

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SNBR - Q4 2018 Sleep Number Corp Earnings Call

EVENT DATE/TIME: FEBRUARY 13, 2019 / 10:00PM GMT

OVERVIEW:

Co. reported 4Q18 reported net sales of \$412m and EPS of \$0.81. Expects FY19 net sales growth to be 6-10% and diluted EPS to be \$2.25-2.75.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

CORPORATE PARTICIPANTS

David R. Callen *Sleep Number Corporation - CFO & Senior VP*

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

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

CONFERENCE CALL PARTICIPANTS

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

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

John Allen Baugh *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

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

Matthew J. McClintock *Barclays Bank PLC, Research Division - Senior Analyst*

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

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

Robert Kenneth Griffin *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Seth Mckain Basham *Wedbush Securities Inc., Research Division - SVP of Equity Research*

PRESENTATION

Operator

Welcome to Sleep Number's Q4 2018 Earnings Conference Call. (Operator Instructions) Today's call is being recorded. If anyone has any objections, you may disconnect at this time.

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 Fourth 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.

Please also note that we have posted an updated investor presentation on our website at sleepnumber.com.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

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

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

Thank you, Dave. Thank you for joining our 2018 earnings call. My average SleepIQ score is 82. Consumers are highly engaged with our purpose-driven brand and responding strongly to our revolutionary 360 smart beds. The execution of our consumer innovation strategy has broadened our relevance as individuals increasingly understand the importance of quality sleep to their overall well-being.

Results for the fourth quarter included net sales growing 13% to \$412 million, including 10% comp growth; net operating profit increasing to \$38 million; and earnings per share increasing 108% to \$0.81.

For the full year, net sales increased 6% to over \$1.5 billion, including positive comp sales for the fifth consecutive year. Net operating profit increased to \$92 million, while absorbing approximately \$16 million of transition impacts and earnings per share increased 24% to \$1.92 compared with \$1.55 for 2017.

Our record sales and EPS performance reflects the acceleration from our 360 smart beds. In the second half of 2018, our adjusted net sales grew by 12% and adjusted earnings per share grew by 48%. The momentum in our business continues and we expect to generate full year earnings per diluted share of between \$2.25 and \$2.75 in 2019.

Our strategic consistency, investments and fortitude over the past 6 years have focused on strengthening our competitive advantages, proprietary sleep innovations, exclusive distribution and lifelong customer relationships, which work together to drive results. We are excited to be in the position of much broader relevance in a changed consumer and competitive landscape.

Our initiatives deliver performance through 3 EPS drivers, which are creating demand, driving leverage and deploying capital efficiently. We remain committed to using all 3 of these EPS drivers in 2019 and beyond.

Here are the highlights, starting with demand. Number one, our proprietary sleep innovations remain at the heart of our strategy and our highly differentiated new 360 smart beds have disrupted the commoditized industry. Our proven quality sleep starting at \$999 is resonating with consumers and driving unit growth, which increased 8% for the fourth quarter. The value of our smart bed complemented by our selling process is driving average revenue per unit, ARU, which increased 5% in the fourth quarter. We expect our growth initiatives to again drive increases in both of these metrics in 2019.

Our 360 smart bed is a key enabler of our future growth. As a sleep innovation leader, we are setting the pace to remain relevant with the fast-changing consumer who is adopting smart, connected experiences to improve her life. The SleepIQ technology platform, which captures over 8.5 billion biometric data points every night, uses artificial intelligence to detect sleep disturbances, movements and biometric changes.

Today, this data is used to automatically adjust the comfort of the bed for proven quality sleep. In the future, our high-quality data will likely enable customers to use their smart bed to manage their health and wellness. Some examples include detecting risk or early onset of conditions, such as heart disease and diabetes, sharing biometric data with her doctor to support a diagnosis and monitoring recovery at home following medical procedures. With an exciting innovation pipeline in front of us, we will increase our investments in R&D.

Number two, our integrated marketing and media initiatives drive quality traffic to our purpose-driven brand by amplifying the benefits of our life-changing innovations. In an environment of fierce competitive spending for consumers' attention, we are breaking through in taking share.

Since the full launch of 360 smart beds, we have driven double-digit traffic increases, record brand health metrics and breakthrough ad awareness. We expect this momentum to continue in 2019 as we advance our initiatives, including our integrated "This is Not a Bed"36 campaign, effective media buying driven by analytical tools and internal digital buying, emotionally engaging consumers through brand storytelling and leveraging our groundbreaking NFL partnership. With over 1,800 NFL players now sleeping on our 360 smart beds, we are amplifying the link of between quality sleep and performance.

FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

Number three. Our exclusive distribution with mission-driven sleep professionals converts traffic at high rates. With the simplification of our 360 smart beds, we drove record levels of conversion in the back half of 2018. In 2019, we expect our initiatives to deliver high conversion, strong sales growth from both comp and new stores and online sales growth that outpaces the stores.

Key initiatives in this area include simplification of the research and purchase experience on our website and in our retail stores, continued market development as we execute our disciplined real estate portfolio strategy. Our approach delivers a relevant customer experience as we optimize location, sales, profits and market share in a sustainable manner. We expect to end this year with 615 to 625 stores.

Number 4. Our lifelong customer relationships with our brand are a key competitive advantage as we drive sustainable, profitable growth. With digital at the core of our smart beds, customers now interact with our brand every day through SleepIQ technology and are benefiting from the life-changing value. And our digital loyalty program is amplifying this passionate brand advocacy. These individualized interactions result in higher brand engagement and customer activation, with over 40% of our sales generated from referral and repeat purchases.

In the words of one of our customers, "We bought the 360 smart bed a week ago and have already noticed a complete change in not only our sleep but the quality of our waking hours. We are both more rested and energetic and also, less stiff, sore and less grumpy." This high level of advocacy is also reflected in our 4.8 star review ratings on 360 smart beds and our #1 ranking in J.D. Powers annual Mattress Satisfaction Report. We also ranked #1 in the top 6 categories, including support, durability, comfort, features, value and warranty.

Moving to leveraging our business model. Our lean practices and initiatives are executed broadly across the organization. Continuous improvement methodology is important for the progression of our robust technology platforms and order fulfillment processes.

In the fourth quarter, we realized efficiency gains associated with inventory visibility through our network. Our fourth quarter net sales growth of 13% and strong cost discipline also led to 350 basis points of operating expense leverage for the quarter.

For 2019, while there are headwinds related to tariffs and increasing freight costs, we still expect the benefits from the absence of transition cost, operating efficiency improvements, pricing power and sales growth to support net operating profit rate expansion.

Importantly, we continue to make progress in our supply chain network evolution with the recent opening of our Baltimore assembly distribution center and 2 delivery distribution centers. We expect improved assembly flow, reliability and scale with this multiyear digitally enabled network evolution.

And finally, our third EPS driver, efficient capital deployment. Strong cash generation and operating with a progressive balance sheet is a key outcome of our differentiated business model and strategy. Along with our board, we frequently assess and advance our capital structure to optimize shareholder returns over the long term. Our capital deployment strategy contributed to our 24% earnings per share growth in 2018 and 16% return on invested capital. Our top deployment priority continues to be investing in high confidence, high-return growth drivers. We have invested over \$500 million in capital and acquisitions to complete our transformation.

Our internal capital demands are now more modest at approximately \$50 million per year. In addition to our capital projects, we continue to innovate our products, customer experience and our go-to-market capabilities. This continuous evolution is a primary discipline to ensure consumer relevance over time.

Our second priority is financial liquidity. With favorable financial markets and our business position, we have amended our revolving credit facility. Our larger \$450 million revolver provides liquidity to support the ongoing execution of our strategy.

Our third priority is to return excess cash to shareholders. In 2018, we returned \$279 million to shareholders through share repurchases, up 86% over the prior year.

Our share repurchase strategy is generating double-digit internal rates of return since its inception in 2012. In 2019, we expect to purchase approximately \$125 million to \$145 million of our shares.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

In summary, we are bullish about our business, and our guidance reflects continued strong momentum. I am very proud of the Sleep Number team, their dedication to our mission and the value they place on our purpose-driven brand and culture. Our team is delivering life-changing sleep to consumers. We hear this from our customers every day and it is extremely rewarding to have this level of impact on people's lives. The execution of our consumer innovation strategy is strengthening our competitive advantages and driving and delivering accelerated growth and performance. We expect our purpose-driven company to generate top-tier shareholder value creation over the long term. In 2015, we established 2019 long-range guidance of \$2.75 of earnings per share.

In many ways, we are just getting started with our 360 smart beds, which have tremendous potential to add increasing value to consumers well-being.

I will now turn it over to David, who will provide more details on the quarter, the year and our guidance.

