FINAL TRANSCRIPT

Spin Master Corp.

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PRESENTATION

Operator:

Good morning. My name is Tiffany, and I will be your conference Operator today. At this time, I would like to welcome everyone to the Spin Master Third Quarter 2019 Earnings Conference Call. All lines have been placed on mute to prevent any background noise.

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. If you would like to withdraw your question, please press the # key. Thank you.

You may begin your conference.

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

Thank you, Tiffany. Good morning, everybody, and welcome to Spin Master's third quarter 2019 financial results conference call. I am joined this morning by Ronnen Harary, Co-Chief Executive Officer; Ben Gadbois, President and Chief Operating Officer; and Mark Segal, Chief Financial Officer of Spin Master.

For your convenience, the press release, MD&A, and unaudited interim financial statement for the third quarter 2019 are available on the Investor Relations section of our website at spinmaster.com and on SEDAR.

Before we begin, 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 assurances 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 statements, whether because of new information, future events, or otherwise.

For additional information on these assumptions and risks, please consult the cautionary statement regarding forward-looking information contained in the Company's earnings release dated November 5, 2019.

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

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

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

Thank you, Sophia. Good morning, and thanks for joining us on the call today.

Our strategy is designed to achieve long-term growth, and we are delivering on that strategy. Since 2015, we have generated gross product sales growth of 20 percent and 10 percent over the last ten years, well in excess of industry growth rates.

Our team remains diligently focused on successfully executing against our growth pillars. Despite an ever-evolving toy and content consumption landscape, we've remained focused on the execution of our 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 organic gross product sales growth target of mid to high single-digits. This is evident in 2019, as we have grown the business 12 percent, excluding the significant decline in Hatchimals from 2018 to 2019.

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 to 5 percent per year. In the last few years, the US market has faced challenges that have created disruption and change, but also opportunities.

We've had a major retailer, TRU, exit the market in 2018, and in response, volume has been redistributed to new customers and channels, creating changes in order patterns and distribution requirements.

The growth and 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 and AVOD and digital mobile platforms, as all this is occurring in a political environment characterized by trade tensions between the US and China, with ever-changing risk of US tariffs.

Through all this change, we remain focused on executing our strategy. We expect overall growth in top line and double-digit growth of our product portfolio for 2019, excluding the decline of Hatchimals, is a testament to the health and overall brand portfolio, as well as our ability to adapt and change.

We planned for a decline in Hatchimals in 2019 and ensured we have had a broad and diverse portfolio, including new product introductions, such as Owleez; Juno; My Baby Elephant; partnerships such as Monster Jam, How To Train A (sic) [Your] Dragon; and entertainment franchises, such as Bakugan, PAW Patrol that are driving revenue, offsetting the decline.

Our growth is being driven by our ability to identify, develop, and acquire new and innovative products and brands; create and license evergreen entertainment content; and grow internationally in partnerships with inventors, broadcasters, production studios, distributors, and licensors.

In 2010, we operated in only seven of the eleven categories in the toy industry, as tracked by NPD. Today, we have diversified the business with representation in categories and now operate in all eleven, providing a solid, diversified base and positioning us for future growth.

We continue to go deeper in our categories through internal innovation, strong partnerships, and acquisitions, constantly fuelled by our disciplined 36-month brand innovation pipeline. Innovation is at the core of our success and will continue to be a significant contributor to our future growth.

We have demonstrated that we are able to excite kids, and we remain confident that we will continue to bring innovative, hip products to markets.

We've been able to generate highly successful properties, such as PAW Patrol, Hatchimals, and Bakugan, which contribute significantly to our growth, and then generate the resources that we can reinvest in future growth opportunities. This allows us to diversify and build broader reoccurring revenue streams across our toy entertainment content and mobile, digital, direct-to-consumer markets.

At the core of Spin Master is our ability to create engaging kids storytelling for multi-platform construction. 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 for licensing and merchandising, and higher margins.

In Q2, we launched a new season of PAW Patrol franchise and products, based on the season six Mighty PAW theme. Since the launch, PAW Patrol has grown through the third quarter. PAW Patrol has higher consumer engagement than ever before. This is a testament to our strategy of refreshing themes to keep the characters and stories relevant.

Progress continues for the first-ever theatrical animated PAW Patrol film, which we are targeting for release in late 2021, and we believe PAW Patrol will set the foundation for other properties to follow onto the big screen.

Regarding Bakugan, we are taking a long-term, multigenerational view of the franchise. We're pleased with the response to Bakugan in the first year of its relaunch. We relaunched in Q1 in North America and Australia and then Japan, UK, and Germany in Q2. We continued to roll out the rest of Europe and internationally during the third quarter, and by the end of 2019 we will be in full distribution globally. We have worked with our partners at Cartoon Network to build a multichannel content approach, and make content available on television, SVOD, and YouTube.

During the third quarter, we launched Bakugan on Netflix, which has accelerated its awareness and growth trajectory. This multichannel approach helps us to ensure that we reach as many kids as possible.

We have strategically invested and focused in all areas of content consumption, which includes our mobile digital presence with Toca Boca and Sago Mini. For years, we've been studying play patterns which have been converging between physical brands, entertainment franchises, and mobile digital platforms. Children are increasingly accessing and consuming entertainment content on mobile devices. The acquisition of Toca Boca and Sago Mini three years ago provided us with a strong brand presence in the digital mobile space, and allowed us to develop a leadership position in the kids mobile app and direct-to-consumer space.

