Spin Master Corp.

Fourth Quarter 2019 Earnings Conference Call

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PRESENTATION

Operator

Good morning, afternoon, evening. My name is Cheryl (phon), and I will be your conference Operator today. At this time, I would like to welcome everyone to the Spin Master Fourth 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 that 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.

Sophia Bisoukis, you may begin your conference.

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

Thank you, Cheryl. Good morning, everybody, and welcome to Spin Master's financial results conference call for the fourth quarter and year ended December 31, 2019. I am joined this morning by Ronnen Harary, Co-CEO; and Mark Segal, Spin Master's Chief Financial Officer.

For your convenience, the press release, MD&A, and audited consolidated financial statements for the fourth quarter and 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.

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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 call 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.

In 2019, we faced several challenges as we continued to navigate an evolving retail and content consumption landscape. Our overall performance for the year was one of contrast.

On the one hand, our diverse portfolio performed very well against the industry-wide softness, growing 16 percent, excluding the decline in Hatchimals. While on the other hand, our operational initiatives were not executed as planned, leading us to miss both our gross product sales and adjusted EBITDA margin targets for 2019.

To put this into perspective, while our gross product sales declined 1 percent in 2019 against an industry that declined 3 percent globally, our margins fell far short of our goals in 2019. We are now

heavily focused on cleaning up any structural issues and driving cost savings in areas where we have identified inefficiencies.

Mark will discuss with you in more detail our plan to address our operational challenges through 2020.

However, I would like to address some significant senior leadership changes that occurred to position us for the next stage of our evolution in an evolving toy industry, content landscape, and retail environment. These changes will optimize Spin Master for growth, with a renewed commitment to operational excellence as we continue to execute against our long-term strategy.

We're moving quickly to adapt to the new realities, leveraging the underlying strength of our core business, our dedication to innovation, and our financial stability.

As part of this operational excellence initiative, we have kicked off a project called Excel, which is a top priority for us. It is critical to our long-term success that we evolve our processes, systems, structures, and accountability to better match our business complexities and better serve our customers.

Project Excel is designed to help us do that. We need to quickly clean up our structural issues and drive cost savings to get our operating margins back to where they belong. We are not happy, neither will we be satisfied until is accomplished.

Our long-term growth is driven by our ability to identify, develop, acquire new and innovative products and brands; create and license evergreen entertainment content; and grow internationally in partnership with inventors, broadcasters, production studios, distributors, and licensors. We can continue to go deeper in our categories through our internal innovation, strong partnerships, and acquisitions constantly fuelled by our disciplined 36-month brand innovation pipeline.

We are ramping up our sourcing and procurement activities outside of China with new manufacturing capabilities in Vietnam, Mexico, and India, with other countries under consideration. This multidimensional global platform gives us a competitive advantage in terms of our ability to understand kids' play patterns and serves as a foundation for future growth.

I encourage you to think of us not only as a toy company, but as an integrated entertainment business with toys, entertainment, and digital toys and games.

Many of you joined us at the New York Toy Fair last week where we revealed our innovative 2020 portfolio of toys, games, entertainment franchises, and digital toys. We continue to be at the forefront of evolving trends, capturing the hearts and the minds of children around the world and maintaining our position as an industry leader.

We've been innovating in toys for over 25 years, and we understand the art form of creating toys and play patterns that resonate with kids globally. At the same time, we've produced entertainment for 12 years, over 1,000 episodes of content and counting.

At the core of Spin Master is our ability to create engaging kids' storytelling for multi-platform consumption. Through the acquisition of Sago Mini and Toca Boca, we entered the digital-mobile business three-and-a-half years ago. This acquisition 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 area.

We've spent the last three-and-a-half years learning and understanding this dynamic new marketplace. Because children are increasingly accessing and consuming entertainment content on mobile devices, we have strategically invested and focused in all areas of content consumption, which

includes our mobile digital presence. For years, we have been studying play patterns which have been converging between physical brands, entertainment franchises, and mobile digital platforms.

Today, Toca Boca and Sago Mini average over 200 million—20 million. I wish it was 200 million, but it's 20 million for now, monthly active users on a combined base 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 three subscription products. These will include Sago World, Sago School, along with an innovative subscription offering of Sago Mini physical boxes, which just launched two weeks ago, and which integrate with the digital world.

In 2020, we're increasing our focus on expanding and deepening the businesses we acquired, such as GUND, Swimways, and Cardinal, and the franchises we believe have long-term growth potential, such as Bakugan, Monster Jam, DC, and PAW Patrol. Our goal is to do more with less.

I would like now to discuss our business segments with you in more detail. The Activities, Games & Puzzles and Plush segment is a strong and stable platform for Spin Master. We are growing the business through brand building, focusing on expanding our existing brands, as well as supporting new promotional activities.

We're targeting global channel expansion to increase our footprint and strategically enter adjacencies that complement our current products. At the end of 2019, we completed the acquisition of the Orbeez brand. The acquisition further strengthens our Activities business, providing opportunities for integration into our existing product lines, as well as further innovation.

Kinetic Sand continues to grow into a global brand. Hollywood Hair from Cool Maker is the only do-it-yourself studio that lets you create your own hair extensions. Games and Puzzles continues to drive steady and reoccurring volume.

Regarding our plush business, GUND, we continue to scale the business for ability to use our global sales and distribution infrastructure and our ability to capitalize on strong licensing opportunities with key partners. This year, we added two strong licensed partnerships to the GUND portfolio: Hilda, the award-winning animation series airing on Netflix, which we announced earlier this year, and the new animated preschool series, Gabby's Dollhouse. Beginning in fall 2001 (sic) [2021], we'll bring these characters from the show to life through a new toy line that will include playsets, figures, plush, games, and puzzles.

We are also very excited about our ability to mine the 100-year-old GUND library of ideas and reimagine them. Crinkle Tinkle (sic) [Tinkle Crinkle] for Baby GUND is a great example of an old idea brought back to life. Baby GUND is an area that we will continue to focus on. We believe it has strong potential to grow globally.

The Boy Action and Construction Category was our strongest-performing business segment in both the fourth quarter and full year. With strong momentum and solid contribution from three major launches this year, How to Train a (sic) [Your] Dragon, Monster Jam, and Bakugan, all performed exceptionally well in 2019.

We saw strong Bakugan brand engagement internationally and solid performance in the US following the launch on Netflix. We've seen a good start in 2020 of Bakugan and expect the momentum to continue through the year. The second season of Bakugan, Armoured Alliance, brings an exciting toy innovation to the franchise and was launched on Cartoon Network on March 1st with the second half of Season 1 also launching on Netflix this month.

The Monster Jam line performed extremely well at retail locations, resulting in the largest year for Monster Jam retail toy sales in the brand's history. In 2020, we will remain committed to continuous

innovation, offering an elevated play experience for Monster Jam fans and further expanding their presence in the wheels aisle around the world. This entry into the wheels category provides us with a great opportunity for diversification and growth. At the New York Toy Fair, we introduced the Monster Jam Megalodon Storm, an RC vehicle that you can drive on water and land.