David R. Callen - Sleep Number Corporation - CFO & Senior VP

Thank you, Shelly. Since 2012, we have completely transformed Sleep Number to enable long-term sustainable profitable growth. In addition to the significant investments of capital, this painstaking work required that we build vital new capabilities. We prioritized innovation, increasing our R&D spending from 0.7% of net sales in 2012 to about 2% today. This led most recently to the completed rollout of our revolutionary 360 smart beds, which drove 8% reported or 12% adjusted net sales growth and 31% reported or 48% adjusted EPS growth for the back half of 2018.

Consumer adoption of our innovations has led to a 47% increase in our ARU since 2012. We've built and implemented two game-changing technology platforms. One, our ERP system is the backbone of our integrated operations, providing scale, security and growth capacity. The second, SleepIQ technology, combines artificial intelligence with adjustable comfort and provides a daily interaction portal for our customers with the Sleep Number brand.

We've overhauled our direct-to-consumer distribution strategy ending 2018 with a healthy portfolio of 579 stores, 41% more than 6 years ago. We shifted from 19% non-mall locations to 63% at the end of 2018. With these investments, we created an exclusive best-in-retail in-store experience through award-winning design, technology enhancements and stores that are about 50% larger on average.

Today, we operate more than 580 stores in 50 states, delivering strong economics with meaningful capacity for growth. While advancing our physical retail, we also streamlined our online experience to improve search, product comparisons and shopping cart convenience. Our vertically integrated go-to-market strategy provides a true omni-channel experience for our customers.

Our average annual sales per store, including online, is now \$2.7 million, with 25% of our stores exceeding \$3 million in sales annually, up from 12% in 2012. The mattress industry has also changed significantly in the last 6 years. Today, we compete in a chaotic, low-interest category with nearly 200 brands. We are taking market share in this environment because of the actions we've taken, including strengthening our proprietary marketing capabilities. Our econometric model, agile digital marketing and partnerships, like the NFL, amplify the Sleep Number brand and break through the competitive clutter with proven quality sleep.

Our 2018 media spend at 13.7% of net sales demonstrates the effectiveness of our marketing capabilities in a far more complex competitive environment. We are benefiting now from the strategic investments, structure and capabilities that we've built since 2012. Our 16% return on invested capital in 2018 is a 78% premium to the 9% cost of capital we employ, demonstrating the efficiency of our capital and investment decisions. Sleep Number, the company, now has sustainable infrastructure we can leverage, while Sleep Number, the brand, is breaking through with consumers. We are delivering superior shareholder value today and are well poised for the future.

Reported net sales in Q4 of \$412 million were up 13%, including 8% unit growth and 5% ARU growth. Comp growth was 10% and new stores contributed 3% for the quarter. For the year, record net sales of more than \$1.5 billion grew 6% with 2% unit growth and 5% ARU growth. Comps and new stores each contributed 3 points of growth for the year.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

For additional performance clarity, please refer to Page 10 of the earnings release for a reconciliation of quarterly shifts that affected the timing of sales and EPS within both 2017 and 2018, but had no impact on full year results either year.

Our 61% gross margin rate in Q4 reflects a 60 basis point step-up sequentially and a 20 basis point improvement versus Q4 last year. In the quarter, we absorbed \$1.5 million of new tariff pressures, while reducing year-over-year transition costs and inefficiencies by \$2.5 million as expected.

Our full year gross margin of 60.6% included approximately \$16 million of gross profit pressures absorbed to transition to all 360 smart beds. Eliminating those transition impacts in 2019 provides a tailwind opportunity that I'll discuss more in a moment. We leveraged operating expenses 350 basis points in the fourth quarter versus the prior year quarter. Key drivers included volume leverage on 13% reported top line growth, 50 basis points of media leverage and lower incentive compensation costs. On a full year basis, we levered operating expenses 120 basis points.

Net operating profit of \$38 million in Q4 reflects a 380 basis point lift versus the prior year as a percent of net sales. For the full year, net operating profit grew 1%, while absorbing approximately \$16 million of transition impacts noted earlier. Q4 reported earnings per share increased 108% on 13% reported net sales growth, while adjusted EPS increased 76% on 11% adjusted net sales growth. Record full year earnings per share of \$1.92 increased 24% or four times our 6% growth in net sales.

Continuing to deliver performance using all three of our EPS drivers in 2018 included \$0.18 each from share count reduction, net of interest costs and income tax rate benefits. Together, these gains offset approximately \$0.36 of transition impacts absorbed during the first 9 months of 2018.