Today, Toca Boca and Sago Mini average over 20 million monthly active users on a combined basis globally, giving us a strong base of users to expand both app sales and direct-to-consumer subscription-based products.

In 2020, we will be enhancing our offering from one to four subscription products. These will include Sago Mini World and Sago School, along with an innovative subscription offering of Sago Mini physical boxes which integrate with the digital worlds.

We continue to actively look for potential strategic acquisition targets while maintaining a measured and disciplined approach. While we will only acquire assets that fit our long-term strategic and financial criteria and are able to generate value for shareholders, we are currently observing an inflation of acquisition multiples for companies that are our targets. This has been caused by the entry of private equity players into the mid- to large-size toy space. We believe these multiples are unsustainable and will not create value. Over time, we believe these companies will come back to the market at more reasonable multiples in line with their true underlying growth potential.

Our brands, partnerships, entertainment, and mobile digital franchises are resonating strongly with children. We’re confident in the success of our strategic direction and are proud of our global teams with their commitment to delivering our success.

With that, I will now turn it over to Mark.

Mark Segal — Chief Financial Officer, Spin Master Corp.

Thanks, Ronnen, and good morning. Q3 gross product sales were down $75 million, or 11.4 percent compared to last year and on a currency adjusted basis were down $70 million, or 10.6 percent.

The gross product sales decline this quarter was driven primarily by the difficult year-over-year comp for Hatchimals in the Radio (sic) [Remote] Control and Interactive Characters business segment.

Excluding Hatchimals, which declined over 69 percent in the quarter, gross product sales increased by over 10 percent, led by the strong performance of the Boys Action and High-Tech Construction business segments.

At a high level, we saw four key factors affecting Q3 results and the cadence of shipments in the second half of 2019, which include, one, our decision to manage our portfolio of brands more tightly using domestic replenishment; secondly, the evolving retailer trend away from FOB, or direct import orders, towards domestic orders, due to a combination of the demise of Toys “R” Us, the threat of US tariffs, and increased online purchases that drive more just-in-time shipments later in the year; thirdly, we saw increased inventory levels arising from our decision to bring in inventory earlier to avoid US tariffs; and finally, our US East Coast warehouse consolidation from four warehouses into one caused short-term disruption and created congestion in our US supply chain. This shifted approximately $40 million of Q3 shipments, primarily in the US, from the last week of September to early October in Q4.

Ben will explain these dynamics in more detail in a few minutes, but I wanted to take a moment to review the seasonality of our business and how the factors above have affected and will continue to affect the underlying—sorry, the timing underlying our financial results.

The toy industry operates on two seasons, spring and fall, which correspond to H1 and H2 from a calendar perspective. Typical toy industry sales seasonality is around 30 to 33 percent H1 and 67 to 70 percent H2. This half-year perspective is the way both we and our customers manage the toy business.

Having emphasized the H1, H2 split, there are some dynamics around the quarterly split within H2 which we need to explain further. Historically, we have shipped most of our H2 sales in Q3 on an FOB, or direct import basis, where our customers take ownership of the goods directly at the ports in Asia. We relied less on domestic replenishment using our own distribution network, which were better equated to Q4 sales.

Toys “R” Us in particular was historically a large FOB purchaser from us in Q3, as they wanted to manage their full purchases earlier and directly through their own distribution network. Q3 was, therefore, typically a much larger proportion of our H2 sales than those of our larger competitors who emphasized more domestic replenishment.

FOB shipments, which are priced lower as the retailer is taking inventory risk, favours cash flow, whereas domestic sales at higher prices offers net incremental margin due to higher pricing, with some offset from increased inventory carrying costs and higher working capital investments due to increased inventory and longer receivable payment terms.

For the reasons described above, both through our own decisions related to the management of our product line and because of industry changes over time, our Q3 will decline in size and Q4 will increase correspondingly. We are seeing this play out meaningfully this year. While quarters are important in public markets, we do encourage you to also remain focused on measuring our performance on a semiannual basis.

This quarter in the Boys Action and High-Tech Construction business segment, we have seen solid performance from the Bakugan franchise following its debut on Netflix and continued strong performance from Monster Jam. With Bakugan’s expanded global rollout, we view this property as a driver of growth going into 2020.

In Pre-School and Girls, our core brand showed strong double-digit year-over-year sales growth, led by Twisty Petz and PAW Patrol, up 6 percent in Q3, and sales of Candylocks and Pre Cool, offset by sales of Party Popteenies in Q3 2018, which was unsuccessful and did not carry forward into 2019.

As expected, we continued to see declines in the Remote Control and Interactive Characters business segment, largely driven by Hatchimals. Year over year, Hatchimals declined over $120 million in Q3 and over $200 million year to date. As we have said for some time, the decline in Hatchimals has been expected and planned, and we are sharing this detailed information with you, which we do not normally do, to put our Q3 results into the proper perspective.

Gross product sales in Activities, Games & Puzzles and Plush saw a slight decline, as most of our significant new product launches began in the back half of the quarter, timed with movie releases such as Frozen II, Toy Story 4, and The Lion King.

Geographically, gross product sales in North America declined 15.3 percent, driven primarily by the decline in Hatchimals. Excluding Hatchimals, gross product sales in North America increased 6.6 percent. Gross product sales in Europe increased 1.6 percent, while the rest of the world was down 12.1 percent. The decline in the rest of the world is partially attributable to the move of Russia, Switzerland, Greece, and Austria into direct markets in Europe which were previously reported in our third-party distributed category in the rest of the world.

