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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Mattel, Inc. Third Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to introduce your host for today's call, Whitney Steininger. Ms. Steininger, you may begin.

Whitney Steininger - *Mattel, Inc. - Investor Relations*

Thank you, operator, and good afternoon, everyone. Joining me today are Margo Georgiadis, Mattel's Chief Executive Officer; Richard Dickson, Mattel's President and Chief Operating Officer; and Joe Euteneuer, Mattel's Chief Financial Officer.

As you know, this afternoon, we reported Mattel's 2017 third quarter financial results. We will begin today's call with Margo and Joe providing commentary on our results, and then we will provide extended time for Margo, Joe and Richard to take your questions.

To help guide our discussion today, we have provided you with a slide presentation. Our discussion and our slide presentation will reference non-GAAP financial measures such as gross sales, adjusted gross margin and adjusted gross profit, adjusted selling and administrative expenses, adjusted operating income or loss, adjusted earnings or loss per share from which we exclude the impact of a $562 million noncash charge related to the establishment of a valuation allowance on U.S. deferred tax assets and constant currency. Our earnings release also includes non-GAAP financial measures. The information required by Regulation G regarding non-GAAP financial measures is included in our earnings release and slide presentation, and both documents are available in the Investors section of our corporate website, corporate.mattel.com.

Before we begin, I'd like to remind you that certain statements made during the call may include forward-looking statements relating to the future performance of our overall business, brands and product lines. These statements are based on currently available information, and they are subject to a number of significant risks and uncertainties that could cause our actual results to differ materially from those projected in the forward-looking statements. We described some of these uncertainties in the Risk Factors section of our 2016 annual report on Form 10-K, our 2017 quarterly report on Form 10-Q, our earnings release and the presentation accompanying this call and other filings we make with the SEC from time to time as well as in other public statements. Mattel does not update forward-looking statements and expressly disclaims any obligation to do so.

Now, I'd like to turn the call over to Margo.

Margo Georgiadis - *Mattel, Inc. - CEO*

Thank you, Whitney. Good afternoon, everyone, and thank you for joining us for our third quarter 2017 earnings call.

Our Q3 performance was clearly disappointing. Results in the quarter reflect continued challenges in The Toy Box and certain underperforming brands exacerbated by the TRU Chapter 11 filing. Despite these challenges, we continued to make strong progress against the transformation plan we laid out in June.

A critical step in our progress is announcing today a significantly expanded initiative to structurally simplify our business and right-size our cost structure in alignment with our strategy. This will unlock substantial resources to invest in our transformation plan and enable us to drive toward the growth and profit targets we discussed at Investor Day.

On today's call, I will provide an overview of our performance in the third quarter and related drivers. I will then show the progress we've made implementing our transformation plan and the road map to selected near-term milestones. Then our new CFO, Joe Euteneuer, will provide further color on our Q3 results and discuss in detail our action plan to right-size our cost structure and reshape how we run our business. Joe will also discuss the timing of upcoming investments and our broader capital strategy, including how we plan to fund our transformation plan. Richard is also here to discuss operations, brand and marketing strategy during the Q&A portion of the call.

Moving on to our third quarter results. Overall results were significantly below expectations. In terms of revenue, international was stable, led by continued growth in Asia. However, the North American business was down 22%. We believe this is somewhat of a unique quarter, and we do not believe it reflects the underlying health and growth potential of this company. This decline is also a departure from what we expected when we spoke to you in June, so I will discuss the drivers in detail.

About half of the North American revenue decline was driven by TRU. About 1/4 of the decline was driven by tighter retailer inventory management, and the remaining quarter was driven by continued challenges in our Toy Box and certain brands. Fortunately, we believe that a majority of these issues are not long-term in nature and expected to turn around over time. I'll walk through each of these impacts in more detail.

The TRU Chapter 11 filing was a significant drag on both revenue and profits in the quarter as we began to reduce shipping in early September due to significant concerns about the potential toward the TRU Chapter 11 filing. We then had to reverse certain revenue in connection with their filing, and we were hit disproportionately compared to our peers, given the higher proportion of sales we realized through TRU. As I mentioned a few minutes ago, tighter retail inventory management accounted for about 1/4 of the revenue decline in Q3. Although we had worked through the Q4 inventory overhang in the first half of the year, we continued to see divergence between POS and shipping into the third quarter.

After in-depth assessment, we have identified 2 principal drivers of this divergence. The first driver is key retail partners moving towards tighter working capital management. We believe that we have been hit harder by this trend due to the evergreen profile of our power brands, which allows retailers to more predictably forecast in-stock levels and hold less inventory. The second driver is our decision to transition to lower levels of retail incentive programs in 2017 relative to prior years. At the end of Q3, key retailer weeks on hand for our power brands were approximately 15% to 20% below 2016 levels. Over the last few weeks, we have seen some stabilization in retail partner weeks-on-hand. However, we will monitor this closely and do expect some ongoing downward weeks-on-hand pressure due to the continuing shift to e-commerce.

The remaining quarter of the revenue decline is due to continued losses from certain underperforming brands. The biggest challenges have been in The Toy Box, in particular, with Monster High, Ever After High and MEGA, as well as a fragmented long tail of launches, which have more than offset positive gains elsewhere. In addition, as we shared in June, American Girl and Thomas remain in turnaround. Our action plans are well underway, and we expect to see benefits of this in 2018. In the third quarter, American Girl results were particularly stressed by comping revenue from a large partnership deal in the Middle East.

Turning to margins. The challenges in the quarter, which were largely concentrated in North America, continued to sharply compress margins in Q3. Given the importance of this to our quarterly results, Joe will provide a detailed explanation in a few minutes. Despite these challenges, we saw several positive trends during the quarter. Barbie is growing POS double digits globally and accelerated each quarter this year. As we shared at Investor Day, Barbie is the farthest along in developing physical systems of play and experiences, which demonstrates the clear benefits when we execute our strategy. We have continued to innovate our core doll play pattern. Diversity is working and driving strong sales improvements for Barbie and Ken. We also continue to enhance the physical system of play with careers, which is accelerating alongside momentum in campers, horses, houses, travel and more. Our social community development on Instagram and new content programs such as Dolphin Magic on Netflix and Dreamtopia on YouTube Kids are driving excitement for our brands and products. And we still have a lot of runway to go further with both physical and digital systems of play, consumer products, gaming and a broader content slate.

We also are pleased with the performance of Cars 3. We are executing this well in close partnership with Disney and our retail partners. And despite challenges with TRU, we expect to come close to our original target. This is just one example of the strong partnerships we continue to invest in to build top partnerships with Disney, Warner Bros., Nickelodeon, Universal and WWE.

Enchantimals is another successful launch for us this year, with strong sales performance across our top launch markets, driven by compelling content. In its first year, we expect Enchantimals to achieve top quartile performance among doll launches, with excellent user engagement in our content and more expansion planned for next year.

Hot Wheels is sustaining solid single-digit growth in POS, with double-digit growth in Latin America. We continue to introduce excitement into the core car line as well as to improve our physical play system with higher-quality play sets and interconnected track and construction systems. Our strong content, "Make It Epic," on YouTube and hotwheels.com is helping to fuel brand passion and purchase expansion.

Our core Fisher-Price business is generating consistent single-digit POS growth globally, with acceleration in China, where we are delivering a strong omni-channel experience for parents. China is one of the largest populations of new babies being born globally and also is now the second largest market for Fisher-Price. So we believe there is significant upside potential ahead for this brand.

As we look to Q4, we expect our key power brands and our Cars franchise to perform well. We are well represented on top toy lists across top retail partners, we have strong marketing investments against our top brands and we have substantially improved our digital execution to ensure we are in step with the shift to online. At the same time, we expect continued drag from some of the issues we saw in Q3 and also intend to make the tough decisions necessary to right-size our portfolio before the end of the year.

As it relates to our full year, we will clearly not achieve the top line expectation we discussed in June due to the factors I discussed earlier. Importantly, we are taking the necessary actions now to reposition for the future with a priority on ending the year clean on inventories at retail and working through the long tail of previous product launches. We have conviction that this is the best decision for shareholders and enables us to move faster toward the results we expect in the medium term.

