Spin Master Corp.

Q1 2018 Financial Results Conference Call

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Operator

Good morning. My name is Adam, and I’ll be your conference Operator today. At this time, I would like to welcome everyone to the Spin Master Q1 2018 Financial Results 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 *, then the number 1 on your telephone keypad. And if you would like to withdraw your question, please press the # key. Thank you.

You may begin your conference.

Ryder — PAW Patrol

Thanks, Operator. Good morning, everyone. It’s Ryder from the PAW Patrol. And I’m here to welcome you to Spin Master’s financial results conference call for the first quarter ended March 31, 2018.

On the call this morning from Spin Master is Ronnen Harary, Co-Chief Executive Officer; Ben Gadbois, Global President and Chief Operating Officer; Mark Segal, Chief Financial Officer; and Karoline Hunter, Senior Director of Investor Relations.

Following the formal remarks, we’ll open up the lines for your questions.

Uh-oh, looks like I’m needed in Adventure Bay. PAW Patrol to the lookout.

Karoline, take it from here. PAW Patrol is on a roll.
Karoline Hunter — Senior Director, Investor Relations, Spin Master Corp.

Thanks for the introduction, Ryder. Good luck to you and the PAW Patrol.

For your convenience, the press release, MD&A, and audited consolidated financial statements for the first quarter are available on the Investor Relations section of our website at www.spinmaster.com and on SEDAR.

Before we start, please note that remarks on this conference call may contain forward-looking statements about Spin Master’s current and future plans, expectations, intentions, results, levels of activity, performance, goals or achievements, or any other future events or developments. Forward-looking statements are based on 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 on these forward-looking statements.

Except as may be required by law, Spin Master has no obligation to update or revise any forward-looking statement, whether as a result of new information, future events, or otherwise. For additional information on these assumptions and risks, please consult the cautionary statement.

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regarding forward-looking information contained in the Company’s earnings release dated May 8, 2018.

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

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

Ronen Harary — Co-Chief Executive Officer, Spin Master Corp.

Thank you, Karoline, and thank you, Ryder. I better watch out because you’re so articulate, you may be the next CEO here at Spin Master.

And good morning, everybody, and thanks for the interest at Spin Master.

Yesterday we reported our financial results for the first quarter ended March 31, 2018. And I’ll begin the call with some brief highlights for the quarter as well as the year ahead before Mark provides you with a more detailed review of our financial results, including our outlook for the balance of the year, and Ben will then discuss our operational results.

Let me start by saying that as a longtime participant in the toy industry, it is very sad to see Toys “R” Us’ demise in the US and in the UK. We are of the belief that TRU had a great franchise. It is not a signal as the strength or the weakness of the toy industry or retail in general for that matter, rather as a function of Toys “R” Us’ specific ownership, capital structure, and operational issues.

We are pleased to see that many of Toys “R” Us’ operations around the world have been solid or are in the process of being sold and will continue to operate, including Toys “R” Us Canada.
We are confident that we will manage the Toys “R” Us disruption in 2018, and believe that the industry will continue to level set itself in 2019. At the end of the day, there is some number—there is the same number of kids out there celebrating birthdays and holidays, and holidays will still come around every single year.

The entertainment group at Spin Master remains the cornerstone of our strategy that enhances our ability to drive consistent revenues and earnings growth through the creation of our own content. In 2018, we will produce over 100 half-hour episodes over five current and new productions.

PAW Patrol continues to perform well. PAW Patrol’s ratings are consistently at the top of the Nielson’s ratings. For Q1 2018, PAW Patrol was ranked number one amongst kids ages 2 to 5 for both new and repeat episodes.

In Q4, Nickelodeon will be airing the first PAW Patrol one-hour TV special titled Mighty Pups. In this TV special, our PAW Patrol pups gain superpowers from a meteor that lands in Adventure Bay. We’re also launching the ultimate rescue theme for the second half of season 5 later this year. PAW Patrol pups will each get a new ultimate vehicle that allows them to travel together on rescue missions. The fall of 2018, a toy line will follow the ultimate rescue team.

We are finding that the average age of recipients of PAW Patrol toys is skewing older, as both boys and girls are staying with the franchise longer. This is providing a larger market share for
the product line and allows us to participate in profitable incremental revenue streams driven by licensing, merchandising, and broadcast revenues.

Our second preschool show currently on air is Rusty Rivets. We launched season 2 in North America in Q1 of this year, and the ratings to date have been strong. According to Nielson data, new episodes of Rusty Rivets are ranked in the number three spots for both kids and boys ages 2 to 5. We’re now developing season 3 together with Nickelodeon.

The Rusty Rivets toy line is launching globally in August 2018 and we’ve developed innovative, easy-to-use building sets specifically designed with preschoolers in mind. Toys are tied closely with the building themes prominent in the second season of the show, and we’re already getting some great feedback on the toy line.

We’re very excited our new entertainment content currently in production and slated for release in 2019. Our new preschool show, Abby Hatcher Fuzzly Catcher, will be airing first on Nickelodeon in the US and TVO in Canada, and global distribution will follow. This adventure comedy series follows our heroine, the 7-year-old Abby Hatcher, as she rescues her favourite creatures, the Fuzzlys, from whatever trouble they have accidently landed themselves in.

We will be strategically launching the toys following a period of the show being on air. This allows the property to really become established with its preschool audience and builds anticipation for the toys in the market.
We will be relaunching Bakugan, both the toy and the television show, globally in 2019. Bakugan became a global hit for Spin Master when it originally was launched back in 2008. It was our first foray into developing our own content and allowed us to build the expertise to create our own in-house entertainment group.

