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SNBR - Q1 2018 Sleep Number Corp Earnings Call

EVENT DATE/TIME: APRIL 18, 2018 / 9:00PM GMT

OVERVIEW:

Co. reported 1Q18 net sales of $389m and diluted EPS of $0.52. Expects 2018 EPS to be $1.70-2.00.

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PRESENTATION

Operator

Welcome to Sleep Number's Q1 2018 Earnings Conference Call. (Operator Instructions) Today's call is being recorded. If anyone has any objections, you may disconnect. I would like to introduce Dave Schwantes, Vice President of Finance and Investor Relations. Thank you. You may begin.

David W. Schwantes - *Sleep Number Corporation - VP of Finance, IR & Decision Support*

Good afternoon, and welcome to the Sleep Number Corporation First Quarter 2018 Earnings Conference Call. Thank you for joining us. I am Dave Schwantes, Vice President of Finance and Investor Relations. With me today are Shelly Ibach, our President and CEO; and David Callen, our Senior Vice President and CFO.

This telephone conference is being recorded and will be available on our website at sleepnumber.com. Please refer to the details in our news release to access the replay. Please also refer to our news release for a reconciliation of certain non-GAAP financial measures and supplemental financial information included in the news release or that may be discussed on this call.

The primary purpose of this call is to discuss the results of the fiscal period just ended. However, our commentary and responses to your questions may include certain forward-looking statements.

These forward-looking statements are subject to a number of risks and uncertainties outlined in our earnings news release and discussed in some detail in our annual report on Form 10-K and other periodic filings with the SEC. The company's actual future results may vary materially.

I will now turn the call over to Shelly for her comments.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Good afternoon, everyone. Thank you for joining our call today. My SleepIQ score was 82 last night. Our revolutionary 360 smart beds differentiate and strengthen our competitive position through measurably better sleep.

As of this week, we now have about 75% of our product mix available in 360 smart beds compared to less than 25% just a few weeks ago. We've made important investments to ensure sustainable, profitable growth as we operate the business for the long term.

Today, I'll share our first quarter results and factors that give us confidence to reiterate our full year earnings guidance of $1.70 to $2. Our reported net sales of $389 million decreased 1% from last year. Our first quarter earnings per share of $0.52 were below last year's record $0.56 and in line with the performance required to deliver our 2018 guidance.

As we highlighted on our February call, we expected flat sales performance in Q1 ahead of completing our transition to the full line of 360 smart beds. By the end of this week, all 558 Sleep Number stores will be set with 5 of our 7 360 smart bed models. Here is a recap of the implementation timing.

We introduced the i10 and i7 360 smart beds in May of last year. We added the p6 smart bed in December. We are just completing our floor set of the p5 and the i8, our 2 most popular models. And we are on track to introduce the c2 and c4 entry-level smart beds by the end of the summer.

In summary, with the introduction of the p5 and the i8, we now have the majority of our product mix in 360 smart beds, including our entire Performance and Innovation Series. This has resulted in an immediate positive impact on our conversion and sales performance.

While it remains a challenging consumer environment, our initiatives and brand positioning give us confidence in mid- to high single-digit growth for the full year. Our 360 smart bed offers consumers compelling value across our full range of good, better and best price points within premium. We are excited to complete our core bed line transition this summer with our highly competitive new C series.

Additionally, we expect momentum from the following factors: Broadening brand interest with record levels of awareness and stable purchase consideration; steady digital and store traffic; 4.7 star reviews on our 360 smart beds and 4.8 star reviews for our Sleep Number stores; a simpler online in-store shopping experience as we move to all smart beds; higher ARU with the attachment of SleepIQ and adjustable bases; and unit growth momentum as we complete the 360 smart bed transition.

Our innovation pipeline is focused on quality sleep and wellness. Our customers' feedback reinforces the value of our proprietary responsive air technology and other features. Here are a few representative smart bed customer reviews.

"Since I've started sleeping on my new 360 smart bed with automatic adjustability, my SleepIQ score has improved over 15 points." Another customer said, "I like that both of us can adjust the comfort level to what we each want. No more getting up with achy joints in the morning." And another one we hear a lot is, "We love the features this bed has. Just last night, my wife started to snore so I pressed the Partner Snore button and she stopped snoring. We both sleep in piece. I love it."

