FINAL TRANSCRIPT

Spin Master Corp.

Spin Master Updates 2019 Full-Year Outlook

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PRESENTATION

Operator

Good morning. My name is James and I will be your conference operator today.

At this time I'd like to welcome everyone to Spin Master Updates 2019 Full-Year Outlook Conference Call. All lines have been placed on mute to prevent any background noise, and after the speakers' remarks there will be a question-and-answer session. If you would like to ask a question during this time, simply press star and then the number one on your telephone keypad. If you'd like to withdraw your question, please press the pound key. Thank you.

Sophia Bisoukis, you may begin your conference.

Sophia Bisoukis – Vice President, Investor Relations, Spin Master Corp.

Thank you, James. Good morning everybody. I'm joined this morning by Ronnen Harary, co-Chief Executive Officer, and Mark Segal, Chief Financial Officer of Spin Master. Ben Gadbois is away and is unable to participate in the call today.

This morning we issued a press release in connection with updating our 2019 Outlook and have invited you to this call to provide further context to the extent that we are able. The press release issued this morning is available on the Investor Relations section of our website at spinmaster.com and on SEDAR. Please note that we are not issuing our 2019 Q4 or 2019 full-year results, nor our outlook for

2020 today. The MD&A and audited financial statements for the fourth quarter full-year 2019 will be published on March 4, 2020.

Given that we are not issuing our Q4 and full-year 2019 results, we will unfortunately have to limit the nature of the responses we can provide in the Q&A.

Before we begin, please note that remarks on this conference call may contain forward-looking statements current and future plans, expectations, intention, results, levels of activity, performance, goals, or achievements, and any other future events or developments. Forward-looking statements are based on the information currently available to Management and on estimates and assumptions made based on factors that Management believes are appropriate and reasonable in the circumstances; however, there can be no assurance that such estimates and assumptions will prove to be correct. Many factors could cause actual results to differ materially from those expressed or implied by the forward-looking statements. As a result, Spin Master cannot guarantee that any forward-looking statements will materialize and you are cautioned not to place undue reliance. Except as may be required by law, Spin Master has no obligation to update or revise any forward-looking statements whether because of new information, future events or otherwise.

For additional information on these assumptions and risks, please consult the Cautionary Statements regarding forward-looking information contained in the Update dated today, January 21, 2020.

Please note that Spin Master reports in U.S. dollars and all dollar amounts to be expressed today are in U.S. currency.

I would now like to turn the conference call over to Ronnen.

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

Thanks, Sophia. Good morning and thanks for joining us on the call today, especially on such short notice.

As we addressed in the press release we issued this morning, our overall performance in the fourth quarter and for 2019 as a whole was disappointing relative to our outlook in early November. Despite the solid performance of several of our brands and franchises, we were unable to fully offset the year-over-year decline in actual sales. Furthermore, we did not execute at the level we needed in order to meet our profitability targets. More on this later.

The traditional toy and games industry representing an approximately $80 billion-plus global market is stable and growing at a compound growth rate of approximately 4 percent to 5 percent a year. In the last few years, the U.S. market, however, has faced challenges that have created disruption. In 2019, various industry reports indicate that the U.S. toy industry contracted at least between 2 percent to 4 percent.

We have had a major retailer, Toys R Us, exit the market in 2018 and in response volume has been redistributed to new customers and channels, creating challenges in order patterns and distribution requirements.

The growth of the trend towards online purchasing away from brick and mortar has continued to accelerate. The content landscape has continued to shift from traditional linear models to SVOD, AVOD and digital mobile platforms. All of this has occurred in a political environment characterized by trade tensions between the U.S. and China and the risk of U.S. tariffs. Fortunately, these tariffs were deferred in December for the foreseeable future.

What affected us in 2019 that drove our disappointing performance? Some of these are macro factors and others are specific to Spin Master. Our decision in 2019 to manage our portfolio of brands more tightly using domestic replenishments; the evolving retailer trend away from direct import orders towards domestic orders due to the demise of Toys R Us, which created congestion in retailer supply chains; the threat of U.S. tariffs and our increased inventory levels arising from our decision to bring in inventory earlier to avoid U.S. tariffs; increased online purchases that drove more just-in-time shipments and buying later in the season than we have seen before.