For the full year, we generated \$132 million of cash from operations and invested \$46 million in high-value capital projects, including 53 new stores opened in 2018. We also repurchased \$279 million of our outstanding shares and ended the year with a \$186 million remaining under our share repurchase authorization. We are planning 2019 share repurchases of \$125 million to \$145 million as we continue to see strong value in our shares.

We ended 2018 with \$198 million of net debt, reflecting continued methodical execution of our capital strategy. We recently expanded our revolver to \$450 million, extended the expiration to February of 2024 and increased the leverage covenant to 4.5x EBITDAR. Our partnership with several leading banks made these changes possible, providing liquidity in varying market conditions.

After discussion and alignment with our board, we are targeting an average leverage ratio of 2.5 to 3x EBITDAR. This range is based on benchmarking of relevant companies and ongoing analysis of our liquidity forecast as well as downside scenarios. We expect to operate slightly above or below that range from time to time as we execute our strategy. In 2019, we plan to harvest returns, while continuing to prioritize investments for long-term sustainable profitable growth.

Our 2019 EPS guidance range of \$2.25 to \$2.75 is expected to deliver top quartile to top decile earnings performance. This range represents year-over-year EPS growth of 17% to 43% and 30% at the midpoint. Our EPS guidance assumes a confident consumer in 2019. The EPS range assumes 6% to 10% net sales growth for the full year with higher growth in the first half than in the back half when we lap 12% adjusted growth from the back half of 2018. We see growth opportunity from both units and ARU. As always, this will vary from quarter to quarter.

We plan to invest \$50 million to \$60 million in capital projects in 2019. This includes an acceleration to open 60 to 70 new stores in 2019, which we expect to contribute to our planned low single-digit new store sales growth for the year.

We expect to improve our gross margin rate 80 to 120 basis points in 2019, while managing through meaningful tailwinds and headwinds. Eliminating the transition pressures absorbed in 2018 provides lift of 90 to 100 basis points. Volume-based leverage, improved logistics operations and benefit-driven pricing are also expected to be 2019 tailwinds.

On the other side, we continue to work diligently to mitigate \$9 million to \$11 million or 40 to 60 basis points of incremental tariffs, freight and delivery headwinds in 2019. Stronger attach of adjustable basis and bedding products are expected to contribute to sales and profit dollar growth, but also pressure our gross margin rate.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

Executing our business plans in 2019 is expected to improve net operating profit margin by approximately 50 to 100 basis points. We continue to see opportunities to improve operating profit margin longer term, while prioritizing growth investments to reach more consumers and expand our sleep leadership position. We also plan to manage capital deployment headwinds and tailwinds in 2019.

We assume a 24.5% income tax rate, which is a headwind versus a 19.6% rate in 2018. Higher interest expense in 2019 will be more than offset by tailwinds from lower share count. We expect the execution of our strategy to deliver at least mid-teen ROIC in 2019 versus our high single-digit cost of capital deployed.

In closing, we are thrilled with the acceleration of our performance in the back half of 2018 and the momentum leading into 2019. Our dedicated teams continue to execute with passion and vigor, delivering life-improving value to our customers results in superior value creation for our shareholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from John Baugh from Stifel.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

I was curious a little bit, I guess, on the tone...

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Sorry, John, I think we lost you. Operator, is John still with us?

Operator

I do apologize. It looks like we've lost John, if you can give me one moment. Our next question will come from Bobby Griffin.

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

I think I know what John was asking, so I'll go ahead and help him out and maybe ask that as my first question. But can you just give us any color on how the tone of the business carried through the quarter? I know October orders were up double digits from the last time we spoke, but how did November and December unfold?

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

Yes, Bobby, we're very bullish about our business. Our guidance reflects the strong momentum that we've experienced since we moved to the new 360 smart beds. I indicated that we've been driving a double-digit increase since that time and that momentum continues into 2019.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. And then, David, maybe two modeling questions for you. One on the cash flow this year. It looked like cash flow from operations was down about 24%. Can you maybe give some color on some of the drivers of that, if there is any timing issues within the working capital accounts and then maybe the outlook for 2019?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Sure, Bobby. We had some changes in our balance sheet going both directions. We had benefits from inventory and we had on a year-over-year cash flow basis and we had some pressures that were associated with our incentive compensation programs. We can grow through the complete list. There's also an accounts payable pressure of about \$32 million of swing from year-over-year, but we can go through that list with you off-line. As far as guidance for next year, we've provided a lot of color around the growth we expect, both top and bottom line. There is a slide in the updated IR deck on Page 8 on our website that you can look at. I would just model out EBITDA as a guidepost for cash flows and use that going forward for 2019.