Overall, international gross product sales in the third quarter were strong, growing to 36 percent of total gross product sales, up from 33 percent last year.

Sales allowances as a percentage of gross product sales were 10.6 percent for the quarter compared to 9.7 percent last year. As a reminder, sales allowances are typically between 10 percent and 12 percent of annual gross product sales and vary by quarter due to the timing of promotional and markdown spending.

Other revenue, which includes television distribution income, merchandise royalty income, as well as app revenue from Toca Boca and Sago Mini, increased by 3.4 percent, driven by higher licensing and merchandising income and higher app sales.

Gross profit for the quarter was $287 million, representing 52.3 percent of revenue compared with 318 million, or 51.3 percent. The 1 percentage point increase in gross margin was largely driven by a favourable shift in product mix towards higher-margin brands and the net impact of higher other revenue. This was partially offset by higher ocean freight costs arising from the uncertainty caused by the US-China trade dispute.

As we discussed, as part of our risk management program, we've been diversifying our manufacturing footprint for several years. We continue to accelerate the supply diversification program out of China, resulting in higher than normal supply chain costs, which we expect to normalize over time and generate cost savings.

SG&A expenses for the quarter remained flat overall compared to 2018. We saw higher selling expenses from increased sales of licensed product, increased marketing expenses, higher distribution expenses resulting from increased inventory storage costs due to higher inventory levels, and costs associated with a distribution centre consolidation in the US, offset by improvements in administration expenses related to lower employee costs.

As a percentage of revenue, SG&A increased to 29.7 percent from 26.2 percent. The increase was mostly driven by lower sales volumes. We expect to see improved operating leverage in Q4.

I want to emphasize two additional points on distribution and selling costs. In the long term, the investments we've made in new DCs located in the East Coast US; Hungary, servicing our expanded Eastern European market; and Moscow, are largely complete. We expect our new supply chain infrastructure will enhance operational efficiencies in the long term, improve customer service levels, and drive operating leverage.

Selling expenses increased as the mix of licensed products, including Monster Jam and How to Train Your Dragon, increased, resulting in higher royalties. We expect variable selling expenses to be slightly higher throughout 2019 due to the success of these properties and remain at these levels in 2020 as we roll out the DC Comics product line.

Adjusted EBITDA for the quarter was 150 million compared to $180 million last year, primarily as a result of the lower gross product sales and higher distribution and selling expenses. Our adjusted EBITDA margin was 27.4 percent compared to 29 percent last year. Please note that adjusted EBITDA for Q3 2018 was not restated for IFRS 16 and would have been higher by approximately 3.4 million, if adjusted.

Net income for the quarter declined to 92.1 million from 107.9 million the prior year. Adjusted net income for the quarter declined by 24.5 million to 93 million.

On a Q3 year-to-date basis, gross product sales are down 8 percent, or 102 million. However, excluding Hatchimals, gross product sales grew 12 percent. This growth in our broader portfolio more than offset—offset more than half of the Hatchimals decline so far this year, and this will accelerate further in Q4.

Despite the year-to-date decline in gross product sales, October orders and shipments have been strong, and include approximately $40 million of shipments that shifted from September to October, as I described earlier. Importantly, as at the end of October, our sales for the month, together with shippable October orders, have more than recovered our year-over-year Q3 year-to-date gross product sales decline.

Turning to our balance sheet. Total net working capital as a percentage of revenue at the end of Q3 increased to 16.7 percent from 14.9 percent. This was primarily attributable to increased inventory levels arising from our decision to bring in inventory earlier, to emphasize domestic replenishment, to mitigate US tariffs, and together with the impact of our US East Coast warehouse consolidation. Our core working capital comprising trade receivables, inventory, and trade payables increased to 19.5 percent of revenue compared to 18.6 percent.

Overall, our cash conversion cycle increased by 10 days to 53 days, mainly from higher days inventory on hand. Free cash flow was 128.6 million, declining from 149.8 million in the prior year, driven primarily by lower profitability and investments in the entertainment franchise development.

Our balance sheet remains very strong, and we ended Q3 with 151 million of cash, up 56 million compared to 2018.

We do not see any change to our outlook for gross product sales for the full year 2019. As I described earlier, Q4 orders and sales at this point are further ahead than last year at the same time, giving us confidence that we remain on track to grow gross product sales for the full year at low single-digits compared to 2018, as previously guided.

To be clear, we still need to perform well during the order replenishment cycle in November and December, as is the case every year, but we are confident that we can achieve our sales outlook for 2019. It is important to reiterate that Hatchimals started to decline in the fourth quarter of 2018 and continued through the first three quarters of 2019. As such, we expect any further decline in Hatchimals to have less impact on the fourth quarter 2019 than it has so far year to date in 2019.

With regard to adjusted EBITDA margin, we continue to be focused on cost management and productivity initiatives. Given some of the distribution and supply chain issues described earlier, we now expect our adjusted EBITDA margin in 2019 to be slightly below the adjusted EBITDA margin we achieved in 2018.

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 this quarter, Spin Master's track record of generating growth, backed by a diverse portfolio and healthy balance sheet, gives us a strong position to take advantage of growth opportunities.

With that, I will now turn it over to Ben.

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

Thank you, Mark, and good morning. We remain confident in the underlying strength of our business, the health of our portfolio, and the operational model we've built, which enables us to move quickly and align to changing industry dynamics.