We produced 186 TV episodes of Bakugan, and the result was a global entertainment and toy phenomenon with significant toy and licensing and merchandising income. We believe the global relaunch of Bakugan with a highly innovative, reimagined toy that has evolved but remains true to its roots represents an exciting opportunity for future growth.

On licensing, which complements our core business, we’re always looking for new properties; however, we remain very selective about the licences we choose. One of the licences we are very excited about investing in is through our partnership with Feld Entertainment for the Monster Jam master toy licence.

Monster Jam is an action-packed live event where the drivers compete in front of stadium crowds in both monster trucks racing and freestyle competitions. For over 25 years, Monster Jam has been combining spontaneous entertainment with the ultimate off-road motorsport competition. This is a global 10-year partnership primarily focused on the die-cast and radio control segments.
We’re working hard on developing the line now, which will be released in January 2019. We are also working closely with Feld Entertainment on further developing the global growth potential of Monster Jam.

We also have the mass toy licence for the third feature film in the How To Train Your Dragon franchise to be released in 2019. We’ve been a toy partner for these films and television series since its original debut in 2010. The How To Train Your Dragon films have grossed over 1 billion worldwide. The third film will feature new characters and dragons and worlds to explore, extending the collectibility of the toy line.

We are also leaning in on some key toyetic themes for the film, such as bioluminescent colouring and dragon armour to be represented across innovative products ranging from collectibles, core action, plush, and role-play. And we are excited to be part of this phenomenal franchise.

Regarding Toca Boca and Sago Mini, they continue to grow steadily. Since acquiring these two mobile digital companies, we’ve left them to focus on the core strengths, which is development of new content for apps and strengthening their brands with consumers.

Toca Boca’s continued to perform well as the number one paid mobile digital kids brand. Our biggest success is the Toca Life series, where we are seeing strong growth and engagement. We’re now building and expanding the success across categories to create more integrated digital experiences.
Lastly, strategic acquisitions have been and will continue to be a fundamental core to our growth. Our most recent acquisition, GUND, closed on April 2, 2018.

Through the acquisition of GUND, we’ve gained deep expertise in plush, which according to NPD was the second-fastest growth category, up 8 percent in the US year over year in 2017. GUND has an iconic status and a loyal brand following, and is in a strong position to drive growth.

As with Cardinal and Swimways, we see an opportunity to use our global sales and distribution structure to scale the GUND business globally. We also plan to capitalize on strong licensing opportunities to leverage GUND’s core competencies of plush design, sourcing, and manufacturing.

We now have access to a well-established specialty retail network that we plan on selectively leveraging for Spin Master’s brands. Ben will provide you with a further update on the GUND integration later in the call.

During the quarter, I travelled to Iraq along with a few colleagues of ours here at Spin Master for the Spin Master Toy Movement. We delivered over 90,000 toys to Syrian refugees in the Erbil region of Kurdistan, Iraq. It was heartwarming to be able to bring some joy to the children who have suffered so much trauma from the civil war in their homeland. Our goal this year is to deliver more toys through the Toy Movement than we have ever done before in different parts around the world.
I’ll now hand it over to Mark Segal, Chief Financial Officer, to review our financial results in more detail.

Mark Segal — Chief Financial Officer, Spin Master Corp.

Thanks, Ronnen. Overall, our first quarter revenue increased 25.5 percent from 2017, driven by Hatchimals, Luvabella, and our games portfolio, including Cardinal.

Foreign exchange tailwinds increased overall revenue by 8.1 million. In constant currency terms, revenue increased by 23.5 percent relative to last year.

Gross product sales increased 25.7 percent in the first quarter. On a geographic basis, Spin Master’s global platform drove gross product sales increases of 19.5 percent in North America, 33.4 percent in Europe, and 49.8 percent in the rest of the world.

Overall, international gross product sales comprised 35.9 percent of sales in the first quarter, increasing from 32.5 percent last year, and continuing the progress we have made over the last few years in growing our international business.

In comparing our Q1 ’18 results to Q1 ’17, one of the key differences between this year and last was the timing of Easter. In 2017, Easter occurred in the middle of April. This year, Easter fell on April the 1st, resulting in a large proportion of Easter sales volume falling into Q1.

The largest impact on our financial results in the quarter was the US liquidation announcement by Toys “R” Us on March 15, 2018. After a very disappointing US holiday season, TRU announced it was preparing to liquidate its US operation. TRU’s weak 2017 holiday
performance was known in the industry in Q1, and we took steps to manage receivables and.inventory exposure ahead of anticipated further restructurings.

However, the extent of the weakness was not fully known, and the decision by their lenders to immediately begin liquidating all stores in the US came as a surprise to us and the rest of the vendor community.

In addition to the US market weakness, TRU UK performed very poorly, and during Q1 TRU closed and liquidated most of its UK business after failing to find a buyer.

At the end of the quarter, we recorded a bad debt expense of $15.2 million, primarily related to TRU US and UK accounts receivable. This bad debt expansion is included in administrative expenses in the P&L. In calculating this charge, we’ve assumed no recoveries from any of the liquidated TRU entities. To the extent there are any recoveries, we will reflect these when we have more certainty as to their potential recovery value.

We are continuing to do business with certain TRU entities that were not directly affected by the US or UK liquidation process. Current reports indicate that TRU Canada has been sold as a going concern to Fairfax Financial. We are shipping to TRU Canada on conservative terms until all the details of the Fairfax transaction are known.

On April the 21, 2018, Smyths Toys announced an agreement to acquire the German, Austrian, and Swiss business of Toys “R” Us, which we believe is good news for the European toy industry. We are currently shipping to TRU Germany, and still have credit insurance in place. We
continue to ship to TRU France, and have credit insurance in place as well. We are also currently shipping to other entities, such as TRU Australia, Asia, and Japan on a case-by-case basis.