In January 2020, we kicked off our DC Entertainment Boys Action line as a new licence for action figures, playsets, remote control and robotic vehicles, water toys, and games and puzzles. The line is off to a strong start. We have innovated the line, and the reaction at retail has been very positive.

Those of you who visited our booth could feel the excitement of the 2020 DC lineup, which includes action-oriented toys inspired by Batman's 80-year legacy that celebrates him as the number one DC superhero.

The Pre-Schools (sic) [Pre-School] and Girls segments saw solid growth in fourth quarter, driven by fresh themes in PAW Patrol and innovative new product lines such as Ready Race Rescue TV special and new toy items that continue to bring the theme to life. PAW Patrol continues to be a top-rated preschool show globally, and we continue to deliver very high ratings on our shows and our specials.

In fall 2020, the Dino rescue theme will be integrated into the PAW Patrol world, staying true to the story lines and the characters while exploring new landscapes and rescues. We will be introducing the first-ever motorized PAW Patrol vehicle, the Paw Patrol Dino patroller, featuring large-scale wheels for extra-rough terrain.

Adding to our partnership and continuing to build the strength of PAW Patrol as a franchise, we are excited to launch the first-ever full-length animated PAW Patrol theatrical film in association with Nickelodeon and Paramount Pictures. Paramount will be distributing the film starting August 21, and this has been a really exciting journey for us as a company and represents our first foray into feature film.

The film will feature an all-new location, a new pup, and will be animated in a high-quality feature film animation. Our goal is for PAW Patrol to be the first of many feature films and will set the foundation for other properties to follow onto the big screen. We expect PAW Patrol to continue to be a strong contributor to our sales for many years based on new themes and innovative products.

In Girls, we're also excited about Luvabella Mealtime Magic, which is a technology-advanced baby doll that delivers a premium play experience and innovation to a tried and true play pattern. Universe is an out-of-this world brand of collectible unicorns that allows kids to explore and immerse themselves in a never-ending world of make believe.

We've had some great innovation in 2019 in the Remote Control and Interactive Character segments. We launched Juno, our animated baby elephant, and Owlies, an interactive flying pet. Juno and Owlies 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 remote control trucks, which performed very well.

In 2019, we launched Hatchimal Pixies, which has allowed us to break into the small doll category. Pixies is a cross between a collectible and a doll housed in an egg. For 2020, we're excited to introduce Hatchimals Pixies Crystal Flyers, Hatchimals Pixies that really fly. The pixies can air-dance, and you can guide her in flight with an IR sensor in her feet.

We also seek to leverage innovation across product lines. For example, we developed the hatching technology that made Hatchimals such a ground-breaking success into our How to Train a (sic) [Your] Dragon line. This will be followed by our new Present Pets (phon) interactive puppy in 2020, which some of you saw in New York and which we are keeping under wraps until later this year. We have more innovation for 2021 and beyond.

I want to take a moment to update you on the impact of the COVID-19 situation to our business. This situation is very fluid and is driven by factory start-up dates, labour return rates, capacity available for Spin Master, tooling availability, and raw material and component availability. Many of our key factories are open, but most are not yet operating to full capacity. Travel restrictions remain in place, and we are doing as much on video conference as we can. We are shifting some production to Mexico and other countries where possible.

As Mark will go over in a minute, we do not expect to see an impact—we do. We expect to see an impact in 2020. I can tell you that we are acting very entrepreneurially and using every tool available to us to mitigate the impact of the virus as much as possible. We have an excellent team in China who are constantly working on mitigation strategies. For example, in the second half of the year fall season, we are compressing our schedules to stay as closely on track as we can and we're working very closely with our retailers. Paradoxically, our elevated inventory levels at the end of 2019 will help us mitigate some production gaps.

To conclude, our outlook for gross products sales in 2020 reflects the pressures our business is currently experiencing, including further declines in our Hatchimal product line, combined with a shifting toy industry landscape; the challenging global growth outlook that is causing heightened uncertainty; and the potential impacts of COVID-19. All this has led us to look at our 2020 growth projections conservatively.

Our 36-month brand pipeline is designed to achieve long-term growth. 2019 was healthy, with the business growing 16 percent, excluding the decline of Hatchimals. Although we are not projecting growth for 2020, our pipeline remains healthy and we will continue to grow again. Our brands, partnerships, products, entertainment, and mobile digital franchises are resonating strongly with children.

We are confident in the success of our strategic direction and are proud of our global teams for their commitment to delivering our success.

Looking forward to 2021, we continue to be excited about our offering and a normalized run rate on growth and profitability.

I will now turn the call over to Mark.

Mark Segal — Chief Financial Officer, Spin Master Corp.

Thank you, Ronnen. On January 21st, we released preliminary gross product sales and adjusted EBITDA results for the fourth quarter and full year ended 2019. At that time, we discussed in detail the challenges that affected both gross product sales and profitability for the full year.

On today's call, I will briefly summarize our final Q4 and full year performance. In addition, I will discuss our 2020 outlook and provide further detail on our operational excellence journey. I'll begin with a brief summary of performance.

Despite the operational challenges we faced during the fourth quarter, revenue of 473.5 million was up 14.3 percent from the same period last year, or 14.7 percent on a constant currency basis. We grew gross product sales in the quarter by 18.3 percent, with an unfavourable foreign exchange impact of 2.6 million. On a constant currency basis, gross product sales grew 18.9 percent.

This growth continued to be led by the Boys Action and Construction segment, followed by 11.6 percent growth in the Activities, Games & Puzzles and Plush segment, and 9.6 percent growth in the Pre-School and Girls segment.

On a geographic basis, Europe grew 27.2 percent, followed by North America at 18.8 percent, and 1.6 percent for the rest of the world. International gross product sales represented 43.9 percent of the total.

Globally, Q4 POS, including Hatchimals, was flat. With respect to the US, we performed better than the industry with our Q4 POS, excluding Hatchimals, up 12 percent year over year in comparison to an industry that showed weakness.

We continued to see positive POS momentum internationally in Q4 in many key markets. In Europe, we saw positive POS growth overall, driven by strong performance in key countries, such as Germany and the UK, where despite the turbulence of the market due to Brexit, we saw POS growth of 4 percent for the year, compared to a mid-single digit decline in the UK toy market overall.

Our overall POS performance for the year was solid relative to the industry, with POS growth of 1 percent globally despite the decline of Hatchimals and compared to a global industry that declined 3 percent and a US industry that declined 4 percent. Global POS, excluding Hatchimals, was up 14 percent year over year.

POS continues to be the leading preschool brand globally. We saw PAW POS growth in Europe through 2019 and strong POS growth in Germany, Russia, Poland, Hungary, and Slovakia in particular. In Asia, the Q2 launch in Japan continued to gain momentum in Q4. In the US, POS for PAW Patrol declined for both the quarter and the year.

As we mentioned in Q3, we saw an impact on PAW POS due to the launch of Toy Story 4, which targets the same consumer. Our main TV driver in Q4, the Jet, also did not perform as expected and was not nearly as strong as the TV driver in 2018. PAW is seeing the normal ebbs and flows of a global brand, but remains very solid, and we will continue to manage the brand for the long term, closely monitoring retail inventories.