All these factors above were greatly exacerbated by the establishment of our new DC on the East Coast, together with the consolidation of four existing warehouses inherited under the Gund, Cardinal and SwimWays acquisitions into this new East Coast DC at the beginning of Q3. This was a major reason behind the significant disruption and congestion that occurred in our U.S. supply chain. I want to tell you that this was a major error in judgment. We should not have undertaken this project. We should not have undertaken a project of this nature at this point in time, just as we entered our seasonal shipping peak. Our supply chain has become more complex. The macro environment has become more complex, and our desire to drive efficiencies and cost savings in the midst of this was aggressive and potentially misguided. When you mix everything together, we had a failure in our supply chain and logistics areas.

Additionally, as you know, our international growth strategy has included the opening of offices in Australia, Central Eastern Europe, Germany, Austria and Switzerland, and Russia. These issues were not isolated to one geography. Our plan to diversify sourcing away from China accelerated this year due to the U.S./China trade disputes. Although new factories in Vietnam, India and Mexico will drive cost savings in the near future, we incurred additional costs and disruption this year as we expedited the changes.

The integration of Gund, Cardinal, LA Games and SwimWays into one office in New York City was also undertaken in 2019.

When you take everything into account, these factors all combine together to put substantial pressure on our back end systems, processes and people that culminated in the results that we released this morning.

If we stand back for a moment and look at the big picture for Spin Master, our strategy is designed to achieve long-term growth. Our team remains diligently focused on successfully executing against our growth pillars. Despite an ever-evolving toy and content consumption landscape, we have remained focused on the execution of our long-term plan. As a result, the strength, diversity and depth of our innovative brand and entertainment franchise portfolio gives us confidence in delivering our long-term growth targets. This was evident in 2019 as we grew the business 16 percent, excluding the significant decline in Hatchimals from 2018 to 2019.

At the core of Spin Master is our ability to create engaging kids storytelling for multiplatform consumption. Through the success of our properties such as Paw Patrol and others, we have proven that creating evergreen, compelling and engaging kids content and combining that with retail initiatives such as toys helps optimize brand equity and in turn drives higher growth, alternative revenue streams from licencing and merchandising, and higher margins. This allows us to diversify and build broader recurring revenue streams across our toy, entertainment content and mobile digital direct-to-consumer markets.

We continue to remain focused on the execution of our long-term strategy. The problems that we have experienced in 2019 are solvable and we intend to solve them sooner rather than later. We will keep you updated on how we are doing on a quarterly basis in this regard.

As we look forward to 2020 and beyond, the strength, diversity and depth of our innovative brands, entertainment franchises and mobile digital portfolio, along with our track record of successful innovation, gives us confidence in delivering our long-term organic growth product sales growth target of mid to high single digits.

To conclude, I want to personally apologize for our performance in 2019. We let ourselves, our customers, consumers and our shareholders down. This performance is not what we built Spin Master on, and again, we are sorry for this.

With that, I will pass it to Mark.

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Thanks, Ronnen, and good morning. I just want to ask you to excuse me up front for the cough and cold that I have, so I will try to do my best to get through these remarks.

As we mentioned in Q3, our performance remained strong through October, driving orders and shipments to date, ahead of where we were at the same time last year on an October year-to-date basis. At that time, we had orders and shipments that made up the decline of 8 percent in Q3 year-to-date gross product sales. However, as we reiterated at that time, we still needed to perform well during the order replenishment cycle in November and December to achieve our low single-digit gross product sales outlook for the year.

Although we started the fourth quarter with positive momentum based on the progress we had made in October with both orders and shipments off to a strong start, order levels, shipments and in particular our operational performance in November and December were considerably below our expectations. As a result, 2019 gross product sales were down approximately 1 percent compared to last year. On a currency adjusted basis, however, 2019 gross product sales were flat year-over-year.

Excluding sales of Hatchimal products, which declined over $230 million year-over-year, gross product sales for 2019 rose approximately 16 percent over 2018, led by the strong performance of the boys' action and high tech construction business segment.

The decrease in gross product sales was driven by a decline in gross product sales in the U.S. caused by industry-wide softness of toy sales during the shortened 2019 U.S. Holiday shopping season, and operational performance challenges primarily related to the consolidation of our new East Coast DC that Ronnen just described.

Let me give you a little bit more colour on the issues that affected us in 2019.

We have evolved toward a more domestic replenishment model to ensure our collectible product line such as Bakugan and Monster Jam, which were a big part of our business in 2019, remained fresh on shelf. This strategy gives us more control to ensure that we have the right product mix on the shelf at the right time. During 2020, we will carefully evaluate what the right FOB versus domestic mix is for the business.

