FINAL TRANSCRIPT

Spin Master Corp.

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Luke
Canaccord Genuity Corp. — Analyst

Adam Shine
National Bank Financial — Analyst

Gerrick Johnson
BMO Capital Markets — Analyst

Jonathan Garfinkle
Scotiabank — Analyst

Stephanie Wissink
Jefferies Inc. — Analyst

Sabahat Khan
RBC Capital Markets — Analyst

Brian Morrison
TD Securities — Analyst

David McFadgen
Cormark Securities — Analyst

PRESENTATION

Operator

At this time, I would like to welcome everyone to the Spin Master Corporation Second Quarter 2020 Results 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 star, then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key.

Thank you. Ms. Sophia Bisoukis, you may begin your conference.

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

Thank you, Keisha.

Good morning everybody, and welcome to Spin Master's Financial Results Conference Call for the second quarter ended June 30, 2020. I'm joined this morning by Ronnen Harary, Co-CEO, and Mark Segal, Spin Master's Chief Financial Officer of Spin Master. For your convenience, the press release, MD&A, and un-audited interim consolidation financial statements for the second quarter 2020 are available on the Investor Relations section of our website at spinmaster.com and on SEDAR.

Before we begin, please note, the remarks on this conference call may contain forward-looking statements about Spin Master's current and future plans, expectations, intentions, results, levels of activity, performance, goals, or achievements, or any other future events or developments. Forward-looking statements are based on information currently available to Management and on estimates and assumptions made, based on factors that Management believes are appropriate and reasonable in the circumstances.

However, there can be no assurance that such estimates and assumptions will prove to be correct. Many factors could cause actual results to differ materially from those expressed or implied by the forward-looking statements. As a result, Spin Master cannot guarantee that any forward-looking statements will materialize, and you are cautioned not to place undue reliance on these forward-looking statements; except as may be required by law, Spin Master has no obligation to update or revise any forward-looking 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 our earnings release dated August 5, 2020.

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

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

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

Thanks, Sophia.

Good morning and thanks for joining us today. On behalf of Spin Master, I hope that you are staying healthy and safe.

We are incredibly proud of our team who have remained committed through these unprecedented times. We're making meaningful progress towards resolving our operational challenges, and at the same time, mitigating the impact of COVID on our business and our customers. COVID has brought our people together, and for a global Company such as ours, it has, in many areas, increased productivity, collaboration, and creativity. This quarter reflects our commitment and the power of having built a diversified portfolio of brands, entertainment franchises, and digital games.

In Q1, we felt the impact of COVID on our supply chain in Asia and through retail shutdowns towards the end of March. Throughout the entire second quarter, we felt the effects of both the retail disruptions caused by COVID as a significant number of our customers were shut down or in online-only mode, as well as supply chain disruptions that began in Q1 in Asia.

In the second quarter, families with kids home from school continued to look for ways to keep them engaged, and toys and games are an ideal way to do so. As a result, the early part of Q2 was dominated by sales of stay-at-home activities, as well as outdoor, which grew significantly later in the quarter.

Our gross product sales were down 10.9 percent in Q2, which exceeded our expectations. Sales in North America were up slightly, as our largest customers remained opened through the quarter. We saw strong demand for home-based products from our Activities, Games and Puzzles, and Outdoor segments, all of which grew in the quarter. Global toy industry POS grew double-digits in Q2, highlighting the resilient nature of the industry, especially the value of toys as low-priced entertainment for kids when other forms of entertainment are unavailable. Mark will provide you with detailed POS data in a few minutes.

We remain unsatisfied with the level of our profitability due to both the impacts of COVID and the carry-over of the challenges we experienced in the second half of 2019. We were focused on improving profitability as 2020 progresses and into 2021. COVID has led to a series of rapid and dramatic changes in how we conduct business. Our top priorities remain the health and safety of our teams, and we've instituted several protocols to ensure that they are safe, while also remaining productive in work-from-home environments. We continue to balance multiple dimensions of our global response, focusing on employees' wellbeing and safety, workforce engagement and productivity, business continuity and health, and finally, ensuring that we continue to live up to our core values.

Currently, many of our offices around the world have reopened. In China and Vietnam, our offices are fully operational. In Hong Kong and India, our offices are in a work-from-home mode. In Europe, our offices have now opened, with employees rotating between office and home. In North America, our Toronto and New York offices have opened, in a phased approach with an emphasis on functions such as product development and packaging, where touching the physical product is beneficial.

In L.A. and Mexico City, where COVID cases remained elevated, our offices remain closed. The situation is fluid, and we are prepared to readjust quickly to changing circumstances.

As a result of the COVID outbreak in China in our first quarter, where 60 percent to 65 percent of our manufacturing capacity is located, we saw some disruption in product flow through Q2, but our Asian supply chain teams did an outstanding job at limiting the impact in Q2 as much as possible. From a manufacturing perspective, we are currently operating at normal capacity for the second half of 2020, when we sell approximately 70 percent of our annual volume, and do not expect any material COVID-related supply chain interruptions.

It has now been nearly five months since consumer demand for our products was affected by COVID. Stay-at-home protocols meant that many of our retail customers were closed for the entire second quarter. Given this disruption, we are fortunate to be operating in an industry that has held up better than originally expected, and better than many others. We believe the macro trend of families spending more time at home with their children, coupled with the fact that they did not spend on movies and theme parks and travel has helped our industry, and lifted certain categories.

Categories that benefited from people spending time together continue to be in very strong demand, including Games and Puzzles, and Arts and Crafts. According to NPD, Games and Puzzles is the fastest-growing super-category in 2020. This category has been a focus of ours for over 10 years. We're the number two player in the industry, with a 4 percent U.S. market share.

In addition to Games and Puzzles, the Activities category performed extremely well, as we continue to see exceptional sales increase in Kinetic Sand, with the entire line benefiting from stay-at-home guidelines. POS grew triple-digits this quarter with existing and new customers discovering the endless creative possibilities and sensory play that Kinetic Sand provides. We believe that demand for these categories will continue to be strong throughout 2020.

Whereas Games, Puzzles, and Activities are benefiting from the pandemic environment, other categories across the industry suffered in Q2. Purchases driven by school, social activities, and group play environments, including events such as birthdays, have declined given kids have more limited opportunities to socialize. Most significantly impacted is the Collectibles and Action Figure category, which, as a super-category, has declined 18 percent this year according to NPD. However, we are seeing these categories begin to grow as stores and communities reopen in various geographies.

From a channel perspective, we are fortunate that in North America, which represents over 60 percent of our gross product sales, Walmart, Target, and Amazon continued normal ordering patterns. Specialty and other retail closures shifted buying towards these big box retailers and pushed shopping online. The strong surge we saw in Q1 in e-commerce continued throughout the second quarter. We estimate that approximately 25 percent of our total sales in Q2 were through e-commerce channels, and expect this to be over 30 percent in Q4.

Our global scale, with 28 offices around the world, combined with our diversified and innovative product capabilities, has represented a valuable asset in the current environment. COVID has affected geographic regions in different ways and at different times. While we saw dips in consumer traffic in some of our markets during lockdown periods, others returned to normal consumer behaviour, minimizing the overall impact.