Sales allowances for the quarter as a percentage of gross product sales were 11.2 percent. The increase over last year is mainly attributable to the management of channel inventories and promotional activities due to the volatility of the marketplace in Q1. As mentioned before, Spin Master’s expected sales allowance range is between 10 and 12 percent.

Other revenue, which primarily reflects merchandising, royalty, and television distribution income from products marketed by third parties using Spin Master’s intellectual property, as well as app revenue from Toca Boca and Sago Mini, rose 45.5 percent. As I mentioned in March, app revenue from Q4 ‘17 onwards is now reflected on a gross basis, and Apple and Google’s commission is reflected as part of COGS. Accounting for app revenue on a net basis, other revenue increased approximately 39 percent in Q1.

Our gross margin for the quarter represented 52.1 percent of revenue compared to 49.8 percent last year. If the accounting change for app revenue is adjusted to a net basis, gross margin for the quarter would have been 20 basis points higher at 52.3 percent.

As a reminder, in Q1 2017 we took a charge to COGS of 2.3 million related to the Swimways fair market value inventory adjustment.

On an apples-to-apples basis, gross margin in Q1 ‘18 was 52.3 percent compared to 50.8 percent last year, an increase of 150 basis points. The increase in gross margin was driven by the
increase in other revenue, favourable foreign exchange, most notably the strengthening of the euro and the pound, partially offset by increased sales allowances.

Total SG&A, excluding share-based compensation arising from the equity participation awards at the time of the IPO, increased 38.6 million. The increase was driven by the bad debt expense related to Toys “R” Us of 15.2 million, as well as by investments in marketing initiatives in the quarter due to Easter timing, partially offset by reduced product development, selling, and distribution expenses.

[audio gap] revenue compared with 5.2 percent last year, due to several new product launches in the quarter, as well as the global marketing initiatives in support of Easter. As I mentioned, in 2018 Easter fell into Q1, whereas in 2017 Easter fell into Q2.

Product development expenses were 2 percent of revenue compared with 2.8 percent in Q1 ’17, primarily due to the timing of our development needs within the 36-month brand innovation pipeline.

Selling expenses represented 5.5 percent of revenue compared to 6.5 percent last year, due to third-party licensed products making up a lower proportion of our sales mix. In recent years, as Ronnen mentioned, we have remained very selective about which licences we choose to enter into.

Distribution expenses were 4 percent of revenue compared with 4.6 percent last year. In 2017, we made investments in upgrading our supply chain infrastructure to support Cardinal and
our predominantly domestic business in Europe. The investments we have made in our supply chain in the US and Europe have placed us in a better position to service our customers and enhance margins, and we are now starting to see the benefit of these investments in our top-line growth and reduced distribution costs. We continue to look at ways to refine our supply chain to optimize customer service in both North America and Europe in a cost-effective manner.

Admin expenses represented 26.9 percent of revenue from 23.7 percent last year. The increase was driven primarily by the TRU bad debt expense and the impact of share-based compensation arising from equity participation agreements at the IPO.

Excluding the TRU bad debt expense and share-based compensation cost, admin expenses were 20.9 percent of revenue, down 1.6 percentage points over last year. This all resulted in net income of $8.7 million, or $0.09 per share compared to net income for Q1 ‘17 of 10.1 million, or $0.10 per share. Net income was reduced primarily by the impact of the TRU bad debt expense.

Adjusted net income for the quarter was $22 million, or $0.22 per share, an increase of 62 percent compared to 13.6 million, or $0.13 per share last year.

Adjusted EBITDA for the quarter increased 40.4 percent to 43.3 million from 30.8 million last year. Adjusted EBITDA margin increased to 15.1 percent compared with 13.5 percent last year. The increase in adjusted EBITDA margin resulted primarily from higher gross margins.

Looking at our business segments for Q1, gross product sales in the Activities, Games & Puzzles and Fun Furniture segment increased 20 percent to $57.6 million, primarily due to increased
sales of the Cool Maker brand of products, Kinetic Sand, and the Games portfolio, which includes Cardinal.

In the Remote Control and Interactive Character segment, gross product sales maintained strong growth, increasing 95.9 percent to $91.2 million, driven by Hatchimals Colleggtibles and Luvabella.

Gross product sales in the Boys Action and High-Tech Construction segment increased 27.1 percent to 16.7 million, primarily due to increased sales of Tech Deck and the initial launch of Flush Force.

In the Pre-School and Girls segment, gross products sales decreased 2.5 percent to 82.6 million. PAW Patrol sales grew year over year, but this growth was more than offset by a decline in sales of Teletubbies and Powerpuff Girls licensed products.

In the Outdoor segment, gross product sales increased 8.9 percent to $40 million in the quarter despite the TRU bankruptcy, which occurred during the seasonal ramp up of Swimways products.

Free cash flow was negative 28.3 million in Q1 compared to 5 million generated last year. The decline in free cash flow in attributable to higher cash taxes paid in the quarter related to 2017 profitability, and nonrecurring capital expenditures related to our new corporate office buildout.

Net working capital as a percentage of revenue decreased by 3.4 percentage points to 6.1 percent of LTM revenue.
As mentioned, we closed the GUND acquisition. It was our ninth acquisition since the IPO. The final purchase price of $76 million after a $3 million favourable net working capital adjustment was paid utilizing internally generated cash resources and our credit facility.

GUND sales in 2017 were in the range of $60 million, with around 20 percent attributable to international sales. GUND’s EBITDA is in the mid-teens. We will be consolidating GUND results from Q2 onwards, and they will be included in the Activities, Games & Puzzles and Fun Furniture business segment.