Kinetic Sand continuously grew throughout the year. In Q4, POS was up 49 percent compared to last year. Current POS year to date is also very encouraging. Globally, our POS is up 5 percent, and up 16

percent excluding Hatchimals. Cardinal, Monster Jam, Bakugan, GUND, Kinetic Sand, and Swimways are all showing very strong POS growth.

In the US, POS is up low-single digits and up low-double digits, excluding Hatchimals, driven by the same brands globally. PAW Patrol POS is up low-single digits globally. PAW Patrol is slightly down in the US currently but trending up very strongly as our marketing kicks in ahead of Easter.

Turning back to the P&L, sales allowances increased to 19.8 percent of gross product sales compared to 18.1 percent in Q4 ‘18. This increase was related to higher markdowns, as well as noncompliance charges from customers, given our supply chain issues, as well as proportionately high sales in Europe and Russia, which have both higher pricing and a higher sales allowance rate.

Other revenue, which primarily reflects licensing and merchandising royalties, television distribution revenue, and app revenue, declined by 3.9 percent during Q4.

Gross profit for the quarter was 226.1 million, or 47.8 percent of revenue compared to 199 million, or 48 percent of revenue in Q4 ‘18. This 20 basis-point decline in gross margin was principally related to higher sales allowances and higher freight expenses related to the distribution issues we faced in H2 2019.

Selling, general and administrative expenses increased 21.3 percent compared to Q4 ‘18. As a percentage of revenue, SG&A was 48.9 percent in Q4, up 280 basis points from 46.1 percent. The increase was primarily related to higher distribution costs arising from the establishment of our third-party DC on the East Coast and the consolidation of the stand-alone GUND, Swimways, and Cardinal warehouses into this new facility. Higher inventory, storage, and transportation expenses contributed to the increase, as we carried more domestic inventory in anticipation of higher tariffs in the US-China trade war and a shift towards domestic sales over FOB.

I do not want to call out the elevated levels of warehousing and distribution expenses in 2019 as onetime. That would be disingenuous. However, I do want to point out that the level of spend we saw in this area in Q4 is highly inflated at 9.8 percent compared to historical spend levels of about half that. We are doing everything we can to get this expense line back down to historical spend levels.

In Q4, we recorded an adjusted net loss of 7.8 million or $0.08 per share, compared with adjusted net income of 6.2 million or $0.06 per share in Q4 of 2018.

Adjusted EBITDA was 6.7 million in the quarter compared to 35.2 million in the prior year. EBITDA margin was 1.4 percent, down 710 basis points from 8.5 percent last year.

Turning now to the full year. Revenue decreased by 3.1 percent to 1.58 billion. In constant currency terms, revenue was down 2.1 percent compared to '18. Although we started the fourth quarter with positive momentum based on the progress we had made in October, with both orders and shipments off to a strong start, order levels, shipments, and in particular our operational performance in November and December, were considerably below our expectations. As a result, we reported global gross product sales of just under 1.7 billion, down 1 percent from 2018, outperforming the G13 countries, which were down 3 percent as measured by NPD.

Gross product sales were flat on a constant currency basis. Excluding the planned decline in Hatchimals, we generated a 16 percent increase in gross product sales, as Ronnen just mentioned. The decrease was primarily a result of a decline in the Remote Control and Interactive segment, principally related to Hatchimals, which declined just over $230 million year over year. This headwind was partially offset by solid gains in the Boys Action and Construction segment, led by Bakugan, Monster Jam, DreamWorks Dragons, and the positive influence of initial shipments of DC-licensed products.

From a geographic perspective, Europe grew 14.4 percent, driven by strong performances in Russia and Germany, Austria, and Switzerland. North America decreased by 5.4 percent and the rest of the world declined 4.9 percent.

On a full year basis, international gross product sales grew to 39.3 percent of total gross product sales, compared to 36.5 percent in 2018 and 34.7 percent in 2017.

In 2015, our goal was to reach 40 percent of sales generated from international markets. We've now increased that goal to 45 percent. As a reference, 70 percent of global industry toy sales occur outside of North America. We have a long runway for growth and we are making the necessary investments to do so.

Sales allowances as a percentage of gross product sales were 13.5 percent, which is well above our typical historical range of 10 to 12 percent. The increase was primarily driven by higher markdowns, an increase in noncompliance charges from customers attributable to our operational performance issues, and continued expansion in Europe and Russia, which have both higher selling prices and a higher rate of sales allowances. In 2020, we are targeting to get this rate down to approximately 12.5 percent as our operational performance improves.

Other revenue declined by just over 3 percent for the year due to lower licensing and merchandising revenue, offset by higher TV distribution revenue and app sales. We expect other revenue to be flat for 2020 compared to 2019.

Gross profit in 2019 represented 49.6 percent of revenue compared to 50.2 percent of revenue in 2018. SG&A increased by $33 million, or 5.4 percent for the full year. The decrease in gross margin and the increase in SG&A during the year were primarily driven by the factors I mentioned in my description of Q4.

Adjusted net income for 2019 was 92.8 million. Adjusted EBITDA for the year was 219 million, a decrease of $85 million. Adjusted EBITDA margin was 13.8 percent, compared to 18.6 percent in 2018.

The decline in profitability was caused by our previously discussed supply chain challenges, lower sales, and increased sales allowances. We were pressured through the back half of 2019 as we continued to do everything to service our customers, using inefficient warehousing and transportation processes.

Total net working capital as a percentage of revenue was 17.5 percent compared to 10.8 percent last year. Core working capital for 2019 increased to 21.5 percent of revenue compared to 13.3 percent. This was primarily driven by an increase in trade receivables due to a shift in shipments to later in the quarter and a by-product of a shift from FOB to domestic, as well as high inventory levels.

Overall, our cash conversion cycle increased by 35 days. Free cash flow for the year was 84.6 million compared to 129.5 million in 2018. The decrease in free cash flow is attributable to lower cash flows from operating activities, partially offset by less cash used in investing activities.

Our balance sheet remains very strong. We ended the year with $115 million in cash. We are well-positioned to take advantage of acquisition opportunities.

I want to outline the steps we are taking to address the operational issues we faced in 2019. As Ronnen mentioned, we have kicked off Project Excel, an initiative aimed at evolving our processes, systems structure, and accountability. We are focusing on three primary areas.

Our first focus is supply chain optimization. We will address issues with our DC structure to ensure we are built to address the changing demands of our industry. We want to improve our on-time delivery and our fill rates and our scheduled attainment. We will aim to improve our customer service. We still have strong relationships with customers; however, these were challenged in 2019.

We're going to be focused very heavily on key metrics and our domestic and FOB mix. There is no right answers to what our domestic and FOB mix should be. It varies by region, by customer, and by product. North America is more FOB-centric; Europe is more domestic-orientated. Historically, our mix has been orientated more towards FOB, which is more efficient for us from a supply chain perspective. Even though our FOB margins are lower than domestic, these sales don't touch our warehouse system.

Secondly, we will focus on process simplification and automation. Increasing our levels of automation and simplifying our business processes will increase efficiencies and drive cost improvements. We want to be focused more on data-driven insights, and we aim to refine our systems to increase productivity.