In June at our Investor Day, we said that we would come back to you with more detail on our transformation plan, including how we will reshape and streamline our business model and how we will fund the investment plan. We discussed self-funding $150 million to $200 million of our transformation plan investment needs with cost reduction and reallocation. We also reconfirmed our previously announced $240 million gross supply chain anti-inflation program designed to offset the rising cost of labor, resins and packaging, which we expect to achieve through the course of 2018.

Now that I have my new management team assembled, we have a clear view of the right-size structure we need to execute our strategy. We believe we can reshape our business through portfolio simplification, organization realignment and an optimized number of product launches, which will allow us to eliminate significantly more costs than we articulated at Investor Day.

After reviewing and realigning all lines of our P&L, we plan to eliminate at least $650 million in net costs over the next 2 years, up from $150 million to $200 million, through a structural simplification initiative, including manufacturing, product, SG&A and marketing, to ensure our spending is right-sized to support our path forward. Our review of the unnecessarily high number of SKUs and product launches from the last few years and benefits from better aligning incentives across our functions gives us confidence that we can deliver much greater savings and better focus our business on our most attractive opportunities. This more significant cost reduction from structural simplification will help us reposition our business more quickly to deliver on our medium-term transformation targets for revenue growth and margins that we shared in June as well as to fund our planned investments.

We intend to invest approximately 1/4 of this savings or $170 million over the next 2 years as the foundational spending for our transformation plan. Our priority focus will be investing in areas that present the greatest near-term potential to drive revenue and margin improvement. These investments will focus on four areas: omni-channel capabilities, which are critical to capturing e-commerce and revenue growth; emerging markets, where we have a demonstrated track record of accelerated growth; IT, to improve line architecture, demand planning and forecasting, which are essential to future margin improvements; and content and gaming, which underpin the development of our brands and present meaningful revenue and margin opportunities.

In terms of investment to build out our connected systems of play architecture, we have determined that we can repurpose existing spending to fund this strategy. We believe next-generation connected play systems and technologies can become a meaningful portion of our product mix over time. We estimate this can contribute 15% of revenue with attractive margins and strong customer engagement in the medium-term. We will use the most efficient approach to both our own development and partner development in a stage-gated manner. As discussed at Investor Day, we have already begun to make some investments in our strategic initiatives, which Joe will discuss in a few moments. Joe will also provide more detail on our structural simplification initiative and broader capital funding strategy.

I will now walk through our progress to-date, implementing our transformation plan. At our Investor Day, we outlined 5 strategic pillars: build power brands into connected 360 play systems and experiences; accelerate emerging markets; strengthen our innovation pipeline; reshape operation; and reignite culture and teams. We have made progress against each of these pillars, and I will describe and discuss near-term milestones for the remainder of 2017 and '18.

The foundation to accelerating our progress is streamlining our organization and putting in place our new leadership team. We have made a number of key strategic hires, bringing on a new CFO, CTO, CCO and Chief People Officer, plus a new Head of Manufacturing and a new Head of Product Development. All of these leaders with proven track record in organization transformation. We have a world-class management team with full alignment to execute our strategy.

In terms of 360 play systems and experiences, we are taking action to unlock growth potential in our power brands. As I shared in Q2, we launched and have completed an in-depth consumer journey and segmentation effort to anchor our brand portfolio and define specific roles and growth priorities for each. We now have detailed maps and action plans for how we will build out our physical and digital play systems and experience with deep focus on our top 3 power brands. This consumer and competitive segmentation analysis has reconfirmed the headroom for us to grow our power brands. We estimate that Hot Wheels has the potential to grow to 2 to 3x; Fisher-Price, 2x; and Barbie, 1.5x, over time. To accelerate our content efforts, we are in the final stages of regaining control over unexploited content rights for our power brands. This enables us to build a slate of premium content for our power brands and pursue more strategic deal making across our partners to unlock value from one of the best portfolios of kids and family IP in the world.

Looking ahead to 2018. For Barbie and Hot Wheels, we believe we can gain share across markets to continuing to build out physical systems of play. We believe our core Fisher-Price business can regain consistent growth across top markets by re-anchoring on its learning and development heritage as a partner to help parents provide their children the best possible start. This global program will take best practices from China and omni-channel engagement and expand them across top markets. We expect to stabilize Thomas into next year. We announced recently that our refresh content is now complete. As a result, we are poised to take Thomas global, and we'll be activating with leading kids content platforms and major networks in the coming months. We expect to stem the decline in American Girl by executing the turnaround actions we have shared previously and are excited about the opening of the new flagship store in New York City this November. We are on track to launch 2 next-generation connected products that are truly interactive and provide a new customer experience. Sproutling, launched this week, is a breakthrough product for parents that collects baby's heart rate, sleeping position and motion to provide insights into baby's sleep pattern. In fall 2018, we plan to launch a next-generation connected Hot Wheels experience. In terms of gaming, as I laid out in June, we have made great progress on scaling our global publishing, marketing and analytics capabilities and are on track to launch two AAA new game titles next year in partnership with leading global development partners.

Looking at emerging markets. We remain on track to scale China 3 to 4x as we shared at Investor Day. We are growing strong double digits and gaining market share in China, led by our leading consumer and digital first approach, as Jeff Wang shared at Investor Day. Our direct parent engagement and our learning and development benefits, our commitment to systems of play and our strength in e-commerce underpin our success. China is a benchmark for the powerful impact our new strategy can have on our business across products.

Looking to the rest of 2017 and 2018. We believe we will continue to gain market share, led by digital partnerships across BabyTree, Alibaba and JD.com. Our Fisher-Price led parenting platform with over 250 pieces of curated parenting content and play tips launched recently to great success on BabyTree. It will also launch soon an Alibaba at the 11/11 major holiday, which will expand our direct reach to millions more moms. This parenting platform effort will expand this fall on BabyTree with an assessment tool that enables customized parent recommendations based on the development needs of each child. In addition, our learning center partnership with Fosun is progressing, with our first center scheduled to open in the first half of 2018.

Looking at The Toy Box innovation pipeline. First, we continue to grow our investment in providing best-in-class relationship management for our top licensing partners, Disney, Universal, Warner Bros., Nickelodeon and WWE. Our global retail execution for Cars is exemplary. We continue to focus on superior product design and collaboration with all of our partners. We are passionate about their brands and creating breakthrough product lines to excite kids and collectors.

Our Jurassic World line for 2018 is a great example of this commitment and impact as we continue to receive rave reviews from retailers across the globe. In addition, we continue to develop co-production opportunities and expect to announce at least 2 new co-production deals with top media partners.

Second, we are streamlining our portfolio of smaller brands and new launches. For example, this year, we trimmed the number of brands by 30% from a high point in 2016 to enable us to better focus execution on the most important opportunities. Our success with Enchantimals and Kamigami are good examples of how we can execute better with increased commitment and focus. We plan to trim our launches for 2018 another 20% to enable us to drive greater impact from our investments. To underpin our successful transformation, we are aggressively reshaping our operations to be leaner, faster and smarter, unlocking the foundation for faster revenue growth and step change margin gains.

Here's a quick progress report. We are on track with the initiatives we shared at Investor Day to reset our commercial operations with a focus on winning share in an omni-channel world. We also have launched our plan to create a streamlined and modernized IT infrastructure across our business led by our new CTO, Sven Gerjets. Our supply chain continues to gain speed as Peter Gibbons discussed in June. His team is on track to reduce time-to-market by 50% versus the historic 12 to 18 months. We are already driving multiple products through this new approach with 4 new products launching recently through our accelerated process, all hitting in 3 to 9 months. This quarter, we launched our new control tower, which, as Peter Gibbons previously mentioned, is designed to radically improve demand and supply chain planning while lowering inventory and improving service. We are in the process of implementing a zero-based budgeting process for all areas across the company to better optimize and allocate existing spend to drive our key strategic pillars. We plan to reduce SKUs in double-digit percentages in 2018 and 2019 through brand product line optimization, smarter localization and merchandising differentiation. We are reassessing plant infrastructure and plan to announce a reshape of our manufacturing footprint in early 2018.

We also are deeply invested in reigniting our culture. We are excited about how our wonder values are being embraced across the company, driving increased focus on creativity and collaboration, which is critical to supporting our transformation. We are reshaping the incentive system to better align with key performance metrics, which Joe will talk more about later.