I will conclude with our outlook for 2018. As you know, the TRU liquidation in the US has created a degree of uncertainty for all industry participants, including Spin Master. We expect that most of the negative impact to the liquidation in the US will be felt in Q2 2018. We expect the overall impact to be contained to 2018, and that most of the sales that TRU historically generated will shift to existing or new entrants to the toy industry in 2019.

Given the uncertainty generated by the US liquidation in Q2, we are maintaining a conservative tone for our outlook for the balance of 2018, despite our strong Q1 results. For the full year 2018, excluding GUND, we now expect organic gross product sales to grow in the mid-single digit range relative to 2017 as compared to the mid- to high-single digit growth rate announced in connection with the release of our Q4 ‘17 results in March.

Including GUND, we expect gross product sales growth in the mid- to high-single digit range compared to 2017. This is in line with our long-term target of mid- to high-single digit growth.
Seasonality for gross product sales in 2018 is expected to be approximately 31 to 33 percent in H1 compared to the seasonality previously announced of 32 to 35 percent in H1.

The TRU liquidation in the US is expected to have an impact on our second quarter gross product sales, which results not only in the lower growth rates overall for the year, but also less of a shift in gross product sales from the second half to first half than we had previously expected.

Adjusted EBITDA margins, both including and excluding GUND, are expected to be in line with prior guidance, which is flat to 2017.

To be clear, adjusted EBITDA margins, which are calculated as a percentage of revenue and not gross product sales, were 18.8 percent in 2017.

I’d now like to turn it over to Ben Gadbois.

Ben Gadbois — Global President and Chief Operating Officer, Spin Master Corp.

Thank you, Mark. We are very pleased with our financial and operating results in the first quarter of 2018, which demonstrated the underlying strength of our products and brands.

According to NDP, in Q1 2018 in the US, Spin Master was the number four manufacturer and was also the number three absolute dollar growth manufacturer.

As we outlined on our last call, we ended 2017 with our best inventory at retail position since going public. Our Q1 results reflect this, as we were in a better position to refill customer
inventories. We measure beginning inventory, shipment-in, POS, and ending inventory regularly as an effective control on our business.

In the US and on a global basis, our POS growth significantly outpaced inventory growth. The strong POS growth on our products is showing customer engagement with our brands. We are seeing a healthy mix of inventory flowing into and out of retailers with new brands contributing to any increase in retail inventory.

As Mark discussed, Easter timing was also a driver for both US and global POS growth year over year.

There were several factors that influenced our performance this quarter, some of which will affect the balance of 2018. Let me walk you through these briefly before I review our four key growth strategies and some of the initiatives we are undertaking to execute them in 2018 and beyond.

Although the TRU liquidation announcement look place over end of the quarter, we were already experiencing channel disruption in Q1 in anticipation of previously announced TRU store closures. As a reminder, TRU was 12 percent of the industry in 2017 and approximately 12 percent of Spin Master sales.

For 2018, we proactively planned and expected that number to be in the high-single digits. Since the announcement, we have seen very high interest levels from other retailers to capture the
lost TRU volume, including putting formal plans in place. We are working closely with all these retailers to recoup as much volume as possible and ensure strong sell-through.

Some of this interest is coming from nontraditional toy retailers looking to increase their toy offering for 2018, mainly in the second half of the year. In 2018, we expect that between 80 to 90 percent of the TRU US volume will shift to existing and new customers in 2018. This implies an approximately negative 2 percent impact to the US toy industry. By 2019, we expect the market to normalize.

Currently, our overall retail inventory at TRU is down over 20 percent compared to the same time last year. We expect this inventory to sell off at an accelerated rate as the liquidation sales proceed during Q2 and for the US liquidation to be complete by the end of July, leaving a clean market for the second half of the year.

In the UK, TRU liquidated most of its stores during Q1. Even with the TRU closures, our UK business grew very strongly in Q1. This is a testament to the strength of our product line and our UK team.

While much of the current focus has been on TRU, it is also very important to know that we were awarded Walmart’s Vendor of the Year award for 2017.

Overall, we feel confident that Spin Master will weather the storm well in 2018, and we see some M&A opportunities arising out of this situation in 2019 and beyond.
We continue to focus heavily on the online channel. The internal e-commerce strategy we put in place three years ago is working. Toys lend themselves well to online sales. Online channels have unlimited shelf space; we want to make sure our entire toy line is available online, whether that is through our own D2C or to our retail partners.

We expect that the liquidation of TRU will only further increase the growth of online channels. In response to growing online shopping behaviour, we have through careful analysis been allocating a greater portion of our marketing spend and internal resources to our digital and social media.

A recent example of our online strategy is the Moonlite launch on Amazon. It has been very successful, with Amazon’s full year’s plan already increasing over initial expectation. When done right, this kind of online launch can be margin accretive for both our online retail partners and us.

I’d now like to briefly review our four key growth strategies, and provide you with an update on some of our current initiatives. Our first growth strategy, to continue to innovate the core product portfolio, relies on our ability to consistently infuse innovation into our branded products.

Our internal 36-month brand innovation process facilitate the identification of market opportunities that we capitalize on to a product development or acquisitions. We view this process as an integral part of our business for sustainable profitability.
Let me run through a few highlights of our 2018 product line now, and how we see things trending based on our early reads. Our 2018 toy lineup was very well received at the major international toy fairs held in Q1. Hong Kong was in January, followed by New York, London, and Nuremberg in February. We had tremendous coverage at this year’s New York Toy Fair, where we hosted over 130 media and influential the tours of our booth.

In the Activities, Games & Puzzles and Fun Furniture segment, we’re getting very strong contribution from our games portfolio, including Cardinal. Titles such as Soggy Doggy, Santorini, Perplexus, Hedbanz, and Cardinal basic puzzles are all performing very well.