At a high level, as Mark mentioned, we saw four key factors affecting the second half of our year and which resulted in a significant shift of both shipments and orders from the third quarter to the fourth quarter. Let me walk you through this in a little more depth, as it is important to understand our Q3 performance and build confidence in Q4 and our full year outlook.

We have evolved toward a more domestic replenishment model to ensure our collectible product lines, such as Bakugan, Monster Jam, and collectibles, which are a big part of our business in 2019, remain 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. Keep in mind further that as we continue to increase our European presence, the proportion of domestic orders increases, as Europe largely operates on the domestic order fulfillment model.

The absence of Toys "R" Us in the third quarter had an important underlying effect on the industry this year. TRU was a large direct import, or FOB Asia buyer, and purchased most of their goods early for the fall season in Q3. This shifted volume more domestically and added to the pressure on ours and industry supply chains.

Also, with an ever-growing e-commerce penetration, retailers' order lead times have narrowed, shifting the buying pattern closer to the holiday season in Q4. The on-again, off-again, on-again bought-less items news on tariffs on List 4 items, including toys, during Q3 was disruptive to ours and the industry's supply chain. At times, we saw some retailers facing stretched domestic warehouses capacity issues, as they also employed mitigation strategies on unrelated Lists 1 through 3 tariff product lines. This situation caused a degree of uncertainty in retailers' 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 as a result, we tried to maintain a measured approach, whilst at the same time continuing to diversify production outside of China.

As we discussed in Q2, we consolidated distribution into 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 quarter shipment flow, but it's the right long-term strategy to advance our supply chain and gain cost synergies from our acquisitions.

We estimate that approximately $40 million worth of shipments were delayed from the last week of September to early October. Even though this will have a short-term cost impact, we have now invested an additional capacity at many of our warehouses to ensure all products ship on time in Q4.

Furthermore, Hatchimals, which has been one of the most successful product launches in our history, exploding in popularity in 2017 and ‘18, continued its decline in Q3, which began at the end of 2018 and was fully anticipated by us. Excluding Hatchimals, we grew gross product sales 12 percent for the year to date, which is due to our relentless focus on our 36-month brand innovation pipeline.

Our performance has 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. We now have orders and shipments that have made up the decline of 8 percent in Q3 year-to-date gross product sales. We still need to perform well during the order replenishment cycle in November and December, but are feeling confident that we can achieve our low single-digit gross product sales outlook for the year.

From a POS perspective, our overall performance this quarter was solid, with high-single-digit growth of 8 percent globally, despite the decline of Hatchimals. Global POS, excluding Hatchimals, was up 19 percent this quarter year over year.

POS growth ultimately leads to shipment growth, but for the first three quarters of 2019, our key US retailers were rightsizing the inventory coming out of the 2018 race to capture TRU share. In total, Q3 US POS, including Hatchimals, was up 6 percent and retail inventories were down 7 percent. It was pleasing to see US Q3 POS, excluding Hatchimals, the territory in which Hatchimals had the highest proportional loss, show POS up 17 percent year over year. At our top three US customers Q3 year to date, POS was up 12 percent and inventory was down 5 percent—retail inventories were down 5 percent.

We continued to see positive momentum internationally in Q3 in many key markets. In Europe, we saw strong double-digit POS growth overall. In Germany, we saw POS growth of 33 percent year to date. In the UK, despite the turbulence of the market due to Brexit, we continued to see low single-digit POS growth compared to a double-digit decline in the toy market overall.

PAW continues to be the leading preschool licence globally. We saw positive POS growth in Europe and especially strong POS growth in Germany, Russia, Poland, and Slovakia in particular. In Asia, the launch in Japan continues to gain momentum in Q3.

In the US, POS for PAW Patrol declined mid-single digit. We saw an impact on POS due to launch of Toy Story 4, which both targeted the same consumer. Overall, however, we expect PAW POS to grow in Q4 with the launch of the new, higher price-point items, including the Mighty Lookout Tower, as well as the Fire Truck and Jet.

In the last few quarters, we discussed various initiatives which we have undertaken during the year aimed at driving long-term efficiency. Briefly, the integration of GUND, Cardinal, LA Games, and Swimways into one office in New York will drive increased innovation, better communication, and significant cost savings as we move into 2020.

Our diversification program out of China accelerated this year, due to the US-China tariff dispute. Although new factories in Vietnam, India, and Mexico will drive cost savings in the near future, we have incurred additional costs this year as we expedited the changes. We expect to be below 50 percent sourced from China by the end of 2020, down from 70 percent—from over 70 percent two years ago and over 90 percent when we went public in 2015.

From a business segment perspective, the Activities, Games & Puzzles and Plush segment is a strong platform for Spin Master. Twisty Petz, Candylocks, and our innovative Cool Maker Go Glam Nail Painter have generated a lot of excitement so far. We launched games and puzzles aligned with the release of Frozen II, Toy Story 4, and The Lion King.

In the Remote Control and Interactive Character segment, we launched Juno My Baby Elephant and Owleez, an interactive flying pet. Retailers are excited about these products, and initial orders have been very positive. Juno and Owleez are both a testament to our team's ability to continue to innovate in this high-tech space and merge technology with great play.

We are very happy with the performance of our Monster Jam RC trucks. And in Hatchimals, where we have over 90 percent brand awareness with US moms and close to the same level with kids, we are continuing to innovate and stretch the brand. Hatchimal Pixies is a cross between a collectible and a dollhouse in an egg and has allowed us to break into the small doll category.

