooks.com), and [www.kobo.com](http://www.kobo.com) which are used in connection with its online business and presence.

## **Foreign Operations**

Kobo's international activities are significant to its revenues and profits. Kobo is subject to the inherent risks of international operations, such as: economic and political conditions; local competition; government regulations, restrictions and requirements; limited technology infrastructure; different business practices; different consumer trends; Internet use levels; staffing difficulties; labour laws; and cultural differences. It is costly to establish, develop and maintain international operations and websites and promote Kobo's brand internationally. Kobo's international operations and partnerships may not be profitable on a sustained basis.

## **Changes to Contracts**

Indigo would not be materially impacted by the renegotiation or termination of any Kobo contract.

## **Reorganizations**

In February 2009, Indigo launched Shortcovers ([www.shortcovers.com](http://www.shortcovers.com)), a new digital destination offering online and mobile service that provides instant access to books, articles and blogs. On December 14, 2009, Indigo transferred the net assets of Shortcovers to a new company, Kobo Inc. ("Kobo") in exchange for common shares of Kobo. The Shortcovers website was changed to [www.kobobooks.com](http://www.kobobooks.com).

On December 15, 2009, Kobo secured funding from Indigo and unrelated investors. As a result of the transaction, Indigo retained 57.7% ownership of Kobo as of December 15, 2009.

On September 8, 2010, Kobo entered into an agreement with certain of its existing shareholders (the "Investors") to provide additional capital to Kobo upon the occurrence of specified funding events. The first funding event under this agreement occurred on September 8, 2010, and Indigo purchased 2,040,816 shares for \$3.6 million. The remaining Investors purchased 680,272 shares for \$1.2 million. The second funding event under this agreement occurred on November 19, 2010, and Indigo purchased 2,040,816 shares for \$3.6 million. The remaining Investors purchased 680,272 shares for \$1.2 million. The overallotment option was exercised on December 13, 2010, and Indigo purchased 1,224,489 shares for \$2.1 million, increasing Indigo's total ownership of Kobo from 57.7% to 61.4%. The remaining Investors purchased 408,163 shares for \$0.7 million.

On February 22, 2011, Kobo issued 6,209,881 shares to a syndicate of investors comprised of both existing shareholders and new investors. Indigo purchased 2,589,580 common shares for \$10.0 million while the rest of the syndicate members purchased a total of 3,620,301 common shares for \$14.0 million. As a result of these transactions, Indigo's ownership of Kobo decreased from 61.4% to 58.3%.

On April 19, 2011, Kobo issued 6,743,486 shares to a syndicate of investors comprised of both existing shareholders and new investors. Indigo purchased 779,361 common shares for \$3.0 million while the rest of the syndicate members purchased a total of 5,964,125 common shares for \$23.0 million. As a result of these transactions, Indigo's ownership of Kobo decreased from 58.3% to 51.4%. This transaction will be accounted for under IFRS and as such, there is no gain or loss to Indigo on the transaction.

## **RISK FACTORS**

For a discussion of risk factors relating to Indigo and its business please see the section entitled "Risks and Uncertainties" in the Company's annual MD&A filed on SEDAR ([accessible at www.sedar.com](http://www.sedar.com)) on May 31, 2011. In addition to the assumptions and risk factors identified in the Company's MD&A, other factors that may affect future results are set out below.

## *Competition*

The retail book selling business is highly competitive. Specialty bookstores, independent bookstores, other book superstores, regional multi-store operators, supermarkets, drug stores, warehouse clubs, mail order clubs, Internet booksellers, mass merchandisers and other retailers offering books are all sources of competition for the Company.

The digital book industry is also highly competitive and is undergoing rapid growth. The number of retailers selling eBooks has increased as has the number of retailers selling eReaders. The eReader industry is changing rapidly with increased competition from new digital reading devices. As the digital book industry continues to expand, increased eBook sales continue to impact the sales of physical books. As eBooks are priced lower than physical books, if consumers reduce purchases of physical books in favour of eBooks, it could reduce the Company's future revenues.

Aggressive merchandising or discounting by competitors in either the retail or online sectors could reduce the Company's market share and its operating margins.

## *The Company faces various risks as an Internet retailer*

Business risks related to its online business include risks associated with the need to keep pace with rapid technological change, Internet security risks, risks of system failure or inadequacy, government regulation and legal uncertainties with respect to the Internet. If any of these risks materializes, it could have an adverse effect on the Company's business.

## *The Company's business is dependent on consumer spending patterns*

Sales of books, music, gifts, toys and movies have historically been dependent upon discretionary consumer spending, which may be affected by general economic conditions, consumer confidence and other factors beyond the Company's control. In addition, sales are dependent in part on the strength of new product releases which are controlled by vendors. A decline in consumer spending on these products, or in the strength of new product releases, could have a material adverse effect on the Company's financial condition and results of operations.

## *External Events*

Weather conditions, as well as events such as political or social unrest, natural disasters, disease outbreaks, or acts of terrorism, could have a material adverse effect on the Company's financial performance. Moreover, if such events were to occur at peak times in the Company's annual business cycle, the impact of these events on operating performance could be significantly greater than it would otherwise have been.

## *Inventory Risk*

The Company is exposed to significant inventory risks on any product that is purchased "non-returnable" as a result of seasonality, new product launches, rapid changes in product cycles and changes in consumer tastes with respect to our products. In order to be successful, the Company must accurately predict these trends and avoid overstocking or under-stocking products. Demand for products, however, can change significantly between the time inventory is ordered and the date of sale. In addition, when the Company begins selling a new product, it may be difficult to establish vendor relationships, determine appropriate product selection, and accurately forecast product demand. For the Company's online business, a failure to optimize inventory within the fulfillment network will increase net shipping costs

due to the need to make split shipments from one or more locations, complementary upgrades, and additional long-zone shipments necessary to ensure timely delivery.