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. That's helpful. I appreciate it. And then I guess, lastly from me on G&A, this is just to help tune up the model. Should we expect more kind of that \$32 million type run rate per quarter next year or, I guess, a little bit higher? How should we think about that?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

We're not going to provide a lot of color on the individual line items. What we've done on that slide is give you the overall rates of our total operating expenses of 54% to 55% of net sales. Variable comp in 2018 was a tailwind for 2018. We expect it to be a bit of a headwind in 2019 as well as we prioritize our innovations, marketing and retail spending to support our growth drivers.

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. That's helpful. So I could think of it as G&A may be a tailwind from a percentage of sales and then maybe inside the other line items within operating expenses, you could have a little -- or I'm sorry G&A is a headwind from a percentage of sales standpoint and then tailwinds with inside the other line items from operating leverage, is that fair?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Not necessarily. If you just look at the modeling, how we're calling it out, Bobby, I called out that we expect 80 to 120 basis points of gross margin rate improvement. And overall, our operating profit is expected to increase from 50 to 100 basis points. So that implies that we're not expecting a ton of leverage out of our operating expenses in 2019 as a result of the things I just mentioned.

Operator

Our next question will come from John Baugh with Stifel.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Can you hear me now?

FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

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

Yes, John.

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

There you are.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. Sorry about that. I guess, I was -- on the consumer, it sounds like, Shelly, you're cutting through some of the macro noise. Obviously, a lot of concern around Christmas with the stock market, you have still some mall-based stores, but it sounds like things have held fairly steady because of all the various things you're doing with products and digital marketing, et cetera. Is that a fair characterization? Or did you see a big drop off and then a big recovery since the markets recovered?

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

No, your description in the beginning is a fair characterization. We've seen consistent growth since we introduced the new 360 smart beds and we're carrying that double-digit momentum into the new year.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And Shelly, how is the mix? Now, I guess, it's been about 6, 7 months we've had the full smart bed 360 on the floor. Is the mix about where you thought it, better or worse? I thank you for all the unit guide, but just curious is this tracking on a mix basis about where you thought?

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

Again, great question. This is an important topic. And when we look at our brand messaging, it is clearly breaking through on proven quality sleep at \$999. That drives quality traffic to our brand. And then, our selling process and our mission-driven team convert that traffic throughout the line, finding the best product for our customers. So we're really happy with the results that we're seeing. We had a similar series mix as we had prior to the 360, but yet you can see the unit and the ARU growth as a result of bringing more customers into the brand overall.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And my final question is, you mentioned a record conversion rate. Your conversion rate has always been high. Maybe on a call like this, you don't want to give out the secret sauce, but is there any color you can give us as to what you think drove that improvement?

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

Yes, a number of factors. First of all, we talk about driving quality traffic. So not all traffic is equal and this is such an important area right now with so much media spend in the marketplace to be able to cut through and have high-quality traffic and the higher quality traffic also leads to stronger conversion. So it's certainly a factor. Another important factor is the 360 smart bed. It's a much simpler sale for our sleep professionals. And especially, when you consider that for the past year, they were selling both our old line as well as some models in the smart bed. Now it's streamlined. We've learned a lot about how to sell that bed and they're mission driven and having a bed that has proven quality sleep and our customers testimonials

FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

and advocacy is so strong and we have the 4.8 rating on the beds. When you can get that kind of value equation as a consumer, it converts high-quality traffic, strong conversion based on the incredible product that we're offering in a very commoditized marketplace.

Operator

Our next question will come from Brad Thomas with KeyBanc.

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

I want to ask about advertising first and get a sense of how you're thinking about advertising as a percentage of sales this year and maybe your appetite to crank up the level of marketing you're doing, given that stores have been reset with a new product and you have all these new partnerships out there, like the NFL.

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

Yes, as we think about our media as a percent of sales in 2019, we expect it to be similar to '18. We've said for a few years around that 14%. We're at 13.7% in 2018. We did drive an increase in media in the back half and we will continue to here in 2019.

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

Great. And then Shelly, with respect to the outlook for stores, I guess, could you give us a sense for your latest thoughts on what the long-term number of stores should be for Sleep Number in the United States, and how many today are still candidates for a relocation or repositioning or remodel?