From a people perspective—our third area of strategic focus in 2020—we want to make sure that we allocate resources to the most important areas of the business to set goals that match our strategy, to improve accountability to a tighter measurement of performance, and we want to make sure that we improve coordination between teams globally.

A few weeks ago, we announced the promotion of Tara Deakin to Chief People Officer, a new position at Spin Master. Spin Master is committed to attracting and retaining the best talent, and a strong leadership team is one of the most integral components to realizing our strategic plan and to the long-term success of our company.

We'll continue to assess and strengthen our leadership team to ensure we have best-in-class leaders with deep expertise to propel our organization forward. Our team is fully aligned on these initiatives, and we will keep you updated on our progress throughout the year.

We continue to believe in our long-term financial framework, and that at its core, this business can consistently grow organic gross product sales in the mid- to high-single digits. There'll be years when

we have very strong growth, but there will also be years when gross product growth is more modest or potentially down.

In general, we are adopting a more conservative tone for our outlook. This is consistent with our philosophy every March, as it is still early, but especially given the year we are coming off and the unknowns regarding COVID-19.

For 2020, we expect gross product sales to decline mid-single digits, excluding any impact on our supply chain from COVID-19. However, we do expect to show low-single-digit growth, excluding the expected decline in Hatchimals year over year.

I wanted to give you a little more colour on our organic 2020 top-line outlook. Hatchimals is still strong as a top-three collectible, but we expect a further 50 percent volume decline compared to 2019. Dragons was very big for us in 2019, and there is no movie this year so we expect it to soften. Bakugan is strong and doing well, as Ronnen mentioned, but we are not guiding to any significant increase in 2020.

We are very happy with our DC Comics launch. The reaction from retail has been strong. However, 2020 is a non-movie year, and we’re being modest in our expectations. Overall, for these reasons, we’re expecting a mid-single-digits decline in organic GPS year over year.

With respect to COVID-19, we are monitoring the environment very closely and are continually assessing the impact to Spin Master as information becomes available. We anticipate that the evolving situation will have an impact on our global operations, as approximately 60 percent of our manufacturing base remains in China.

Currently, all of our suppliers have resumed production. All of our toolmakers have resumed production. Seventy-one percent of workers have reported back at all of our factories. The delay in

production is estimated to be between one and four weeks. We expect to be back in full production at the end of March.

As a result of these factors, given the delay so far this year and based on our current assumptions, we're expecting a further reduction in organic gross product sales, which will affect Q2 shipments in particular. This will result in an organic gross product sales decline towards the high end of the mid-single-digit range.

We have initiated a broad range of actions to mitigate any supply chain disruptions, and we will try to reduce the above impact as much as possible through inventory substitution and schedule management with our suppliers, logistics providers, and customers.

From a profitability perspective, we expect 2020 adjusted EBITDA margin to be in line with 2019. Margin pressure is likely to continue through 2020, as we focus on improving our supply chain and delivering operational excellence through process simplification and automation.

We are not where we want to be, and we are taking actions to address that. We are committed to disciplined cost management, operational efficiency, and productivity gains as we transition through 2020 and set the foundation for a return to solid midterm growth and margin improvement. Beyond 2020, we expect to continue trending towards our 18 percent adjusted EBITDA margin target.

To assist you with your 2020 models, we want to provide you with a few other details. In terms of revenue phasing, we expect the split between H1 and H2 revenue as a percent of full year revenues to be 30 to 32 percent in H1 and 68 to 70 percent in H2. We expect Q3 and Q4 to be closer to each other in size going forward, as e-commerce grows as a proportion of our business and retail is switched to a higher portion of domestic fulfillment. I'd expect us to carry higher inventory levels at the end of Q3 to manage

this. By way of background, when TRU was in business, their model focused more on FOB, which drove more of our revenue into Q3.

We expect depreciation and amortization to be up approximately $13 million compared to 2019. Of that, 10 million results from more deliveries of entertainment content. We expect interest expense to remain in line with last year and our effective tax rate to be between 26.5 and 27.5 percent. We expect capital expenditures of approximately 5 to 6 percent of revenue.

To conclude, we remain committed to our long-term financial framework, which targets organic gross product sales growth of mid- to high-single digits. Our formula for innovation and growth is still valid, and our strategy is to continue with what has worked. We are extremely focused on cost management and productivity initiatives in order to return to our targeted margin structure.

That concludes our call. Ronnen and I will now be pleased to take questions.

Operator, please open the line.

Q&A

Operator

Thank you. If you would like to ask a question at this time, please press *, 1 on your telephone handset.

Our first question comes from Sabahat Khan from RBC Capital Markets. Your line is open.

Sabahat Khan — RBC Capital Markets

All right. Thanks, and good morning. Just on the top-line guide, I guess, how much of it would you say is maybe demand-driven versus the supply chain issues preventing you from meeting some of the demand that's out there?

Mark Segal

So, Sabah, I would say to you, as our guidance indicates, we think we're going to be mid-single digits down organically. The supply chain impacts, we've guided separately to that. The guidance that we've given you really is driven by some of the commentary that I just went through in my script around the Hatchimals decline and Dragons down and other products that I just went through now.

It is important to note, Sabah, that if you exclude the decline in Hatchimals, which will probably be around $100 million year over year, we expect organic gross product sales to grow around 2 percent. So that is still an indication of our brand innovation pipeline working and our innovation machine still driving growth.

Sabahat Khan

Okay. And then on the East DC side, I guess, just maybe a two-part question there. I think if I understood correctly, the issue there with that DC was just overconcentration of product in that facility. Am I thinking about that right in terms of the headwind? And then, secondly, are you able to share how much of your overall kind of GPS moves through that facility at all?

Ronnen Harary

Yeah. Hey, Sabah. The East Coast warehouse structurally was not architecturally set up correctly. It wasn't sized right and it wasn't outfitted correctly. And so now we're actually redoing it and making all the changes necessary to make sure that there won't be any issues set up during peak season.

I was personally down there in the warehouses myself last week and meeting with the founders and going through everything with our team and putting a plan in place to actually re-architect what was done in the past. So it is all getting reconfigured for peak season.

Mark Segal

Yeah. In terms of the second part of your question, Sabah, I don't want to break out the specifics of how much revenue moves through a particular DC. In 2019, the problem was that we tried to move too much through there. It was, as Ronnen described, it wasn't structured correctly for the amount of volume we try to move through that facility. And one of the big challenges we have now is to simplify that, to structurally change it, and to actually get the balance right so that we can get back to our normal warehousing rates.

If you look at the P&L in 2019, you will see that we actually spent around $98 million in warehousing, which is nearly $37 million more than we did in 2018. The rate was around 6.4 percent compared to a historical average of less than 4. So we are very focused on getting our numbers back down to our historical warehousing and distribution levels, and in order to get our margin back up. And so the whole structural simplification program in '20 is designed to help us do that.

Sabahat Khan

Okay. And then the additional headwind that you're building in from COVID-19 into your guide, the few percentage points, is that driven by the inability to maybe get some product here that you need? Or is that consumers just not getting to the store and buying toys? Is it like kind of supply or demand?

Mark Segal

No, no. That was based on supply chain, because if you understand what was happening in—or what was happening and is happening in China right now, there've been delays in starting up manufacturing. We're not at full capacity. And so we're not able to get the goods into our customers in particularly Q2 because of that disruption to our supply chain.