The acquisition of certain types of non-book inventory, or non-book inventory from certain sources, may require significant lead-time and prepayment. The Company carries a broad selection and significant inventory levels of certain products, and it may be unable to sell products in sufficient quantities or during the relevant selling seasons.

Any one of the inventory risk factors set forth above may adversely affect our operating results.

### *Regulatory Environment*

The distribution and sale of books is a regulated industry in which foreign ownership is generally not permitted under the *Investment Canada Act*. As well, the sourcing and importation of books is governed by the Book Importation Regulations to the *Copyright Act* (Canada). In April 2010, the government of Canada issued a one-time ruling to allow U.S. online retailer, Amazon.com Inc., to operate a distribution centre in Canada. There is no assurance that the existing regulatory framework will not change in the future or that it will be effective in preventing foreign-owned retailers from competing in Canada.

### *Credit, Foreign Exchange, and Interest Rate Risks*

The maximum exposure to credit risk at the reporting date is equal to the carrying value of accounts receivable. The Company has two streams of accounts receivable. Indigo's customer base primarily consists of retail customers who pay by cash or credit card, while a significant percentage of Kobo's customer base are corporate clients who pay on account. Kobo sells eBook readers to corporate clients and performs back-end operations for corporate eBook stores. Cash and credit card payments have minimal credit risk and the limited number of corporate receivables are closely monitored.

The Company's foreign exchange risk is largely limited to currency fluctuations between the Canadian and U.S. Dollars. However, the strategic partnerships entered into by Kobo have resulted in sales to customers worldwide in a number of different currencies. Therefore, foreign exchange risk is expected to increase as Kobo expands its operations. Kobo is in the start-up phase of operations and its current impact on foreign exchange risk is not significant. Given that Indigo has determined that its foreign currency risk is manageable, the Company does not use foreign currency derivative contracts to hedge its foreign exchange risk.

The Company's interest rate risk is limited to the fluctuation of floating rates on its cash and cash equivalents. Counter-party credit risk is considered to be negligible as the Company only deals with highly rated financial institutions.

### *Leases*

The average unexpired lease term of Indigo's superstores and small format stores is approximately 3.7 years and 2.8 years, respectively. The Company generally attempts to renew these leases as they come due on favourable terms and conditions, but is susceptible to volatility in the market for supercentre and shopping mall space. Unforeseen increases in occupancy costs, or costs incurred as a result of unanticipated store closing and relocation could unfavourably impact the Company's performance.



### *Dependence on Key Personnel*

Indigo's continued success will depend to a significant extent upon its management group. The loss of the services of key personnel, particularly Ms. Heather Reisman, the Chair and Chief Executive Officer of Indigo, could have a material adverse effect on Indigo.

### *Legal Proceedings*

In the normal course of business, Indigo becomes involved in various claims and litigation. While the final outcome of such claims and litigation pending as at April 2, 2011 cannot be predicted with certainty, management believes that any such amount would not have a material impact on the Company's financial position.

### *Compliance with Privacy Laws*

In Canada, the *Personal Information Protection and Electronic Documents Act* ("PIPEDA") was passed into law by the federal government effective as of January 1, 2001. Currently, this law applies to all organizations that collect, use or disclose personal information in the course of commercial activities, except to the extent that provincial privacy legislation has been enacted and declared substantially similar to the federal legislation. To date, certain provinces have enacted "substantially similar" private sector privacy legislation. The federal privacy legislation also regulates the inter-provincial collection, use and disclosure of personal information. Applicable Canadian privacy laws create certain obligations on organizations that handle personal information, including obligations relating to obtaining appropriate consent, limitations on use and disclosure of personal information and ensuring appropriate security safeguards are in place. In the course of its business, the Company maintains records containing sensitive information identifying or relating to individual customers and employees. Although the Company has implemented systems to comply with applicable privacy laws in connection with the collection, use and disclosure of such personal information, if a significant failure of such systems was to occur, the Company's business and reputation could be adversely affected.

### *Other*

The Company's performance may also be affected by other specific risks that may be highlighted from time to time in other public filings of the Company available on the Canadian securities regulatory authorities' website at [www.sedar.com](http://www.sedar.com). The Company cautions that the preceding discussion of factors that may affect future results is not exhaustive. When relying upon forward-looking statements to make decisions with respect to the Company, investors and others should carefully consider these factors, as well as other uncertainties, assumptions, potential events and industry and Company specific factors that may adversely affect future results. The Company assumes no obligation to update or revise them to reflect new events or circumstances, except as required by law.

## **DIVIDENDS**

In fiscal 2011, Indigo paid a total of \$0.44 per share in dividends.

In fiscal 2010, Indigo implemented a quarterly cash dividend of \$0.10 per common share, or \$0.40 per share annually on its common shares. In fiscal 2010, Indigo paid a total of \$0.40 per share in dividends. On April 19, 2010, Indigo announced a 10% increase in its quarterly cash dividend to \$0.11 per common share, or \$0.44 per share annually on its common shares. Indigo did not pay dividends in fiscal years 2009 or 2008. Indigo has no contractual restrictions that would limit its ability to pay dividends in the future. Future declaration of quarterly dividends and the establishment of future record and payment dates are subject to the final determination of the Company's Board of Directors.

## DESCRIPTION OF CAPITAL STRUCTURE

The authorized share capital of Indigo consists of an unlimited number of common shares, of which 25,158,540 common shares are issued and outstanding as at May 31, 2011.