Kinetic Sand has had a resurgence following our decision to launch an opening price point at $2.99 in an innovative container that doubles as a mold.

Our innovation in Etch A Sketch, which we acquired in 2016, has been successful, as POS growth is being driven by the new Etch A Sketch Freestyle.

Our JoJo Siwa licence for the activities area is doing well so far with both the Bow Maker and JoJo Glitter Nails delivering growth.

In Remote Control and Interactive Characters, according to NPD, Hatchimals was number 10 in total toys, number 2 in the plush super-category, and number 3 in the doll-super category in the US.
Hatchimals Colleggtibles drove a significant amount of growth this quarter, as it was not in the market in Q1 2017. Colleggtibles (unintelligible) and a popular Easter gift this year. According to NPD, 3 of the top 15 Easter item were Hatchimals Colleggtibles.

Harnessing this momentum, we will be launching almost 200 new characters to collect in 2018. We expect the demand for the high price point eggs to pick up around our third Hatchimals Day launch in October. We have now developed great brand awareness for Hatchimals, and are capitalizing on this by building a global licensing and merchandising program. Core top-line categories such as apparel, hosiery, bedding, backpack are performing very well, with retailers reporting back that Hatchimals is one of their top licences.

Zoomer is largely a brand that sells in the second half of the year. Although we did not launch any new items in Q1 2018, we refreshed the low price point Zupps line to ponies, and sold more units this quarter over Q1 2017. We are excited about our fall 2018 Zoomer line. Zoomer is entering in its sixth year as a brand, and we are continuing to introduce new play patterns and interactivity at both high and lower price points.

As you recall from New York, the Playful Pups is our most realistic playful and expressive robotic dog yet, delivering all new interactivity. Hungry Bunnies is a line of cute rabbits that eat paper foods, and is priced in between our low- and high-price items in the Zoomer line.

Moonlite also represents some diversification with Remote Control and Interactive Characters. As I mentioned earlier, it is doing very well on Amazon. We are now expanding
distribution to the UK, Australia, and France this year and then expanding globally in 2019. Moonlite is patented and could be disruptive to the children’s book category.

In Pre-School and Girls, PAW Patrol continue to grow globally, and POS was strong in the quarter. According to NPD, PAW Patrol was the number one property in the infant, toddler, preschool toy super-category in the US, UK, and Australia for Q1. Products featuring the Sea Patrol theme first introduced in the second half of season 4 and airing now in season 5 are driving sales.

The PAW Patrol basic vehicle and pup assortment maintains a spot in the top ten item in the US, demonstrating consumers continue to be highly engaged with the brand.

Our two new exciting Girls products plan on launching later this year, and we will provide an update on them in our next quarterly call.

In Boys Action and High-Tech Construction, Tech Deck was a top performer. We are now selling Tech Deck globally, and we are pleased to see that consumers have reengaged with the brand very strongly. We are disappointed with Flush Force, the boy collectible line we introduced this year. With hindsight, there were too many players splitting the pie for an item with narrow appeal.

In the Construction segment, in the US, we are relaunching the Erector brand name for Meccano product to reconnect the US consumer with this heritage brand. In 2018, we are shifting focus to basic building concepts away from high-tech robotics programming. Although we delivered strong innovation, price points were too high for most consumers, delivering mixed results for us.
In our Outdoor segment, we were up for the quarter; however, the impact of TRU was felt disproportionately in the outdoor space, as the disruption arose during the peak season for the outdoor area.

We will provide further segment performance updates as we usually do in August and November.

During Q1, in addition to three TOTY awards, we received several additional acknowledgement, including best wearable toy from Parents Magazine for Twisty Petz, Techlicious and Toy Buzz each recognized Boxer, and two NPD U.S. Toy Industry Awards for top-selling toy by super-category for PAW Patrol basic vehicle and pup assortment and Hatchimals Penguala.

Overall, we remain very optimistic for our new products launched in the second half of 2018.

Our second growth strategy is to significantly increase our international sales. We revised our medium-term goals following our 2017 results at the upper end of our previous target of 35 to 40 percent of our sales internationally.

Our international growth continues an upward trajectory for the first quarter of 2018. Key established markets such as Germany, Mexico, and UK perform exceptionally well, and our newer markets such as Australia and Central-Eastern Europe, are continuing to show strong growth.

In China, our brands and products are resonating with consumers, and sales, while still small, are exceeding our expectations.
PAW Patrol recently received the Most Popular Store award from e-commerce giant JD.com, one of the largest online retailers in China. The award represents PAW Patrol’s success in the Company’s maternity and children’s division through 2017. PAW Patrol was one of only two toy brands acknowledged chosen from more than 100,000 brands participating in the selection.

PAW Patrol also received the Fast and Furious Award from Alibaba Tmall in the maternity and children’s section, recognizing the success of the brand on Tmall in 2017. PAW Patrol was the only toy brand to receive this award.

Following these successes, we are in the process of planning for additional brand and product launches in China in 2018, including Air Hogs, Meccano, Luvabella, KumiKreator, and selected marble games.

Third, we continue to develop evergreen global entertainment properties. Ronnen gave you a detailed overview of our current slate of properties, as well as the new content we will be delivering in 2019.

I want to highlight for you something that is working particularly well in our entertainment strategy. Our entertainment and brand teams work closely together integrating the show and the toy line to deliver innovative toy ideas that translate on screen, on shelf, and at home.

PAW Patrol is a great example of the fusion of storytelling and toy design. We are introducing themes each season that are timed to the delivery of our fall product line. This ensures
that during our largest selling quarter, the new products on retailers’ shelves and the new episodes on air are closely linked in both theme and content.