This is what our mission is all about. Life-changing sleep. Our customers' engagement and advocacy, which is strengthened by their frequent interactions with our brand, continues to be an important source of growth with over 40% of our sales generated from referral and repeat customers.

Consistent with the progression of our initiatives, we also expect improving margin in the second half of the year. Factors that are pressuring the first half margin include inefficiencies associated with managing two supply chains, and higher attach of sourced products, including our adjustable bases. Our teams are making good progress on cost and process improvements across the business, and our network reconfiguration, which is a multi-year initiative, is on track. It will contribute to margin expansion and improved service over the long term.

During the quarter, we generated $49 million in cash from operations. We invested $9 million in capital expenditures and repurchased $75 million of our shares. We will continue to execute against our capital deployment priorities of: number one, investing in our business; number two, maintaining financial flexibility; and number three, returning cash to shareholders.

We feel strongly about the power of our consumer innovation strategy and the value in our shares. We are leaning into our share repurchases, while operating with modest debt and adhering to a conservative financial posture. Our trailing 12-month ROIC was 14.1%, well above our weighted average cost of capital.

In summary, we continue to differentiate and strengthen our position in the marketplace by delivering life-changing value to our customers. Our 360 smart beds offer measurably better sleep and linked to wellness with daily stats, trends and the ability to connect to other apps and devices. Our direct-to-consumer model with the cohesive online in-store experience in all 50 states are also strong advantages for our brand. And our culture and team's dedication to our mission of improving lives by individualizing sleep experiences set us apart in this commoditized environment that struggles to deliver a high-quality store experience.

With our agile, innovative core business and a superior sleep experience, we expect continued market share gains, while delivering top-tier shareholder returns. We are confident that our performance-driving initiatives will result in achieving our full year guidance, and we remain committed to our 2019 EPS target of $2.75.

I'll now turn it over to David, who will provide more details on the quarter.

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Thank you, Shelly. With the progress we've made against our transition key milestones, we are on track to deliver annual EPS of $1.70 to $2 in 2018.

Net sales of $389 million in the first quarter were 1% below the prior year. We provided color on our last call that Q1 sales would be about flat year-over-year given the 12% growth in Q1 last year and the timing of our various initiatives. Our detailed Q1 sales metrics reflect these dynamics.

We drove a 9% increase in our ARU as more customers opted for 360 smart beds complete with SleepIQ and add an adjustable base and bedding. Our company controlled units were down 9% versus the double-digit prior year growth. We expect full year unit growth as we complete the remaining smart bed transitions by midyear.

Comp store sales in Q1 were down 3%. With performance against our initiatives on track, we continue to forecast low to mid-single-digit comp growth for the year. New stores contributed two points to our results in Q1 as planned. We ended the quarter with 558 stores and are operating in all 50 states. Our trailing 12-month average sales per store, including e-com was $2.6 million, up 1% from this time last year. We continue to progress toward $3 million average sales per store and see this as a compelling profit-driving opportunity. The transition of our product line to 360 smart beds is fundamental to our strategy. The execution has required a period of operating 2 supply chains. As planned, this is causing temporary inefficiencies in our manufacturing, logistics and retail operations. These transition costs, including higher freight and logistics costs, pressured our gross margin by about 80 basis points compared to the prior year first quarter when we had no transition costs.

We also realized 70 basis points of pressure from a greater mix of sourced products, which benefits our ARU. While very early, we like what we're seeing from both delivery of fully assembled mattresses and evolution of our outbound logistics network.

Since our last earnings call, we converted another spoke, making it our fourth delivery distribution center and expect to complete the fifth later this quarter. These initiatives, along with our lean operating efforts and streamlining our supply chain post 360 launch, will drive meaningful gross margin expansion in the back half and beyond.

Our overall operating expenses in Q1 were flat with the prior year. We prioritize spending that drives long-term shareholder value, while driving operating efficiencies across the business. Our earnings per diluted share for the first quarter were $0.52 versus $0.56 the first quarter last year.