The Boys Action and High-Tech Construction category was our strongest performing business segment. We continued to see momentum and solid contribution from the three major launches this year. How to Train Your Dragon, Monster Jam, and Bakugan are performing well from a POS perspective.

Regarding Bakugan, we started seeing growth happening in the USA in mid-September—we started seeing acceleration in the growth happening in the US in mid-September around the Netflix launch. France, UK, Germany are leading our strong international launch results. We have great placement in the fall category lineup and very strong, positive brand feedback.

The innovative product line for Monster Jam was introduced in January, and continues to show very strong POS results globally, especially Mexico and Australia, in addition to the US.

Beginning spring 2020, we will be the new toy licensee for the DC Entertainment boys action category, including remote control and robotic vehicles, water toys, and games and puzzles. Our teams are already hard at work developing the line for 2020, and initial customer reaction has been very positive.

The Pre-school and Girls category saw strong performance, driven by fresh themes in PAW Patrol and innovative new product lines. In Q2, we began shipping the new Mighty Pups line, and volume grew globally in Q3. This fall, we introduced the Ready Race Rescue TV special and new toy items that brings the theme to life. Overall, we've seen significant growth in views of our content. The Mighty Pups trailer was our top-performing PAW Patrol content ever with 34 million views.

We are excited about the launch of our lower price-point die-cast line, which was successfully launched at the beginning of Q3. We remain confident in PAW Patrol's prospects for 2019 and beyond based on upcoming content, new themes, and innovative products.

To conclude, we are confident in our projected performance for the fourth quarter. We have built a strong, diversified portfolio of products and brands and entertainment franchises that are resonating well with consumers. Our team remains focused, and we are proud of the efforts and results our employees have delivered around the world. We also remain focused on driving growth and value through our four key growth strategies that you are familiar with.

Ronnen, Mark, and I are now pleased to take questions. Operator, please open the lines.

Q&A

Operator

Thank you. As a reminder, to ask a question, you will need to press *, 1 on your telephone. To withdraw your question, please press the # or hash key.

Our first question this morning comes from the line of Sabahat Khan from RBC Capital Markets. Please go ahead.

Sabahat Khan — RBC Capital Markets

Thanks, and good morning. Just starting with the top line, I just want to clarify a comment you made earlier around that you've already made up the Q3 drag year to date, so you're sort of flat year over year. Is that the right way to read it? And then a second part, can you maybe talk about at this point of the year the kind of visibility you have to your orders for the remainder of Q4? And I guess, what part of those orders is still variable? Or is it the replenishment that you don't have a lot of visibility? Just trying to understand over the next seven weeks what kind of visibility you have from this point onwards.

Mark Segal

Good morning, Sabahat. I'll take the first part of the question, then I'll pass it over to Ben for the second part.

Yes. What I said in the script was that, as at the end of October, we have actually shipped during the month of October a significant increase over our previous October and had shippable orders in October that will actually end up shipping in November. But if you actually take those shipments, plus the shippable orders for October, we've essentially caught up the $100 million decline that you saw in our cumulative top line at the end of Q3 year to date. Is that clear?

Sabahat Khan

Yeah. That helps.

Mark Segal

Okay. Great.

Ben Gadbois

Okay. And then, Sabahat, good morning. For the second half of your question on our confidence, I'll build into what Mark has said is the way we manage our forecast, we look at it monthly in terms of FOB orders and domestic orders. We do global rollup at the country level, where we review all the plans with every one of our countries. And then what we're able to see is we track the orders on the books this year versus last year. And what—and as Mark said is when we exited Q3, we were down approximately 8 percent to last year, or $100 million. And in October, we recovered this $100 million of shipments and orders.

And now when we look at November and December, we can say with confidence, without going into too much detail, that the orders are ahead of where they were last year at this time in order for us to achieve our Q4 target. And our portfolio has been doing well in Q3, and our inventories at retail, as we mentioned, at the end of Q3 in the US alone was down 7 percent, our retail inventory. So we continue to see very healthy order patterns as we speak now.

Sabahat Khan

Okay. Thanks. And then just on the margin side, I guess the guidance revision to slightly lower margins, the commentary in the press release was around this being attributed to higher shipping and storage costs. Just want to understand if you could provide some colour on maybe the magnitude of the expenses that you realized that were unexpected? And then your visibility, I guess, for the rest of Q4, is there flex in your expenses to ensure that you come within this new kind of guidance range? Just trying to understand your visibility to, I guess, the margin side for the rest of the year as well.

Mark Segal

Yeah. So the reason for the margin revision, Saba, was primarily due to two factors. One is supply chain costs, and that's really warehousing, increased storage costs from high inventory average levels. We've also put on more shifts. We've increased capacity at our warehouses to make sure we can ship the higher amounts that are going to flow through in Q4. There's also a transportation impact around increased volume and expediting some of our freight. There's also some impact from Asia where we've got diversified procurement activities going on now, which we accelerated because of the tariffs. And then finally, the tariff impact, which we estimate in Q4 is around $3 million, is part of that guidance revision.

As to our visibility, we feel comfortable that that margin revision guidance is reasonable. There's fixed costs, obviously, that we understand very well, but we think that the pressure on costs that we've described to you in supply chain and tariffs are going to be the primary drivers of the margin for Q4 and for the full year.

Sabahat Khan

Okay. And then as you, I guess, look forward into 2020 and you think about the dynamic now with a bit more direct shipment versus prior years, do you feel that—I guess you indicated you get a higher price from your customers because they're not picking up the product in Asia. Is that—basically, is that enough to offset the additional costs? I guess, how do you think about the—or managing those incremental supply chain costs go forward if more retailers are taking domestic shipping?