Each Common Share entitles the holder thereof to one vote at meetings of shareholders of Indigo and to participate equally and rateably in any dividends declared on the common shares by the Board of Directors of Indigo, and in any remaining property or assets of Indigo that may be distributed in the event of voluntary or involuntary liquidation, dissolution or winding-up of Indigo.

## CONSTRAINTS

For a discussion of constraints imposed on the ownership of Indigo's securities please refer to the section "Description of the Retail Business – Regulatory Environment".

## MARKET FOR SECURITIES

Common shares in the capital of Indigo are listed and posted for trading on the TSX under the symbol IDG. There are currently no other classes of shares in the capital of Indigo issued or outstanding.

The following table sets out the price ranges and volumes traded for Indigo's common shares on a monthly basis for each month in fiscal 2011:

	OPEN (\$)	HIGH(\$)	LOW (\$)	CLOSE (\$)	VOLUME
April 2010	17.86	18.11	16.07	17.30	1,097,909
May 2010	17.44	17.46	14.53	15.01	497,192
June 2010	14.25	15.60	14.00	14.30	199,276
July 2010	14.12	15.44	13.50	14.86	127,701
August 2010	15.05	15.49	14.00	14.15	178,121
September 2010	14.01	14.90	13.25	14.80	690,371
October 2010	14.66	15.74	14.51	15.31	275,344
November 2010	15.31	15.86	14.86	15.02	380,396
December 2010	15.15	15.50	14.15	14.65	725,185
January 2011	14.51	15.15	14.38	15.09	297,266
February 2011	15.14	15.25	13.86	14.15	326,491
March 2011	14.27	14.43	12.92	13.10	342,546

## DIRECTORS AND OFFICERS

The following table and notes thereto state the names and provinces or states of residence of all the directors and officers of Indigo as at May 31, 2010, their respective principal occupations, business or employment within the five preceding years, their beneficial ownership of common shares and, with respect to the directors, the year in which they became directors of Indigo. Each director will hold office until the next annual meeting of shareholders of Indigo, or until such director's successor is duly elected, unless the office is earlier vacated in accordance with the by-laws of Indigo.

<u>Name, Province or State and Country</u>	<u>Position and/or office with Indigo</u>	<u>Present principal occupation, if different from office held</u>	<u>Period during which served as a director</u>	<u>Common Shares beneficially owned or controlled as at May 31, 2011<sup>(5)</sup></u>
HEATHER REISMAN ..... Ontario, Canada	Chair & Chief Executive Officer And Director	n/a	Since February 4, 2001	98,391 Common Shares
BONNIE BROOKS <sup>(6)</sup> ..... Ontario, Canada	Director	President and CEO, the Bay, Hudson's Bay Company (diversified general merchandise retailer)	Since May 23, 2009	nil Common Shares
FRANK CLEGG <sup>(1)(3)</sup> ..... Ontario, Canada	Director	Chairman, Navantis Inc. (custom computer software application developer)	Since February 1, 2005	nil Common Shares
JONATHAN DEITCHER <sup>(2)</sup> ..... Quebec, Canada	Director	Investment Advisor, RBC Investments (wealth management company)	Since August 7, 2001	nil Common Shares
MITCHELL GOLDHAR ..... Ontario, Canada	Director	President & Chief Executive Officer, SmartCentres (commercial real estate development company)	Since February 2, 2006	nil Common Shares
JAMES HALL <sup>(1)(2)(3)</sup> ..... Ontario, Canada	Director	President & CEO, James Hall Advisors Inc. (Advisory Firm)	Since August 7, 2001	nil Common Shares
MICHAEL KIRBY <sup>(1)(2)(3)</sup> ..... Ontario, Canada	Director	Corporate Director Chair of the Mental Health Commission of Canada (non-profit organization created to focus national attention on mental health issues)	Since February 4, 2001	nil Common Shares
TEDFORD MARLOW <sup>(7)</sup> ..... Connecticut, USA	President & Director	n/a	Since November 9, 2010	nil Common Shares
BRUCE MAU ..... Illinois, USA	Director	Chairman and Creative Director, Bruce Mau Design (design and innovation studio)	Since November 1, 2007	nil Common Shares
ANNE MARIE O'DONOVAN <sup>(3)</sup> ..... Ontario, Canada	Director	Executive Vice President and Chief Administration Officer, Scotia Capital (global corporate and investment banking company)	Since December 27, 2009	nil Common Shares
JOEL SILVER <sup>(8)</sup> ..... Ontario, Canada	Director	President Trilogy Growth (investment firm specializing in media, technology and retail opportunities)	Since April 19, 2011	3,100 Common Shares
GERALD SCHWARTZ ..... Ontario, Canada	Director	Chairman, President and Chief Executive Officer Onex Corporation (diversified company)	Since February 4, 2001	15,218,474 Common Shares <sup>(4)</sup>
KAY BREKKEN ..... Ontario, Canada	Chief Financial Officer	n/a	n/a	nil Common Shares
RAY CAMANO <sup>(9)</sup> ..... Ontario, Canada	Executive Vice President and Chief General Merchant	n/a	n/a	nil Common Shares
LAURA DUNNE <sup>(10)</sup> ..... Ontario, Canada	SVP Human Resources and Organizational Development	n/a n/a	n/a n/a	nil Common Shares
KATHLEEN FLYNN ..... Ontario, Canada	General Counsel and Corporate Secretary	n/a	n/a	nil Common Shares
JOYCE GRAY ..... Ontario, Canada	Executive Vice President Retail & Customer Experience	n/a	n/a	nil Common Shares

<u>Name, Province or State and Country</u>	<u>Position and/or office with Indigo</u>	<u>Present principal occupation, if different from office held</u>	<u>Period during which served as a director</u>	<u>Common Shares beneficially owned or controlled as at May 31, 2011<sup>(5)</sup></u>
DEIRDRE HORGAN Ontario, Canada	Chief Marketing Officer	n/a	n/a	nil Common Shares
ROSS MARANCOS .....	Executive Vice President Supply Chain	n/a	n/a	nil Common Shares
JIM MCGILL .....	Chief Operating Officer	n/a	n/a	5,000 Common Shares
SUMIT OBERAI .....	Chief Information Officer	n/a	n/a	800 Common Shares
ANDREW SLOSS .....	Executive Vice President, Online	n/a	n/a	nil Common Shares

(1) Member of Human Resources and Compensation Committee.