The absence of Toys R Us in 2019 had an important underlying effect on the industry this year. TRU is a large direct import or FOB Asia buyer and purchased most of their goods early for the fourth season in Q3. This shifted volume more domestically and added to the pressure on industry supply chains, including ours. Also, with an ever-growing eCommerce penetration, retailers order lead times have narrowed, shifting the buying patterns closer to the Holiday season in Q4, which reduces the potential replenishment cycle. The on again, off again, on again but less items news on tariffs on List 4 items including toys was only resolved very late in 2019 and was very disruptive to our and the industry's supply chain. At times, we saw some retailers facing stretched domestic warehouse capacity issues as they have also employed mitigation strategies on unrelated List 1 to List 3 tariff product lines.

This situation caused a degree of uncertainty in retailer order patterns as retailers shifted orders in anticipation of the tariff implementation, which then put pressure on our supply chain as we brought in inventory earlier and domestically in order to avoid tariffs.

With long lead times from Asia, we could not flex as quickly as the news unfolded, and a result, we tried to maintain a measured approach while at the same time continuing to diversify production outside of China.

As we discussed in Q2 and Q3, we established an East Coast DC to serve our customers better and at the same time consolidated Gund, Cardinal and SwimWays warehouses into the new DC. This was disruptive to our third and fourth quarter shipment slot.

For the reasons described above, these factors combined to affect us negatively in a number of areas. We lost a considerable amount of sales that we could otherwise have shipped on the solidly performing parts of our portfolio. We incurred fines and penalties for late shipments which increased sales allowances and reduced our gross margin. We were required to increase the levels of promotional spending as customers shopped later and in order to ensure we kept retail inventories as low as possible at the year-end, again which increased sales allowances and reduced our gross margin. As a result, sales allowances as a percentage of gross product sales in 2019 were significantly higher for the year compared to last year.

We also incurred significantly higher than normal freight, warehousing and distribution costs in order to get deliveries to customers due to delayed shipments, the movement of goods between warehouses and much increased inventory storage costs.

We also undertook higher levels of lower margin closeout sales to reduce inventory in our warehouses on those lines which were not performing and which we did not want to carry forward into 2020.

In addition, variable selling expenses increased as the mix of licenced products, including Monster Jam, Bakugan and How to Train Your Dragon increased, resulting in higher variable royalties.

As you might expect, lower gross product sales, higher warehousing and distribution, higher promotional spending, higher selling expenses and deleveraging of fixed operating costs combined to reduced Adjusted EBITDA margin.

Our Adjusted EBITDA margin for 2019 was approximately 14 percent compared to 18.6 percent last year. Previous guidance provided on November 3 was for Adjusted EBITDA margin to be slightly below those achieved in 2018. Please note that actual results will depend on some factors that have not yet been finalized.

Decisive management actions are currently underway to rectify our issues and we intend to improve execution going forward with a strong focus on cost management, operational efficiency and productivity initiatives. We believe we are better positioned for 2020 and look forward to discussing our outlook when we release our audited fourth quarter and 2019 results.

To conclude, we remain committed to our growth strategies and long-term financial framework which targets organic gross product sales growth of mid to high single digits.

While we acknowledge the short-term uncertainty caused by the various factors which affected 2019, Spin Master’s solid track record of innovation and generating growth backed by a diverse portfolio and very healthy balance sheet gives us a strong position to take advantage of growth opportunities.

Ronnen and I are now pleased to take a few questions. Please note that as Sophia mentioned, given that we are not issuing our Q4 and full-year 2019 results, we will have to limit the nature of the responses we can provide in the Q&A.

Operator, please open the line.

Q & A

Operator

At this time I would like to remind everyone in order to ask a question, please press star followed by the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Our first question comes from the line of Saba Khan from RBC Capital Markets. Go ahead, please. Your line is open.

Sabahat Khan – Analyst, RBC Capital Markets

Thanks and good morning.

Of the factors that you outlined for the margin hit during Q4, can you maybe breakout or quantify the contribution from the discounting versus the DC issues? Then, to follow-up I guess, with the DC issues, where would be in sort of resolving those as you head into 2020?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Saba, thank you. I want to be actually too specific on numbers but I can tell you that the warehousing and distribution and gross margin impact was roughly equivalent in size to the sales allowance impact if you actually look in dollar terms year-over-year. Those two items together comprised a big chunk of the year-over-year EBITDA miss that we had. Those were the two most significant items, by far.