The way we think about entertainment and physical toy as converging content is a strategy we feel will be successful for our coming entertainment property launches, including Abby Hatcher Fuzzly Catcher and Bakugan.

Fourth, we intend to grow through strategic acquisition. We have the balance sheet and financial flexibility to do so, and we are actively seeking opportunities with the right strategic fit.

We are swiftly moving ahead with the integration of GUND. We have kept the current GUND strong leadership team in place.

To position GUND for future growth, we are working on several integration initiative, including hiring resources to support GUND; aligning the business with internal Spin Master processes; preparing GUND to move onto SAP; and transitioning the warehousing, order management, and inventory control processes.

Overall, the integration is going very well so far. It is still early, but everything is on track. And we are fully expecting to have the business integrated by the end of the year.

I want to conclude a comment about the balance of 2018. As Mark described in his outlook, we expect our overall growth rate for 2018 to moderate compared to the past few years.

While our results in Q1 2018 were very encouraging, we expect the second quarter to be more challenging as we manage through the TRU US liquidation. As we have described before, we
prefer to look at the business in halves and not quarters, due to the holiday timing and normal supply chain movements.

Our core products are resonating well, and we are confident for the second half of 2018 building on the strong and focused platform we have established over the last five years.

Overall, we are incredibly proud of the effort and result that our employees have delivered by executing on our four key growth pillars, despite the short-term headwind created by TRU closure in the US and the UK.

We remain very focused on executing our four key growth strategies at every level of the business globally, and we’ll be using our results-driven, high-performance culture to continue to drive value.

That concludes our formal remarks now. Ronnen, Mark, and I will now be pleased to answer your questions.

Operator, please begin the question period.

Q&A

Operator

Thank you. At this time, I’d like to remind everybody if you do want to ask a question, just press *, then the number 1 on your telephone keypad.

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And our first question comes from Sabahat Khan from RBC Capital Markets. Sabahat, your line’s open.

**Sabahat Khan — RBC Capital Markets**

Thanks, and good morning. Just on the Toys “R” Us situation, you provided some colour on the response that you’re seeing from other retailers in the industry. Can you maybe talk a little bit about are they allocating additional shelf space? Is it more promotions? And maybe what some of the nontraditional guys are doing? I’m assuming you maybe are referring to department stores, et cetera. So maybe some colour there.

**Ben Gadbois**

Good morning, Sabahat. So what is actually happening is, as you guys know, Toys “R” Us had a significant market share in the US. And with their liquidation, it leaves that market share wide open. So you have all the traditional retailers that you would expect that are already significant in the category aggressively wanting that market share, so there’s a lot of meetings, there’s a lot of reviews, there’s a lot of discussion with them. And what they’re looking at doing is to add space to their stores and do a lot of out-of-aisle promotion, so there’s a lot of activities for them to be able to accommodate the expected extra volume coming into their stores, trying to drive new promotions with their stores.

And then what we’re also seeing is in the rest of the market there’s a lot of players that—not sure we want to name them, given that they’re working on their own plans—but there’s a lot of
nontraditional players that are very eager to also enter the toy category sales, just because they see that now as a tremendous opportunity for them to also drive their comps and grow.

And then the last thing, but not least, is there’s a lot of variables at play now with the Toys “R” Us liquidation, as Mark and I discussed, and Ronnen, and everyone is really, really hard at work to partner up with the retailers just to make sure that from an operational standpoint it all gets executed.

Sabahat Khan

All right. Thanks. And then just if we could shift over to the Hatchimals platform. I think early last year at some point it was mentioned that you were looking at potentially a three-year pipeline of products. Given the progress that you’ve made with that platform, I guess is your view changed on the life span or where you might be with that platform? Or can you maybe talk a little bit about your outlook for that franchise?

Ben Gadbois

Yeah. I’m happy to answer that. So Hatchimals continues to do very well on a global basis at the various price points, which mean the original big eggs, as well as the collectible lines. So we also have—you guys are familiar at this point with our 36-month brand innovation pipeline, so we feel very, very confident with the amount of innovation now that we see for the next several years. And furthermore, we also will continue to invest in the brands.
And as a reference, if you guys remember just a few years back, we launched Zoomer when a lot of the conversation internally was can Zoomer be more than a one- or two-year item, and now we’re in year six because we’ve fostered the brand and we’ve continued to drive innovation that really fascinated the consumer. So we’re going to do the same thing with Hatchimals.

So there’s a lot of runway left in Hatchimals, and we’re focused on it to make sure that it has a long life cycle.

Ronen Harary

Yeah. And just to add to Ben’s point, our entertainment team has become very engaged now to create a lot of short-form content that you’ll see coming out in the fourth quarter and then throughout the balance of 2019 and beyond.

Sabahat Khan

All right. Thanks. And just—

Ronen Harary

Predominantly to support the collectible part of the line.

Sabahat Khan

All right. Great. And then just one kind of housekeeping one. On the CapEx on the traditional PP&E, can you maybe talk about how much of that was related to your head office and how we should think about full year CapEx without that head office spend?
Mark Segal

Thanks, Sabah. Yeah. So traditionally I’ve given you some guidance around CapEx running at around 4.5, 5 percent of sales. I think just given the expenditure this year, this onetime expense on the head office, that’ll probably go up a percentage point.

We had around $10 million of CapEx in the first quarter going through, and there’ll probably be a similar amount in the second quarter.

Sabahat Khan

Thank you.

Operator

And your next question comes from Kenric Tyghe from Raymond James. Kenric, your line’s open.

Kenric Tyghe — Raymond James

—first and then you had the benefit of more Easter in this first quarter. Could you just help us understand how the franchise performed and the level of growth in the first quarter net of those differences relative to your expectations?