(2) Member of Corporate Governance Committee.

(3) Member of Audit Committee.

(4) Mr. Schwartz is the principal of Trilogy Retail Enterprises Inc., the general partner of Trilogy Retail Enterprises L.P. (“Trilogy”). Trilogy owns directly or indirectly 13,028,167 common shares, representing approximately 51.78% of the outstanding Shares. Ms. Reisman, who owns directly or indirectly, 98,391 common shares, is Mr. Schwartz’ spouse.

(5) As at May 31, 2011, our directors and executive officers as a group, beneficially owned, directly or indirectly, or exercised direction or control over 15,325,765 common shares, representing approximately 60.91% of the outstanding Common Shares.

(6) Ms. Brooks has been the President & CEO, the Bay, Hudson’s Bay Company since September 2008. From 2003 to 2008 Ms. Brooks was the President of Lane Crawford Joyce Group, a Hong Kong based department store chain.

(7) Mr. Marlow has been President of Indigo Books & Music Inc. since April 3, 2011. From June 2001 to June 2010, Mr. Marlow was the Global Brand President of Urban Outfitters, a specialty retailer based in Philadelphia, Pennsylvania, USA.

(8) Mr. Silver has been with Trilogy Growth since April 2011. From December 2003 through April 2011, Mr. Silver held the following positions at Indigo Books & Music Inc.: October 2009 through April 2011 – President; April 2007 through October 2009 - Chief Merchant; June 2005 through April 2007 - Executive Vice President, Print & Entertainment; December 2003 through June 2005 – Vice President, Print Procurement.

(9) Mr. Camano has been Executive Vice President and Chief General Merchant of Indigo since January 10, 2011. From 2007 through 2010, Mr. Camano was the Executive Vice President of Design, Merchandising, Production, and Product Management with A|X Armani Exchange, a division Giorgio Armani SPA, and was the Senior Vice President, Merchandising and Production with A|X Armani Exchange from 2002 through 2007.

(10) Ms. Dunne has been Senior Vice President, Human Resources and Organizational Development of Indigo Books & Music Inc. since October 4, 2010. From August 2005 to January 2009 Ms. Dunne was the Senior Vice President, Human Resources with Canadian Tire Corporation Ltd., a Canadian retail and financial services firm. From 2009 to 2010 Ms. Dunne was an independent consultant.

**Heather Reisman – Chair & Chief Executive Officer.** Ms. Reisman has been Chief Executive Officer of Indigo since February 4, 2001. She has also been Chair, Director and Chief Executive Officer of Indigo and its predecessors. Prior to the merger of Indigo and Chapters, Ms. Reisman was Chief Executive of Indigo Books & Music, Inc. Ms. Reisman is also the chair of Kobo.

**Bonnie Brooks – Director.** Bonnie Brooks is the President and CEO of The Bay, Hudson’s Bay Company. Ms. Brooks has spent more than 25 years building prestige retail formats around the world, including Holt Renfrew, Lane Crawford, Harvey Nichols, and leading designer brand stand-alone stores in Asia. Most recently, Ms. Brooks was the President of the Lane Crawford Joyce Group based in Hong Kong. She has also served as Editor-in-Chief of FLARE, Canada’s largest fashion and lifestyle magazine. In August 2010, Ms. Brooks was appointed to the position of Trustee of the Royal Ontario Museum by the Premier of Ontario. Ms. Brooks holds an MBA from the University of Western Ontario.

**Frank Clegg – Director.** Frank Clegg was President of Microsoft Canada Co. from September, 2000 to January, 2005. Prior to that he was Vice President, Central Region of Microsoft Corporation. Mr. Clegg is Chairman of KINSA, a kids internet safety non-profit organization. Mr. Clegg is also a member of the board of directors of Kobo. Mr. Clegg is a member of the Indigo Audit and HR & Compensation Committees and is the Technology Advisor to the Indigo Board of Directors.

**Jonathan Deitcher – Director.** Jonathan Deitcher is an investment advisor with RBC Dominion Securities where he has been employed since 1977. He served as a Director at RBC from November 2000 to September 2003. Mr. Deitcher has been a Vice-President at RBC since August 2004. Mr. Deitcher is a member of Indigo’s Corporate Governance Committee.

**Mitchell Goldhar – Director.** Mitchell Goldhar is the owner of SmartCentres, a private real estate development company. SmartCentres has developed over 210 shopping centres across Canada in the last 15 years. Mr. Goldhar holds a B.A. in Political Science from York University and is in his 10th year as an adjunct professor with the Joseph L. Rotman School of Management, University of Toronto. He is also a member of the Board of Directors of the Calloway Real Estate Investment Trust and the Sick Kids Foundation.