We have encouraged you to think of Spin Master not only as a toy company, but as an integrated entertainment business producing toys, entertainment content, and interactive digital toys and games. With kids at home all day and parents getting more flexible with screen time, we've seen a strong increase in the demand for our entertainment content and digital gaming. Our Entertainment team is working with our third party animation studios to keep production of all our TV shows and movies on schedule. We are not experiencing any production delays. It is much easier to keep on track with animated content, which lends itself more to a work-from-home environment, as compared to live action content.

In late June, the first episode of the new PAW Patrol theme for 2020, *Dino Rescue*, premiered. In the two to five age category, we garnered strong ratings, and with boys specifically, we saw the highest ratings since the *Mighty Pups* special in January. We were very pleased to see this premiere also attract older audiences, in the six to 11 age category, which bodes well for our movie release next year. Overall, *PAW Patrol's Dino Rescue* ranked as the number one show on television in Q2 amongst preschoolers. We remain on track to deliver the *PAW Patrol Movie* in August '21, as planned.

We continue to build our library of content, including exciting new preschool franchise Mighty Express, which will debut on Netflix this September 22. *Mighty Express* features a cast of trains and kids in an expansive world filled with amazing adventures. This launch is another example of our ability to push the boundaries of quality children's entertainment.

Mighty Express, which represents an evergreen play pattern that has resonated with kids worldwide, is our biggest production to date, and marks our first series launching directly on a streaming platform. Mighty Express toys will launch in fall ’21, following the global entertainment rollout. The Mighty Express launch marks our shift for us as we are taking a full franchise approach, and we will hold the rights to all consumer products, not just toys. The franchise strategy will allow us to improve the margins we make on non-toy licensing and merchandising revenue streams.

In addition, we’ve secured the global master toy license for DreamWorks Animation for the new animated preschool series, *Gabby’s Dollhouse*, which is set to debut globally on Netflix later this year. Beginning fall ’21, we will bring characters from the show to life through a new toy line that will include playsets, figures, plush, games, and puzzles. Gabby is an exciting addition to our growing portfolio, and we continue to focus our strategy on establishing ourselves as the global leader in the character-based preschool category.

Our digital games offering, including *Toca Boca* and *Sago Mini*, continue to experience significantly increased demand, with parents looking for ways to educate and entertain their children at home. *Toca Boca* now has over 22 million monthly active users, and *Sago Mini* now has over 185,000 subscribers from the *Sago Mini World*, *Sago Mini School*, and *Sago Mini* Subscription Box platforms, compared to just over 100,000 in Q2 last year. In early ’21, we are planning to launch a new *Toca Boca* Subscription Box, targeted at five to nine year olds, as well as our first multiplayer game, *Toca Days*.

As part of the Bakugan franchise, in November we are launching the *Bakugan Champions of Vestroia*, a new game for Nintendo Switch, in conjunction with Warner Bros. and game developers WayForward.

I want to briefly update you on the operational challenges we encountered last year, and Mark will add more details later. We are already seeing the benefits of the remediation efforts we discussed in Q1, and we are gaining momentum. We are focused on consolidation, realignment, and simplification, while ensuring we remain sufficiently agile to respond to the evolving industry and retail environment. One of the issues we had last year was that we created increased complexity by stocking the same SKUs in multiple locations. We have now implemented a one SKU, one location strategy. Our goal is to improve operational efficiency to the point where the run rate of our cost structure is closer to the level we saw in 2018.

We have used the process of addressing our 2019 operational challenges to build a continuous improvement mindset, which has become embedded in our Organization globally. We plan to continue to drive operational efficiencies in every area globally. We’re doing deeper and more proactive planning for 2021, earlier, and more detailed than ever before. We have also improved accountability over every line on the P&L, and are building operational procedures to ensure that we manage it more consistently, globally.

We are always on the lookout for accretive M&A opportunities that support our organic growth strategy. We continue to apply a disciplined approach to assessing all opportunities. In the toy area, where the industry remains highly fragmented beyond the 10 largest manufacturers, pressure on smaller suppliers supports our view that there will be opportunities over the next one to two years. We’re also increasingly focused on our entertainment and digital areas for M&A opportunities. If we execute properly, our operational efficiencies, combined with our capital structure and our M&A strategy, will allow us to reinvest the cash we generate into the business, or to accelerate growth.

From a market perspective, COVID has given rise to several challenges in consumer behaviour, some of which we believe will be enduring, and which are influencing our strategy. Personal safety will play an important role in the future of consumer behaviour as consumers look to lessen the amount of time they spend shopping in stores. We anticipate more control of foot traffic in stores, shorter, more mission-focused trips, potentially without kids, and fewer opportunities for impulse purchases in-store.

We are seeing more parent-driven decision-making from the shift to e-commerce. We expect the shift to e-commerce to continue, and to represent around 30 percent or more of Q4 POS. Many customers who set up accounts with online retailers will likely find it easier to continue buying online. According to industry research, post-COVID, 69 percent of shoppers expect to shop online and pick up curbside; 64 percent expect to shop online and pick up in-store; and 37 percent expect to shop online for home delivery.

Click & Collect has become an increasingly popular method of purchasing toys. It is helping Walmart and Target to particularly drive growth. The post-pandemic world will have shoppers more focused on value and efficiency, with greater sophistication in online buying and price sensitivity. That’s good news for deep discounts and big box retailers that offer products from a wider range of categories at lower prices.

We have observed an increase in screen time, but where the content is being consumed continues to shift away from linear TV towards SVOD, gaming, and YouTube. Linear TV ratings are down 29 percent year-to-date and are expected to be down over 30 percent for 2020.

In response to all of the above, we want to create a seamless shopping experience using digital tools and data to gain better insight on shoppers and guide them through the path to purchase. We will focus more on parents, gift-givers, and shoppers with shopper-focused messaging in-store, and shopper-specific digital, social, and search marketing driving to e-com. Our fall marketing mix will see lower spend on linear TV, and an increase in our mix of digital, comprising social, influencer, and e-commerce. In addition, social distancing measures have resulted in fewer physical gatherings, which in turn have decreased our experiential marketing spending.

Not only have we shifted spend, we've also built internal capabilities and deep expertise, and changed our approach to increase productivity. We've done this by moving our digital buying in-house, and established a new Marketing Growth team, focusing on D2C and our Spin Channel network. Finally, we will build flexibility and real-time optimization plans into our strategy to allow us to shift in season as needed. These challenges have positioned us to create marketing as innovative as our toys, entertainment, and digital games, which we'll see come to life this fall.

Looking forward to the fall season from a product perspective, we are excited about our innovation across multiple categories. The RC team has several innovative items including "The Animal" motorized truck that unboxes itself, and which kids can repeat over and over, as well as the new Monster Jam Megalodon Storm, an RC truck for both land and water. Our Robotics team has developed Hatchimals Crystal Flyers and Hatchimal Pixie that kids can fly and control with their hands. The Activity team continues to raise the bar on the DIY products and building on the success of Go Glam Nail Stamper, which we are launching a new Deluxe version this fall.

The toy line from the new PAW Patrol Dino Rescue theme, including the Dino Patroller, our first ever motorized preschool vehicle, has been very well-received by retailers. This innovation complements our existing strong and diversified line-up, including Bakugan, Kinetic Sand, Games and Puzzles, Monster Jam, DC, Outdoor, and many others.