Mark Segal

Sorry, Kenric, we lost you for the first part of your question there. Would you mind repeating that question, please?

Kenric Tyghe
Sure. Sorry, Mark. I’ll switch over here. The question was, we saw great outlook on PAW Patrol; we have obviously a strong performance in-quarter. What I’d like to try and handicap is the performance in quarter net of the various timing shifts, fourth quarter into first, Easter into the first quarter versus the second, and try get to how that growth performed or what that growth was relative to your expectations?

Ben Gadbois

Okay. Kenric, happy to answer this question. So PAW Patrol continues to add very strong POS on a global basis. It’s a bit different by different countries and regions around the world. Nonetheless, the POS globally was up low-double digits, so the franchise continued to do extremely well.

And just as a reminder, several parts of the world are one to three seasons behind North America, and actually we continue to be extremely positive with the results we’re seeing with PAW Patrol. Ronnen mentioned earlier that later this year we’re launching a one-hour TV special, the Mighty Pups, which is very much on trend with what captures kids these days. We’re having season 5 launching soon. And we’re excited for our new product launch, including ultimate fire truck and the new vehicles, too, that Ronnen mentioned earlier.

So we remain very, very positive with the performance of the franchise.

Kenric Tyghe
Great. Thank you, Ben. And certainly the fire truck was impressive at the toy fair. If I could switch gears, Ronnen, on Rusty Rivets perhaps ... you’re sounding perhaps a little more confident with respect to the franchise; performance perhaps better expected; supporting the toy launch or a fuller toy launch than perhaps we had sort of been looking for in this year. Could you just speak to that Rusty Rivets performance what’s either changed in terms of the opportunity or changed in terms of your confidence?

Ronen Harary

I think we’re going to put Rusty on the next call for the third quarter. That’s a shot. It’s interesting, television shows they’re kind of like children. They all kind of develop at a different pace. And I think that the first season of Rusty Rivets, even though it rated really well, I’d probably give it a 7 out of 10. And season 2, the team has just done an exceptional job really tightening up the storytelling and the pacing of the show, and I’d probably give it a 9 out of 10 as a television show. And they’ve also done an incredible job to focus in on what the kids were gravitating to, which were these special bots like the Elephantbot and the Tigerbot and the Gorillabot, and brought in a nemesis to Rusty and Ruby, which creates for great storytelling. So I think the show itself is much tighter, and I encourage all you guys to actually watch season 2.

And then the team did a smart thing, which was they gave the property more gestation time with the consumer to really start to get into the characters and to get into the show. And I think we made a good strategic decision by pushing off the toy launch to the fourth quarter of this...
year, and also taking some of the learnings that we had from Toys “R” Us last year and modifying a line to what were the higher-selling feature products versus the other ones that were underperforming.

So cautiously optimistic, and we’ll see in the fourth quarter how the toys resonate. But I can tell you that the show is a lot stronger, and the ratings are proof that the kids are engaging and watching the show.

Kenric Tyghe

Great. Thank you. And a quick final one for me. Mark, the timing shift first half versus the second half, is that simply reflective of the Toys “R” Us US windup perhaps proceeding quicker than expected or some combination of that and how aggressively other entrants are looking to go after the Toys “R” Us share?

Mark Segal

It’s primarily, Kenric, a function of the volatility in the second quarter in the sense that there will not be replenishment sales, obviously, as a result of the US Toys “R” Us liquidation. And that kind of shifts some toy sales out of Q2 that we were expecting to make, and that changed the seasonality a little bit.

Kenric Tyghe

Great. That’s it for me. Thank you.

Operator
And your next question comes from Stephanie Wissink from Jaffrays. Steph, your line’s open.

**Stephanie Wissink — Piper Jaffray**

Thanks. Good morning, everyone. I want to unpack a couple of things. First, just congratulations, guys, on the success of the licensing program. Curious if you can dig a little bit deeper and share with us where some of that is coming from, if that’s PAW Patrol, or if you’re starting to see some success with some of your other franchises? And then also I know the advancement in international has been a key strategic pillar for you, so I’m curious if you can just break down a bit of where you’re seeing some market penetration opportunity and growth? And how we should think about that cadence moving beyond kind of 35 percent of total sales over the next couple of years? Thank you.

**Mark Segal**

Okay. Steph, I’ll take the first piece of that question, and then maybe Ronnen will add some comments and then Ben will deal with the international piece. We have seen some strong growth in other revenue. We don’t break down all the components of other revenue, but there are three primary drivers of that.

You have your licensing and merchandising program, you have your distribution sales of the TV shows, and then we also have app revenue. We’re actually seeing growth in all of them. We’re actually starting to see some of our own licensing out doing nicely as well. The Hatchimals...
program we started last year is starting to get some traction as that brand has grown. And so that’s becoming an element of our other revenue streams as well, and that’s a program that we’re going to continue to build.

As well, we’re also seeing strength in the Toca Boca and Sago Mini app sales. Both of those companies are continuing to do well and build their franchises, and so all of those are really driving growth in the other revenue line.

Do you want to add anything, Ronnen, to that?

Ronen Harary

Yes. Just to build on your comment on Hatchimals, there’s interesting things happening in the industry now where you have toy properties that are driving L&M, such as Hatchimals, LOL, Shopkins. And when you add them up, it’s quite a large share of the industry that’s being driven by toys.

And I think potentially a large factor of that is the ability for kids to watch the content based on those toy properties on YouTube, which is driving a lot of growth and really opening up a lot of opportunities for companies in our space.