In summary, we have made substantial progress in restructuring our organization so that we can operate more effectively in terms of strategy, planning, incentives, resource allocation and organization execution and, in turn, accelerate margin improvement and growth. The significant structural simplification program now in place is the foundation for jump-starting profit improvement as well as funding our transformation plan. Despite the current challenges, we continue to believe in the future of Mattel. We own some of the most iconic brands in the world with a demonstrated ability to transform and meet the demands of tomorrow's kids and parents. We are in a growing industry and well-positioned in the fastest-growing market. We believe the progress we are making illustrates momentum and will allow us to capitalize on our enormous headroom for growth. We are optimistic about the road ahead, but we recognize the need to make the tough decisions to address and resolve current issues and rigorously shape the business to capitalize on the many opportunities before us.

We appreciate your support as we continue to execute on the transformation of Mattel for the future. We are deeply committed to restoring profitability and delivering our transformation plan and maximizing long-term shareholder value.

Now, I will turn it over to Joe.

Joseph Euteneuer - *Mattel, Inc. - CFO*

Thank you, Margo, and good afternoon, everyone. I am very pleased to join the call today, my first as Mattel's CFO. Let me begin by saying that I am thrilled to have joined Mattel during such a pivotal time in the company's history. I was drawn to Mattel by its rich heritage, portfolio of iconic brands and impressive partnerships. In addition, the leadership team Margo has assembled truly exemplifies the core values I believe in: partnership, accountability and execution. And I look forward to leveraging my past experiences as we work together to bring Mattel back to historic performance levels and develop a path for future sustainable value creation, growth and industry leadership.

Since Margo has already taken you through our third quarter performance, I'll start with my 30-day evaluation of the factors that have led the business to this point. Next, I will provide some additional detail on the quarter to shed some light on the underlying performance of the company. I'll then discuss how we are building a new foundation for the company through a focus on structural simplification. Finally, I'll provide expectations for our near-term performance as well as important strategic and capital-related initiatives. We will then take your questions.

Let's get started. In trying to better understand our third quarter performance, I quickly realized the need to take a look at the last couple of years. In reviewing Mattel's recent history, it became apparent to me that there had been an emphasis on compensating for the loss of revenue associated with the significant Monster High decline and the loss of the Disney Princess license over the last several years. While our key power brands were being revitalized in an effort to drive additional revenue growth, we launched many new brands and SKUs, with Toy Box SKUs increasing 64% from 2015 to 2017, representing about half of our total SKUs. The increased number of brands and launches added more complexity to our supply chain and more cost to the system. The resulting fragmentation in the Toy Box continues to weigh on the business today. Additionally, predicting consumer demand for new product lines and SKUs is particularly challenging, given our historical production lead times. This, combined with the more pronounced tightening of inventory by retailers and SKU proliferation, has led to inefficiencies in our supply chain and the erosion of our gross margin.

As Margo touched on earlier, the gross margin was negatively impacted by a number of significant items in the third quarter. First, we are seeing much greater levels of unfavorable SKU mix, closeouts and obsolescence as a result of the challenges we just discussed. These challenges represented roughly 1/3 of the total margin decline year-over-year. Another item was the TRU net sales reversal since our gross margins included the associated cost of goods sold. This made up approximately 1/5 of total margin decline year-over-year. Other items impacting gross margins included operational inefficiencies caused by logistics challenges related to opening a new distribution center on the East Coast and the tough comparison to last year's franchise licensing deal to expand American Girl into the Middle East.

Moving forward, we will be taking in the coming quarters to streamline our Toy Box innovation pipeline and reduce fragmentation to improve operational efficiencies. Additionally, as Margo has stated before, we will shift our sales philosophy to better manage supply with consumer demand, and we'll change the organization's incentives beginning in 2018 to balance revenue growth, gross margins and operating income.

Despite these challenges, I believe our core fundamentals of the business are sound. That said, it's imperative that we recognize that we will be working off a reset 2017 revenue base going forward. Therefore, we have to reset expectations for ourselves and make the necessary structural adjustments as we build the new foundation.

As we plan for our future, our first point of action is to right-size our cost structure. While the company has executed a number of gross cost saving programs over the years, those programs were primarily used to offset inflation and other cost increases. As a result, gross savings programs did not always lead to sustainable growth and profitability. Going forward, we will be making fundamental changes to the way we operate to enable sustainable profit growth in order to maximize shareholder value. After examining the business with Margo and the leadership team, I am confident that we can structurally simplify the organization and improve our end-to-end processes to achieve at least $650 million of net cost reductions over the next 2 years with full run-rate in 2020.

As Margo mentioned, this is an even more significant opportunity to take cost out of the business than the original $150 million to $200 million we announced at Investor Day. As we looked at the business, it became apparent that the proliferation of SKU counts and our historical approach to planning led to operational inefficiencies and added cost to the system. The proliferation of SKUs over the last few years has been driven by our fragmented innovation pipeline in our Toy Box representing 50% of our total SKUs, inconsistent operational execution across our regions and the lack of a merchandising standardization framework. SKU proliferation has added cost across the P&L. Examples include additional tooling costs, stress on plant capacity, excess inventories, higher logistics cost, increased obsolescence expense and a disproportionate SG&A structure.

Our previous approach to planning unintentionally rewarded higher targets and objectives through a greater allocation of resources. Additionally, achieving targeted production optimization was made difficult as a result of insufficient processes related to our order quantities and frequency of changes. In combination, these shortcomings have resulted in the profit challenges we are confronting in our business today. That said, our structural simplification initiative is aimed at eliminating these drivers of cost and inefficiencies from the organization along with better balancing incentive compensation targets across revenue, gross margin and operating income. Through our structural simplification initiative, we expect the following improvements to the P&L as we work to return to historical levels of performance.

First, we will go after gross margin, which is our largest opportunity, as we simplify by streamlining the number product lines, SKUs and improving our approach to demand planning. We will be able to significantly reduce our cost via reduced tooling and logistics expense and far better optimized manufacturing footprint, both ourselves and vendors, with longer runs and better schedule.

The second largest bucket is SG&A, as we rebalance our workforce and address other indirect areas of spend. A significant portion of this reduction will come from simplifying and delayering our corporate structure by increasing the average span of control from 4 to 6 for leadership positions and reducing the number of layers of leadership. In addition, we will be reducing consultants and temporary labor spend. In total, these restructuring efforts will account for more than half of the SG&A reduction. While this will be a global reduction in headcount, we will be careful not to impact customer-facing functions. We will also continue to invest in core capabilities and support areas of strategic growth, including emerging markets, digital content strategy and creative functions to support innovation.

Finally, we plan to optimize our global advertising spend by streamlining our number of product lines while maintaining our strong support for our investments and partner opportunities. We have a clear line of sight into 2018, where we expect to achieve 1/3 of the $650 million net savings through process simplification and the optimization of advertising, SG&A and cost of goods sold. Larger, more structural changes like our manufacturing footprint and our investments in IT to allow us to further streamline our processes are expected to drive the remaining 2/3 in year 2 for a run-rate savings of $650 million exiting 2019. In the meantime, I will provide you quarterly updates on our progress as we work to make Mattel a leaner, faster, smarter and more profitable business.

Looking ahead to the remainder of 2017. We expect to see revenue stabilization in the fourth quarter in contrast to last year's fourth quarter decline of negative 8% year-over-year and this quarter's decline. This would result in mid-single-digit decline in gross sales for the full year versus 2016, weighed down by recent Toys"R"Us Chapter 11 filing and our lower than expected year-to-date financial performance. We will also be intently focused on managing retail inventories and continue to make tough decisions to achieve a clean start to 2018. As expected, capital expenditures were up in the third quarter as we continue to make investments to grow the business, including increases in automation as well as to build our flagship American Girl store in New York City. As part of our structural simplification, we will be reviewing our capital spend to ensure it's appropriately optimized against our new strategic direction.