Our 22.1% tax rate in Q1 included nearly 300 basis points of equity award accounting benefits, which was comparable to the benefit in Q1 last year. We continue to execute initiatives that support each of our EPS drivers to grow demand, yield operating leverage and generate share count accretion. We see value in our shares and at the end of the first quarter, had $390 million remaining under our share repurchase authorization. Our posture regarding our capital structure will continue to be conservative, including the $100 million to $150 million liquidity cushion we feel is appropriate to run the business. The increase in the revolver will be used over time to invest in the business, including share repurchases.

We ended the quarter with $75 million drawn against our $300 million revolver and anticipate modest debt on our balance sheet going forward. Our 2018 EPS guidance range of $1.70 to $2 represents 19% EPS growth at the $1.85 midpoint. We highlighted key assumptions supporting this guidance on our last call. Here is a reminder of some of those assumptions.

We expect quarterly fluctuations in our results as we pace our initiatives differently during the year. Our EPS guidance assumes above market mid- to high single-digit 2018 net sales growth in a slowly growing economy with annual growth from a combination of ARU, units, comp and new stores.

After adjusting for prior year's shifts discussed in 2017, we forecast stronger sales growth in the back half of 2018 than in the first half. This acceleration follows the completion of the rollout of our Sleep Number 360 smart beds. We now project an annual gross margin rate in 2018 that's in line with 2017. Specifically, our 360 smart bed launches and closeout sales are likely to cause quarterly margin rate fluctuations, while driving performance overall for the year.

Costs from 360-related supplier transitions and logistics migration in 2018 are forecasted to be $6 million to $8 million compared with $10 million in 2017. Q1 included $3 million or 80 basis points of these operating in efficiencies in cost of goods sold. We project $2 million to $3 million will impact Q2.

As a result, we are forecasting our seasonally low second quarter EPS to be about breakeven. As we closely manage costs across our all lines of our P&L, we are -- we also expect up to 25 basis points of operating expense leverage in 2018 and continue to see opportunities long term.

We forecast approximately $50 million of capital projects in 2018 and expect to deliver mid-teen ROIC as we continue to reap profits from nearly $0.5 billion of investments since 2012. We are executing against high confidence initiatives to deliver strong value creation the balance of 2018 and beyond. We continue to strengthen our competitive position by executing with urgency and resolve, while prioritizing our customer.

Christine, at this point, we'd like to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Peter Keith with Piper Jaffray.

Peter Jacob Keith - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

I wanted to dig into the unit trend for the quarter, which was a little worse than what we were expecting. And I guess, I'm having a hard time getting my arms around the unit trend in Q1 and then what would be very meaningful acceleration starting, I guess, for Q3 to Q4. Could you give us some -- maybe some insights into Q1, if there is any anomalies? And what I mean specifically is, did you have some pull forward into Q4 that you could quantify? Also curious if you are seeing any disruption from some competitors out there? We are hearing about that. And maybe if you could give us a trend through the quarter and did you exit stronger than how you started?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Great. Thanks, Peter. Okay. A lot there to unpack. Let's start with talking about sales and the shape of the quarter and what we're seeing. So first of all, our Q1 sales were down 1% versus our expectation of flat to slightly up. The shape of the quarter was pretty consistent. What we saw a slight shortfall in is the lift from the closeout. So we expected a little bit more lift in the March time frame from the closeout. Our challenge has been in conversion as our customers' primary interest has been in our 360 smart bed and we've only had it towards the top of the line. So right now having the p5 and the i8 floored, everything is so much simpler because we have the entire Performance and Innovation Series now in the 360 smart bed.

And that's the bed the customer is choosing and wants to be able to purchase it at a price that makes sense for her budget. So bringing the p5 and the i8, our two most popular beds in has made an immediate -- has resulted in an immediate change for us in both conversion and in overall sales. There was a fair amount of complexity on our floor with both product lines. And just to give you an illustrative example with our selling process, our customers will go through a minimum of experiencing three different beds. Before April, before the p5 and the i8, our customer experienced two of our prior beds and then, one smart bed at the top of the line, the i10. Now going into our store, she will experience all three smart beds in that initial selling process. So it does make a big difference for us. And as I highlighted, Peter, we immediately move from 25% of our assortment in smart bed or 25% of our mix in smart bed to 75% with the p5 and i8. So we're excited about what that's going to mean. From a unit ARU perspective, as David highlighted, our ARU was up 9%, very consistent with the increases in attach that we've been seeing in our smart beds. And at the same time, we know that the unit momentum will come as we transition to our smart beds. So we expect that with the p5 and the i8. And then, most importantly, with the new C series, which is very competitive at our opening price point of around $1000.