Mark Segal

Well, look, we'll get into 2020 in more detail later in March. But, Saba, we'll obviously build that into our thinking. In general, domestic is higher pricing. There are higher costs associated with that through the inventory carrying costs and we carry receivables longer as well. But overall, there's a net incremental margin benefit to that, but then there is a negative effect on our cash flow. So all of that kind of has to get offset.

But overall, we feel that we're okay in terms of our guidance for 2020. Nothing is going to fundamentally change, and we'll get back to you in March when we normally do around our guidance for 2020.

Sabahat Khan

Thanks. And then just one last one on DC Comics. Just a two-parter, I guess. Is it fair to assume that even in non-movie years, you're able to make products for a character that may not have a movie out?

And then the second part being, I guess, is there a difference in the royalty you pay? So for example, say, there's a Batman movie, is there a different royalty when you make products related to specific movies versus just generally putting out DC Comics products in the market? Just trying to understand the dynamics in movie years versus non-movie years.

Ronnen Harary

Yeah. Hey, Saba, I'll take that question. The royalty remains the same during the course of movie years and non-movie years. It's just a flat royalty rate. And obviously, during the movie years, you're going to see a spike in sales. But DC and Warner Bros. works very hard to generate a year-round business with other promotional activities and other marketing to keep their characters top in mind with the kids, and so we're able to benefit from that. So there's a base business and then there's definitely a spike in the business during movie years.

Sabahat Khan

Good. Thank you.

Operator

Your next question comes from the line of Steph Wissink with Jeffries. Your line is open.

Steph Wissink — Jeffries

Hi. Good morning, everyone. I'm wondering if we can compartmentalize Hatchimals into the two core pieces of the business. You've got the iconic and viral larger-scale form factor piece and then this underlying piece that is the collectibles or the Hatchimals piece. If we can look at those two pieces separately, I'm just trying to understand Q3 versus Q4, it looks like the comparison in Q4 to that iconic view becomes much easier. But how should we think about the longer-term value of the underlying or foundational business as you move through Q4 and into 2020?

Ben Gadbois

Steph, I'll take this one. Good morning. So just reiterating what Mark just pointed out in our script is, our largest shipments last year for Hatchimals were in Q3 and mainly FOB. And as we just pointed out, our sales were down 69 percent for the brand in Q3, which was by far the largest Hatchimal quarter last year. So when you look at Q4, we already started—the brand already started to decline in Q4 last year, so the year-over-year comp quarter over quarter will be significantly lesser in Q4.

And as far as the qualitative between the, call it, the big egg and the little egg, the big egg has seen the larger part of the decline and Colleggtibles, the small egg, continues to be a good business, but also declining. But furthermore, this year we launched our new Pixie lines, which is performing well and according to plan, and we're very pleased with it.

We're also launching a higher price-point item in Q4, the Hatchi WOW that you most likely have seen already. And this year, we're launching the Week of WOW marketing campaign. But our expectations overall for the brand are more modest than prior year, in order to reflect the brand maturity. But we do believe in terms of how we innovative our portfolio, there's plenty of new innovation that will come out with the Hatchimal brand. And we remain very confident in the brand. It will just be more at a smaller level than, call it, the toy phenom level that we've been lucky enough to experience in the last few years.

And last, but not least, I think it's important to talk about the fact that even outside of Hatchimals, our POS was up 17 percent, which is truly a testament to our 36-month brand innovation pipeline. So we're continuing to keep Hatchimals fresh, but we're also having other segments of the portfolio where we're launching a lot of new innovation that is resonating very well.

So does that answer your question, Stephanie?

Steph Wissink

It does. That's very helpful. My second question was just on inventory and, Mark, maybe this is one for you is just looking at the inventory at the end of Q3 versus where your current inventory would stand kind of intra-quarter. If we assume that you were able to recapture that order carryover into Q4, are you also managing your own inventory more tightly at the current point versus maybe where you were at the end of the quarter? How should we think about your own inventory management throughout the course of Q4?

Mark Segal

Yeah. So, Steph, when we talk about domestic inventory and we talk about the shift to dom, that effectively is our inventory on our book. So as you saw at the end of Q3, inventory was up $67 million, and that reflected all the factors that we discussed already on the call, which I'm not going to repeat. And then we will be managing that at the—with a high degree of vigor throughout Q4. The goal is at the end of the fourth quarter to be down at the same levels that we would have been at if you compare us to historical levels. So if all goes according to plan and we ship through what we need to ship through in Q4, you'll see our inventory on our books, which is domestic inventory, effectively, getting back down to normal levels in relation to prior years.

Steph Wissink

Okay. Very helpful. Thank you.

Ronnen Harary

Thanks, Steph.

Operator

Your next question comes from the line of Derek Dley with Canaccord Genuity. Your line is open.

Derek Dley — Canaccord Genuity

Yeah. Hi, there. Just in terms of the shift into Q4, if we exclude the 40 million in sales that were pushed into Q4, but outside of that, should we continue to expect this sort of shift from Q3 sales into Q4 going forward? Like is this something you would expect to happen in 2020 again?

Mark Segal

Yes. I think, Derek, we are seeing the shifts that we described previously reocurring in future years. Obviously, there's some degree of variability around this. It's not a precise formula, and to some extent, they are product lines that tend more towards dom vs. FOB. This year, we had a strong predomination of domestic lines that actually boosted that percentage. But going forward, there are secular and industry shifts that we see happening and that both Ben and I discussed earlier that I think are going to continue and will actually make Q4 a larger proportion of our year than it has in the past.