With regards to our capital financing plan. In the third quarter, we signed an amendment to our credit facility establishing new covenant ratios along with a guarantee mechanism to provide continued access to the credit facility in the event of a potential rating agency downgrade during this repositioning phase of our transformation. In addition, we are proactively evaluating alternative forms of financing with our banks, including an ABL facility. We are also suspending the dividend starting in the fourth quarter in order to increase financial flexibility over time, strengthen our balance sheet and facilitate strategic investment. Executing on the strategic investments we outlined at our June Investor Day is more imperative now than ever. I am confident when implemented, in conjunction with our structural simplification initiative, will lead to improved revenue and profit growth.

As we exit 2017, we will have spent approximately $30 million on our strategic investment. We intend to invest $170 million beginning in 2018 over the next 2 years as we continue to execute on our transformation plan. These investments will be focused on a number of key areas, including: power brands 360 play experiences for toys and beyond toys; emerging market investments, including China partnerships and select investments in other emerging markets; along with reshaping our operations, including the continuation of our IT transformation, mature market turnarounds and omni-channel and e-commerce capability. Overall, we expect the breakdown of these investments to be more weighted toward operating expenses than capital expenditures. We also expect these initiatives to restore operating margins of 15% plus once our new model is fully implemented over the medium-term.

While we have undoubtedly had our challenges this year, as I said earlier, I believe the fundamentals of this business remain intact. And during my short time at Mattel so far, it has become abundantly clear that we are in an industry that continues to grow. The opportunity we have as a company is substantial and sustainable. Parents will always care about the development of their children, and children will always want to play. We are the company that can bring both fun and learning into the play experiences of children and families around the world.

We are well-positioned. We continue to be a leader in the industry and have a large, consistent revenue base, with approximately 60% of our revenue generated by our power brands. We also have the opportunity to supplement this revenue base with the generation of new IT and continued collaborative executions with our licensed entertainment partners. And we have a significant opportunity to restore our margins through actions that are very much within our control.

With these solid fundamentals, a strong and refreshed leadership team and a clear set of strategies on which we've begun to execute, I believe Mattel presents a compelling shareholder value proposition, and I am confident we will deliver on this transformation, creating sustainable growth in the years ahead.

While I might be new to Mattel, I am not new to executing transformation. And one thing I want to make very clear from the outset is that this transformation is achievable. My goal is to improve the accuracy of our financial forecast and build a strong relationship with our investors one quarter at a time. We, as a management team, will hold ourselves accountable for the commitments we make to you. To do that, we will continue to provide you with quarterly updates on the progress of our strategy. On our fourth quarter earnings call, I will provide milestones on our structural simplification and our strategic investments for 2018. I'm glad to be here, and I look forward to partnering with the management team to realize the full potential of the opportunities ahead for Mattel.

I'll now turn it over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Greg Badishkanian with Citigroup.

Gregory R Badishkanian - *Citigroup Inc, Research Division - MD and Senior Analyst*

Did you mention the overall POS trends in the U.S. and why you think that Hot Wheels, Fisher-Price, Thomas were seeing a little bit softening trends there in the third quarter as well?

Margo Georgiadis - *Mattel, Inc. - CEO*

Richard, do you want to take that?

Richard Dickson - *Mattel, Inc. - President and COO*

Sure. Greg, we are remaining very confident particularly in our core brand narrative, Barbie, Hot Wheels and Fisher-Price. We've seen the most significant progress ultimately on the Barbie brand, and we continue to strengthen that brand and others will, of course, follow. We certainly acknowledge that there's some work to do on American Girl and Thomas. Specifically, as you asked on Thomas, we've got some great powerful key item product this quarter with Thomas SuperStation where our media is about to really kick in. And we're really looking forward to 2018 with that brand, with new content that will hit the marketplace as we introduce a tease, if you will, at MIPCOM that went really very, very favorable. As we continue to look at the U.S. POS, POS is still better than our shipping levels. We're confident particularly in our core brand narratives as I suggest. And even in new brands like Cars, we're performing -- continuously performing up to what we hope to be a good year for Cars.

Gregory R Badishkanian - *Citigroup Inc, Research Division - MD and Senior Analyst*

Could you -- are you able to put a number around the U.S. POS? Or -- is that possible?

Richard Dickson - *Mattel, Inc. - President and COO*

Total POS for us was slightly up when we look at our core brand narrative.

Margo Georgiadis - *Mattel, Inc. - CEO*

Sorry, Greg, was your question about specific brands? Can you just repeat the question just to make sure we answer it?

Gregory R Badishkanian - *Citigroup Inc, Research Division - MD and Senior Analyst*

No, I think you did. I think that was helpful. And as you see the retailers reducing inventories for you, and it seems to be more than other manufacturers, when do you think that will be more normalized, would you say, where shipping and sell-through are pretty similar?

Margo Georgiadis - *Mattel, Inc. - CEO*

So, Greg, as I've shared earlier in my remarks, the divergence that we've seen between POS and shipping is largely explained by this inventory reduction situation that we articulated earlier. What we have seen is a stabilization of that trend towards the back half of the third quarter. And our sense is that we've largely worked through the biggest chunk of it, that 20%, roughly 15% to 20%. And we expect and we'll obviously closely monitor it going forward. There will always be a little bit of a downward pressure due to e-commerce, that pivot to e-commerce because it's more of a demand-driven supply chain. But we do believe that we've worked through the majority of that issue at this point.

Gregory R Badishkanian - *Citigroup Inc, Research Division - MD and Senior Analyst*

So fourth quarter is going to -- will reflect -- the shipments will reflect more of the POS, right?

Margo Georgiadis - *Mattel, Inc. - CEO*

Well, the fourth quarter is obviously a very different quarter because you have the timing of shipments and sales. It can be a little bit different between the 2 quarters, but yes, we would expect over time the POS and the shipping to align.

Gregory R Badishkanian - *Citigroup Inc, Research Division - MD and Senior Analyst*

Right. Okay. Yes, I mean, fourth quarter is an unusual quarter for that. Good. And then just finally, so the sales slowed in early September for Toys"R"Us. So I'm wondering, that's in addition to that $43 million reversal, right? So that's an incremental for the third quarter?

Margo Georgiadis - *Mattel, Inc. - CEO*

Correct. As we were aware that they were potentially going to go bankrupt, as you know from public documents, we had a large exposure to Toys"R"Us. And not understanding exactly the timing of the bankruptcy, we made the difficult decision to begin to reduce shipments to them until we understood fully what the plan was. And then it took quite some time for us to begin shipping again because of the timing of their own settlement. In fact, the final settlement only happened a couple of days ago. So they account for more than half of the decline in North America sales in the quarter.

Gregory R Badishkanian - *Citigroup Inc, Research Division - MD and Senior Analyst*

Okay. All right. And just finally, so if you were to look at some of the onetime impact to sales and you were, let's say, on a go-forward basis, if those were to have been eliminated, so would you be seeing sort of flat or up a little bit shipments in probably because it's similar to POS, where you said it was up a little bit. Is that where you would expect kind of a normalized sales growth because there are obviously a lot of onetime impacts this quarter?

Margo Georgiadis - *Mattel, Inc. - CEO*

Correct.

Joseph Euteneuer - *Mattel, Inc. - CFO*

Yes, correct. I think you're answering it just totally right. And the fact that getting this stuff out, you get back to stable and then you start finding your pathway back to growth. So yes, I think you hit the nail on the head.

Operator

And our next question comes from the line of Linda Bolton-Weiser with D. A. Davidson.

Linda Ann Bolton-Weiser - *D.A. Davidson & Co., Research Division - Senior Research Analyst*

You had mentioned some disruption also on margins due to the opening of a new distribution center on the East Coast. Is there anything like that or similar to that coming up in the coming months or next year that you can envision also causing disruption of that sort?

Joseph Euteneuer - *Mattel, Inc. - CFO*

No, no. It's something that we started earlier in the year. We ran into a little bit of an additional cost issue as we were exiting second quarter into third quarter, and that's what caused the blip. But no, there's nothing on the horizon. Currently, we haven't finished the 2018 plan, but nothing that I'm aware of that would cause a similar situation next year.

Linda Ann Bolton-Weiser - *D.A. Davidson & Co., Research Division - Senior Research Analyst*

Okay. And then just sort of in a kind of broader strategic sense, I guess, more with regard to the brands and the strategies with regard to the brands. Margo, as you've started to examine the business more, are there any actions that were taken in the past that you feel were so misplaced strategically that they actually have to be reversed? I mean, just one example would be launching of Wellie Wishers as a subline under American Girl. I mean, are there any actions that were in the past that you really feel were damaging to certain brands?