To conclude, we remain very confident in our ability to create excitement and magic for children globally, through the strength of our diversified portfolio of products, brands, entertainment franchises, and digital offerings. However, we need to balance our confidence against critical macro unknowns, including a potential second wave of COVID, uncertainty of spending around the U.S. election, and the duration of fiscal stimulus packages in our key markets.

Overall, our strategic direction, our solid financial foundation, and diverse geographic platform combined with the commitment of our global teams positions us to take advantage of the evolving opportunities and drive long-term success.

I will now turn over the call to Mark.

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

Thanks, Ronnen.

Looking back to when we spoke in May, second quarter sales and demand came in stronger than we expected. Gross product sales declined by 10.9 percent in the quarter to $282.2 million, which included a favourable foreign exchange impact of $3.4 million. On a constant currency basis, gross product sales declined 12 percent. We generated revenue of $281.1 million in Q2, which was down 12.4 percent from the same period last year, and down 13.4 percent on a constant currency basis.

On a geographic basis, North America was the strongest region, with gross product sales of $204 million, up slightly compared to last year. This was a strong performance under the circumstances. As Ronnen noted, we saw a continued shift away from Collectibles and Action Figures in favour of Activities, and Games and Puzzles. Growth in North America was led by Games and Puzzles, Kinetic Sand, Outdoor, and *DC* licensed products. Offsetting the strong performance from these brands were declines in Dragons, Hatchimals, Bakugan, PAW Patrol, and Gund.

In Europe, gross product sales declined 21.6 percent to just under $50 million, and in the rest of the world, gross product sales declined 42.4 percent to $28.5 million. Many of these markets saw a large and negative impact from consumer activity as a result of COVID in North America, for two reasons. Firstly, many do not have sufficiently broad e-commerce adoption to offset school closures. Secondly, many of these markets have a much larger specialty toy component compared to North America, where mass retailers are more dominant. Although product lines including Bakugan, Dragons, and PAW Patrol were most significantly affected, our newly launched DC line partially offset this weakness.

In the quarter, international gross product sales represented approximately 28 percent of total gross product sales, down from 36 percent in 2019. The relative strength in North America during COVID was the key driver.

The Activities, Games and Puzzles, and Plush segment led our gross product sales growth for the quarter, increasing 19.2 percent. According to NPD, the U.S. Games and Puzzles market was up 46 percent year-over-year. We benefited from this, with particular strength in our Cardinal games and puzzles portfolio. In Activities, we are seeing exceptional growth in Kinetic Sand, which doubled this quarter over last year. Plush, which comprises Gund, has however been disproportionately affected by COVID, since its business is largely driven by U.S. specialty stores, most of whom were not open in Q2.

Gross product sales in Preschool and Girls declined by 22.9 percent. PAW Patrol, which was down for the quarter, remains among the top 10 properties in the toy industry, but was under pressure from the COVID-driven reduction in birthday parties and other events-driven sales. We are currently seeing this start to shift, and I will provide details on PAW Patrol POS performance shortly.

We saw a significant decline in gross product sales in the Boys' Action and Construction segment, which was down 30.5 percent. As Ronnen noted, and as we called out in May, the industry-wide shift towards stay-at-home Games, Puzzles, and Activities came at the expense of other categories, most notably Action Figures and Collectibles, which rely on social interaction. The decline was driven by Dragons, which was expected as it's in a post-film year, as well as Bakugan, partially offset by sales of DC licensed products and Tech Deck.

The Remote Control and Interactive Character segment continued to decline, and was down 25.4 percent, driven by lower sales of Hatchimals, Juno, and Luvabella. These declines were partially offset by increases in Monster Jam RC, and PAW Patrol RC. Monster Jam RC was up despite large-scale live event cancellations.

Gross product sales in our Outdoors segment rose by 9.1 percent as parents looked to get the kids active outside, and in pools and on beaches as the weather warmed up.

Let's now look at POS. The global toy industry grew mid to double-digits in Q2. Globally, our POS in Q2 exceeded the industry growth rate and was up 18 percent. We are very pleased with this performance as it demonstrates that our brands are resonating with consumers, and is a testament to our product diversification strategy. In the U.S., our POS for Q2 rose 23 percent, in line with the industry growth rate.

Looking at H1, according to NPD, POS for the global toy industry grew 9 percent. Globally, our H1 POS was up 14 percent. In the U.S., our POS for H1 was up 15 percent, compared to 16 percent for the U.S. industry. However, if the Outdoor and Sports category, where we have a limited presence relative to the size of the industry, is excluded, our POS was up 15 percent and the industry was up 11 percent.

Industry POS is strong, but retailers are remaining cautious replenishing inventory, resulting in POS exceeding shipments and retail inventory levels being drawn down. In the second half of 2020, as is typically the case, we expect to see a rebalancing between shipments and POS, as retailers replenish channel inventory. The scale of this replenishment will likely be affected by macro factors, including global back-to-school decisions, which could emphasize stay-at-home and educational play categories, especially if online or hybrid school models emerge.

In the U.S., PAW Patrol POS recovered in Q2 to negative 1 percent from negative 17 percent year-over-year in Q1, and reducing the year-to-date decline to negative 10 percent year-over-year. The Ultimate Fire Truck performed well, with Q2 POS growing 12 percent year-over-year. In-store displays at Walmart and Target supported the recovery in Q2, as more customers returned to stores. Outside of the

U.S., PAW showed POS growth in Q2 in markets such as France, Benelux, and Australia. PAW Patrol is currently rebounding strongly, with high-teen POS growth in most markets.

Kinetic Sand continues to show triple-digit year-over-year POS growth, and we're starting to see an overall strong rebound in European POS, especially in France, the U.K., and Germany, driven by growth in PAW Patrol and other core brands.

We are fortunate to have strong retail partners such as Walmart, Target, and Amazon, which remained open during the worst of the lockdown, and have picked up a larger share of consumer spending. Target and Walmart comprised approximately 50 percent of our global volume in Q2. Including Amazon, our next largest customer globally, our top three represented 60 percent of global volume in Q2.

Turning back to the P&L, sales allowances increased to 10.5 percent of gross product sales, compared to 8.3 percent last year. The main driver of the year-over-year increase was higher non-compliance charges from customers related to our 2019 performance issues. This was offset to some extent by a shift in geographic sales mix towards North America, which has a lower sales allowance environment.

Although these charges are higher compared to Q2 2019, we are steadily making progress in remediating the underlying causes of these charges, and are seeing significant sequential improvements over Q1 when sales allowances were over 15 percent. Non-compliance charges are a key part of our efforts to improve operational performance in 2020 and beyond. On a year-to-date basis, sales allowances are 12.7 percent, which is approximately where we expect to be for the full year.

Other revenue, which primarily reflects licensing and merchandising royalties, television distribution revenue and app revenue declined by $2 million or 6.3 percent in Q2. The decline resulted from lower licensing and merchandising royalties, which was offset by increased app revenue from *Toca Boca* and *Sago Mini*, as we continue to ramp-up our Digital Games business.