Sabahat Khan

Okay. And then on the comment around Q3 and Q4 being of equal size, I guess you mean on a revenue or EBITDA basis or both for this year?

Mark Segal

No. I was referring to top line. And I don't think I said exactly equal. I think they'll be more equal. If you go back in previous years, Q3 was significantly bigger than Q4 top line, around 45 percent verse 25 percent. So we see that balancing out more.

But in terms of EBITDA, Q3 will always be significantly more profitable than Q4. And the reason for that is because most of our marketing spend happens in Q4, when we're actually marketing closer to when the customers are in the actual retail stores. So you're always going to see a significantly higher profitability in Q3 versus Q4. And if you go back historically, that's always been the case.

Sabahat Khan

Okay. And then if I could squeeze in one last one. I guess on the flat year-over-year margin guide, is your sort of baked-in assumption that some of the supply chain issues kind of continue through to Q3, and then year over year you have somewhat better performance in Q4 because that's when most of the issues were? How are we—is that the right way to kind of think about sort of the unwind of the supply chain headwind through the year?

Mark Segal

Yeah. Look, it's going to take us some time to get the warehousing structure set up. But what we are very focused on doing is getting as much as we can done as we enter the second half of the year. And then as we actually exit 2020, we want to be in a situation where our run rate is getting us back to our historical margin structure.

Just keep in mind, though, that the P&L impact in 2019 was not only warehousing; it was also sales allowances. So we're very heavily focused on sales allowances as well. And the two issues are actually interrelated, because if your warehousing is not performing well, then you're subject to fines, noncompliance charges, penalties, and so on, which hit us hard in 2019.

So we want to get that all straightened out so that the $35 million hit that we took in 2019 for warehousing and the $25 million hit in 2019 that we took for sales allowances, which are really the primary components of our margin compression in 2019, are out of the way so that when we get back to 2021, we're back on a normal track.

Sabahat Khan

Great. Thank you.

Operator

Thank you. Our next question comes from Adam Shine from National Bank Financial. Your line is open.

Adam Shine — National Bank Financial

Thanks a lot. So if we think about the Q4 implications and sort of what initially was, I think, implicitly described as sort of $50 million of forfeited GPS in 2019, you would've thought that that would've made for a fairly easy comparable into 2020. Then you also add whatever we want to guess at DC Comics. Regardless of whether it's a movie year or not, that's incremental. So one would think that Hatchimals would've been able—or any decline in Hatchimals would've been able to sort of partly mitigate some of that bounce-back in incremental revenues to come from DC Comics. So there's got to be a bit more at play. So maybe, Ronnen, can you speak to, first off, how do we go from achieving a degree of stability in the back half of last year on Hatchimals to a further 50 percent decline? And what else is going

on in 2020 beyond just conservative outlook being articulated? Are you clearly losing market share and shelf space in regards to a penalty lingering from the—with the misfiring in Q4? I mean, there seems to be a few missing pieces to the puzzle there.

Ronnen Harary

Yeah. Hey, Adam. Actually, our portfolio is super diversified. It's probably the most diversified it's ever been. And from a POS perspective, coming into—coming out of 2019 and rolling into 2020, the POS is actually doing very well. And not only doing well in—it's doing well across the portfolio and it's doing well across geographies.

So from that perspective, we're very pleased. We're dealing with this, what I call a self-inflicted wound or a bump in the road that has really interrupted our supply chain. I don't think that we are seeing any shelf space losses from retailers or anything like that. We have a long-standing relationship with all these retailers. They understand that this was a bump in the road, and they know our vigilance and tenacity to go in and to fix problems when they arise. And that's what we're currently doing.

We just don't like missing our numbers, we're embarrassed when we miss our numbers, and so we're taking a conservative tone. We're very focused on growing the top line above what we guided you guys to this year. We can't make those promises, but the team's out there, and they're out there selling and very focused and actually going out to get even more shelf space and more promotions and more ads and everything like that to grow the top line.

And we're also trying to mitigate the EBITDA percentage because that's not acceptable. But stuff is going to take some time for us to work the way up and we're just taking a conservative outlook. And we're looking for the long term here. We're around—this is a company that's been around for 26 years

and we continue to be around for long periods of time, for much longer. So we just wanted to take a conservative outlook.

But I can tell you that the portfolio is very diversified, more diversified than it's ever been. We're taking a renewed focus in companies that we've bought, like GUND, which is showing a lot of promise, putting a lot of energy back into Swimways. Cardinal is doing—in Games—is doing exceptionally well. We don't talk about it very much on our calls, but it's an incredible business. And everybody's very focused on fixing the year and trying to make the year as strong as possible. And then rolling into 2021, as Mark addressed, back to the levels that we've been at historically. We just don't want to overpromise going into 2020.

Adam Shine

Okay. I'll leave it there. Thanks.

Ronnen Harary

Thank you.

Operator

Thank you. Our next question comes from Derek Dley from Canaccord Genuity. Your line is open.

Derek Dley — Canaccord Genuity

Yeah. Hi, guys. Just want to confirm what you said just on Bakugan. So did I hear right that you're not expecting any growth out of Bakugan this year? Just wondering why that would be the case.

Ronnen Harary

That's—

Mark Segal

No. I mean, that's—I mean, we are expecting growth, but we are taking a conservative view of that growth.

Derek Dley

Okay. But you—

Ronnen Harary

Yeah. But—sorry, go ahead.

Derek Dley

Sorry, I'm just a bit confused there. So did you guys say that you were not expecting growth, but you are expecting growth? I'm a little confused here.

Mark Segal

Yeah. So, Derek, we don't guide to individual products and individual—we talk about our business overall from a guidance perspective. I tried to give you a little bit of colour on Bakugan in the sense that we are guiding to growth for Bakugan. We do expect it to grow, but we're taking an overall conservative view of growth in general.

Derek Dley

Okay. Okay. That's more clear. Thank you for that. In terms of your inventory position, up quite a bit here and in Q4, how comfortable are you carrying that inventory into 2020? Should we—are you likely going to do some markdowns to try and clear it and get it more current?

Mark Segal

So inventory was up from around $110 million in '18 to over 180 million at the end of 2019, which is a big increase. We did what we could in Q4, either through markdowns or promotional activity or closeouts or whatever we could, to get rid of inventory we didn't want to carry into 2020. We're

comfortable that the vast majority of that inventory will actually sell through at reasonably normal margin levels, so we don't believe we have any major exposure in that area.

And paradoxically with COVID, it's actually helping us now because we are able to substitute some shortages in new products with existing inventory, particularly where it's in lines that don't change very much, like Kinetic Sand, or GUND, or a few other areas where there isn't a very big shift in the product line. So we're comfortable overall with the inventory, and we expect it to be back down to close-to-normal levels by the end of 2020.

Derek Dley

Okay. That makes sense. And then just the last one for me on the CapEx, just want to confirm the number. So you said 5 to 6 percent of sales. Is that gross sales? Or sales after rebates?

Mark Segal

No, no. That's net sales, revenue. And that's split around two-thirds of CapEx will go towards entertainment and around one-third will be for tooling.