Margo Georgiadis - *Mattel, Inc. - CEO*

No, what I can tell you is that we've been going through each one of the brands against a very, very specific framework about where and how we want them to compete. What I would say is one of the biggest opportunities for us is to overall and then by market have a much clearer shared understanding across our company about where we're trying to play and win. And so I do think we have significant opportunities in some of our brands to be far more focused about where our biggest opportunities are. We tend to expand age ranges quickly or go into new categories, not always with as much depth or focus than I think we would benefit from for some of our brands. In addition, as we shared earlier on the call, well, I think we've made very strong progress in resetting the foundation for our power brands, the center, the value propositions for those, putting quality back in those products. There have been a lot of choices made the previous years to kind of take some costs out of the system. We've put the quality back in, so we really command that premium price and experience. But in addition to try to outrun some of the challenges with Monster High, Ever After High and Disney Princess, we've launched a large number of items over that time period which I think really drove a very high level of complexity, which was something that when I stood in June, I hadn't fully anticipated the scale of that SKU creep and the resulting cost around it. And when you compound that, as Joe was saying, with the relatively high sales targets that we were setting, you really just build up a tremendous amount of issues within our supply chain, infrastructure as well as a bloated corporate center. So I think those things are enormous opportunities for us to streamline, as I said, on the structural simplification program, to focus on the things that offer us the biggest opportunity. And so I think we're really excited about the going forward plan to be leaner, meaner and faster.

Operator

And our next question comes from the line of Gerrick Johnson with BMO Capital Markets.

Gerrick Luke Johnson - *BMO Capital Markets Equity Research - Senior Toys and Leisure Analyst*

I have 2 questions. First, just for Joe, can you explain the $47 million sales reversal? Others are taking a bad debt charge in operating expense. So accounting-wise, what are you doing with the sales reversal? And why? And Margo, I've heard a lot about SKU rationalization process, cost savings, things like that. But not a lot on how you make better toys, cooler toys, more fun toys. And what are some steps you're taking to just make better toys?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Sure. In regard to your first question on the reversal, in looking at generally accepted accounting principles, when a situation like this happens, you look at it -- you look at your receivables and stuff on a first-in, first-out basis which means the last stuff you have that is reported in the period of the bankruptcy is actually a reversal of revenue rather than a bad debt expense. And so it was something that we reviewed with our auditors and we are confident in the accounting that we had.

Margo Georgiadis - *Mattel, Inc. - CEO*

And then Gerrick, on your questions on the cooler toys and more fun toys, completely agree with you. That creativity is the hallmark of this company and something that we absolutely needed to reignite. So the wonder values that we've actually put in place are so much of the foundation of what's important in this company. In fact, just today, we had something we call [Creative Con]. We've, under Richard's direction, created a creative council that really ties together our distinctive creative leaders and talent from across all of the brands. We've been quite siloed in the past and bringing them all together. And really enabling us to have really incredible mix [there] and other places where we are really celebrating creativity. We are bringing in external speakers to challenge our thinking and really taking more advantage of the inspiration that we have out there. In addition, I'm a big believer -- if you look at many of the hottest toys that are in the market today, they're really very much driven by insights on the focus group of the world. It doesn't take much to go online and see how the unboxing videos and see the things that inspire kids in the media today. And we very much need to be more aggressive about taking advantage of those insights, combining them with the latest material, technology and other things to ensure that we are coming to the market more consistently with some of those breakthrough ideas, both within our existing core iconic brands as well as launching new initiatives. I'm very excited about certain products that we've launched this year, for example such as Kamigami. We brought that to market in less than 9 months from beginning to end. It's a really wonderful execution on how do we bring the magical experience of robotics to kids. And it appeals to both boys and girls and it's a wonderful opportunity for us. Another great example of breakthrough innovation is our business Imaginext which continues to come out with some of the most creative and breakout toys in the marketplace. The Batbot has been featured as one of the hot toys for the holidays. And that's really a great example of us at our best when we really focus on that inspiration and innovation portion of the company. And that SKU rationalization initiative actually will create enormous opportunity for us to free up the time of our creative organization and our supply chain to focus much more on innovation versus the SKU creep. We had so many different versions for different retailers, the localization process -- and all those different things were actually making it harder for us to actually focus on the magic. So we're very excited to get back to that focus in the company.

Operator

And our next question comes from the line of Arpine Kocharyan with UBS.

Arpine Kocharyan - *UBS Investment Bank, Research Division - Director and Analyst*

So the $650 million of cost reduction in your release, it sounds like the incremental is about $450 million to $500 million. Does that mean half of that into next year flows through to your operating margin in terms of a benefit? In other words, operating margins will benefit in a magnitude of about $150 million to $200 million? Do we understand that? If could you clarify that? And then I understand this comes with some kind of right-sizing of top line. Could you perhaps talk about the extent of that right-sizing for next year? I guess what I'm trying to understand is, does this resetting include getting rid of some brands that have been an overhang for you? What are the implications for top line? And I know it's very hard to forecast Q4 here from a base perspective.

Joseph Euteneuer - *Mattel, Inc. - CFO*

Sure. So I think on your first question, yes, the $650 million, we are assuming that we're going to get 1/3 of it next year and 2/3 in the year after. If you're netting the $170 million of investments against the $650 million, yes, I would look at it in the same way. Take that net number and assume 1/3 of it hits the bottom line next year and 2/3 in the year after.

Margo Georgiadis - *Mattel, Inc. - CEO*

Arpine, on the revenue piece, the way I think about it is, the reason why we gave you those dramatic numbers in terms of the SKU creep in the company is that a lot of that actually isn't attached to a lot of revenue. Much of that was driven by localization practices. We're a very global business and our localization didn't have a systematic process. Each one of the markets could request a localized version of almost any product on the SKU list. And so when you launched so many new things that people could request their own version, that just drove the amount of complexity without a lot of return. In addition, there's been an increasing demand which is an industry trend for merchants to want exclusives. Again, that was not a process that was managed centrally. So for example, the hypermarket in France would request -- might have requested an exclusive in addition to someone in the U.S., in addition to somebody in Australia, et cetera. So you actually -- there's not as much issue in terms of revenue loss as you would think given some of these things are driven by the multiplication factor of a long tail of launches, localization, lack of standardization and merchandising, lack of standardization across markets. So that's one of the reasons why we were comfortable announcing a much larger cost reduction initiative because by streamlining and simplifying across the board, we can actually take a lot of that cost out without a lot of revenue impact. We are still working our way -- and this year was the end of some of those bigger challenges such as the Monster High, Ever After High. We've largely worked our way through those challenges in our Toy Box large brands where they were in very large decline. In fact, and I think you and I have even talked about the fact that Monster High and Ever After High, the loss from that was as big this year as it was last year. So if you think about, we've had many strong performances for example on Cars. But they've been offset by some of these continued falls. We've largely worked our way through those large numbers this year. So we look at this as really a reset year for Mattel and then we'll start to see the benefits of our transformation into 2018 with a lot more focus and a lot leaner approach to how we run the business.

Operator

And our next question comes from the line of Michael Ng with Goldman Sachs.

Michael Ng - *Goldman Sachs Group Inc., Research Division - Research Analyst*

I have a couple. First, I wanted to dig in a little bit on the manufacturing facility footprint restructuring in 2018. Would you reassess the ownership of some of your manufacturing facilities and consider transitioning to an asset-light model and use third-party manufacturers?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Yes.

Michael Ng - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Okay. And did the recent covenant renegotiation that you did, did that contemplate the results that you guys reported today?

Joseph Euteneuer - *Mattel, Inc. - CFO*

No. The covenant was done before our results. I mean, it was before I got here. So I think it was done in September. So it was before -- well, I guess they were clearly -- in putting the amendment together, they were giving themselves the waiver for anything that would happen within the quarter. So I guess they anticipated that they didn't want to have to be caught in this quarter. So yes, I guess the answer would be yes.