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

Yes, great. Our distribution strategy is such a key element of our sustainable, profitable growth and we continue in an evolutionary manner with great discipline of execution here. And we're excited about where we are and our growth opportunity in front of us. We're clearly opening a significant number of stores this year in a retail backdrop that is not -- where that's not necessarily the case. For us, we still have markets that we're further developing, but importantly, there are great relocations, too. We had a number of them just in the last few weeks that have just been phenomenal right out of the gates and -- particularly in some of our more mature markets, continuing to have a healthy real estate portfolio and making sure that you're not just opening your store and leaving it sit there over time and focused only on store count. This is about sustainable, profitable growth and it's about driving top and bottom line and we really like some of our great performances right now in relocations and seeing how much more we can take out of a marketplace when we're constantly evolving and improving that location based on where the consumer is shopping in each local market. So we haven't put a number out there on how many stores. We had stated that a target for 2019 would be between 600 and 650 and that's where we're coming in. We still see growth potential and we're also signaling that online sales are important to us too and we expect our online sales to continue to outpace our store growth in just percentage of growth overall, but it's, obviously, on a very small base.

Operator

Our next question will come from Peter Keith with Piper.

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

I just want to look at the full year guidance of \$2.25 to \$2.75 and let's just call the midpoint at \$2.50. So it is down about \$0.25 from what you were telling us about 3 months ago of targeting \$2.75 and the bottom end of the sales range came down a couple of percent too. So -- and it sounds



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

like you have some good momentum in the new year and you sound good. I guess, could you help us frame-up what the changes were from a couple of months ago?

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

Yes, Peter, as I stated, our business is performing really well. Our guidance reflects the strong momentum that we've experienced with our new 360 smart beds and that has continued into 2019. Our EPS guidance range of \$2.25 to \$2.75 represents a 17% to 43% growth versus our \$1.92 EPS for 2018. And we believe that will represent top quartile to top decile performance. And finally, I would just add that the execution of our consumer innovation strategy has strengthened our competitive advantages. We're driving accelerated performance and confident in how our business is performing.

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

I'll add on, Peter, that we've also given you a little bit of color about the front half versus the back half growth and we're expecting stronger growth in the first half and then mid-single digit kind of growth in the back half as we lap the 12% adjusted growth from 2018.

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

Okay. That is helpful. And then, certainly, on the tariff front, the headwinds there are very understandable. What are the logistics and transportation headwinds right now? And I guess, thinking that most companies saw that in 2018 but are now potentially looking that as a slight tailwind for '19.

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

Well, we saw it last year too, we highlighted it. It certainly still exists and there is a slide in the IR deck that outlines the headwinds and tailwinds and there is also labor pressure. We have home delivery in our business model as well and there is labor pressure in that arena too.

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Yes, just, Peter, the continued challenges for the trucking industry to hire enough drivers, that continues to be a pressure point that we anticipate for -- to be a headwind in 2019. We are also -- while gas has been favorable recently, the labor rates have been high. You see a lot of people issuing bonuses or hiring bonuses just to attract people into these jobs. So we expect that to be a headwind for us in 2019.

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

Okay, that's all fair enough. And actually, David, one last quick question for you. So thanks for framing up the targeted debt-to-EBITDAR range. Where do you guys stand at the end of 2018?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

I think it's 2.7. I just want to look it up, 2.7, 2.8.

Operator

Our next question will come from Seth Basham with Wedbush.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

So you've talked about some growth expectations in terms of both units as well as ARU in 2019. If we look at the fourth quarter results and we back out the \$24 million from the backlog shift, looking at implied comparable store unit growth, we actually saw declines. So I'm trying to understand why that is? And what gives you confidence for 2019? Are you expecting declines in comparable store unit growth, or are you just thinking things will reverse?

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

Well, first of all, I'll speak to ARU and unit growth overall and we do expect growth from both metrics in 2019.

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Seth, I think you're reaching pretty hard to try and find a blemish in these results. Frankly, we had really impressive growth. We provided you a slide on Page 10 that highlights the impacts from all the shifts, both in 2017 and 2018, delivering on an adjusted basis 12% top line growth in the back half, 11% in the fourth quarter, that included both ARU and units and comp.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Understood. I'm not trying to take anything away from your results and certainly, it seems like you have some momentum in the business. But to that effect, you talked about strong double-digit order growth for the first few weeks of the quarter. Shelly, last time we spoke, your results ex the backlog shifts suggest there is a slowdown for the balance of the quarter. First of all, is that correct? And have we seen an improvement into 2019?