Peter Jacob Keith - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Okay. Thank you for that, Shelly. And just to follow-up quickly, would you guys at this point be able to quantify what the sales shift out of Q1 into Q4 was at this point to help us frame up maybe a true Q1?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Sales shift, I'm sorry, what sales shift are you talking about?

Peter Jacob Keith - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

At last quarter, you were talking about expedited deliveries at the end of Q4 because of very sort of even weather or lack of snowfall and that was one reason why you were going to have kind of a flattish sales quarter. Maybe I'm overplaying it, but maybe you can (inaudible) quantify it.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

I would -- we've mentioned that we had favorable weather through the quarter, which compared to the prior year, we probably had more disruption in the fourth quarter of 2016, it would have been. But if you look at the first quarter of this year, from a shape perspective, I highlighted the closeout which was a small. I mean -- in general, I mean, we missed expectations on the top line by 1%. We thought we would be flat and we came in down 1. So we did expect a little bit more from the closeout. We also had much greater number of store closures and rescheduled deliveries related to weather in the first quarter of this year compared to prior year, but in general, I would put more emphasis on what I talked about in the transition from a regular line to our smart bed, especially with the immediate change that we're seeing as we floored the p5 and the i8, Peter.

Peter Jacob Keith - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Okay. And I do have a separate question for David. Just on that Q2 earnings outlook where you expect kind of a flattish quarter, if I had my notes correctly, I think, last year, because of the sales shift out of Q2 and Q3, there was about a negative $0.12 impact to Q2. So just adding that back in, you should get to $0.10 of EPS. You are guiding flat. If I even go back a couple of years, you guys had earnings of $0.20 and $0.30 in Q2. So what's really changed here that's caused this breakeven beyond the supply chain headwinds?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Well, Peter, I think, it's how we kind of envision the year. When we set out our guidance for the year, we talked about the shape of our initiatives and when those would take effect. We are really expecting the benefit from our full 360 smart line to really kick in, in the back half of the year and that's going to help us both in terms of top line growth and overall performance, profitability. We have different initiatives that we are supporting and spending behind and those costs are incorporated in how we're thinking about the second quarter, as well as the gross margin pressure that we talked about in Q1 is going to impact us again in Q2 to some degree.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

With the two lines.

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes, from operating two product lines, again, still through the full first half.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

And if you think about compared to the prior years, Peter, that is a significant change with having both product lines out there right now through the first half of the year. That would go away as we head into the third quarter.

Operator

The next question comes from Bobby Griffin with Raymond James.

Robert Griffin

First, I was just curious, on the supply chain issues that were kind of reference in the release of running -- operating the two different supply chains, did that cause any hiccups for deliveries during the quarter?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Not really. Not really that, Bobby. It was more focused on things like a couple of examples specifically of operating two supply chains. We have legacy suppliers that are going to be going away on products that are going to be going away that are end-of-life products that have increased their prices to us. So that puts some pressure on our margin rate. That happened in the first quarter, will continue on in the second quarter. Another one is that we -- you notice from our balance sheet, we've got more inventory than we've had in the past. And that's because we are in this transition period where we have to support both product lines. That's a temporary state of being and -- but it comes with additional handling costs, additional storing costs, freight costs. So those are some pressures that we are experiencing here in the first half that's putting pressure on our margin rate that go away eventually when we get to the other side of the 360 launch.