**James Hall – Director.** Mr. Hall, a chartered accountant, is President & CEO of James Hall Advisors Inc., a corporate advisory firm. Mr. Hall is a director of International Datacasting Corporation and Immunovaccine Inc. and was, until March 2009, Chairman and Chief Executive Officer of Journal Register Company. Mr. Hall is Chair of Indigo’s Human Resources and Compensation Committee and is a member of the Audit Committee and the Corporate Governance Committee. Mr. Hall holds an HBA from the Ivey School of Business at the University of Western Ontario.

**Michael Kirby – Director.** From January 1984 to October 2006 Michael Kirby was a member of the Senate of Canada. From 1994 to 1999, he was the Chairman of the Standing Senate Committee on Banking, Trade and Commerce. From 1999 to 2006 he was the Chairman of the Standing Senate Committee on Social Affairs, Science and Technology. Mr. Kirby is the Chair of the Audit Committee and a member of the Executive Committee of the Bank of Nova Scotia and the Chair of the Audit Committee of the Just Energy Income Fund. Mr. Kirby is Indigo’s Lead Director, the chair of the Audit and Corporate Governance Committees and is a member of the Human Resources and Compensation Committee.

**Tedford Marlow – President and Director.** Ted Marlow was appointed President of Indigo on April 1, 2011. From July 2001 to June 2010 Mr. Marlow served as the Global President of the Urban Outfitters Brand. Over the course of nine years Ted shepherded a dramatic period of growth for Urban Outfitters through retail store expansion in North America and Europe, leveraging online contribution in North America and Europe and catalogue/database marketing in North America. Prior to joining Urban Outfitters, Ted held a variety of senior management and merchant roles with some of North America’s most established and successful retailers, including Neiman Marcus, Saks Fifth Avenue, Marshall Fields and Limited, Inc.

**Bruce Mau – Director.** Bruce Mau is the Co-Founder and Creative Director of Bruce Mau Live, a new initiative committed to developing purposeful projects in education, health, leadership, and security. Bruce is an author and designer of several award-winning books, including LifeStyle (Phaidon), S,M,L,XL (The Monacelli Press) in collaboration with Rem Koolhaas, and the iconic and celebrated ZONE BOOKS series and Mau’s Incomplete Manifesto for Growth. Bruce founded the Institute without Boundaries – an innovative, studio-based postgraduate program in collaboration with George Brown College, Toronto. He is also the Founder and Chairman Emeritus of Bruce Mau Design and has 25 years of studio experience in design innovation and collaboration with some of the world’s leading artists, institutions and businesses, where he used design and optimism to originate, innovate, and renovate businesses, brands, products, and experiences.

**Anne Marie O’Donovan – Director.** Anne Marie O’Donovan, FCA - Director. Anne Marie O’Donovan is the Executive Vice President and Chief Administration Officer for Scotia Capital. She is responsible for finance, technology, operations, strategy and governance for the wholesale and capital markets

businesses of Scotiabank. Ms O'Donovan was previously a partner with Ernst & Young. She holds an HBA from the Ivey School of Business at the University of Western Ontario and is a Fellow of the Institute of Chartered Accountants of Ontario. Ms O'Donovan is a member of the Indigo Audit Committee.

**Joel Silver – Director.** Joel Silver leads Trilogy Growth, a partnership with Trilogy Retail Enterprises LP, the majority shareholder of Indigo. Trilogy Growth makes direct investments in innovative retail, online and media companies. Prior to this, Mr. Silver served as President of Indigo, driving the growth and profitability of the core print business, guiding the launch and development of the kids' toy business, significantly expanding the lifestyle business, as well as spearheading IndigoGreen, a key initiative, for which the Company has won several awards. Mr. Silver began his career at Procter & Gamble and co-founded Salesdriver, a web-based company sold to Carlson in 2002. Mr. Silver holds an MBA from the Harvard Business School.

**Gerald Schwartz – Director.** Mr. Schwartz founded Onex Corporation, one of North America's oldest and largest private equity firms, in 1984. Mr. Schwartz is presently the chairman and chief executive officer of Onex and a director of Celestica Inc. Mr. Schwartz was inducted into the Canadian Business Hall of Fame in 2004 and was appointed an Officer of the Order of Canada in 2006.

**Kay Brekken – Chief Financial Officer.** Ms. Brekken joined Indigo in November 2003 as Vice President Finance and was promoted to the CFO role in April 2011. As CFO, Kay is responsible for Indigo's Finance, Accounting, Internal Audit, Loss Prevention, and IndigoGreen teams. Prior to joining Indigo, she served as CFO and VP of Regional Operations for Medical Consultants Network, a leading national provider of medical judgment services based in Seattle, Washington. Before that, Kay was a Senior Consultant with Deloitte & Touche and a Vice President in Key Bank's Corporate Banking Division. Kay holds a Masters in Business Administration from the University of Washington and a Bachelors of Business Administration from the University of Minnesota.

**Kathleen Flynn – General Counsel and Corporate Secretary.** Ms. Flynn joined Indigo in February 2000 as Corporate Counsel of Chapters Online, then Corporate Counsel of Chapters Inc. and now holds the position of General Counsel and Corporate Secretary of Indigo with responsibility for legal and corporate governance matters. Previously, Ms. Flynn was corporate counsel with Sears Canada Inc. Ms. Flynn holds an LLB from Queen's Law School and a Masters Degree in law from Osgoode Hall.

**Deirdre Horgan – Chief Marketing Officer.** Ms. Horgan joined Indigo in 1998 and is responsible for overall marketing and brand management in both the store and online businesses. Prior to joining Indigo, she was a management consultant with The Boston Consulting Group.