So for us, we’re taking a very focused effort in terms of expanding out what Hatchimals means, and expanding out what that means from a character perspective with the content that we have in development now. And I think the team’s done an incredible job by creating an in-house—reacting very quickly by signing up over 50 licensors, and they’re not only getting out the product,
but getting out a really incredible product that’s tailored and that is in keeping with the meaning of what Hatchimals is all about. And that product’s really resonating with the consumer, and suddenly we have an incredible in-house licensing team where this time around we capture 100 percent of the revenue coming in.

Ben Gadbois

On international, Steph, we were actually very pleased with our performance at pretty much all of our individual countries. We track the POS in each one of these countries, and in almost all of our countries where we have direct offices our POS is a multiple of the market.

And what is so positive for us is it shows that not only the POS is very strong, but the portfolio as a whole is doing well, which is very encouraging for us. And as far as changing our target from that 35 percent that we’ve initially set to the 40 percent is we’ll go from 35 to 40, and the next step before we change to 40, but we’re always studying new markets; we’re preparing more countries.

And as a reminder, we don’t like to launch countries and lose money for three years just for the sake of entering new countries. So we like to be very calculated and measured in our international approach, and as we enter we like to be profitable very fast in our entry. So you will continue us to ... you will continue to see us step up our international effort, but we’re very pleased as a company in terms of how our international offices are doing because it’s not a function of one or two countries leading all the other ones. We’ve done really well in Q1 across the board.
Stephanie Wissink

Thank you. Very helpful.

Operator

And your next question comes from Adam Shine from National Bank Financial. Adam, your line’s open.

Adam Shine — National Bank Financial

Thanks a lot, Mark. I’d like to push you a little bit on the guidance update because—and I don’t begrudge you making the move in the context of the uncertainty around Toys “R” Us—but everything I’ve heard today was pretty consistent with the messaging sort of around the last disclosures in March, and I think during the course of some of the marketing that you’ve done subsequently. And I don’t think I’ve heard anything particularly negative in regards to a lot of the themes that continue to drive some of your historical outperformance in the industry.

And so given the start of a very good Q1 that blew away Street numbers—and arguably in a small quarter—acknowledging a dip that I think is being signalled heading into Q2, how should we be thinking about the context of this guidance particularly as you historically tend to get a lot more visibility as to your H2 outlook once you get through some of your summer planning and discussions with retailers? I’ll leave it there, and perhaps maybe you can elaborate.

Mark Segal
Okay. Thanks, Adam. I think with our guidance we’re being prudent, Adam, because we don’t have all the facts. We do know that the Toys “R” Us liquidation in the US is going to have an impact on Q2. We are also—as we said earlier, we had a shift of revenue from Q2 into Q1, which will affect the Q2 comps.

We don’t give quarterly guidance, but we are, I think, being reasonable and prudent here by adjusting our overall growth rate for 2018 down a little bit as a result of the uncertainty, not only in Q2, but also in the second half of the year. As Ben described, we do feel confident, but I think at this point in time given where we’re at with the information that we have, we believe that a slight tweak of the guidance with a more conservative tone is the right thing to do for the Company.

Ben, would you like to add?

Ben Gadbois

And—

Adam Shine

Sorry, go ahead.

Ben Gadbois

Yeah. Just one thing to add, Adam, is we are very positive with our product launch that are upcoming for the second half of the year. I think we feel great about the portfolio for the rest of the year.
You guys have all seen it in New York, but with that said, there are more variables in the market and in the industry this year than in the traditional years. And it’s difficult to model all these new variables with a high degree of accuracy. And as you know—as you know us, we tend to be more conservative and prudent and measured in our approach.

With that said, I think once we—over the next three months we’ll have a lot more clarity. And until we have that clarity, we just prefer to be more prudent.

Adam Shine

Okay. So fair enough. So notwithstanding the Q2 noise that could be coming, I guess I look forward to you guys beating Street numbers again. All the best. Thanks.

Mark Segal

Operator, I think we’ve got time for one more question at most. We’re going to have to cut it off at 10:30 a.m.

Operator

Certainly. So that final question comes from Derek Dley from Canaccord Genuity. Derek, your line’s open.

Derek Dley — Canaccord Genuity

Yeah. Hi, guys. Thanks for squeezing me in here. Just a question on some of your allocation of products outside of Toys “R” Us. Can you just give us an update on perhaps e-commerce and how
much of an impact e-commerce is having, both with your retail partners and your direct-to-consumer business?

Ben Gadbois

Yeah. I think when you look at ... if you look at the channel split in the US, there’s a—mass is obviously ... the mass retailers are obviously the largest channel. The online retailers continue to grow. We don’t expect that to slow down, although the traditional retailers are also very much focused on e-commerce as well now.

So I think it’s going to be a function of the pie re-splitting, I’m not going to say equally, but probably in a fairly balanced way amongst all the different retailers. And again, like we mentioned earlier, the one thing that is interesting for us is retailers that have typically not really been into the toy categories wanting to also try to participate going forward.

But I think, look, I think e-commerce will continue to grow; I think not as a function of Toys “R” Us, but I think as a function of how consumers like to shop.

Derek Dley

Okay. And do you experience a different margin profile when your products go e-commerce? Or is it the same?

Mark Segal
No, we’re relatively neutral from a margin perspective, Derek, when it comes to bricks-and-mortar versus online. Obviously within our customer category there are different levels of profitability overall, but it’s relatively neutral for us.

Derek Dley

Okay. Great. Congrats on a strong start to the year.

Ben Gadbois

Thanks, Derek.

Operator

And at this time, I’ll turn the call back over to the presenters for any closing remarks.

Mark Segal

Well, just to thank you, all. We will be talking to you again in early August with our Q2 results.

Thanks, everyone. Much appreciated.

Ben Gadbois

Thank you.

Operator

And this concludes today’s conference call. You may now disconnect.

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