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

Since we introduced the 360 smart bed, Seth, we have had double-digit growth in our business and that has continued in 2019 and we have had growth from both units and ARU. We expect that in 2019. We will have quarterly fluctuations on the units and ARU. So when we're up against closing out the C series, we drove a lot of units last year at lower margin on that closeout. We'll have some fluctuation there. But we often talk about that because we always will on a quarterly basis, but again, we'll see growth from both in the full year.

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Again, just to highlight again, over a longer period of time, the back half of the year and going into 2019, we're saying we've had strong double-digit growth. So I mean there has -- that's a very long stretch of period of time for us to be talking about. If you want to look at day-to-day or month-to-month, there are always going to be fluctuations, but that's a really strong performance over a long period of time.

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

And it's been consistent.

Operator

Our next question will come from Matthew McClintock from Barclays.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

Matthew J. McClintock - Barclays Bank PLC, Research Division - Senior Analyst

Earlier, you referenced to the chaotic industry environment, and clearly, your performance today appears pretty solid. I was wondering if you could give us just an overview of what you see across the industry so far this year, especially as we enter the all-important Presidents' Day weekend, maybe from a promotional standpoint or just from a competitive standpoint.

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

Sure. I'm primarily speaking to the amount of media dollars in the marketplace and the number of brands with a variety of different messages. There is a lot of, what I would say, clutter for the consumer to sort through. In the end, this is the type of environment that we've been operating in and it continues and we are breaking through with a strong message of proven quality sleep starting at \$999 with our Sleep Number 360 smart beds. And yes, this heavy spending environment, particularly around search terms, continues in the first quarter of this year and at the same time, we're speaking to the momentum that we've been driving here in the first year continuing as well.

Matthew J. McClintock - Barclays Bank PLC, Research Division - Senior Analyst

And then if I could get one follow-up. Just you talked about the rels and I was wondering if you could give us -- and you were pretty optimistic about how those perform. I was wondering if you could give us any metrics toward how a relo typically performs in terms of maybe 4-wall uplift or sales uplift or anything just so we can get our head around that.

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

There are couple of pages in the deck that go into a fair amount of detail on slides 16 and 17 that provide a fair amount of detail on our distribution strategy and how we execute against that and it does illustrate some 4-wall profit based on average revenue per store too.

Operator

Our next question will come from Keith Hughes with SunTrust.

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

Based on what you said earlier, it looks like this is going to be a heavy store opening year just in terms of units, one of the biggest we've seen. And I think you have said on the guidance for '19 revenue, it only will be a low single-digit contributor. It seems like it would be more than that based on the numbers. What am I missing and how this is going to work?

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

Yes, it's a heavier year than last year. The first half of last year, we were so focused on the introduction of the full line of smart beds. We've had some other years in the recent past that have been this large as well and it always includes a combination of net new stores along with closures and relocations.

David R. Callen - Sleep Number Corporation - CFO & Senior VP

It also depends on when the store gets opened in the course of the year, the number of store weeks that is actually open during the course of the year that contributes to your results and it's on a larger store base overall.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

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

No, it looks like from the net you're going to increase your stores about 7% this year. So I would normally assume about half of that would contribute. You're saying it's less than that, is that right?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

If you're splitting the difference its 6% to 8% growth, in the range that we provided, 6% with units, yes.

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

That would be half that...

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Yes. We said, we've got 3% growth in 2018 from new stores and that's a little higher than that, and we're saying a low single-digit growth in 2019 from new stores.

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

And we opened -- we were a little heavier in opening our stores in the back half post 360 implementation.

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

And the remainder of the organic growth, I think should certainly be split between ticket and units, correct?

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

Yes, it's fair to look at it that way on an annual basis. Again, yes, quarterly fluctuations, yes.

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

And so when you work those numbers down, it's a positive number, but based on (inaudible), I expected it to be higher on the unit given you've relaunched the whole line. Is there anything else within the numbers there that's mix thing I'm missing or something like that, that would impact just the raw calculation?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Well, in the back half, units were up 8% or excuse me, 6% and in the fourth quarter, they were up 8%. That's on an as-reported basis, not adjusted for the shifts that we talked about, but that's when we saw the acceleration that we've been highlighting from the 360 smart beds.

Operator

(Operator Instructions) Our next question will come from Michael Lasser with UBS.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

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

So you seem to be really confident, excited about the tenor of the business. And 90 days ago, you knew you were going to have a tough comparison in the back half. So what's changed in the last 90 days that has resulted in the midpoint of your 2019 top line guidance to be ratcheted down by 100 basis points and the low end to be ratcheted down by 200 basis points?