**Jim McGill – Chief Operating Officer.** Mr. McGill was hired as Chief Financial Officer in March of 2003, and was subsequently appointed as Chief Operating Officer and Chief Financial Officer in October of 2009. Mr. McGill stepped down from the position of Chief Financial Officer on April 2, 2011; he retains his Chief Operating Officer responsibilities for all Human Resources, Supply Chain and Information Technology related issues. Mr. McGill has resigned from Indigo with an effective date of June 30, 2011.

**Sumit Oberai – Chief Information Officer.** Sumit Oberai joined Indigo in April 2006 and is responsible for all information technology functions. Prior to Indigo, Sumit was SVP, Engineering at Eloqua, a venture backed marketing automation firm and a consultant for McKinsey & Company where he focused on strategy & operations for technology and telecom clients. Before that, he held various technology leadership roles at Critical Path, DocSpace, and Nortel Networks. Sumit holds a Masters of Business Administration from INSEAD, a Masters of Computer Engineering from University of Toronto, and a

Bachelors of Mathematics & Engineering from Queen's University where he graduated as the Gold Medalist.

**Joyce Gray – Executive Vice President, Retail and Customer Experience.** Joyce Gray joined Indigo in July 2007 and is accountable for retail operations, customer service and store performance. Prior to joining Indigo, Ms. Gray managed The Gap's North East Territory. Prior to The Gap, Ms. Gray was EVP of Marketing at Wild Escape Theme Park in Omaha and Vice President, Business & Strategic Planning with Disney Entertainment.

**Ross Marancos – Executive Vice President, Supply Chain.** Ross Marancos joined Indigo in July 2007 and is accountable for inventory management, transportation, warehousing and master data. Prior to joining the Indigo organization, Mr. Marancos served as Director of Supply Chain for Whirlpool Canada and Senior Director Supply Chain at KRAFT Canada Inc.

**Andrew Sloss – Executive Vice President, Online.** Andrew Sloss joined Indigo in September 2009 and is responsible for the growth and profitability of the online business. Prior to joining Indigo, Andrew was the general manager of eBay and Kijiji Canada, Canada's leading online marketplace and classifieds platforms. Andrew holds a Masters of Business Administration from the Kellogg Graduate School of Management, and a Bachelor of Applied Science in Systems Design Engineering from the University of Waterloo.

**Laura Dunne – Senior Vice President, Human Resources and Organizational Development.** Laura Dunne joined Indigo in October 2010 and is responsible for the Company's human resources and organizational development. Laura joins Indigo after almost a decade at Canadian Tire where she most recently served as SVP Human Resources and sat on the retailer's Executive Committee. Laura brings a broad range of experience in all aspects of Human Resources, with particular specialty in compensation, to Indigo. Laura holds a Bachelor of Arts from the University of Toronto.

**Ray Camano – Executive Vice President and Chief General Merchant.** Ray Camano joined Indigo in January 2011 and is accountable for the sales and profitability of Gift, Paper, and Lifestyle product. Prior to joining Indigo, Ray was Executive Vice President of Design, Merchandising, Production, and Product Management at A|X Armani Exchange, a division Giorgio Armani SPA. Ray holds a Bachelor of Arts degree from Hamilton College.

## **AUDIT COMMITTEE**

The text of the Audit Committee Charter is attached hereto in Appendix A.

### **Composition of the Audit Committee and Relevant Education and Experience of the Members**

The Audit Committee is composed of: Frank Clegg, James Hall, Michael Kirby, and Anne Marie O'Donovan all of whom are independent and financially literate within the meaning set out in National Instrument 52-110.

Mr. Clegg was the President of Microsoft Canada Co. from September, 2000 to January, 2005. Mr. Clegg brings his extensive information technology background to the Audit Committee at a point in time when the oversight of IT governance has become an important responsibility for boards and audit committees.

Mr. Hall is a Chartered Accountant and a director and chair of the audit committees of International Datacasting Corporation and Immunovaccine Inc. and was, until March 2009, Chairman and Chief

Executive Officer of Journal Register Company. He previously served as chair of the audit committees of Terravest Income Fund and General Donlee Income Fund, and was a member of the audit committees of Global Credit Pref Corp and Journal Register Company. Mr. Hall is Chair of Indigo's Human Resources and Compensation Committee and is a member of the Audit Committee and the Corporate Governance Committee.

Mr. Kirby is Chairman of the Mental Health Commission of Canada and a corporate director. Mr. Kirby was a member of the Senate of Canada from 1984 until 2006. He holds a B.Sc. and M.A. in mathematics from Dalhousie University and a PhD in Applied Mathematics from Northwestern University.

Mr. Kirby sits on the boards of Extencicare REIT, MDC Partners Inc., Just Energy Corporation, The Bank of Nova Scotia and Immunovaccine Inc. Mr. Kirby is Chair of the Audit Committee and the Risk Committee of Just Energy Income Fund, Chair of the Board of Immunovaccine Inc, Chair of the Audit Committee and member of the Executive and Risk Committee of the Bank of Nova Scotia, Chair of the Audit Committee and the Corporate Governance Committee of Indigo. He is Chair of the Extencicare Human Resources and Corporate Governance Committees, the Chair of the Human Resources Committee of MDC Partners Inc., and a member of MDC Partners Inc. Audit and Corporate Governance Committees. Mr. Kirby was the Vice Chair of the Accounting Standards Oversight Council. Previously, Mr. Kirby was Chair of the Standing Senate Committee on Banking, Trade and Commerce, the Senate Committee which handles all business legislative and regulatory issues, and was Chair of the Standing Senate Committee on Social Affairs, Science and Technology. In addition, at different times during the period from 2002 to 2007, Mr. Kirby served as a director of the following publicly-traded companies: Azure Dynamics Corp., Brainhunter Inc., Maxxcom Inc., CPI Plastics Group Ltd., and Extencicare Inc.