Derek Dley

Great. Okay. Thank you very much.

Operator

Thank you. Our next question comes from Brian Morrison, TD Securities. Your line is open.

Brian Morrison — TD Securities

Hi. Good morning. I want to go back to the guidance on margins, if I could. Just the 500 basis points last year was really largely due to the DC, whether it be volume or allowance distribution costs. So you've mentioned and identified the issues, be it automation or process simplification. I realize it's not a fix overnight, but I'm not sure I understand why there's no margin recovery this year. Will the East Coast

DC not be ready for the busy season? Or essentially, you're saying, Mark, it'll be flat, and then you're going to get a hockey stick back to 19 percent in 2021? Is that the message?

Mark Segal

Well, let me just peel that question down into a few different components here. Firstly, we're not guiding to 2021 margins today. So I said to you in terms of the trend, that's our target. And we've historically operated at around 18 percent or even more. That's our goal and that's what we want to get back to as soon as we possibly can.

If you look at what happened in 2019, there were three major things that hurt our margins. And one was our sales allowances, second was the warehousing, and then there was also the impact of selling expenses, which is really a variable cost. And that is not something that—we actually get an offset through marketing, and so I'm not really focused too much on that. It's selling—it's the sales allowances and it's the warehousing. And my estimation is that around $35 million of that was from warehousing and distribution and around $25 million was from the sales allowances. And then there was also the impact on lost sales because we actually could have probably generated another $50 million of sales and got the margin on that.

So we are very focused on cleaning that up in 2020. The warehousing and distribution side of it does have a direct impact on sales allowances. As we clean that up we'll be suffering less noncompliance charges, fines, penalties, and so on. But what we're doing, Brian, is that we're taking a conservative view of that for 2020 because until we get traction—we're only in March and this addresses a question that Adam Shine had as well—we're only in March, it's early, and until we get traction, we want to make sure that we are actually guiding conservatively. And we'll update you as things go along in May, in August, and as we normally do, we update our guidance through our quarters.

So at this point, we're taking a cautious tone. We're not happy where we're at. We want to beat flat or in line, and we are doing everything we can to get there. We're just not committing to it today.

Brian Morrison

I understand that, but I would have to think that some of those material costs that were incurred last year—I mean, $35 million in warehousing—like would we not be in a position where that would be addressed by the busy season? I just I find it a little bit maybe overly cautious, if that's the message.

Mark Segal

Well, look, let's get there, let's get the traction, let's prove we can do it, and then we'll guide.

Ronnen Harary

I can say that it is definitely our goal to be set up correctly with the most optimized warehousing structure, 80/20, by the peak season. That is our goal. I think it would be a travesty, okay, to have a repeat of last year, okay, in 2020. We're just taking a more conservative view of everything.

But, Brian, I can just tell you that it's all hands on deck. And we actually are very fortunate. We brought in a really seasoned head of supply chain, Paul Blom, and I encourage you guys to look up his bio. He's working out—has only been in the job three weeks. I've spent a lot of time with him. I'm very pleased. We've brought in some more people in operational finance which we're very pleased about. And so the team is getting rounded out and everybody here, we're rallying the organization to mitigate this issue. So—

Brian Morrison

Yeah.

Ronnen Harary

—I'm with you. It's not where we want to be. But as Mark says, we'll update you guys in six weeks' time. We'll give you guys some more insight on what's happening, and we'll keep you very current on everything.

Brian Morrison

Okay. I appreciate that colour, Ronnen.

Ronnen Harary

Yeah. Okay.

Brian Morrison

In terms of gross product sales, Mark, can you just maybe discuss your exposure to the Asian marketplace? I believe that was a growth engine sort of on a going-forward basis. Maybe you can just—the exposure there to gross product sales?

Mark Segal

Yeah. It's actually is really small, Brian. I mean, we do have some sales in China which will be impacted as a result of what's happening with the virus currently. We have some distribution in other Asian countries. But overall, it's really quite immaterial for us in the general scheme of things. PAW Patrol continues to do well in Japan, and that's really about it. But it's overall a relatively limited impact. It wasn't a major factor when we considered our guidance for 2020 there.

Brian Morrison

Okay. And then lastly, your balance sheet. Nice to be in that position at this time. But in terms of M&A, are you seeing greater opportunities? And with such surplus capital, would there be potential to maybe shift to a certain extent for opportunistic opportunities to return capital to shareholders?

Mark Segal

So I would say to you we're continuing to look at acquisition opportunities all the time. I think right now, just given what we're focused on for 2020, as Ronnen and I just described, I think any large M&A would probably be off the table. But tuck-in acquisitions we continue to look at and we'll continue to do them throughout the year because it's a key part of our innovation pipeline and it's a key part of how we intend to grow the business.

Ronnen Harary

Yeah. Just to add to that, I mean, I think as we mentioned at Toy Fair, we're focusing even more heavily on the digital mobile space, the gaming space, and we're seeing some exciting opportunities in that area. So I think that returning capital back is not in line with our being a growth company, so we'd rather allocate the capital to make some strategic acquisitions to continue to grow and set ourselves up for the future. And that is one area where we're starting to see a lot of opportunities come our way.

Brian Morrison

Okay. Sorry, I had one last one too. Thank you. Mark or Ronnen, what is your expectation for industry growth this year?

Mark Segal

Well, we haven't actually said anything on that, Brian. We don't really have a view right now. Nothing's been published formally by the traditional forecasters, so we'll have to get back to you when something more formal is published.

I think overall, the general theme is that globally, the industry's continuing to grow in the historical ranges of around 4 to 5 percent. The US is definitely more challenged and is growing at a lower rate than that. So I would say there's a bifurcation between the US and other countries around the world, but we haven't actually published a formal view on that.

Brian Morrison

All right. Appreciate the colour, guys.

Mark Segal

Thanks.

Operator

Thank you. And our next question comes from Gerrick Johnson from BMO Capital Markets. Your line is open.

Gerrick Johnson — BMO Capital Markets

Great. Thank you. Mark, how can you plan your business without having a view on the industry performance for 2020?

Mark Segal

Well, Gerrick, we don't plan our business with a macroeconomic view of the world. I mean, the toy industry has grown very differently to economic cycles. We had our best years ever in the toy industry in 2008 and 2009. And the reality is that we are focused on innovation, we're focused on our product lines, we're focused on taking share, and it's not driven directly by correlation to industry growth rates.

Gerrick Johnson

Understood, but those are tailwinds and headwinds, but we'll move on. You said 71 percent of your workers are back at the factories in China. When I was at Toy Fair a week-and-a-half ago, that range was about 20 to 30 percent from the public—sorry—the private toy companies I spoke with. You guys had not mentioned at the time what the rate was. So is this a better ramp-up than you were originally planning?

Mark Segal

So when we were at Toy Fair we didn’t publish a specific number at that time. But in our factories a couple of weeks ago, it was around 54 percent. So it’s gone from 54 to 71 in a couple of weeks. And so I think it’s going at a positive rate.