Gross profit for the quarter was $118.2 million, or 42 percent of revenue, compared to $164.3 million or 51.2 percent last year. The decline in gross profit margin arose from several factors: higher sales allowances, as I just described; unfavourable shifts in product mix from increased volume in lower-margin products, such as Cardinal games and puzzles; the closeout of non-carry forward products at lower margins, such as Marshmallow Furniture, older games and puzzles, and Hatchimals lines, as we realign inventory as part of our operational improvement initiatives. We also incurred costs to suppliers related to procurement commitments that were made in 2019. Finally, we had higher in-land and ocean freight expenses this quarter compared to last year, which related to inventory purchase in 2019 and sold in 2020.

Overall, we estimate that in Q2, approximately $13 million of the $46 million decline in gross profit related to inefficiencies arising from the second half of 2019. There will continue to be an impact to gross margin in H2 2020, as a result of our ongoing inventory cleanup. However, the scale of the impact will decline in H2, as we ship our fall line, which should more than offset any compression. As our operational performance continues to improve, we expect gross margins for the second half of 2020 to be in line with prior years.

SG&A as a percentage of revenue declined to 40.8 percent in Q2, down from 42.9 percent last year. The biggest driver of the decline was a $14.1 million reduction in marketing costs, due to lower spending as a result of COVID. As a percentage of revenue, marketing decreased to 4.1 percent from 7.9 percent. We spent less on both traditional media, experiential marketing, and trade shows. Offsetting this were increases in influencer and e-commerce marketing spend. We intend to increase our marketing spend in H2, and expect marketing spend for the second half of 2020 to be higher compared to 2019.

Selling expenses were lower in absolute terms but higher as a percentage of revenue, due to an increase in the sales mix of licensed products. Warehousing and distribution expenses were $18.8 million or 6.7 percent of revenue, up from $16.3 million or 5.1 percent last year. The increase related primarily to higher freight-related and warehouse handling charges, as part of our ongoing operational improvement initiative to shift one SKU out of only one physical warehouse location. These transfers of inventory between DCs in the U.S. will not reoccur in H2, as we are now largely set up to successfully execute our distribution strategy.

In Q2, our adjusted net loss was $9.5 million or $0.09 lost per diluted share, compared with adjusted net income of $19.8 million or $0.19 per diluted share last year. Adjusted EBITDA was $21.5 million, compared to $55.1 million last year. EBITDA margin was 7.6 percent compared to 17.2 percent. The decline in EBITDA was primarily driven by lower gross profit, offset by marketing savings. We estimate that approximately $15 million of the $34 million decline in EBITDA in Q2 related to inefficiencies arising from the second half of 2019.

The tax rate for the quarter was adjusted to reflect our forecasted tax position for 2020. We expect the tax rate for 2020 to be 15 percent, well below our normal rate of approximately 26 percent, driven by the results for the first half of 2020, and the jurisdictions we expect taxable income to be earned for the remainder of the year. For 2021, we expect to revert to our historical effective rate.

From a capital allocation, leverage, and liquidity perspective, we are in a strong position. Our balance sheet remains in great shape. We ended the quarter with just over $410 million in cash, with net cash of over $110 million, compared to $77 million last year. In the first quarter, we drew a total of $350 million on our committed, $510 million revolving credit facility. During the second quarter, we repaid $50 million. We plan to continue to pay down more in Q3. Given the amount of cash on hand at the end of the quarter, the cash flow we will generate in H2 and the capacity in our credit facility, we are very solidly positioned regarding available liquidity.

Net working capital was $173.5 million at the end of Q2, down from $222 million last year. Free cash flow for the quarter, excluding changes in working capital, was negative $9.8 million, compared to $18.6 million last year. However, free cash flow for the quarter, including changes in working capital, was $40.2 million compared to negative $34.7 million, a nearly $75 million improvement in free cash flow.

Inventory was $154.3 million compared to $185.3 million at the end of 2019, and $145.4 million last year. We are beginning to make meaningful progress reducing our inventory levels, although our progress was hindered to some extent by COVID, as some outlets for sales were closed through the quarter. We are constantly weighing gross margin against inventory, and the benefit of reducing our inventory carrying costs and improving cash flow.

Let’s now turn to our efforts to improve operating efficiencies. In Q2, we generated strong momentum towards remediating the challenges that emerged late in 2019, and we have begun to see a decline in the elevated cost levels from Q4 ’19 and Q1 ’20. We made significant progress in reorganizing and simplifying the structure of our North American third party distribution centre network. In North America, we began the year with 18 DCs and storage locations. As of today, we are at eight, and we will close a further two by the end of Q3. By the end of 2020, we’ll be down to our steady-state number of five DCs: four in the U.S., and one in Canada.

We have also significantly improved our sales and operations planning processes, as well as our freight management processes. Our goal is to ship more cost-effectively and manage inventory flow to minimize storage requirements. We are focused on rebuilding our operations and IT teams, and improving internal and external cross-functional collaboration. Along with the leadership changes made in Q1, we continued to strengthen these teams. We have now implemented our customer-focused teams strategy. These are customer-first internal hubs, focused on a single large customer or customer group, and comprised of a blend of dedicated sales, order management, demand planning, logistics, and credit management team members, all focused on serving a customer or group of customers. These teams are ready to serve our customers as we enter our seasonal shipping peak.

I want to now turn to the balance of 2020. We have made significant process aimed at driving structural cost savings and improvements to get our operating margins back to where they belong. Our overall goal is to spend more judiciously, reallocating overhead spending to improve efficiency and redirecting marketing spend to brands most likely to exhibit strong sell-through in the current environment, all while we prudently manage discretionary spending. Our goal was to enter Q3 with a more refined supply chain infrastructure, and to exit 2020 at a normalized warehousing and distribution run rate. We are on track to do this.

Although we are encouraged by the strength of our POS across almost the entire product line and by the progress we have made with our operating improvements, we are not providing formal guidance at this time. Several factors drive this decision, including the fact that many parts of the U.S., our largest market, continue to see rising cases of COVID. Twenty-twenty is a Presidential election year in the U.S., and in past years in which there has been a hotly-contested election, consumer spending often slows until after the election.

In addition, we are also mindful of other variables, such as possible tariffs, the level of retail store openings, especially specialty stores, and physical e-commerce channel rebalancing, which may impact the timing and mix of orders and replenishment. We will therefore hold off providing a detailed outlook for 2020 and beyond until a clearer picture emerges.

That said, we believe we have an exciting innovative product portfolio and very strong entertainment and digital game content. Our solid financial foundation and diversification has allowed us to weather a challenging nine months. We have made significant progress on many fronts, and believe we are now in much better shape to handle seasonal second half volumes, and we have both an asset light platform capable of generating sustainable long-term growth.

That concludes our formal presentation. Ronnen and I are now happy to take questions. Operator, please open the lines.

Q & A

Operator

At this time, I would like to remind everyone, if you would like to ask a question, press star, then the number one on your telephone keypad. We'll pause for a moment to compile the Q&A roster.

Our first question comes from Derek Dley with Canaccord Genuity.

Luke – Analyst, Canaccord Genuity Corp.

Thanks. This is Luke on the line for Derek.

My first question, the sales losses obviously came in much lower than what you expected. I guess, just broadly speaking, are those non-compliance charges largely behind you now at this point?

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

Yes, we cleared a lot of progress on remediating the underlying causes for those non-compliance charges. As you saw, they were extensive in Q4 and in Q1 as well. That is now trending down, and we believe we are well-positioned operationally to execute well, and if we do that then, the non-compliance charges will continue to decline.