Then, obviously, there's an impact on profitability of the sales miss as well, but that was much smaller than the two that I just described above.

In terms of resolving the issues, Ronnen, could you?

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

Yes. Just in terms of, Saba, we are extremely focused on resolving these issues. We've jumped into them for the last 45 days, 60 days, very intensely, and we're very focused on resolving everything. We will be giving you guys more updates in March, quarterly, but I can just assure you that there is 110 percent focus on resolving these issues. The last thing we want as a company is to miss sales, which is what we classify as a sin, missing sales. We had an opportunity to ship more product in 2019 which we weren't able to do, and obviously lost the margin from those dollars. We are very, very focused on resolving the issues ASAP.

Operator

Our next question comes from the line of Derek Dley from Canaccord Genuity. Go ahead, please. Your line is open.

Derek Dley – Analyst, Canaccord Genuity Corp.

Hi guys. Just one for me.

Just in terms of the cadence in terms of sales shifting from Q3 into Q4, which based on your guidance implied that we did see that. We did see a pickup of your percentage of sales in Q4 versus what we've seen historically. Is that something you expect to continue given your commentary on sort of shorter lead times from many of the smaller retailers and not having Toys R Us in the mix any more?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

The underlying secular trends that we described in Q3, Derek, are still prevalent. We still do anticipate a shift from Q3 to Q4. I think you will actually see when we release our results that Q4 was actually up and it would have been up significantly more had we not had the operational challenges that we both just described. I think that point is still intact, and as I said and as Ronnen just said, again, we would have hit our guidance numbers that we issued in Q3 had we not had our operational challenges and you would have seen that shift from Q3 to Q4 being more pronounced than it actually was.

Derek Dley – Analyst, Canaccord Genuity Corp.

Okay. I guess just following up in terms of the operational challenges, that comment to me implies that you had the view that you'd be able to rectify these operational challenges quite quickly, given I think your call was early November. Is that how we should think about your ability to rectify the situation heading into Q1? It should still be pretty rapid?

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

I think we made a strategic judgment error where we consolidated all our warehouses into one big East Coast warehouse. We put in Cardinal, SwimWays, Gund, everything for this warehouse and we did it in the third quarter, with which hindsight should have been done in the first quarter.

When you take that and you compound that with all of the macro issues that the industry was facing in terms of changing order patterns and the tariffs and stuff like that, it did not put us in a good situation to execute at the level that we wanted to execute on.

Going into first and second quarter, we're very focused on taking all the pain and the learnings from the third and fourth quarter and smoothing out the order patterns and supply chain in the first and second quarter, obviously to be ready for the big third/fourth quarter of next year.

Derek Dley – Analyst, Canaccord Genuity Corp.

Okay. Thank you very much.

Operator

Your next question comes from the line of Steph Wissink with Jefferies. Go ahead, please. Your line is open.

Stephanie Wissink – Analyst, Jefferies Inc.

Hi guys. Good morning everyone.

I wanted to just follow-up, Mark, on one comment you made on inventory, just to make sure we're understanding that your channel inventory and your own inventory at the end of the year are clean based on the actions that you took to rectify some of the excess.

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

I would say to you we undertook a lot of promotional spending, Steph, in the fourth quarter to ensure that retain inventories were as clean as they possibly could be. I would say from warehouse—sorry, from inventory in our warehouse we did the same thing with closeout sales. I would not say to you that at the warehouse level we are fully satisfied with where we landed up. We are still seeing much higher inventory at the end of the year in our warehouse relative to what we had in 2018. I think at retail we're okay, but in our warehouse we still have some inventory levels that we are not happy with, so we are carrying more into 2020 than we would like to.

Stephanie Wissink – Analyst, Jefferies Inc.

Okay. Then just a follow-up on the ex- Hatchimals being up mid teens, it's quite impressive to still be able to grow your underlying business at that pace. Can you just give us a couple of highlights on what you found worked well in the category, even the headline being a bit weaker but just looking at your underlying business. What were you most proud of in the quarter?

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

I think that Bakugan was delivering for the Company and was building as the year went on, which is very nice to see. Things like Monster Jam consistently building, I think we had the best year that

Monster Jam as a licensor has had in many, many years. Things like Kinetic Stand were very strong for the Company. The RC part of the business, which in previous years was down, really performed. They've done an incredible job transitioning away from just basics like commodity products into really innovative flying products. Then also, the big monster truck, $100 Monster Jam RC was a sell-out. So I think that a lot of other areas of the business really pulled. It was across the portfolio, which was nice. It really got spread out. It wasn't one runaway Hatchimals type success that made up that drop of Hatchimals.