Michael Ng - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Okay. So I guess said differently, do you think the covenant levels for 4Q and then into 2018 are good levels given your current plan? Or do you think there's a risk that you may have to renegotiate those?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Yes, look. Being new, I'm just getting my head around what we think we're going to do in 2018 and we're going -- as Margo said, we're going to have the bottoms up budget. We're going to take a look at that as we speak and address that. The other thing I'm doing is along with touching every line item in the P&L, I'm looking at the capital structure and looking at what alternatives are and trying to find the most cost-effective one that will serve the needs of the company in the long term to take care of what needs to continue going. So I haven't come to any conclusions yet, but we are turning over every stone to take a look at what works for us.

Michael Ng - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Okay. Great. Thanks. And then just a comment on the guidance for revenue stabilization in 4Q. Do you think that stabilization holds into 2018? I'm just trying to think about whether or not you're assuming that revenue can grow in 2018?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Well, yes. So look, I think in regards to 2018, we're in the process of getting it forecasted out. The idea, I think when we talk about stabilization is look, we got to get back to have a stable revenue or 0 growth to then start regrowing the company. 2018 is 4 quarters ahead of us and we would like to think that we're going to see some growth in some of those quarters. How it ends up for the full year? We'll come back to you on the year-end call and give you more detail.

Operator

And our next question comes from the line of Tim Conder with Wells Fargo Securities.

Timothy Andrew Conder - *Wells Fargo Securities, LLC, Research Division - MD and Senior Leisure Analyst*

Thank you for the color so far and Joe, welcome aboard, sir.

Joseph Euteneuer - *Mattel, Inc. - CFO*

Thank you.

Timothy Andrew Conder - *Wells Fargo Securities, LLC, Research Division - MD and Senior Leisure Analyst*

A couple of things here. Margo or Joe, whoever wants to take this. The inventory clearance, sort of that last 25% with the Toy Box and so forth. So it sounds like, and please correct me if my assumption is wrong here, that you flushed through a lot of that, some or many of those brands that you own will go into the vault and that would be potentially also part of your manufacturing footprint reduction that you're kind of finalizing up. Is there anything I'm missing in that sort of chain of logic?

Margo Georgiadis - *Mattel, Inc. - CEO*

I think that's a very good chain of logic. We are taking a tough look at all the different things that we're trying to put through our supply chain. Not just our own but we -- 50% is in-sourced today and 50% is outsourced. And so the combination of the long tail of SKUs, many of which have been ordered in quite small quantities plus the forecasting approach where we started with a very high target and have worked our way down has led to essentially a lot of fragmentation, a lot of challenges in scheduling, as we talked about earlier, that are not optimal. And so we are very confident

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when we are able to set a tighter plan from the beginning of the year, reduce the number of SKUs that we're trying to make. The alignment of those 2 things alone gives you such a benefit on your existing and your vendor manufacturing footprint. And then going into the beginning of '18, we'll also talk about the broader strategic approach to how we want to drive our investments and things like manufacturing going forward.

Timothy Andrew Conder - *Wells Fargo Securities, LLC, Research Division - MD and Senior Leisure Analyst*

Okay. So that would sound like even beyond what you're basically, let's call it, throw-it-in-the-vault, there are other footprint reduction considerations that seem potentially very viable.

Margo Georgiadis - *Mattel, Inc. - CEO*

Very viable, especially when you think about -- when you do that many short runs, it's just incredibly inefficient for you and the vendor. You don't just get optimal pricing. And so we want to make sure that the way we're setting our plans, both the number of SKUs and the way we set our sales targets, enables our supply chain to be dramatically improved. And I know that our entire company end-to-end is really excited about that opportunity for structural simplification because we'll be able to do some of the things that we really want to do for also our retail partners which provide far better in-stock levels for them which is just sales sitting on the table. And then in addition to that, we'll be able to get our products to market far faster because there will be a lot less pressure on our systems. So you can imagine this. As we've discovered and got into this much more deeply than I was in June, it's very exciting for us to really put this kind of a program together across the company for how we're going to run this business differently end-to-end and free up that many resources so that we'll be able to actually have a very different profile of business going forward.

Timothy Andrew Conder - *Wells Fargo Securities, LLC, Research Division - MD and Senior Leisure Analyst*

Okay. And then Margo, one of the other 25% was that tighter retail management and maybe you're just alluding to that there. But is that also a step-function adjustment given, is that occurring or could we continue to see another may be 1 or 2 step-functions given that you said Mattel tends to have more evergreen brands maybe than others in the industry? How do you see that part?

Margo Georgiadis - *Mattel, Inc. - CEO*

As I shared earlier, we saw this as a trend. After we worked off that inventory overhang from Q4, we started to see at the end of Q2 a little bit of a trend. We weren't sure if that was driven by e-commerce. As we got into Q3 and spent more time working with our retail partners, we did assess that it was a more structural resetting of their inventories with us, as their new working capital policies were kicking in. In addition to that, we had, as we shared, higher weeks on hand but perhaps others in the system due to some of the sales incentive practices that we had in the prior years. And therefore, we do think that this was a larger one-time structural adjustment into this year. But then, it will -- it's starting to stabilize I think, Q3 and we would expect to see always a little bit of downward pressure with the shift to e-commerce. But we're not anticipating another step-function decline that would happen rapidly.

Timothy Andrew Conder - *Wells Fargo Securities, LLC, Research Division - MD and Senior Leisure Analyst*

Okay. Okay, helpful. And then lastly, Joe, just to follow up on one of the prior questions. As you see things now looking at year end, I know there's a lot of variability. Do you anticipate that, that $450 million leverage covenant will be sufficient?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Look, we're only into October. We are anticipating having a pretty good fourth quarter. We are looking at doing things in the quarter to increase our profitability given what we've come off on the third quarter. So I don't know that I actually have the answer to that question. And as I said, I am looking at the entire capital structure and our alternatives just to make sure that I have them.

Operator

And our next question comes from the line of Steph Wissink with Jefferies.

Stephanie Marie Schiller Wissink - *Jefferies LLC, Research Division - Equity Analyst*

Two questions from us as well. Margo, if you could just talk a little bit about this idea of rationalizing SKUs. Does that mean fewer, bigger ideas as well as a shorter tail? And how does that play out in your ad spend and some of your gross to net spreads? How should we think about the balance of those costs? And then Joe for you, just a question around the $650 million. How does that play into the management incentive models? Is there an incentive structure built around cost savings? Or how do you motivate your team down below to make that a focus?

Joseph Euteneuer - *Mattel, Inc. - CFO*

That's a great question. Yes, that's why we both said that we are going to change the incentive plan starting in 2018. You need a balance, right? You need to have -- you keep the eye on the ball in making sure that we achieve these cost takeouts so that we can improve our profitability. But at the same time, we have to stay focused on the topline. So we're going to get that balance between the top line, taking the expense out, profitability and then our investments. And I think if we focus that on a holistic basis, we will be a much better company going forward.

Margo Georgiadis - *Mattel, Inc. - CEO*

And to answer your other question on the advertising investment. This was a significant challenge again as I dug in at a much, much more detailed level, what we uncovered as we moved to one brand leader, that was one of the big changes we made so we could really think about managing the portfolio on an integrated basis. So we have Juliana Chugg now looks across all of our brands. That was a key organization decision. As we then looked at that and really thought about how do we allocate our resources at a much more detailed level, we were uncovering that we were spending as much on a lot of these small long tail launches as we were disproportionately versus their productivity even versus our core brands. So, in fact, it was a double benefit for us that we can better optimize the investments in our core brands as well as put more investments -- as I was sharing earlier, around the properties that we really believe in. So, this is going to give us, I believe, a significant return on the investments that we're making going forward.

Stephanie Marie Schiller Wissink - *Jefferies LLC, Research Division - Equity Analyst*

And one follow-up if I could. This is a nomenclature question, but the word stability has been used a lot in the past. And I just want to clarify. Does that mean that you don't expect to see further rate decline? Or that you expect to see flat comparable, whether it's sales, margins. What does the word stability mean overall?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Sure. As we are referring to the fourth quarter?

Stephanie Marie Schiller Wissink - *Jefferies LLC, Research Division - Equity Analyst*

Just in general. If you talk about stability, does that mean -- yes.