Ronnen, do you—

Ronnen Harary

Yeah. We gave you guys the latest; we got that information last night at our weekly COVID meeting. And I will say I’m—versus some of the other companies out there, I mean, I’m exceptionally proud of our Asian operations and our team there, both in China and Hong Kong. The discipline that they’ve applied to this situation, the accuracy they’ve applied to the situation, the ability to work through it, I mean, it was staggering to see on our videoconferencing everybody on the other side wearing masks but showing up to work. The policies and procedures that are in place in our China office to not spread the virus and in Hong Kong office and the fact they can’t travel, the fact people are working at that capacity is breathtaking.

And I’m super-proud. I mean, we have a lot of factories in the region and the team is working super hard to get our share. And I would also say is that the relationships we’ve had with these factories are long-standing and these are great factories. So I applaud the factories for doing what they need to do to get this back in place.

So I would say this. I was surprised at the jump last night myself, Gerrick, but also very pleased at the same time to see that things are getting—almost getting back to normal.

Gerrick Johnson

Okay. Great. And I think Brian nailed it with his question—he got to the crux of the matter here—we’re looking at your guidance for your EBITDA margin for 2020. I would also add that you also had a

threat of on-again/off-again tariffs last year that you had to deal with that probably caused some extra costs and disruption. So I think he nailed that question. And I just wanted to make a statement there on that, and that's what we're all looking at right now. But one thing that may relate to it, what is the cost that's going to be associated with this Project Excel?

Mark Segal

So, Gerrick, that's part of kind of our conservativism around the adjusted EBITDA margin guidance. There will be a cost to simplify and change. We're working to actually minimize that as much as we can. We're working with partners, we're working with vendors, and we're doing everything we can to make that project and the changes we have to make as efficient as possible.

We're not going to call out a specific cost in terms of what the impact is going to be, but we will update you throughout the year as that Project Excel continues to evolve and as we make progress. And hopefully, you'll see it actually flow through our P&L.

Gerrick Johnson

Okay. We'll see it flow through, but are you going to pull it out as onetime items and adjusted EBITDA, adjusted EPS?

Mark Segal

We are. To the extent that there are costs that meet that criteria, we'll do that.

Gerrick Johnson

Okay.

Ronnen Harary

But I'd like to just comment on that, if I may. It's just there isn't—the majority of the work is being done internally with our own teams. There's a few people from the outside coming in to help, but the majority is done internally.

Gerrick Johnson

Okay. And since everyone else asked eight questions, I will too. Gross margin was down only 20 basis points. But if your sales allowances were up 170 bips, freight was higher, there must have been some fairly solid, positive offsets. So what were those?

Mark Segal

So we did actually have some offsets from product mix on the stuff that we did sell. We saw some increased app sales. We saw some increased TV distribution. Although even though we did see a decline in licensing and merchandising, there were some things going in the right direction. Product mix was the most significant factor that went in our favour.

Gerrick Johnson

Okay. All right. That's all I have for now. Thank you very much.

Ronnen Harary

Thanks, Gerrick.

Operator

Thank you. Our next question comes from Stephanie Wissink from Jefferies. Your line is open.

Ashley Helgans — Jefferies

Hi. This is Ashley Helgans on for Steph. Most of my questions have been answered, so I'll keep it really quick. Can you please quantify Hatchimals total volume in 2019? Thank you.

Mark Segal

Yeah. So we're actually not—we don't break that out specifically, Ashley, but what we're doing is quantifying the delta between the years. And so what we called out in 2019 was the year-over-year decline of around $230 million in '19 verse '18. And what we're saying again in '20 is that there'll be around a 50 percent decline in '20 verse '19. So part of the guide down in terms of the MSD decline is due to the reduction in Hatchimal sales.

Ashley Helgans

Okay. So like 115 million in 2020 is the guide?

Mark Segal

It's around $100 million, yeah.

Ashley Helgans

Okay. Great. Thanks for the colour.

Operator

Thank you. Our next question comes from Linda Bolton Weiser from D.A. Davidson. Your line is open.

And, Linda, you may be on mute.

Linda Bolton Weiser — D.A. Davidson

Hello. Hi. I just wanted to double-check on something you said about free cash flow. I thought you said 50 million or 80 million or something, but I just wanted to double-check. Your operating cash flow was 98 million and your CapEx total was 94 million in 2019? Is that correct?

Mark Segal

I don't have the numbers off the top of my head. I think our free cash flow was 84.6 million was what I actually read out, which was—

Linda Bolton Weiser

Okay. That—

Mark Segal

Linda, I can get back to you with the specific numbers after the call, or Sophia can.

Linda Bolton Weiser

Okay. And then secondly, one thing that hit me at Toy Fair was that you have a lot of innovation in your product lines, but that I felt a little bit like it was just a proliferation of product lines and products going on. Do you think it might be helpful to sort of frame your business around core brands and then express that to analysts and investors? Is that the way you think about how you run your business? And I know you mentioned four things—Bakugan, Monster Jam, PAW Patrol, and DC Comics. Is that what you view to be your four biggest core brands? Maybe you could just comment on how you think about it and how you run your business?

Ronnen Harary

Well, the way we've been running our business and reporting to you guys is in the segments that we talked about before and—but I do think you bring up a good point. I mean, we have some opportunities to, as I mentioned on my earlier remarks, to do more with less.

We do have some very large segments of business, especially our Games business, both with our Spin Master Games and with the acquisition of Cardinal. GUND has a lot of potential. And then our franchises, like PAW Patrol and Bakugan, and then our partnership franchises like DC and Monster Jam and Kinetic Sand is becoming a real growth engine in the whole activities area of our business.

So yeah, I think you bring up a good point. I mean, the way we organize ourselves at Toy Fair is it is a lot about the products because that is the DNA of our business. We love showing the innovation and

the excitement and going product by product. But I could hear what you're saying. It may be a little bit hard for you guys to parcel through, especially in a short amount of time, in an hour, and there's a lot of people there and stuff like that.

So we'll take that feedback and, no, it's some good feedback. It's some good feedback in terms of how to give you more colour to go deeper in the various different segments and with what's going on. So thank you.

Mark Segal

Linda, one of the things we did do, and we are doing is, we're actually getting analysts and investors into our facilities more. So the day after Toy Fair, we actually took some investors and analysts through our Spin Master East office, and we went deep in Outdoor and GUND and Cardinal. And we want to do that more, just to help you understand the business better. And we'll continue to do that.

Linda Bolton Weiser

Okay. Thank you.

Operator

Thank you. Our next question comes from Jamie Katz from Morningstar. Your line is open.

Jamie Katz — Morningstar

Hi. Good morning and thank you for taking my questions. At Toy Fair last week, I think you guys said you were going to try to do everything you could to grow your margins back up again in 2020, and obviously now you guys are calling for flat EBITDA margins. So I'm curious if anything has changed outside of COVID-19 between then and now. And then second, as you guys continue to push towards international expansion, should we continue to expect sales allowances to rise this year, as generally I think those have run a little bit higher abroad than domestically? Thanks.

Mark Segal

Yeah. So in connection with your first question, I think we've covered the EBITDA margin piece in a lot of detail on the call. What I will just reiterate is that we are guiding conservatively on our EBITDA margins until we get traction. We're not happy where they are, and we're going to do everything we can to get them back up. And we'll give you more guidance throughout the year as we get traction. So there's—nothing has changed between this week, today, and when we actually spoke to you at Toy Fair. Nothing has changed in that respect.