Ben, do you want to add something to that?

Ben Gadbois

Yeah. The only thing to add is that the benefit of domestic orders is that when you look at our portfolio, which is this year, for example, more geared toward collectible and mixed management and assortments, if you ship it from Asia, you pretty much have a can assortment. And when the products sell differently on the shelf, you end up with a lot of stock out and sometimes more inventory into different characters than others. And it creates some retail issues, which ultimately affects POS. So for us, managing our product line more on a domestic basis, as Mark said, it moves the sales to Q4, but ultimately it allows us to manage the mix at the retail shelf in the way that we can always replenish the shelf with what is exactly needed at the time within a few days, so. And we believe that ultimately, this will drive POS, and it's much better for brand and franchise management and life cycle of our innovation.

Derek Dley

Okay. And then as it relates to the I think it was—what you called it, the congestion in your supply chain relating to the rollout of the new DC, are you predominantly through those growing pains as of November?

Ben Gadbois

Yeah. Yeah. So what I can say is because as we described, we consolidated four DCs into one this year. And then with the—and we had plans for an order pattern that was probably more spread out during the quarter. So we've noticed in Q3 that the orders came in later than planned. And then as Mark described, we made the decision to bring in more inventory to mitigate potential tariff issues.

So what happened is, all at the same time we experienced a significant bottleneck in that new DC. And there's a new DC and we're still ramping up, and we just couldn't handle the ramp-up at the end of September. So it was a bit of a perfect storm, and we're quite disappointed with ourself and to the performance at the end of September. But what we did is we turned around in October and we had our highest domestic shipment in the history of the Company. We're getting ready to beat that again in November. We've added resources and capacity into this warehouse, and we feel confident that we will be able to deliver. And it was a very hard learning lesson from us.

Derek Dley

Okay. Thank you very much.

Operator

Your next question comes from the line of Brian Morrison with TD Securities. Your line is open.

Brian Morrison — TD Securities

Yes. Thank you. Good morning. I think you've conveyed the gross product sales shortfall and the inventory increases is essentially timing-related, but is there any notable product line that was disproportionately impacted relative to your expectations?

Ben Gadbois

Good morning, Brian. No, there wasn't. It was really more blanket. It was truly a lot of it was truly caused by just the DC not being able to ship products on time, which as you know, if any one of our customers order, they place orders across multiple product categories in our brands, so it was pretty much across the board.

Brian Morrison

Okay. And maybe just change gears here. Ronnen, you talked about the opportunity with Toca Boca and Sago Mini. Just from a higher level with the adoption of 5G, I'm wondering what you've done in terms of preparation for its adoption? And maybe just qualify and quantify the opportunity on your digital front as streaming becomes much more popular.

Ronnen Harary

Yeah. Thanks, Brian. I didn't think I'd get any questions today. But 5G really opens up a lot of possibilities for us. I think the rollout of 5G is going to take a while. It's 36 months to 56 months away, but the greatest thing about Toca Boca and Sago Mini is that the acquisition has given us two incredible mobile gaming studios of which to build out games for kids: one in Toronto and one in Sweden. And both of those studios are located in probably two of the best talent hubs for digital gaming on the planet.

And we've been very focused on a bit of a diverse strategy for both Toca Boca and Sago Mini. And so Toca Boca is focused on games for kids 5 to 9. And the 5G, what that enables us to do, is you'll be seeing in the future, multiplayer games that we're developing similar to Fortnite or Roblox or Minecraft that give kids the ability to play together, and to not only play together, but to share what they're playing and to share that with a wider audience.

So that creates a lot of opportunities for us. And then on the Sago Mini side of things, it's a bit of a different approach. And I talked about it in my comments, which was around subscription. And so we're seeing a big shift. We were looking at some data the other day, and 22 percent of US households all have subscription-based products in their homes and a lot of that's focused in around kids. So we're going down that road where we're building out subscription-based products that have monthly reocurring revenues, lifetime values of the customers. It's quite different to what our regular business is and it's still at the early stages, but we're very excited to share more with you guys in 2020 around that rollout and offers that we have around subscription.

Brian Morrison

Hello?

Mark Segal

Yeah. Go ahead, Brian. Did you have a follow-up?

Brian Morrison

Sorry, there was just a little bit of cutting out there. Yeah. No, I appreciate that. The last question I had is just with respect to Bakugan and how it's trending. You mentioned with respect to its introduction on Netflix; maybe you can just share any data on how you've seen the benefits once it was placed upon this channel?

Ben Gadbois

Yeah. Okay. So I can take this one, Brian. So I'm going to say that overall, with Bakugan, we're continuing to see nice growth and momentum building in the franchise on a global scale. The recent launch in France, UK, Germany, Australia, and Belgium, just to name a few, have been very strong. And in some of these countries, the franchise is already in the top five boys property. And it continues to build very nicely in all the other markets.

In the USA, as you referenced, the series launched on Netflix in mid-September. And it really accelerated the growth rate in the franchise, and we've seen very positive results from the additional exposure.

Overall, we remain very positive for the Bakugan franchise to keep building globally in Q4 and also in 2020, based on our current market reads and the continued momentum that we're experiencing everywhere globally.

Brian Morrison

All right. Thank you.

Ben Gadbois

Thanks, Brian.

Operator

Your next question comes from the line of Linda Bolton Weiser with Davidson. Your line is open.