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

But Steph, I think it's an important point that you raise here because I think when you actually realize that we were comping a negative comp of over $230 million and we still grew 16 percent outside of that, I think it goes to our brand innovation pipeline, it goes to the way we have tried to diversify our business and so I think it is an important point for everyone.

Stephanie Wissink – Analyst, Jefferies Inc.

Thank you.

Operator

Our next question comes from the line of Adam Shine with National Bank Financial. Go ahead, please. Your line is open.

Adam Shine – Analyst, National Bank Financial

Thanks a lot.

Ronnen, just going back to the dynamics around this East Coast DC, when we reflect on some of the comments made during Q3, obviously acknowledged some issues that undermined the performance in the Q3 presumption was that some degree of resolution to that was at-hand going into the Q4. Was it just the amount of product that was coming through that just choked you guys? Were there other things that materialized? It seemed as if there was either a compounding of issues or, I don’t know what further undermined the Q4 versus the Q3. You would have thought that some lessons would have been learned in the prior period.

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

For sure. I think we underestimated the capabilities of the warehouse and our set-up of the warehouse to be able to handle the volumes that we were looking at. And when you look at the shift of volumes, October, traditional October became November and December, so those really big months we did not—I don’t think we tested the strength and structure and underlying capabilities of that warehouse to handle that type of volume.

I think we had a bit of hubris. We were gunning for consolidation, cost savings, integration, all these things in the midst of all these macro factors and, again, I reiterate, with hindsight it was a mistake. But to answer your question, we saw—when we spoke to you guys on the phone, we saw early signs of challenges happening in the warehouse, but we thought that they were resolvable. We didn’t realize that the structure there was not—the underlying structure was not as strong as it needed to be and so it really, it caught us all by surprise and then it became a ‘all hands on deck’ situation to resolve the situation and actually ship all the product out and get the product to the customers.

For us, first and foremost is delivering the products to the customers and keeping our promises and delivering to the consumers because we make promises to the consumers through our marketing, so we had to stand behind everything and incur a lot of costs to actually keep our commitments, which is the most important thing.

I'm proud of the fact that we kept our commitments because that's exactly what our company does, but it costs a lot of money to keep those commitments. It was a judgment error. It was really a judgment error on our part.

Adam Shine – Analyst, National Bank Financial

Maybe just a follow-up for you.

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

Yes.

Adam Shine – Analyst, National Bank Financial

Then one after for Mark. We've looked at the post Toys R Us dynamic as a sort of two-year dislocation period, the presumption being that—and you guys have said this—a cleaner year ahead in 2020 was to be expected. I think we're now talking about some work that you guys have to do, albeit in a seasonally lighter period in the first half of the year, but how should we think about 2020? I'm not asking for guidance. I'm just thinking is 2020 yet another transitional year for the industry, or perhaps more specifically for you guys? How would you characterize it?

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

Well, I would say like this. I think we have done a lot of things in the last 24 months to adapt to this environment. First, starting with our factory diversification in Asia and then with the consolidation into these warehouses, and with the acquisitions. I think that from a Spin Master perspective there's a lot of learnings and not only learnings but we've done a lot of things and I would say that we are—a lot of them are under our belt and I would say a lot of them are actually we've—a lot of them are under hand.

I would say from a macro perspective I think that the industry after two years had adjusted to everything and is continuing to adjust. I think this is the new reality that we are living in, what we described to you today in terms of all of these issues. This is the new reality. I think that we've adjusted and we will continue to adjust to it and run the Company to match with that environment. That's what we do and that's what we've done for 25 years. We've always adjusted. I think that this year we had to just adjust with a lot more variables at play and also take into account some other variables in terms of our own product lines shifting and changing, and a lot of learnings in terms of the integration of acquisitions.

There is going to be a huge amount of focus, just the same way we have an incredible amount of focus on our 36-month brand innovation pipeline, and as you can see that's doing well and everything is very focused on that side of the business. The same type of rigour and focus and attention will be paid on this part of the business to make sure that we've adjusted to this new environment.

So, to answer your question, I gave you a long short answer, but I think this is the new normal.

Adam Shine – Analyst, National Bank Financial

Okay.