Luke – Analyst, Canaccord Genuity Corp.

Thanks.

I also wanted to follow-up on the colour, Mark, that you gave on marketing expenses, and how you expect that to kind of accelerate, I guess, compared to—relative to 2019 and the back half of the year. I'm just curious, with obviously the trade shows and other events that previously would have been put on in past years and not necessarily occurring this year, I'm just curious to know where you can… Maybe you can talk to where you expect those dollars to be allocated across your marketing programs through the back half of the year.

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

Yes. We held back overall on marketing in Q2 for obvious reasons, as I just described in my script. We do expect our marketing spend in the second half to increase. There will not be things like trade shows and experiential marketing in the second half due to COVID, but we are going to be leaning into other areas, particularly digital.

Ronnen, why don't you describe some of the activities that we're going to be doing in that area?

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

Yes. It's Luke, right?

Luke – Analyst, Canaccord Genuity Corp.

Yes.

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

Hi, Luke.

Our marketing for the third and fourth quarter are going to change considerably compared to previous years. We're taking a digital-first approach to our marketing this year. And the acceleration of the digital shopping, it's moved us from 2020 almost to 2030; we've jumped 10 years in a short amount of time. We're very fortunate that we were on the digital marketing path early on by making some key hires, bringing some people in from BuzzFeed - the person who runs marketing is originally from BuzzFeed - and realigning our team and thinking about our spend.

We've done some fundamental things like bringing our buying in-house, so we buy all our digital media in-house. What that enables us to do is to make real-time changes to the creative; when we see that the effectiveness of the creative is not working, then we can actually change it on the fly, and we can actually modify the buying to match the creative.

The other thing is that, in the past, the marketing was traditionally spent on television or experiential, but now there's so much fragmentation in the marketplace where it goes from linear TV to SVOD, to video games, to influencers, to YouTube, to Facebook, to Instagram, to Roku - it just goes on and on - to echo at Walmart, to different things at Target. With that fragmentation, it really entails actually doing the creatives specifically for the actual medium itself. Traditionally in the past, we would have one bit of creative and we'd use that across all the mediums; now, creative is made specifically for the medium.

You could have, for one brand, over 250 pieces of creative made at a time. That's really the iterative, agile approach to advertising, and the interplay of digital buying that we've brought in-house. You'll see the effects of that in this third and fourth quarter, and we're looking forward to sharing more with you guys in the future.

Luke – Analyst, Canaccord Genuity Corp.

Understood. Last one for me and then I'll pass the line; I appreciate the commentary that you guys gave about how the *PAW Patrol Movie* is still on schedule to be introduced a year from now, in August 2021. I'm just curious if you've had any discussions internally, or with your partners, about maybe changing the distribution method for that movie, just given what's happened with COVID-19, maybe going straight to SVOD or something of that nature?

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

Yes. We're still early. The production, fortunately, because it is animation, is on track and has not been affected by COVID. That being said, it is not easy on any of the animation studios that produce content for us, so we really appreciate the hard effort that everybody's making by a work-from-home environment. But things are on track, and currently right now, we're still in plans to deliver the movie theatrically in the fall of 2021. As we get closer to the time, we'll evaluate some other options if the COVID is still persisting at this high level.

Luke – Analyst, Canaccord Genuity Corp.

Thanks, appreciate the comments.

Operator

Our next question comes from Adam Shine with National Bank Financial.

Adam Shine – Analyst, National Bank Financial

Thanks, good morning.

Maybe one first for you, Ronnen; usually as you guys get through June and July and you have your conversations with retailers heading into the second half, you have a good sense of what they're thinking. Can you maybe talk about or characterize how those discussions were, given the backdrop of COVID? A sense of caution, or with the reopening, a sort of cautious optimism, in terms of, as you alluded to, the replenishment cycle that seems to be lie ahead in the seasonal stronger period?

Then maybe one for you, Mark; just in terms of other, given some of the closures that existed and disruption on the entertainment side in the H1, can you speak maybe a little bit in terms of how H2 other revenue should evolve? The presumption being that we should see some degree of growth going into the second half, on other revenue. Thanks.

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

Hi, Adam. Nice to hear from you.

I would say that we're very fortunate as an industry, where our industry has held up better than I personally expected. We're very fortunate to be in this position.

From a retailer perspective, as we noted in our opening remarks, that there are certain retailers that are doing very well in these categories of goods. But at the same time, I would categorize it as cautiously optimistic. You said it well. I mean, there's still—they're buying, and they're buying in a healthy manner, but that being said, they're cautiously optimistic and there's still some caution in the way they buy and how they buy. I would say that they're being measured, and I think that can bode well for the overall industry, and I think it could bode well for everybody, because retail could end up being very clean come the fourth quarter and set everybody up for a healthy first and second quarter of next year.

It's almost like an opportunity to clean out the inventory, both ourselves in our warehouses, and retail and stuff like that. But I think they're looking to keep their rate of sale high, and inventory levels moving very quickly.

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

Okay, I'll deal with the second part.

Adam, just to add one point to what Ronnen just described, obviously our POS results are significantly higher than shipments right now, so that means retail inventories are being drawn down. Every week that goes by, retailers are getting better line of sight to Christmas, more data points. At some point, they're going to have to step in, offset by the macro caution that Ronnen just described. But overall, we feel optimistic about that.

In terms of other revenue, other revenue, as you know, comprises of licensing and merchandising income, TV distribution income, and app revenue from *Toca* and *Sago*. I think for the second half of the year, as we see a rebound in PAW Patrol and other franchises which we generate a lot of licensing and merchandising income from, we should see a pickup in it. I think it's going to be tempered to some extent by the environment in which we are operating, so we're not expecting to see a significant increase, and that certainly, overall, I think other revenue will be down relative to prior years. But we are seeing a strong increase in app revenue and revenue related to our subscription activities in *Toca* and *Sago*, so there's a nice balance there.

Adam Shine – Analyst, National Bank Financial

Okay. I'm sorry, just to be clear, you think in the second half, there's going to be tempered growth, or an actual decline, year-over-year, in the other revenue line?

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

I think there will be an overall decline in other revenue, relative to prior years.

Adam Shine – Analyst, National Bank Financial

Okay, thanks.

Maybe just one follow-up if you don't mind, Mark, for you. Just in terms of what's happening in Europe, where there seems to be the lack of e-commerce in terms of reliance while there's store closures, is there a risk in regards to any bad debt or other concerns related to potential closures among specialty and other retailers outside of North America?

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

The one thing, Adam, that we are seeing in Europe is that we actually are seeing a fairly significant shift in some of our key retailers towards e-commerce there. Although the U.S. and North America is way ahead of Europe in terms of their capacity and capability, we are seeing that change very rapidly. I'm actually quite encouraged by the way that the industry is shifting towards e-commerce over there, and I think it's accelerating very rapidly.

Having said that, there were obviously some very significant shutdowns in countries like France and Italy, and in the U.K., etc., and that has put the retail industry under pressure, and also in places like Mexico. We have seen an uptick in our provision for doubtful accounts. Just keep in mind that we are credit-insured in all of our major markets; we do have a deductible which is not covered, and we also have some co-insurance. We have seen an uptick but it's very minor. I would have no concerns from your end on any material bad debts or impacts to our receivables during either the rest of the year or next year, because we do have credit insurance policies in place for all of our major markets.