Robert Griffin

Okay. And then maybe just to follow-up, again, on Peter's question. I understand the transition costs that's in 2Q, but if you add back kind of the $25 million, you kind of get to $310 million starting point from revenue. And I guess, if you're guidance assumes kind of positive comps, there's got to be something else going on in the P&L to kind of get back to breakeven with lower tax rate and lower shares for EPS standpoint. Is there a marketing investment with the new beds coming on there or a G&A investment? How -- what else is happening to try to help us get the shape of this year right in our models?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

There are -- we are investing behind our marketing efforts in the year. We are going to spend to support our initiatives. And we believe those are the right things to do to have the brand breakthrough, and we're operating the business for the long term. So yes, we have some operating expense pressure in the second quarter. It is the seasonally low quarter otherwise, and so it does put some pressure on the profitability in the second quarter.

Robert Griffin

Okay. And then I didn't hear in the prepared remarks, but where did marketing for 1Q end up where we can true our models up?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes. We don't break out marketing separately, but it was -- our total operating expenses were flat to the prior year. Some of that reflected some various offsets. Some good guys on the commission side, good, bad guys or bad, good guys, I would say. But otherwise, executing the initiatives the way we thought we would.

Operator

The next question comes from Brad Thomas with KeyBanc Capital Markets.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Let's see, a couple of housekeeping items. Can you give us any insight into the margin profile of the p5 and the i10, just as we think about what kind of mix implications there could be for you here as some of these strong-selling models get out on the floor?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Well, you know that the i8 is near the top of the line. It's the i10 and the i8 are in the Innovation Series, and they come with highest price points and the highest margin rates. The i8 has historically been one of our most popular beds, as Shelly highlighted. And the p5 is spot in the middle and it's also one of our most popular beds. And so the margin rate profile for our beds with 360 are very similar to those to the previous, but the attach rate of sourced products is higher generally. And so that's expected to have a little bit of margin rate pressure as we go forward. But it's good kind of pressure as it should drive more sales as well.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Great. And then a follow-up on the supply chain evolution. I think you said you converted your fourth spoke, if I heard you correctly. I thought you guys have about 15 hubs in like over 100 spokes, if I'm not mistaken. What inning are we in here? And help me connect the dots on when this transformation starts to actually benefit the margin structure of the business given that you have a pretty expansive delivery network and supply chain network across the U.S.?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Right, Brad. You can take a look at the investor deck. There is a slide on this on our -- for industrial materials as well, but we're very early innings. We are talking about ultimately having 6 assembly hub or factories and 30 to 40 DCs or these distribution centers. So we are very early on in the process. But we are seeing a lot of really goodness, a lot of good things coming out of it and we like the advantage for the consumer. So we'll continue to learn and progress it, but we're going to ease our way into it.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Brad, I think, one clarifying point too is, we're not intending to convert all spokes to the distribution centers that David highlighted in his prepared remarks. So some of the spokes will continue with the cross-docks, and we highlight that on Page 18 of the investor deck. About 70 spokes will continue as cross-docks. Some will go away, some will convert to the distribution centers.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Got you. I mean, the process and the changes makes a lot of sense to me and look like they should have a good payoff. I'm just -- I guess, I'm trying to quantify and connect some of the dots here. So you're running two networks today and in this quarter with an 80 basis point drag. It feels like you're early in the process. Help me connect the dots on if this takes several years to change our supply chain, when this starts to be breakeven or a payoff on the change?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes, Brad, I'm glad you are talking about this because you're talking about two different things, very different things. The cost pressures that we're seeing are related to the transition of our product line, and that's where we have -- Shelly highlighted very well about some of the complexities in the retail environment, but that translates all the way through our operations, whether that's in manufacturing. On the manufacturing floor, more space is required because we have to assemble and manufacture both product lines. And then, we have to maintain the inventory for both product lines, et cetera, and handle all of that through our overall logistics network. That's what the cost pressure is today. That's not -- the vast majority is not related to the network evolution, the outbound logistics network that we are evolving. That portion of it is fairly self-funded so far.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

So Brad, as we referenced, the two product lines or the two supply chains related to 360, that will go away as we finish the transition to 360 with our C series by the end of the summer.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Got you. The 80 basis points is more on the product side as opposed to the supply chain. The supply chain redesign that you are undergoing?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Yes. It's related to the products that comes from supply chain. And then, the network redesign is -- has been self-funding. And there's great efficiencies that come with it. So there's upside margin expansion related to it.