Linda Bolton Weiser — Davidson

Hi. Thank you. So not to beat the whole FOB issue to death, but just I was wondering if you could shed some light on exactly why Mattel didn't experience the same issue. Is it just simply what you said is that they have just much less reliance on FOB already than you?

And then secondly, I think in Hasbro's comments, they actually said they expected this issue to shift some revenue from the fourth quarter to the first quarter as well, so is that something that you're thinking as well? Because it doesn't sound like that's the case.

And then finally, I just was curious if you could give a breakdown, very roughly, of the distribution channels that you think picked up the Toys "R" Us void. So do you think it's like 80 percent the Big 3 or 50 percent the Big 3? And then grocery and food or something, food, drug, and mass? Can you give some kind of rendition of where you think the distribution went? Thanks.

Ben Gadbois

Okay. Good morning, Linda. I'm going to try and answer them all. So when you look at our changes from FOB to domestic and you compare us to some of our key competitors, if you actually study the Q3, Q4 that they've had historically, they have already been much more skewed towards Q4, where we were one of the companies that had the highest, probably, FOB percentage in Q3. So what you're actually seeing now, is you're seeing our company evolve as we mature and how we manage our brands and franchise toward more of that model as well. Okay? So I think that's what you're seeing.

As far as orders from Q4 to Q1, I can say that we are not seeing any order cancellation so far. And what we're actually seeing is we've obviously seen some shift from Q3 to Q4, as we described, but we're not seeing any order cancellation that would be material.

And then from a distribution channel, I think, which was your last question, was who's kind of gaining and picking up is there's something that I haven't heard anyone talk about yet in this earning season is that last year, what actually happened in Q3 is, although Toys "R" Us was gone, there was a significant race from a retailer's standpoint to either enter or gain market share in the toy industry, and that also created a bit of an inflation in Q3 for the industry. And we're not seeing that this year, which also is a factor that I think impacts the industry in the US this year. So as far as who is gaining is so far, we do continue to see the Big 3, the Walmart, Target, and Amazon continuing to grow and continuing to pick share up.

Linda Bolton Weiser

Thank you very much.

Operator

Our last question comes from the line of Adam Shine with National Bank Financial. Your line is open.

Adam Shine — National Bank Financial

Thanks a lot. Maybe one for you, Ben, and the next one for Mark. Ben, you touched earlier on lessons learned, I think, this year some of the supply chain dynamic. And then last year, just in terms of how much of a void was not ultimately filled in the absence of Toys “R” Us. As we look into 2020, are there more lessons to be learned? Or is there a big sigh of relief that, frankly, you’ve gone to school, it’s a new paradigm, and you’ve adjusted to that reality and there’s no greater shocks to the system next year?

Ben Gadbois

Yeah. Good morning, Adam. Yeah. So I’m going to start by saying that overall, I think what we’ve accomplished this year is we’ve undertook a significant amount of restructuring in our business this year, where we’ve consolidated and closed down our GUND offices. We’ve consolidated and closed our Swimways office. We have consolidated our games business and we opened up our new Long Island City office. We opened an office and a DC in Russia. We opened a DC in Hungary. And we have significantly accelerated our Asia diversification plan to be below 50 percent to protect the Company going forward based on these tariff threats.

So I think we undertook a lot this year, including the consolidation, last but not least, of these four DCs into one. And we did not anticipate this, I guess call it, the perfect storm to hit the DC in the matter of a few weeks.

So we don't expect that to repeat next year. We don't have any—we're not opening any new DCs next year, and we don't plan on any further consolidations of offices. And I also believe that we've made tremendous amount of progress this year in our supply chain diversification in Asia. And so we opened a lot of different vendors in Vietnam, in India, and Mexico. So I think the team did a pretty good job, and we had a stumble for a few weeks in the DC.

And just as a fun fact, Adam, is our throughput in the DC now as we speak is approximately 250 percent of what it is on a daily basis and what it was in September. So we definitely reacted to the issue and are dealing with it.

Adam Shine

Okay. And then just one for Mark in regards to maybe a little more cleanup in visibility around guidance. With respect to sales allowance, the conversations previously have really been around maybe upper end of a 10 to 12 percent historical range. Do we still stick to that? Or is there any concern of further slippage to the upside?

Mark Segal

So you're correct, Adam, 10 to 12 percent has always been the range that we've talked about. I would say for the purposes of modelling and thinking about going forward, I would stay towards the higher end of that range. And that's particularly and actually a geographic mix issue because in Europe as our business grows, Europe is a higher price, higher allowances structure. And purely mathematically, that's going to push our average allowance rates up.

There isn't any fundamental change to the way that we actually handle sales allowances in the business. But certainly, as our European business grows at a higher allowance structure, higher price structure, that allowance rate will tend towards the higher end of that range.

Adam Shine

Okay. And that's something that we should also think about, just by virtue of that European dynamic continuing, obviously, post-2019 as well?

Mark Segal

Yes. Correct.

Adam Shine

Great. Thanks a lot.

Mark Segal

Thank you.

Ben Gadbois

Thanks, Adam.

Mark Segal

Thanks, everyone. We much appreciate it. Appreciate your time. And we look forward to talking to you again in March with our Q4 and full year results.

Ben Gadbois

And in New York.

Mark Segal

And in New York, that's right.

Ben Gadbois

Thank you, everyone.

Mark Segal

Thank you. Bye.

Operator

This concludes today’s conference call. You may now disconnect.