Adam Shine – Analyst, National Bank Financial

Great, thanks a lot for that.

Operator

Our next question comes from Gerrick Johnson with BMO Capital Markets.

Gerrick Johnson – Analyst, BMO Capital Markets

Hi. Good morning.

Worldwide POS up 18 percent, that's pretty impressive. It is second quarter, so won't get too excited just yet. But I wanted to be more specific on POS. Is this a clean number; does it exclude Hatchimals or something like that, and does it include all your retailers, top customers, NPD? What is it based on?

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

Gerrick, in the past we've actually always split that POS, including and excluding Hatchimals. We're not doing that anymore, as Hatchimals is declining as a part of our business. The numbers that you're seeing are all-in, and they include NPD and all other forms of data that we actually get. As you know, NPD doesn't measure everything; they're very extensive and we rely on them extensively and they're excellent, but we also have our own other tracking mechanisms. This represents our numbers in terms of what POS represents.

Gerrick Johnson – Analyst, BMO Capital Markets

Okay. Maybe if I could drill down a little bit more specifically, since we are comparing retail versus retail POS for shipments; it could be a little bit apples to oranges there, because your shipments are to everybody, and if your POS is only a slice of it… Is your POS covering 100 percent of your customers, 80 percent? That's what I'm trying to get at.

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

I actually don't have a specific number for you that says our POS covers an exact proportion of our customer base, but obviously our shipments are to the whole market. The POS numbers that we have is to a large segment of the market, but it's not 100 percent. We don't get POS from every single retailer around the world, so there is an element of a disconnect with that, but I think that's true for everybody in the industry.

Gerrick Johnson – Analyst, BMO Capital Markets

Yes, definitely. The NPD numbers are overstated, because you don't have those small specialty retailers included that have obviously been closed and backlogged.

But moving on, the massive declines in international kind of match real performance of some of your brands, and I know, Mark, you talked about a couple, but you went a little quickly and I might have missed. But could we talk maybe in terms of North America only, your performance of some of your key brands? I'm most interested in PAW Patrol, Bakugan, Hatchimal, and then Games and Activities, how they performed, both shipments and retail, in North America only?

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

Sure. In North America. Are you talking about for the quarter?

Gerrick Johnson – Analyst, BMO Capital Markets

Yes.

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

Okay, let me just refer you back to what we said. Overall, POS in the U.S. was up 23 percent. In the U.S., PAW Patrol was actually down 1 percent in Q2, from negative 17 percent in Q1, and overall, the U.S. to-date decline in POS is 10 percent. Currently, we're seeing that POS even grow further. Kinetic Sand POS is up triple-digits, and really, if you actually look at what's happening right now in the U.S., current POS continues to accelerate.

We've seen continued strength driven by features at Walmart and Target, and the Dino SKUs are beginning to set, so that's driving POS up at PAW Patrol. Kinetic Sand remains a triple-digit POS growth. Cardinal and board games and puzzles are showing high double-digit growth POS. Bakugan POS has picked up to mid-teens; it was actually lower than that in the quarter. Bakugan, as you know, was affected by COVID in Q2 itself. Monster Jam is showing consistent, 20 percent plus POS growth, and POS for Batman and DC are solid.

The negatives, from a POS perspective, are Hatchimals and Dragons, which are both down double-digits from a POS perspective. Just one interesting data point - it's not materially in dollars - but Etch A Sketch is showing very strong double-digit POS growth due to the introduction of our licensed lines, so that's an interesting data point on one of our acquisitions. Hopefully that helps you.

Gerrick Johnson – Analyst, BMO Capital Markets

Yes, that does, that's very helpful and I appreciate it. Yes, on Etch A Sketch, we've been seeing the big programs out there, they look excellent.

One more for me, similar to Luke's question; it looks like your DC movies for next year, *Batman*, I guess, are still on schedule, so is *PAW Patrol*. How are you thinking about entertainment next year, because it looks like we're going to have a huge log jam with everything moved into 2021; *Minions* moved, you still have *Jurassic World*, you still have *Ghostbusters* moved, all the Marvel movies moved. How are you thinking about those programs next year? Does that give you some pause with all the other stuff cluttering the landscape?

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

It's a good question, Gerrick. First of all, hi, how are you doing?

Gerrick Johnson – Analyst, BMO Capital Markets

Hi, Ronnen.

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

I'd say with *PAW Patrol*, I mean, there really is not a lot of offerings in the feature film area for the younger set, so I think we really stand alone in that space. Then when you look at things like *The Batman* and DC movies, it's going to be interesting. They're going to be fighting it out for audience share and stuff like that. But I think that when you look at the strength of the franchise itself, when you look at Batman, it has such a strong franchise. It's holding up right now, not even in a movie year, quite well. I also put a lot of, let's call it emphasis on the product line itself. I mean, our team has put an incredible program together, and you see the results in the sales themselves with the product, and I think they'll do the same with an exceptional product line that will match the movie in the theatres.

I think at the end of the day, that the underlying property is extremely strong, and the product will match it very well. I don't know whether or not if theatre receipts will be down a little bit, whether or not that will affect the overall sell-through of the line. But it's yet to be determined, and you don't know whether or not—there's a lot of uncertainty, so things may continue to move, and people may move their movie to 2022. We don't know, so we'll see.

Gerrick Johnson – Analyst, BMO Capital Markets

Yes, okay. Great, thanks, Ronnen.

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

I think it's something we should drill down a little bit more, probably on the next call or the call after that.

Gerrick Johnson – Analyst, BMO Capital Markets

Yes, okay. Sounds good. Thank you guys.

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

Thanks, Gerrick.

Operator

Our next question comes from John Garfinkle with Scotiabank.

Jonathan Garfinkle – Analyst, Scotiabank

I'm stepping in for George Doumet.

I just had a couple questions. There have been a lot more online sales that typically have a larger impact on Q4 compared to Q3. I was wondering if you could quantify the new seasonality in terms of gross product sales in the back half of the year.

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

Yes, so typically the second half of the year comprises around 70 percent of our sales, give or take a few percent either way. If you go back to the days where Toys R Us was in existence, typically Q3 was around 45 percent and Q4 was around 25 percent. With the growth in online, with the demise of Toys R Us, we've seen Q3 decline and we've seen Q4 increase, and I think we'll see the same trend this year. I'm not going to give you specific factors or specific percentages, because we're not giving guidance, but I think you will see a shift towards more domestic, and you will see a shift towards a larger Q4 as a result of more domestic due to online just-in-time type buying, than you have seen in prior years.

Jonathan Garfinkle – Analyst, Scotiabank

Okay, great. Thanks for that.

Just one more for me; I was wondering if you could break out the percent of gross product sales under a normalized environment that you generated from specialty stores as a whole, and maybe by geography?

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

Yes. We don't break that out specifically, but I can tell you, it's actually very small. Our specialty business is actually quite minor, it's in the low single-digits in terms of our total volume. I don't know what the exact number is, but it is quite small.

Jonathan Garfinkle – Analyst, Scotiabank

Okay, thanks for that.