Joseph Euteneuer - *Mattel, Inc. - CFO*

When you have a company that's been in decline, the first thing you do is get to flat, right? So wherever you are, you just want to sort of flatten things out so you can then turn the curve back up to growth. So stability is just trying to get to flat. And by the way, just one other point is remember, this isn't going to be a V. It's going to be a U. It's sort of like you're going to start flattening out and it's going to take a little bit and then it starts coming back up. So I just want to point out that when you're going through these things, I'd love to say you just hit a point in time and it's 1 day and boom, you're back up. It does take a little bit of transition at flat to head back up to positivity.

Operator

And our next question comes from the line of Felicia Hendrix with Barclays.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

I wanted to start with a clarification and I have a few others. Just Margo, in response to it or just in relation to an earlier question, I just want to be more specific. When you think about the top line, you had explained that removing the SKUs wasn't really going to have much of an impact because those just weren't productive. So we're still looking at a company that would be a 5-ish billion dollar revenue type of company. Is that fair?

Margo Georgiadis - *Mattel, Inc. - CEO*

Fair.

Joseph Euteneuer - *Mattel, Inc. - CFO*

Yes.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

Okay, thank you. And Joe, your -- the net cost savings that you defined is slightly over 30% of operating expenses. I'm also wondering what...

Joseph Euteneuer - *Mattel, Inc. - CFO*

No.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

No?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Well, I think what you have to do is you got to look where we've come off historically, right? If you think the company was a $6.5 billion company and what the expense base was there versus the drop in revenue. And remember, you need to include the cost of goods sold in this, right? So it's not just SG&A or advertising. It's really going after the cost of goods sold to drive a much improved gross margin. And then in additionally, hitting the other line items of the P&L.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

Okay, so can you...

Margo Georgiadis - *Mattel, Inc. - CEO*

Think about it as having your SG&A in alignment with more industry standard levels that you would expect, which when we have descaled, we're not quite in alignment, getting our [AMT] cleaned up and then getting your COGS back. Again, where a more simplified, more focused lean machine would actually deliver a COGS line.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

Yes. No, it all makes sense and it's quite refreshing to hear. I just think it was helpful to put that all in context. Is there a way you could tell us what the gross number is?

Joseph Euteneuer - *Mattel, Inc. - CFO*

That's a good question. I mean, I think the only reason I said net is that it really is the gross number because we're going to take it right to the bottom line. Other than the fact that we said that of this $650 million, we are going to use about $170 million over the 2 years for investments. So that's the way to think about it.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

Correct.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

Okay. And then, just stepping back from all of this and I realize this is a tough question. But you talked about the U which I think was helpful. But how long do you think it takes for the company to kind of get on the other side of the U to get to a more productive steady-state?

Joseph Euteneuer - *Mattel, Inc. - CFO*

So I mean, look. I'll give you a guide. I've only been here 30 days opinion. When I look at the top line, we have our 5 core brands, 3 of which -- 2 of which are great, one is doing really good. You've got 2 others that when you look at it, there are executional issues that I think we can fix. I mean, I have a lot of confidence in our ability to get this thing turned around. But the issue is you need a little runway room because of the cycle time of what happens in here and we're trying to -- you heard Margo talk about improvement of the cycle time. I think all of those things as we move out will help us increase the speed of moving the top line growth. But -- and from a cost perspective, I think the things we need to do is just get a better integration across the line. And obviously, focusing on margins first before we hit the medium term plan are what we need to do. So I think it's very doable and the thing that I'm trying to work out and I've only been here 30 days is the speed of getting it done and how fast can I not only help you on the top line, but get you the bottom-line contribution. And the easiest way on the bottom line is obviously expense take-out but without hurting the momentum that we are starting to build on the top line.

Felicia Rae Kantor Hendrix - *Barclays PLC, Research Division - MD and Senior Equity Research Analyst*

Okay, helpful. And then Margo or Richard or whoever else may be on the call, on American Girl, because of some decisions that were made previously, Toys "R" Us is one of your distribution partners there. And when it was presented at the time, it became kind of an important partner along with Kohl's. How do we think about an American Girl reinvigoration as you also have to reduce the exposure of that brand to Toys "R" Us?

Richard Dickson - *Mattel, Inc. - President and COO*

I'll start and Margo can step in on this. As I mentioned to you, our objective here is to drive a return to the premium brand positioning of American Girl. And it's not something that's going to be, to some extent, a fix overnight. But there are several programs in place -- essentially sort of how style investments building new consumer relationships, significantly [driving] new girl engagement with refreshed content that we are starting to build. And ultimately, ensuring that our products have the premium quality and appeal that they have always had historically. In messaging as well, we're driving new marketing, we are launching a new program called [Character Counts], which is essentially the essence of the American Girl narrative. We're working on customer service aspects of both our store and our call-in and we are also leveraging data collection and we will continue to optimize all of the marketing along the path to purchase in the right place to get this back to premium status. And by the way, as I mentioned to you, our New York City store flagship opening later this month, I hope to see many of you out there. We're really excited about new experiences and what that will bring to the franchise.

Operator

And our next question comes from the line of Drew Crum with Stifel.

Andrew E. Crum - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

So Joe, I think you identified gross margin as the largest opportunity with respect to cost reduction. If you look at the business, it's -- the mix has changed pretty drastically over the last couple of years when dolls was about 45% of gross sales back in 2013, the gross margin peaked at around 54%. Today, that's about a 30%, 35% of your mix and obviously, gross margin has been under pressure. So aside from reducing tooling and logistics, do you see mix as an impediment to improving the gross margin profile of this business or maybe it's an opportunity?

Joseph Euteneuer - *Mattel, Inc. - CFO*

Yes. So the first 2 things that you said for the cost take-out are totally spot on. But I do think the latter is an opportunity. We should view it as an opportunity. The fact is when you go back historically and look what was going on, the company lost Disney Princess and Monster High. And all of a sudden, started sprinting at trying to out run the loss of that revenue. And when you have a 64% increase in your SKUs for half of your non-core brands, that's a big deal. You know? That's just eating at it. So, I think there are things we can do there and I do view it as an opportunity.

Andrew E. Crum - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Okay. And then separately, maybe for Margo, you've identified one of the key strategic pillars that's growing the emerging markets business. Are you willing to size that business and just talk about how you balance growth versus reaching break even? Because right-sizing the cost structure and realigning the cost structure seems to be thematic on this call. So just talk about balancing growth versus profitability for emerging markets.

Margo Georgiadis - *Mattel, Inc. - CEO*

So we're very focused on a strong ROI for shareholders and our emerging markets. We actually have multiple of our high growth emerging markets that are already extremely profitable and we are very, very disciplined about how we're investing against the absolute side of the opportunity. So for example, our tolerance for investment would be higher in a place like China where you've got a 3 to 4x opportunity and the ability for us to establish ourselves as a clear differentiated market leader in a window where there's a breakout moment for parents and kids as they move -- the baby boomers move into childbearing age. And then you've got on top of that, the 2 child policy and then you got rising income. So that's just an accelerating opportunity for us. So we should over invest. I think in some of the other markets we're taking a very stepwise approach in thinking about how could we change the game and go into those markets with a more efficient model. With -- in many of these countries, they're very digital-first particularly in Asia. And this is an opportunity for us to leverage partnerships such as Alibaba and others so that we can enter and scale more cost-effectively into those places. So we're taking a very disciplined approach to it and we will be sharing more with you over the coming quarters given that we do believe this is one of the most exciting opportunities in the industry.

Operator

And our next question comes from the line of Mike Swartz with SunTrust.

Michael Arlington Swartz - *SunTrust Robinson Humphrey, Inc., Research Division - Senior Analyst*

Margo, I just want to touch on something that you had talked about briefly in your prepared remarks. I think you had thrown out some numbers -- the opportunity for some of the core brands and growth you see longer term. Could just give us a little more color about how you get there? And what maybe you're anticipating in terms of market growth during that period as well?

Margo Georgiadis - *Mattel, Inc. - CEO*

Sure. Are you referring to the Hot Wheels, Barbie and Fisher-Price examples that I gave in terms of the refresh that we've done? Is that what you mean?

Michael Arlington Swartz - *SunTrust Robinson Humphrey, Inc., Research Division - Senior Analyst*

Yes.