Operator

The next question comes from Michael Lasser with UBS.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Earlier in your prepared remarks, I think, you mentioned that 40% of your sales come from referrals and renewal, and I may be wrong, but I remember in the past, you said 1/3 of your sales come from referrals and renewal. So are you -- do you think you are just having a little bit of a challenge attracting kind of that new customer? You said that you're still seeing the strength from the renewals and referrals. Is that the right way to think about it?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

No, with the referrals, referrals are new customers -- bringing new customers to the brand. So they are generated -- they're helped and generated by existing customers, but they are new customers to the overall brand. It's -- if you think about how social media is today and the influence of social media, it influences other people to refer -- social media refers people to brands. And so, our insider base has been growing over the last number of years. And it's an important source of growth because it's an efficient source of growth, when you have existing customers not only repeating but also referring new customers to your brand.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Those are right. Has that gone from 1/3 of the base to 40%?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Yes. And we're excited about that growth and continue to work strongly on that growth.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

And Shelly, is it -- it's just been a challenge to get nonreferrals and nonrepeat customers because customer acquisition costs are rising, the field of alternative and competing products in the mattress space has become wider in the last few years, is that correct?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Yes. Well, our metrics have been improving on new customers to the brand. The pressure that I would characterize in the first quarter and we've talked about it a few times is that, our customers want our new smart bed. Our new smart bed in our advertising is generating the interest. It's bringing people. Our traffic has been great. The conversion has been the bigger opportunity in the first quarter. And we do -- you see the complexity in our stores and online with having both lines and really only having the availability of the smart bed at the high end of the line. So we're really excited about where we are now. And we have seen an immediate change, Michael, as soon as we set the p5 and the i8 to be able to offer the smart bed in our full Performance Series and Innovation Series. And as we indicated, we expect some unit improvement, which we characterize units and new customers together and we think a lot about ARU and innovation. So -- and that's a good way to think about the business that we expect to continue to grow both ARU and units on an annual basis, will have quarterly fluctuation. We expect unit growth with the rollout of the 360. So we'll see momentum here in Q2. And then, with the C series by the end of the summer is what really when we'll see some strong unit growth here in the back half of the year. So think about that as new customers to the brand. And what we really love about this business model is that it will do both. ARU is not just dependent on price increases like it is everywhere else. We don't have a commoditized product like everywhere else. We have differentiated products that deliver meaningful benefits to our customers with better sleep and also being able to offer this new smart bed at good, better, best price points in the premium sector starting at $1000 that, that will be very competitive against a lot of commoditized products that are around that price point.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

And my follow-up question is, you provided at the outset of your remarks an indication that you have more -- a greater percentage of your stores reset with the new product line or some of the new products than you had a few months ago. So have you seen overall sales turn into this first quarter as you had a greater percentage of your stores reset?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Yes. We started setting the p5 and the i8 just 2 weeks ago. So it's been in April, in Q2, since we have set the p5 and the i8. And by the end of this week, we will have all 558 stores set. So it's the larger set that we've ever done in our history. It involves the most changeover on the beds. And we have been able to experience and see an immediate impact in both our conversion and sales. So it's quite exciting and it's the kind of momentum that we expect out of this product.

Operator

The next question comes from Seth Basham with Wedbush Securities.

Jordan William Flannery - *Wedbush Securities Inc., Research Division - Associate*

This is Jordan Flannery on for Seth Basham. Just a question. So outside of the supply chain transition -- product transition cost that you mentioned, could you talk more structurally about the underlying transient commodities and then maybe some more color on the freight cost headwind that you mentioned earlier?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Sure, Jordan. We've highlighted that with our business model we have intended through the years to offset inflationary pressures from commodities through cost improvements or lean initiatives throughout our operations. There -- I have been some other discussions about things like steel tariffs or pressures on our -- on foam, raw materials. We see those elements as being a relatively small component of our overall COGS. However, we work very closely with our suppliers. We have contracts in place that control the amount of price increases that get passed along. And also, we have efficiency projects that we work with our suppliers to help offset cost increases. So we feel like we've got a lot of tools in place to manage those cost increase -- cost elements. And at the -- if the case requires, we also have pricing power. And have over the history, had about a 3% benefit-driven pricing increase annually over time.