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

I think the online patterns, shopping is a new normal. I don't believe that we're going to see any more tariffs issues. That's personally my personal opinion, but I think the consumer buying later in the season, domestic replenishment and understanding how to supply consumers on domestic replenishment basis is the new reality and we are adjusted and we are ready for that reality.

Mark, anything else you want to add?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

No. Adam, did you have a follow-up?

Adam Shine – Analyst, National Bank Financial

Yes. Yes, maybe just two questions for you, Mark.

One, is your intention to give 2020 guidance? I know you alluded to it earlier but just curious if indeed that's going to happen? Second, as we look for this stock to take a check backwards and acknowledging that you guys have a lot of work to do internally—that's not to say you can't walk and chew gum at the same time in regards to doing M&A, but we've not seen much in the way of material

M&A. Do we start to anticipate a buyback being instituted or at least food for thought being considered at the board level? Thanks.

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Okay. So, 2020 guidance, yes, we intend to provide guidance. If you remember, our cycle for guidance, our outlook is to give preliminary guidance in March, which we'll do. We'll update that in May based on our Q1 results. We'll then do the same in August on our Q2, and then Q3 as we did last year. Just given what has happened in 2019, my view at least is that we need to and we should be providing you and the market with as much information as we can to help us evaluate our performance and our stock, so we will continue to do that.

Regarding M&A, I think we actually talked about it quite a bit at the end of Q3. We have seen stretch valuations. We have a very strong balance sheet. We still generate strong cash flow and we continue to look at M&A as a prime growth driver. I think we do need to pause and look at how we executed some of the M&A that we've done in the past in relation to the integration that we just talked about now. I would say to you we have made some mistakes in the past, but that doesn't the underlying thesis or the strategy and we're going to continue to look at that.

I don't believe and we're not announcing any buyback or any capital structure strategy like that at this time. If we're sitting here in another year, we'll reflect again and figure out how that works, but I think we're still driving forward with M&A, I think with a slightly more intelligent and jaundiced view of how to integrate.

Adam Shine – Analyst, National Bank Financial

Okay. Thank you.

Operator

Again, as a reminder in order to ask a question, please press star, one on your telephone keypad.

Our next question comes from the line of Brian Morrison with TD Securities. Go ahead, please. Your line is open.

Brian Morrison – Analyst, TD Securities

Hi, good morning.

Mark, just going back to the elevated merchandise level at the warehouse, what's the plan to lower that? Have provisions been made in the Q4 with respect to that inventory?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Brian, what we did in Q4 was we focused—when we realized what was actually going on, we were aggressively focused on making sure we got the inventory out of our warehouse that we didn't want to carry into 2020. I would say to you we largely did that. It did come at a cost because it affected gross margins through the closeout sales, which was an impact on EBITDA as well, but I would say to you the vast majority of what we're carrying forward into 2020 is inventory that still has relevance and can be sold in 2020, so it’s not like we’re carrying some kind of huge liability into 2020 that you need to be concerned about. The reality is that the lines that we can carry forward, we did.

All I was pointing out to Steph in relation to the earlier question was that in absolute dollar terms we are carrying more inventory dollars into 2020 than we did from ’18 into ’19. But it’s mostly good inventory and it will be sold at normal margins.

Brian Morrison – Analyst, TD Securities

Okay, so it’s current.

Ronnen, just, I hate to repeat things here, but just I appreciate your candour. Just in terms of the DC, so overall here you’ve had a shift in OB domestic, it’s brought merchandise more sales into November and December, there was too much flowing through the new DC and so you had troubles getting product out the door and that resulted in extreme costs. Is that a summary of what’s taking place?

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

That is a good summary.

Brian Morrison – Analyst, TD Securities

Then the last question—sorry, go ahead.

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

If we were to do it all over again, it should have never been done in the third quarter. Right? Going to a new DC and—yes, anyways. Just wanted to reiterate that.

Brian Morrison – Analyst, TD Securities

Understood. Thank you.

Then the last question on a different note. Maybe, Ronnen, you can just talk about the performance of your key entertainment properties to date, specifically Paw Patrol and maybe Bakugan as well.

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

Yes. As I mentioned before, I mean Bakugan continues to build, continues to build globally. We have our second season which is starting to air very shortly. We have our partnership with Netflix, which is great. We have our partnership with Cartoon Network, which is great. We're very happy with that. We're in production of season three. We're working on a movie. Lots of things happening with Bakugan.