Operator

Our next question comes from Steph Wissink with Jefferies.

Stephanie Wissink – Analyst, Jefferies Inc.

…might have been asked, but I have two bigger picture questions. Ronnen, this one is for you; it caught me off guard a bit when you talked about, in your prepared remarks, that profit is more important than sales, or profit versus sales. Maybe just extrapolate a little bit on that, respecting that you are a large shareholder yourself. Can you help us think through the balance of the agenda between protecting profits and growing the business?

Then secondly, Mark, this one's for you. It also struck me that you talked about Mighty Express as a shift to a full franchise model versus what you had with PAW Patrol. Can you maybe just walk us through some of the financial articulation of that just so we can go back and refer to the differences between the two, in terms of how the financial structures work to your benefit? Thank you.

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

Hi, Stephanie.

I think that, at the end of the day, I mean, growth and profitability have to go hand-in-hand. They're both equal and they're both important to the Company. We stumbled last year from a profitability perspective, and we're working very hard to remedy that and to fix it and make sure that the Company is set up from a profitability perspective, first and foremost, so that when you layer on the growth and you take the growth, you can maintain the profitability at the same time.

Don't misunderstand my comments in terms of growth; I mean, we're constantly out there planting seeds and producing lots of television shows and movies, and developing new product lines, and doing everything we do and growing in the digital area. But everything has to be done in a measured approach so that we don't give back profits at the end of the day. It's managing the two, and I'm happy you asked the question because there's such an interesting interplay, when you look at inventory. At the end of the day, you're shipping a lot of inventory in the third and fourth quarter, but then you end up paying the price in the first and second quarter with markdowns and allowances and things clogging up at retail, and then your POS going down and your new themes can't get traction.

We’re really pushing the Company to be really a best in class operator, on top of a best in class innovator, on top of a best in class growth company, and all three things combine together. I think it’s a different skill set, and I think the days when we went public in 2015 and ’16 and we had this big rise of Hatchimals and it was hundreds of millions of dollars and stuff like that. But it’s a different Company today, when you’re diversified and you have 28 offices around the world and you have a company like the Games division, and you have a Plush company, and now you have mobile studios in Europe and in Canada, and your entertainment production office is much bigger than it was before and you have way more productions happening. The Company is just way more diversified, and I think that just takes a different mindset to operate. I think we’re on this beautiful transition to being those three things that I just described before.

Then just in terms of—maybe, Mark, I’ll take—just in terms of Mighty Express, in the way we’re structured with PAW Patrol, it’s really an amazing partnership with Nickelodeon, and Nickelodeon handles all the licensing and merchandising; they do all the style guides that all go out to the partners. They work with the partners, they do all the retail meetings for PAW Patrol; they help promote the franchise itself. With Mighty Express, this is our first foray into Spin Master managing the franchise first and foremost. We’ll be producing the style guides, we’ll be actually bringing on all the various different licensing partners; we’ll be doing all the retail campaigns.

You’ll see in the third and fourth quarter a lot of spending that will go to actually promote *Mighty Express* and drive viewers actually back to Netflix, to watch the show. You’ll see other marketing activities, plus lots of content activities to actually build out this franchise in what I would say is a new point in time with how kids view content.

As a result of that, we've staffed up and we have a new Head of Franchise, which is reporting in to Jennifer Dodge, and building out the team. As a result of that, we will be garnering a larger share, or a much bigger share, of the licensing and merchandising revenues, if we'll be so fortunate that Mighty Express will connect with the consumer.

Stephanie Wissink – Analyst, Jefferies Inc.

That's great. Thank you so much, Ronnen. Appreciate it.

Operator

Our next question comes from Sabahat Khan with RBC Capital Markets.

Sabahat Khan – Analyst, RBC Capital Markets

Thanks and good morning.

Your comment earlier around increasing marketing spend on some key brands through H2; I guess, should we assume that's primarily focused on PAW Patrol, or are there other brands that you're looking to increase investment behind over the next quarter or so?

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

I think that it goes across pretty much the whole portfolio, Saba. As Mark shared with you, with the POS numbers, we're having good traction in the marketplace, and to keep that traction going, we've got to support it with marketing across the board. There is a whole host of marketing activities that are going to happen. Again, as I mentioned, slightly different than previous years, because of all the digital shopping and the transformation to digital that our society is seeing, but everything's going to be supported. Obviously, there'll be more support in some of the larger franchises, but Monster Jam, Bakugan, Activities, Games, Kinetic, PAW Patrol, everything.

Sabahat Khan – Analyst, RBC Capital Markets

Okay. Then on your DC Comics agreements, I guess the licensing agreements that you have with Warner Bros., just probably I should expect from the whole industry, but I guess depending on how those timelines move and some of the minimums that you may have agreed to, I guess, is there room for some flexibility there as you move into 2021 and the outlook is somewhat unclear on the movie release schedules and so forth?

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

Yes, I think if it moves into '22, it's still part of our overall deal with them, so I wouldn't see any risk there.

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

Saba, were you referring to minimum guarantees and advances and those kinds of issues?

Sabahat Khan – Analyst, RBC Capital Markets

Yes, exactly, just on the economics of it, yes.

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

I don't know the specific details of the deal, but I think they're great partners and I'm sure that there is some flexibility in there. But I would also say that there's—I can't speak to the specifics of the deal, I think it's not probably appropriate on the call either, but I would say that I don't think it's an issue.

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

In general, I would say, Saba, we're aware of all of these issues with all of our license agreements, MG's (phon), advances, whatever. We're not currently seeing any major issues or concerns. We have good relationships with people and if something was to need to be negotiated for whatever reason, then I'm sure we'd have a reason for business conversation. But there's nothing that's front and centre right now in any way.

Sabahat Khan – Analyst, RBC Capital Markets

Great, thank you.

Operator

Our next question comes from Brian Morrison with TD Securities.

Brian Morrison – Analyst, TD Securities

Hi. Good morning, guys.

For the interest of time, I'll keep this short. Just on the supply chain where you've obviously made good progress, I want to understand, Ronnen, just quickly, the back-up plans you have in place as you rationalized the footprint down to five at year-end.

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

First of all, Sophia's hitting her head because she's embarrassed about the ambulances outside, but I'm happy you guys are hearing this because now you know that we're actually in the office.

Brian, I think that, I would say that what we had before was one of the most bloated, inefficient, strange warehousing distribution set-ups. I'm embarrassed by what we actually grew into, and we're going back to something that, like what Mark stated, is something that we've had traditionally for many, many, many years. I think if you look at us compared to our competitors, it's a very similar warehouse and distribution footprint: one in Canada, which is more than enough to cover the country, and the four that we have in the United States. Even the four, I think, is probably one too many, but we'll net out there.

I'm confident that we're going to the right spot, plus also, I can tell you that our partners, the engagement. More important than anything else, the engagement of our partners is so high now. We have top relationships. We have CEO to CEO meetings with our teams and their teams, with our warehouse at DFC (phon), the CEO, he calls in from Europe. He's there every two weeks on our meetings.

The CEO on our East Coast warehouse is there all the time. Our freight boarder, Robinson, the CEO's very engaged. All our partners, more than our structure, everybody's really engaged, and the integration between the teams is the highest it's ever been. Our systems and our EDI setups between the warehouses and our visibility is far better than it's ever been before.