Jordan William Flannery - *Wedbush Securities Inc., Research Division - Associate*

That's helpful. And then just one follow-up here. Obviously, there is a mass-market competitor that was somewhat very promotional during the first quarter. Have you seen any lasting impact on that on consumer response to promotions and any more recent trends that you can talk about in the competitive landscape?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

So most of that's happening at the commoditized end of the lower -- the entry-level price points of the marketplace. You know that we participate in the premium space, and we differentiate ourselves through sleep-improving benefits. And so, we are not really affected by some of those behaviors by the competition.

Operator

The next question comes from Keith Hughes with SunTrust.

Keith Brian Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Heavy share repurchase activity in the quarter. I guess, my question is, are you willing to carry a debt balance in the future? You've historically not had a debt -- a long-term debt balance for some time. Has that methodology changed?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes. We have been talking about this for the last couple or three years or so in that we continue to look at our capital structure, and it's important that we evolve that just like we evolve every other element of our business model. And we've been highlighting that with the revolver and then the increased revolver that it gives us additional liquidity that provides us the opportunity to have debt on our balance sheet.

Keith Brian Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

And is there a certain metric you would not go above a debt-to-EBIDTA target that you would not be comfortable going above?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Well, our leverage ratio for EBITDAR is 4.25x and clearly, we wouldn't exceed that. But truthfully, internally, we have a fairly conservative or a pretty conservative orientation. And we like to maintain $100 million to $150 million of cushion -- liquidity cushion, and we wouldn't go above borrowings that would take us below that.

Keith Brian Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay. Final question. In the $2.75 guidance, share repurchase is obviously part of it. Is there any limitation from the Board in terms of how much that could make up to get to that number?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

I'm sorry. I missed the last part of that. Sounded like there was some background noise.

Keith Brian Hughes - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

We're fine. We're loud here. I guess, is there any limitation to how much share repurchase helps get you to the $2.75? Or is it just part of the mix?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes. We've committed to three EPS drivers, and demand driving -- demand drivers, the operating business leverage and then, share repurchases and we are committed to using all three of those leverage to get there.

Operator

(Operator Instructions) The last question comes from Curtis Nagle with Bank of America Merrill Lynch.

Curtis Smyser Nagle - *BofA Merrill Lynch, Research Division - VP*

So just a quick one on the guidance for OpEx. Are you still targeting 25 bps of leverage? And how should we expect advertising dollars to trend for the year?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes, Curtis. We are still projecting that we have an opportunity for 25 basis points of operating expense leverage for the full year. That, of course, is going to flow according to how our demand evolves during the course of the year, but that's how we are thinking about it at this point.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

And then specifically on media, last year, we ended with some great -- over 100 basis points of leverage and it was 13.4% of sales. We talked about on the last quarter that we would invest in media this year and to think about a 14% in your models. Here in the first quarter, we just had a slight increase year-over-year in media.

Curtis Smyser Nagle - *BofA Merrill Lynch, Research Division - VP*

Okay. That's very helpful. And then just kind of thinking about comp for 2Q, looks like you guys are running a clearance on the two outgoing beds. It sounded like clearance wasn't much of a factor in 1Q. Do you think that steps up a little bit given the two beds that are on clearance now and you're transitioning to are pretty popular, is that in the guidance in anyway?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Well, what's most important for our momentum is absolutely the 360 smart bed and we are beyond the clearance now, as of tomorrow, on the p5 and the i8. So it is really about the momentum of the smart bed. So if you think about clearance and transitioning, our C series, we're not counting on a big sales lift as a result of that. It's more about bringing the new products on to the floor and that's what we are seeing from our customers and our sleep professionals is their excitement for the smart bed and the ease of being able to sell it versus the complexity of having both lines out there.

Operator

Thank you. There are no further questions. And I would now like to turn the call back to the company for closing statements.

David W. Schwantes - *Sleep Number Corporation - VP of Finance, IR & Decision Support*

Thank you for joining us today. We look forward to discussing our second quarter 2018 performance with you in July. Sleep well and dream big.

Operator

This concludes today's conference. Thank you for your participation. You may disconnect at this time.