In regard to Paw Patrol, globally it's doing very, very well. In the U.S., we had a couple of product lines that didn't do as well with the airplane and with the lookout tower. A little bit of fatigue with the lookout tower and with the airplane. In the U.S., some of the POS was a little bit down in the fourth quarter, but overall going into 2020 and coming out of the Hong Kong Toy Show, the retailers very, very strong on Paw Patrol, very strong in terms of not a lot of competition in this year. I think we experienced a bit of competition last year with Toy Story, so it's amazing how well Paw Patrol did up against something as powerful as Toy Story.

Coming out of Hong Kong, the response to our new themes in terms of the dinosaur theme was amazing and the way everybody is very, very excited about it. The competition set doesn't seem high. We're very focused. We're in production with our feature film, which is coming out in 2021 and we'll have some more information to share with you guys on that in March.

Brian Morrison – Analyst, TD Securities

Thank you.

Operator

Our next question comes from the line of David McFadgen from Cormark Securities. Go ahead, please. Your line is open.

David McFadgen – Analyst, Cormark Securities

Thank you. Just a couple of questions.

You talked about the outlook for gross product or what the expectation is for gross product sales for 2019 and EBITDA margin of 14 percent, but you also said that the sales allowance is up significantly in 2019 versus 2018. Can you give us an idea what it is in terms of a range? Because we need that number to calculate revenue and then calculate EBITDA given EBITDA margin you've given us. Can you give us any additional details on that?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

I'm a little cautious here as, as Saba asked earlier, just in terms of actual numbers. I don't want to be too specific just because our numbers are still being audited and we will obviously give you precise numbers when we release our results.

But, David, I can tell you that our typical range is 10 percent to 12 percent. Last year we were at about 11.6 percent, so towards the top end of that range, and we were in the zone of around 100 to 200 basis points above this, the top being the upper range.

David McFadgen – Analyst, Cormark Securities

Okay, okay. That's helpful. Thank you.

When you look at what you cited in the press release in terms of focusing on efficiency and you have a little higher inventory than you would like in the warehouse and you've also been dealing with some more licenced product this year versus the past, it would seem to me that you're not going to bounce back quickly to that 18 percent EBITDA margin level; it might take a couple of years to get back there. What do you think about that?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Well, I want to be again a little cautious as to provide any kind of specific guidance at this point in time. I will say to you that we have been at around 18 percent for quite some time, so I think we've proved that as a company we can do that. I think 2019 was an aberration, and dropping to around 14 percent is obviously a significant drop. We do not want to be at those levels. We think we can get it back up quickly. How quickly exactly we can do that remains to be seen. We will update you constantly but I can tell you that both Ronnen and I are extremely focused at getting Adjusted EBITDA margins back up to the high teens and not staying at the level that we're at now for 2019.

David McFadgen – Analyst, Cormark Securities

Okay. That's it for me. Thank you.

Operator

Our next question comes from the line of Saba Khan. Go ahead, please. Your line is open.

Sabahat Khan – Analyst, RBC Capital Markets

Thanks for the follow-ups.

The comment earlier around shifting your inventory between kind of FOB versus domestic relative to 2019, I guess is that a decision you're making internally, or is that in conversation with your retailers that you're sort of looking to maybe change that mix?

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

Do you want to go?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

I think it's a combination of both, Saba. I think we actually made some decisions in 2019 independent of retailers. We actually—because of tariffs we took some views about what we were actually going to do in preparation for tariffs, which obviously never landed up happening.

I think there's no right answer as to what the mix is. It is at the end of the day a negotiation between retailers and ourselves, but we do have some influence over the matter. There are obviously considerations from a pricing perspective, from a P&L versus free cash flow perspective that we have to weigh up, and from a risk management perspective. So, it is a negotiation, but my personal view is that we overindexed in 2019 with a shift towards domestic and we probably have to tweak that a little bit.

If you look at where we have been historically, as a company we were about 60 percent FOB, 40 percent domestic. In 2019, we landed up well more than 50 percent domestic, so that is a big shift in one year.

Now, the industry is going in that direction anyway, as Ronnen described, because of online purchases, which does make it more favourable to carry domestic inventory because retailers are ordering more on a just-in-time basis. The question for us is to hone our supply chain, to hone our understanding of customer supply chain and our supply chain to get that optimized. That's what we're going to try and do in 2020.

Sabahat Khan – Analyst, RBC Capital Markets

Okay. Then one on just the promotional cost or promotional activity that you undertook during Q4. Just trying to understand the dynamic there a little bit more. Was it that product shipments got a little bit delayed and once it go on-shelf you wanted to move them so you promoted them? Or was it sort of payment to retailers for things being delayed? Just trying to understand the dynamic around the promotional spend during Q4.