Margo Georgiadis - *Mattel, Inc. - CEO*

So as we've created the 360 play experiences and the systems work, we've systematically laid out both for those brands and across markets where we see the most attractive opportunities for growth. And for example, in the case of Hot Wheels, if you just look at us continuing the strength on the track set side, as well as the diversification on our core iconic cars, you add that in terms of driving up your attachment rate as I talked about when I was at Investor Day and then you have us taking a modest portion of the construction bit industry for example of that segment. In some of our key markets, you pretty quickly get to some of those numbers. So, we've sized these, both in terms of looking at our share in existing categories, looking at key adjacencies where we have a right to win and then looking at how we would layer that by market. So, we've done that for each one of these brands. And that's how we think about that. We've also looked at obviously, the market growth rate versus our growth rates, the benchmarks for what we think is achievable and what other people have done in similar circumstances. And we do feel pretty confident. And obviously, the profile is slightly different for each one, right? For Hot Wheels, obviously, it's the attachment, right, of the play sets and the track sets. And then, obviously, also moving into the construction play pattern. In the case of Barbie, we've actually been that size in the past. We've been a 20% share player in the doll industry before. So how you think about that is, regaining our footprint and really innovating across more of the doll platforms as well as extending some of our experiences. And on the Fisher-Price side, again, we have been a much bigger player and a much stronger player historically. But for different reasons around margin decisions and other things like that, we'd exited some of the categories. If you thought about it as consistently executing the range of products that a mom wants for her baby from 0 to 5 and doing that consistently well across the enormous opportunity in a place like China which is not a #2 brand for Fisher-Price. Again, you can get to these numbers quite easily. And you don't need everything to be perfect.

Michael Arlington Swartz - *SunTrust Robinson Humphrey, Inc., Research Division - Senior Analyst*

That's helpful. And then, Joe, just with the net cost reductions of $650 million over the next couple of years, you gave us a sequencing by year. But I didn't hear it and I apologize if you had said it. But how do you think about that by buckets, cost of goods sold, A&P, SG&A?

Joseph Euteneuer - *Mattel, Inc. - CFO*

I think I didn't give any specific guidance on that. But what I would tell you to just look at historically and benchmark the company of where SG&A should be as a percentage of sales or gross margins, stuff like that. And I think you can get pretty close to how we're going to attack this thing.

Operator

And our next question comes from the line of Eric Handler with MKM Partners.

Eric Owen Handler - *MKM Partners LLC, Research Division - MD, Sector Head, & Senior Analyst*

I wanted to focus on a couple of different brands. First, American Girl doll. As you think about expanding the company gross margin and you think about the current state of retail, does it make sense to maybe shrink the American Girl store presence? Or is that something that you think is vital to the brand? And then maybe focus more on the online channel at the expense of retail -- of bricks and mortar retail? And then with Thomas. When -- and this predates you guys. But when Kid Entertainment was acquired, the strength of the Thomas brand was probably at an all-time high. And since then, there's been a decay. And meanwhile, with the HIT brands, other than Thomas, it seems like a lot of those brands or pretty much all the brands were nearly shuttered and sort of locked in a vault somewhere. How do you think about what you have with HIT and why Thomas fell, and maybe how do you get it back?

Margo Georgiadis - *Mattel, Inc. - CEO*

So let me take these in turn. First, American Girl is just a phenomenal franchise. And we have enormous opportunity to regenerate that business and really get back to that direct-to-consumer excellence that really was the hallmark of that property historically. In terms of the store footprint, we will always be optimizing the returns of those things. It's a very profitable franchise for us. So it's, in my view, much more about resetting the stage for how do we actually sustain the steady growth of the franchise and the consumer engagement through CRM and other content-driven initiatives that build passion for the franchise. It's still one of the most beloved products of all time. In terms of Thomas, I'll take that in 2 parts. The HIT acquisition -- as I've really looked into the incredible IP libraries that this company has, one of the things that I mentioned on the call was one of my priorities was to ensure that we had taken back control over the rights of our IP because we have one of the best portfolios of kids and family IP in the world. And we were not fully taking advantage of the opportunities against that IP in terms of how we thought about content development. Which then I think dovetails into the opportunity for Thomas. I think when the company purchased Thomas, they had a strong content development capability. I can't really speak to the past. But I think we did not probably leverage those capabilities as well as we should have. But we still actually have those incredible IP assets. Thomas has challenged -- again still a very beloved franchise. But it's a competitive market. And we were not as quick to the punch as we should have been in terms of updating and refreshing that content. I'm incredibly excited about the new content we just launched. You can search for it online. We just launched it at MIPCOM to rave reviews and I feel like we're right in the zone of really what matters. We've got 3 new girl categories. Thomas is getting out of Sodor and he's traveling the world. And in addition, we have partnered with the UN in having Thomas teach kids about some of the key elements of sustainability which we know is incredibly important to millennial moms. So Thomas really needed to be modernized. But the beloved play pattern and its success is really significant. If you take a market like China, where we're extremely successful with Thomas and we a [theatrical] and it sells out instantly. We localize the engine. We've done a wonderful job of making it part of popular culture. We just actually launched our movie there in September. It was #2 in the box office during that period. So we know when we execute this franchise well, we deliver enormous returns to the company. But we have not done a consistently good job as I talked about at Investor Day at supporting these franchises across markets. So Richard and I are extremely aligned in how we can think differently is one of the reasons we flattened out our international structure with things reporting directly to Richard and they are driving a very different kind of an accountability approach to how we develop and manage our franchises across markets. I don't know, Richard, if you want to add anything.

Richard Dickson - *Mattel, Inc. - President and COO*

The only thing I can add is in the context of the HIT portfolio outside of Thomas. We are looking to monetize the IP within that portfolio and have announced various different deals associated with THX and 9 Story, particularly for Bob the Builder, Barney, Angelina, brands like Fireman Sam -- these are not necessarily key brands in the context of our focus as Mattel, but they are certainly intellectual property within HIT that we're looking to monetize and have some great partners in place to start to reactivate some of those properties.

Eric Owen Handler - *MKM Partners LLC, Research Division - MD, Sector Head, & Senior Analyst*

Great. Very helpful. And just one other follow-up. At your Analyst Day or Investor Day, you spoke a lot about the need to go after more licenses. And given your statements today, how does -- is that changing at all? What's your view there?

Margo Georgiadis - *Mattel, Inc. - CEO*

Our licenses -- partnerships are a real focus of our business. In my remarks earlier, I emphasized the fact that partnerships with people like Disney, Warner Bros., Universal, Disney, WWE, are at the cornerstone of leveraging our capabilities at the company both our creative and innovative designs as well as the way we can take products to market globally. And I think our success with Cars, despite the initial slow box office in the U.S. and then our ability to take that franchise globally and come close to our initial targets in close, close partnership with Disney really demonstrates our ability to take a franchise and take it to the next level. The Jurassic line that we put out for next year, incredibly excited about that partnership with Universal. We've received rave reviews from retailers across the world about the innovation that's in that product and how excited they are to carry that at retail. And Richard has been working, literally, weekly with all those partners and we're excited about what's ahead. Richard?

Richard Dickson - *Mattel, Inc. - President and COO*

Yes. Part of that Toy Box strategy originally was two-fold. Of course, one was to reestablish the partnerships in the entertainment community, which I believe that we've done a good job and made some great progress indicative of the brands Margo mentioned. But also noting, as we look to 2018 with some of the new properties from partnerships like Warner Bros., Justice League -- which we haven't mentioned, is launching at the end of this year. So we'll have a nice new brand in 2018 as that has a clean slate. And also at the end of 2018 with Warner Bros., we also have Aquaman which we're incredibly also excited about. So partnerships is a key component of our strategy. And as we mentioned, fewer things, bigger and better. That ultimately will benefit these type of partnerships as we look to redeploy the resources that were fragmented across many, many other aspects and look to enhance and reinforce those fewer things in a bigger and better, more pronounced way.

Operator

And I'm not showing any further questions at this time. I would now like to turn the call back to Whitney Steininger for closing remarks.

Whitney Steininger - *Mattel, Inc. - Investor Relations*

There will be a replay of this call available via webcast and audio beginning at 8:00 p.m. Eastern time today. The webcast link can be found on our Investor page. Or for an audio replay, please dial (404) 537-3406. The passcode is 84841057. Thank you all for participating in today's call.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a great day.

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