I think it really comes down to part is the structure, and the one SKU, one location which is really imperative, which simplifies everything for us, and also the connectivity between our teams and our people and the collaboration; and also the visibility, the sight lines for the products coming in, on the water, when they're coming, how many pallets we have in each warehouse, pallet per brand, what's going down. We also have different things like year-end targets now. It's much more—it's very interlinked.

But again, just going back to your original question and comment on warehouses, I think that we're set up with the right amount to service our customers and get our customer levels back to where they need to be, and also set ourselves up to supply for this e-commerce world, which is really becoming a big deal.

Brian Morrison – Analyst, TD Securities

Got it. A follow-up then, Mark, just point blank, you did say exit 2020 at normalized distribution levels. Is the message here that we should expect a recovery toward normalized EBITDA margins in the back half of 2020 and then for 2021 to be at historical margins for the year, or to achieve a run rate of historical margins in 2021?

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

Brian, you asked me a point blank question, I have to give you a point blank reply. I mean, we're not giving guidance, right? We're not being that specific on guidance. But directionally, what you're saying is what we're trying to get to. We've actually now positioned ourselves to be in a position to get back to normalized margins, but we have to execute. Really, what it comes down to for the second half of 2020 for Spin Master is execution. I think we've done all the right things to get us to the point where we can execute, and now we've got to do it.

When we exit 2020, as I said to you before, 2020 will obviously, as a year, not get us back to where we want to be. But going into 2021, we want to be at those run rates where, for 2021, we'll be operating at levels that you and the market have come to expect from us.

Brian Morrison – Analyst, TD Securities

Excellent. One last small one, in terms of the strong ratings of *PAW Patrol*, are you seeing any shift in the demographics of your audience with the new theme? Are you seeing an expansion of it with the *Dino* added?

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

It's interesting. I think the answer is yes. I think that the themes, if you watch - and I encourage everybody on the call to watch the latest theme, because it's amazing - it's slightly aged up versus the traditional *PAW Patrol* show that we make. I think that that actually enables us to get a wider breadth of audience where we can still capture some six and seven year olds. It's funny, I think the themes give the older kids some cover over their younger siblings, where they're watching a themed version of *PAW Patrol* versus watching the traditional *PAW Patrol*.

I think that themes, at the end of the day, and things like the movie are enabling us to keep the fans into the franchise longer, so I think the answer is yes.

Brian Morrison – Analyst, TD Securities

Thank you.

Operator

Our next question comes from David McFadgen with Cormark Securities.

David McFadgen – Analyst, Cormark Securities

Hi. A couple of questions. There's been a few questions asked about the *PAW Patrol* feature film, and I was just wondering if you could tell us what the level of capital is at risk, or if you can't get specific, is there anything to be worried about, just given what we're seeing in the theatrical market here with people pulling films and so on?

Then secondly, you gave us an outlook on the gross margin you expect for the second half of 2020. I was wondering, can you give us something similar for the selling, marketing, distribution, and product development expenses as a percentage of revenue?

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

Yes, so in terms of the *PAW Patrol Movie*, I think that we're on track right now to finish the film and have the film ready to go to a wider audience. We'll see closer to the time if the theatrical is the right option for it, but what we're seeing in the marketplace, if you look at things like *Trolls* that changed their strategy last minute as a result of COVID, they were still able to garner a huge audience share and also garner a lot of revenue as a result of it.

Other options have emerged as a result of COVID that give optionality for us, for *PAW Patrol*, and we'll look at the optionality closer to the time. But right now, we're on track for the theatrical. If COVID persists, we'll look at all options, but the fans are there and the fans are excited to see something like a theatrical, and the content is very different from a traditional TV show.

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

Yes, so again, I've got to be a little careful in terms of forward-looking numbers. If you look at historical numbers and if you look at the breakdown of SG&A, SG&A as a total of percentage of revenue has been as low as 38 percent in 2018. That's directionally where we want to be back to. I think it's going to take us a little while to get there, and obviously as our top line has compressed, we've seen de-leveraging from an operating leverage perspective. As we continue to grow, that will help us as well.

But if you look at the major components, warehousing is running close to 7 percent, and that really should be at around 5 percent or below; marketing is typically at around 10 percent of sales; selling expenses are typically around 7 percent of sales, depending on product mix - that's totally variable; product development typically runs at around 2 percent of our sales; and then you have admin, for the balance, at around 15 percent or 16 percent. That gives you the cost structure, effectively, David.

David McFadgen – Analyst, Cormark Securities

Okay, great. Thank you.

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

We'll make this the last question, Operator.

Operator

Our last question comes from Gerrick Johnson, BMO Capital Markets.

Gerrick Johnson – Analyst, BMO Capital Markets

Hi. Good morning again. Brian wanted to keep it short, I want to keep going.

Two quick questions, I guess. FOB versus domestic, that's been in flux over the last couple years, shifting more to domestic versus FOB. But how are things looking this year relative to last year on that shift between the ways of fulfilling, and how is your distribution system, how are you setting that up? What are you planning for in that regard?

Then just if you could be a little bit more specific on what proportion of your stores that you sell through on a retail basis were closed in the quarter: how many were closed at the beginning, how many were closed at the end, and how's it looking right now?

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

On the FOB versus domestic, Gerrick, just for context for everyone on the line, if you go back historically to around 2018, our FOB was around 60 percent of our sales, domestic was around 40 percent, give or take a few points either way for the longest period of time. That was with TRU in the market. Then in 2019, things shifted; TRU was not around anymore. We had our own issues in terms of bringing more in domestically, and we had tariffs and we had the whole issue and debacle in 2019, as you know.

What we said at the time and what we've continued to say is that we think a mix of around 50/50 is the right place for us to be. There's obviously no specific wrong or right answer here; this is a negotiation between us and retailers, and it does depend on product lines. Having said that, in 2020, because of the large inventory carryover balance that we had, we've seen for the first half of 2020 a much higher domestic versus FOB ratio, particularly because we've had all this inventory on-hand and we needed to actually clear it out. For the first half of 2020, our dom ratio was 60 percent compared to 40 percent FOB. Now, that will shift in Q3 as we'll ship some more FOB, but as online continues to grow in the industry and for Spin Master, we'll see a trend towards more dom. I would say to you, we are planning to be at around 50/50. I think we'll be slightly higher dom for this year than that target, but that's directionally where we want to be.

In terms of store closures, to be honest, I know some of our larger competitors actually track specific numbers of stores, but we actually don't have that data. I would say to you, from a commentary perspective, we've given you the data on our top three. In the U.S., department stores and toy specialty stores have been very badly affected in Q2, as you know. Some of them are beginning to open; some of them may never reopen.

In Europe and France and Italy where there's a much bigger specialty market, I think things are starting to re-emerge there, but again, some may never reappear. But we don't have the specific data, Gerrick, that you may see from our other larger competitors.

Gerrick Johnson – Analyst, BMO Capital Markets

Okay, fair enough. Thank you, Mark, appreciate it.

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

Okay. Operator, I think that concludes the call. I'd like to thank everybody. We did go over extra time just to give you more information and more insight. We appreciate your interest, and we look forward to seeing you in November for our Q3 results. Thanks everyone.

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

Thanks, guys.