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Okay. Saba, what happened was it was a two-pronged issue.

When you can't perform at a warehouse level, you can't get the goods that are moving well to your customers, right? We had actually strong performing items that we couldn't get replenishment to our retailers, and then conversely, the items that weren't performing as well were sitting on the shelf longer than we wanted, and so that's what we had to attack with our promotional spending. We had to get those moving by increasing promotions, (inaudible) advertising, whatever it took, markdowns, and that's what impacted us in Q4. Does that make sense?

Sabahat Khan – Analyst, RBC Capital Markets

Yes, it does. Thank you.

Operator

Our last question of the day comes from Tim Conder with Wells Fargo Securities. Go ahead, please. Your line is open.

Tim Conder – Analyst, Wells Fargo Securities

Thank you, gentlemen, for all the colour.

Just to maybe kind of re-bucket it, if you didn't have some of your own, let's just call it self-inflicted warehouse issues, how much would you bucket that as far as the shortfall and not being able to deliver products that were selling well, the additional cost to meet the commitments to get them to the retailers and to the customers that you describe? It's the right thing to do long term for your business, obviously, but if you just had to strip out that, how much of the percentage of the total shortfall would you put into that bucket versus just core market weakness for the industry or your products all kind of collective as you put it in one of those two buckets?

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Let me answer it like this, Tim.

From our perspective, we had warehouse and supply chain issues regardless, so we would have had increased warehousing and distribution costs under any circumstances because of the challenges that we were having. That was always going to be a problem.

However, from our perspective, if we could have delivered what we would have liked to have delivered, we would have at least met, if not beaten, our top line guidance for the year. If you look at consensus, that gives you a sense of the order of magnitude that I think we left on the table when it comes to 2019.

Tim Conder – Analyst, Wells Fargo Securities

Okay. Again, the underlying ex- the Hatchimals obviously, the business still looked good, so thank you for that colour also.

One last thing here. Let's just assume the Trump administration is remains, is re-elected, what if the China situation then would—if there's not perceived enough forward movement and then things would go downhill again, have you started to—would you change anything from what you know now? I guess just to say, do you think you would see the similar or even more accelerated domestic demand needed, or would you maybe change some of those incentives to sort of give yourself an option if the customers takes product in Asia and then if those tariffs would re-emerge then you wouldn't make them whole. Somewhat a contingency from that perspective, would that be an option?

Ronnen Harary – co-Chief Executive Officer, Spin Master Corp.

I would say it like this. I would answer from two ways. One is we need to continue to refine our supply chain to have the most resourceful, fast-paced, quick supply chain that can adapt and adapt to the online world. We need to have a very, very, I would say nimble and responsive supply chain and that's what we're gunning for and that's what we're building. It doesn't matter what happens with the Trump administration elected or not elected.

Then, from a diversification perspective, from a manufacturing, we started diversifying before Trump came into office, we continue to diversify when he's in office and we will continue to diversify, okay, if he's elected or not elected. It's a healthy thing for the business overall. We have now products being manufactured in India. We have products being manufactured in Vietnam, Mexico, and decreased reliance on China. That's going to continue to happen and I'm very proud of our team for being able to actually actualize on that, and I think if you look at—anyways, I'll pause there and just say I'm very proud of our team that it's actually able to make that happen because it's a very—it's much more difficult than it was 15 years ago when you can make everything in China and when I was running Operations.

Mark Segal – Executive Vice President and Chief Financial Officer, Spin Master Corp.

Tim, just to end, one point on your question was pricing. Obviously during 2019 we were having a lot of discussions with retailers about different models based on that, so we have those plans in place should the need arise. I sincerely hope that that need does not arise, but as Ronnen said, I think from a supply chain perspective we've done a lot of work already to diversify and we also have plans in place should there need to be a change in how retailers approach us because of tariffs.

With that, let me just thank everybody for participating on short notice. Really appreciate it. Obviously we're not happy to be in this situation or to have the call, but we do look forward to seeing you in New York at Toy Fair. We have a great line for 2020 which we'd love to show you and talk about the business some more. Then we'll be publishing our results on March 4, our full P&L and balance sheet and cash flow.

Thank you everyone. Much appreciated.

Operator

This concludes today's conference call. You may now disconnect. Thank you for your participation.