In connection with sales allowances, mix is a small element of the sales allowance increase because in Europe, in particular, the Europe countries and the way the retail structure works there is a higher price, higher allowance model. The net price is actually relatively similar to the US. But if you look at the sales allowance line in isolation, as we grow Europe it does push our sales allowances up just mathematically.

We're going to look at pricing everywhere, but that in particular, we want to make sure there isn't any dilution on that front. But that explains the mix element of the sales allowance increase. The vast majority of the issue in sales allowances is not mix; it is simply our ability to control markdowns, co-op spending, noncompliance charges, and all of that. And that's where we're really going to be focusing on in 2020.

Jamie Katz

Thank you. That's very helpful.

Operator

Thank you. Our next question comes from David McFadgen from Cormark Securities. Your line is open.

David McFadgen — Cormark Securities

Hi. Great. A couple of questions. So first of all just on the sales allowance, so it obviously ticked up in 2019. I was just wondering what your view is for 2020 where you think that might come out?

Mark Segal

Yeah. So, David, as I just answered previously on Jamie's question, the three components of sales allowances that we're going to be heavily focused on is markdowns, it's going to be on noncompliance, and obviously any promotional spending that we actually have to undertake that hits the sales allowance line. Warehousing and our ability to service our customers effectively has a direct impact on our noncompliance charges, so to the extent that we drive efficiencies through our warehousing system, we will be able to reduce sales allowances as a result of that.

And then on the markdown side, obviously the strength of our line has a direct impact on that, our ability to deliver, our ability to sell through has an impact on that, so we're going to be very focused on that. I did say in my remarks that we would like to get down to around 12.5 percent compared to where we were in '19, which was 13.5 percent, and that would still put us above our historical range of 10 to 12 percent. In 2018, we were at 11.6 percent, so I still see our numbers being higher for 2020, but we're pushing very hard to get them back down to our historical ranges.

David McFadgen

Okay. And then just a question on the mid-single-digit decline, excluding any impact from the coronavirus. I was just wondering, so obviously, you flagged Hatchimals is going to be down again. Can you give us any colour on your expectations for PAW Patrol? I mean, you did say earlier that PAW Patrol so far this year in the US is down a bit, so I was just kind of wondering what you think that product would do in 2020? What's baked into your guidance there?

Mark Segal

Yeah. So we're not going to give specific guidance on PAW Patrol, David, but I can tell you that it's a very solid line. It continues to resonate with kids around the world, and so it's going to be a very solid contributor in 2020, just like it was in '19 and in '18.

Ronnen Harary

And the early—

Mark Segal

Yup.

David McFadgen

Can you—sorry—can you give us an idea of like how much it's down so far this year in the US? Any colour there?

Mark Segal

No. We'll give you colour when we report our Q1 results in May.

David McFadgen

Okay.

Ronnen Harary

Let me just share with you that POS on PAW Patrol globally is up.

David McFadgen

Okay. Because I thought you said POS was down in the US so far in 2020.

Mark Segal

No. Overall globally POS is up currently.

David McFadgen

Okay.

Mark Segal

It's down in the US, but that's because we actually haven't done any of our marketing. And what we're doing now is we're actually getting our marketing in and it's picking up very strongly. So the trend is actually very strongly up ahead of Easter.

David McFadgen

Okay. And then just on the distribution expenses as a percentage of sales. As you shift more of your production out of China into other geographies, wouldn't that sort of limit the ability to get distribution expenses down as a percentage of sales?

Mark Segal

Well, distribution expenses on our P&L is made up of a number of factors. Just keep in mind, though, when we actually move goods from different countries in the world, that freight cost actually hits COGS. It doesn't go through our warehousing and distribution. So understand that that element is sitting in our cost of goods sold.

But so when you look at our warehousing and distribution line, you're looking at our third-party distribution costs in North America and in Europe primarily, and you're also looking at the transportation costs to the extent that we pay those to our customers. Not all of our costs; some are collect, some are prepaid. So really what drives our warehousing and distribution costs is the amount of goods that go through what we call domestic, or dom, as opposed to FOB. Because FOB doesn't go through our warehousing at all. It goes directly to the customer. So our ability to manage our 3PLs in North America and in Europe drives the warehousing and distribution cost line that you see in SG&A. And that's where we're heavily focused on improving it and getting it back to less than 4 percent.

Historically, we've operated between 3.5 and 4 percent of sales and we now peaked over 6 percent in 2019. And that delta is the delta that Ronnen and Paul Blom and everyone else and myself are all heavily focused on reducing and getting back to our historical levels.

David McFadgen

Mm-hmm. Okay. All right. That's it for me. Thank you.

Operator

Thank you. And our last question today comes from Kirill Kozyar from CIBC World Markets. Your line is open.

Kirill Kozyar — CIBC World Markets

Good morning and thank you for taking my call. Can you just provide some more colour about the difference between guided GPS and expected industry growth, besides the nonorganic impact you have mentioned and the lower industry expected growth in North America? Thanks.

Mark Segal

Sorry, are you—could you just repeat that question? Are you asking for the impact that's nonorganic, as in the COVID-19 impact? Is that what you're saying?

Kirill Kozyar

Yeah. That's right.

Mark Segal

So basically, the COVID-19 impact is really as a result of supply chain disruptions because of our factories getting back to work at full production much later than they originally would. Usually after Chinese New Year in early February, the factories are back and at full steam, but really now they're going to be back in full production only by the end of March. And so as a result of that production loss and supply

chain deficit, Q2 is going to suffer from that impact. And that's why we gave additional guidance in addition to our organic mid-single-digit guidance.

Does that answer your question? I'm not sure I got it quite correctly there.

Kirill Kozyar

Yeah. Thanks. That's helpful. I have another follow-up. Do you have any solid timelines for when the challenges in East DC are put behind? Or are you going to update us in six weeks from now or with Q1 call?

Ronnen Harary

I think we're going to continue to update you guys on—in six weeks and we'll update you guys again in the summer. On all our calls we'll update you guys.

Kirill Kozyar

Yeah. And the last quick one, if you can also remind us there about Hatchimals increase from 2018 over '17?

Mark Segal

We'll have to get back to you on that one. I can't remember that number off the top of my head, but obviously 2017 and '18 were the years where Hatchimals was really very large and growing very rapidly. And so that really was the peak of when the Hatchimals phenomenon was actually—we were experiencing that phenomenon, which is why the '19 and '20 comps are that much more difficult, as Hatchimal declines as we planned it. But it's obviously making the comps year over year quite challenging.

Kirill Kozyar

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

Mark Segal

Okay—

Operator

Thank you.

Mark Segal

I think that was the last one.

Operator

And I'll turn the call back to management for closing remarks.

Mark Segal

Okay. Well, listen, thank you, everyone. That was a long—

Ronnen Harary

Thank you.

Mark Segal

—call, but we wanted to give you the additional colour. And we look forward to talking to you again in early May with our Q1 results.

Thank you very much.

Operator

Thank you, ladies and gentlemen. This concludes today's conference call. We appreciate you participating, and you may now disconnect.