Mr. Kirby is Indigo's Lead Director, the chair of the Audit and Corporate Governance Committees and is a member of the Human Resources and Compensation Committee.

Ms. O'Donovan is a Chartered Accountant and has held numerous financial management roles including her current role as EVP Chief Administration Officer for Scotia Capital. She also brings experience in governance, internal control and risk management from her previous positions as the Chief Auditor for Scotiabank and a partner at Ernst & Young.

### **Pre-Approval Policies and Procedures**

All Audit Committee decisions regarding the engagement of Indigo's auditor for the provision of non-audit services are approved by the Board of Directors.



## External Auditor Service Fees

The following table summarizes the Audit, Audit Related, Tax Related and Other Fees (excluding expenses and taxes) of Indigo's Auditor, Ernst & Young LLP, for the two most recently completed fiscal years.

	2011	2010
Audit Fees (\$)	337,000	310,500
Audit-Related Fees (\$)	110,372	123,550
Tax Fees (\$)	66,500	151,950
All Other Fees (\$)	3,200	nil
TOTAL (\$)	517,072	586,000

The foregoing fees and expenses relate to services rendered from April through March of the fiscal year, notwithstanding when the fees and expenses were billed.

In 2011, Audit-Related Fees incurred related to translation services and accounting consultations on Kobo, segment reporting and International Financial Reporting Standards. In 2010, Audit Related Fees incurred related to translation services. In both 2010 and 2011, tax fees related to tax compliance and tax planning/consulting services.

## TRANSFER AGENT AND REGISTRAR

Indigo's transfer agent and registrar is CIBC Mellon Trust Company and Indigo's Common Share register is located at their offices at 320 Bay Street, P.O. Box 1, Toronto, ON, M5H 4A6.

## EXPERTS

As at the date hereof, the partners and associates of our auditor, Ernst & Young LLP do not beneficially own, directly and indirectly, any Common Shares of Indigo. Ernst & Young LLP is independent of the Company in accordance with the Rules of Professional Conduct of the Institute of Chartered Accountants of Ontario.

## ADDITIONAL INFORMATION

Additional information, including directors' and officers' remuneration and indebtedness, principal holders of Indigo's securities and options to purchase securities and interests of insiders in material transactions is contained in Indigo's most recent Management Information Circular as filed with Canadian securities regulatory authorities on SEDAR on June 2, 2011. Further information can also be found on SEDAR at [www.sedar.com](http://www.sedar.com). Additional financial information is provided in Indigo's comparative financial statements and MD&A for the fiscal year ended April 2, 2011, which are included on pages 9 through 51 of Indigo's 2011 Annual Report.

Copies of the following documents may be obtained, upon request, from Indigo's Secretary at 468 King Street, Suite 500, Toronto, Ontario, M5V 1L8:

- a) one copy of this Annual Information Form, together with one copy of any document, or the pertinent pages of any document, incorporated by reference in this Annual Information Form;

- b) one copy of Indigo's consolidated financial statements for its most recently completed financial year together with the accompanying report of the auditor and one copy of any of Indigo's interim financial statements subsequent to the financial statements for its most recently completed financial year; and
- c) one copy of the Indigo's most recent Management Information Circular as filed with Canadian securities regulatory authorities on SEDAR on June 2, 2011.

## SELECTED CONSOLIDATED FINANCIAL INFORMATION

	<u>52-week period ended April 2, 2011</u>	<u>53-week period ended April 3, 2010</u>	<u>52-week period ended March 28, 2009</u>
<i>(in thousands of Canadian dollars, except share and per share data)</i>			
<b>Statement of Operations</b>			
<b>Data: Revenue</b>			
Superstores .....	667,582	670,542	634,727
Small format stores.....	148,702	157,418	166,225
Internet .....	90,617	92,180	95,232
Other .....	110,424	48,787	44,215
Total .....	1,017,325	968,927	940,399
Cost of sales, operations, selling and administration.....	991,155	895,930	867,945
Earnings before the following: .	26,170	72,997	72,454
Depreciation of capital assets ..	19,311	19,682	22,223
Amortization of intangible assets	10,679	8,326	5,638
Capital assets write-off	-	1,086	-
Amortization of pre-opening store costs	-	-	-
EBIT <sup>(1)</sup> .....	(3,820)	43,903	44,593
Interest on long-term debt and financing charges .....	212	214	309
Interest on current debt.....	(567)	(333)	(1,443)
Dilution gain on reduction of ownership in subsidiary.....	(3,915)	(3,019)	-
Deemed disposition of goodwill	-	891	-
Earnings before income taxes & non-controlling interest .....	450	46,150	45,727
Income tax expense (recovery) .	2,682	12,537	15,077
Non-controlling interest .....	(13,578)	(1,310)	-
Net earnings .....	11,346	34,923	30,650
Earnings per share (basic) .....	0.46	1.42	1.24
Earnings per share (diluted).....	0.45	1.39	1.21
Weighted average number of common shares outstanding...	24,874	24,550	24,675
Total Assets.....	516,180	519,842	487,506
Total Long-Term Debt .....	3,285	3,037	5,006

- (1) Indigo defines EBIT as earnings before interest, taxes, non-recurring expenses and non-controlling interest. Management of Indigo believes that EBIT is an important measure in evaluating the performance of the Company. However, EBIT is not a recognized earnings measure under Canadian GAAP and does not have a standardized meaning prescribed by Canadian GAAP. Therefore, EBIT may not be comparable to similar measures presented by other issuers. Investors are cautioned that EBIT should not be construed as an alternative to net income or loss determined in accordance with Canadian GAAP as an indicator of Indigo's performance or to cash flows from operating activities as a measure of liquidity and cash flows. The following table reconciles EBIT to earnings before income taxes and non-controlling interest, based on the historical financial statements of Indigo for the periods indicated, in thousands of Canadian dollars, presented in accordance with Canadian GAAP:

	<u>52-week period ended April 2, 2011</u>	<u>53-week period ended April 3, 2010</u>	<u>52-week period ended March 28, 2009</u>
(in thousands of Canadian dollars)			
Earnings before income taxes and non-controlling interest .....	450	46,150	45,727
add back:			
Interest .....	(355)	(119)	(1,134)
Non-recurring expenses.....	(3,915)	(2,128)	-
EBIT .....	(3,820)	43,903	44,593

## APPENDIX A

### Audit Committee Charter

#### 1. Purpose

The primary function of the Audit Committee is to assist the Board of Directors in fulfilling its oversight responsibilities by reviewing: the financial information that will be provided to the shareholders and others, the systems of internal controls which management and the Board of Directors have established, and the Company's and its subsidiaries' audit and financial reporting process.

The independent accountants' ultimate responsibility is to the Board of Directors and the Audit Committee, as representatives of the shareholders. These representatives have the ultimate authority to evaluate and, where appropriate, recommend replacement of the external auditors.

The Audit Committee will primarily fulfill these responsibilities by carrying out the activities enumerated in Section 5 of this Charter. The Audit Committee will, at all times, be given full access to the Company's management and records and to the external auditors as necessary to carry out these responsibilities.

#### 2. Composition of Committee

The Audit Committee shall be comprised of four directors, each of whom will be an independent, as contemplated by *National Instrument 52-110 - Audit Committees*.

All members of the Committee shall be financially literate and thus be able to read and understand fundamental financial statements including a balance sheet, an income statement and a cash flow statement that presents a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements.

#### 3. Committee Meetings

The Audit Committee will meet on a quarterly basis and will hold special meetings as circumstances require. The timing of the meetings shall be determined by the Audit Committee.

At all Audit Committee meetings a majority of the members shall constitute a quorum.

#### 4. Relationship with External Auditors

The external auditor shall report directly to the Audit Committee.

## 5. Responsibilities and Duties

To fulfill its responsibilities and duties, the Audit Committee shall:

- review the accounting principles, policies and practices followed by the Company and its subsidiaries in accounting for and reporting its financial results of operations;
- review the Company's audited annual consolidated financial statements and the unaudited quarterly financial statements and recommend to the Board for approval prior to publicly disclosing this information. Also review and recommend to the Board for approval any accompanying related documents such as the Annual Information Form or equivalent filings and the Management's Discussion and Analysis prior to publicly disclosing this information;
- review the annual and interim draft earnings press releases quarterly and recommend to the Board for approval prior to publicly disclosing this information;
- satisfy itself that adequate procedures are in place for the review of the Company's public disclosure of financial information extracted or derived from the Company's financial statements and periodically assess the adequacy of those procedures;
- recommend to the Board of Directors the selection of the external auditors in connection with preparing or issuing an auditor's report or with performing other audit, review or attesting services for the Company;
- recommend to the Board of Directors the compensation of the external auditors;
- oversee the work of the external auditors engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the Company, including the resolution of disagreements between management and the external auditors regarding financial reporting;
- obtain, on an annual, basis a formal written statement from the external auditors delineating the relationship between the audit firm and the Company, and review and discuss with the external auditors such relationship to determine the "independence" of the auditors;
- review any management letter prepared by the external auditors concerning the Company's internal financial controls, record keeping and other matters and management's response thereto;
- discuss with the external auditors their views about the quality of the implementation of Canadian Generally Accepted Accounting Principles, with a particular focus on the accounting estimates and judgments made by management and management's selection of accounting principles. Meet in private with appropriate members of management and separately with the external auditors on a regular basis to share perceptions on these matters, discuss any potential concerns and agree upon appropriate action plans. Review with the external auditors their views on the adequacy of the Company's financial personnel;
- approve the scope of the annual audit, the audit plan, the access granted to the Company's records and the co-operation of management in any audit and review function;
- review the effectiveness of the independent audit effort, including approval of the fees charged in connection with, the annual audit, any quarterly reviews and any non-audit services being provided;

- assess the effectiveness of the working relationship of the external auditors with management;
- review the financial risk management policies followed by the Company in operating its business activities and the completeness and fairness of any disclosure thereof. Review the use of derivative financial instruments by the Company;
- review and approve any management decision relating to any potential need for internal auditing, including whether this function should be outsourced and if such function is outsourced, approve the supplier of such service;
- establish procedures for (i) the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters; and (ii) the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters;
- review and approve the Company's hiring policies regarding partners, employees and former partners and employees of the present and former external auditors of the Company;
- the Committee will determine the nature of non-audit services the external auditors are prohibited from providing to the Company. The Committee will pre-approve all non-audit services provided by the external auditors to the Company;
- review annually this Audit Committee Charter for adequacy and recommend any changes to the Board;
- report to the Board on the major items covered at each Audit Committee meeting and make recommendations to the Board and management concerning these matters. Annually report to the Board on the effectiveness of the Audit Committee; and
- perform any other activities consistent with this Charter, the Company's Bylaws and governing law as the Committee or the Board deems necessary or appropriate.

## **6. Authority**

The Audit Committee has the authority:

- (a) to engage independent counsel and other advisors as it determines necessary to carry out its duties;
- (b) to set and pay the compensation for any advisors employed by the audit committee; and
- (c) to communicate directly with the internal and external auditors.