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

Yes, Michael, we're providing guidance today for our 2019 performance and it reflects the momentum we've experienced since we've introduced the 360 beds. It also reflects a 17% to 43% growth in EPS with a 30% growth at the midpoint.

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Michael, I'll just add on that we haven't provided detailed guidance for 2019 before this call. So we provided a walk that helps you understand how we were thinking about going from 2018 performance, which had a guidance midpoint of \$1.85 and bridging that to the 2019 \$2.75 target. Today is the first time that we're actually providing you our detailed guidance for 2019 and this is how we're thinking about the business.

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

Okay. I guess, the slides are -- when you look back at that third quarter slide of the past and the path you provided for your guidance, they're very similar. So I guess, that's where the change is being interpreted, but it sounds like you guys don't see that necessarily as a change, is that fair?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Yes, it's a guide map to help you understand how we're thinking about the business and how we can deliver against the guidance we've just provided.

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

And we mentioned on the slide the last quarter that was illustrative and then, for this year now closer in, we have some headwinds and tailwinds that we detailed out as well. And providing guidance today on 2019 that includes the \$2.75 target.

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

Okay. I understood. And as my follow up, your range of outcomes for this year, in terms of earnings is a \$0.50 range. It's much wider than you've provided in the past that's been typically a \$0.15, \$0.20 range, maybe \$0.30 last year. Why is it wider? And what could drive the upside case and what could drive the downside case? Is it all dependent on sales?

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

Yes, well, first of all, the sales spread that we've associated with our EPS guidance is about 4 points. We said 6% to 10% growth. And as far as the different variables, I think looking at the headwinds and tailwinds can give you a good illustration. There is varying degrees of where they will come in and that's a good way to think about it.



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

It's also -- let me just weigh in a little bit too. This is as a percentage of the dollars that we're talking about of our actual guidance, it's not that much difference. And we've got benefits from both share count reduction and tax rate that make incremental impacts on an EPS basis much more. So those have also be taken into account on how we're thinking about the guidance range.

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

Understood. If I can sneak one last one in. In light of the fact that you are committing to higher leverage ratio, Dave, should we assume that the heavy drain from working capital that occurred in the fourth quarter is reversible or at the very least, not going to continue again into 2019?

David R. Callen - *Sleep Number Corporation - CFO & Senior VP*

Yes. I mean a lot of that was the impact from our accrued compensation and incentive compensation programs and those things certainly do fluctuate from year-to-year. We did -- I called out earlier 32% -- or \$32 million swing in our AP impact on the cash flows year-over-year, but those things are going to change based on the amount of inventory, the amount of media that happens, the timing of media, et cetera. So those will always fluctuate.

Operator

Our last question will come from Curtis Nagle with Bank of America.

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

So I guess, the first one is, let's talk about pricing a little bit. Just kind of looking back at the past maybe 6, 3 months or so, it looks like you guys have taken price on a number of models, some perhaps fairly materially and it does seem to be a bit of a change in stance relative to at least a year ago. I know you guys have made some commentary about your pricing power, but just wondering if that is the case. How much you've taken? And then just how should we think about pricing for this year?

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

Yes, Curtis, we over time have talked about our ARU growth and that it represents approximately 3% pricing, that is almost always associated with additional benefits for the consumer and that number still stands true. So it's a good way to think about it. Overall, we did take \$100 of price increase on the p and i series in October, but still that falls into that 3% overall ARU growth.

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

Okay. Fair enough. And then I'm just kind of curious to hear a little bit more of your thoughts when you made reference to, I guess, an assumption for a confident consumer. I guess, just looking at the most recent indices, we're still at high levels, but it is declining. We're going to start lapping tax rates, housing softening, who knows what happens with trade. I guess, what gives you confidence or what is behind that assumption of a strong consumer through the year?

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

When we look at our overall guidance and the environment that we've been operating in since we introduced the full line of 360 smart beds, we would characterize the consumer as confident. And generally, our business is most correlated with consumer confidence and that's what we've experienced and we've been able to perform with double-digit growth throughout this environment with our 360 smart beds. Clearly, the industry



FEBRUARY 13, 2019 / 10:00PM, SNBR - Q4 2018 Sleep Number Corp Earnings Call

hasn't performed at that same level and that's, I'm sure, what's on people's minds, but we are -- and with a confident consumer and a strong value equation like the 360 smart bed starting at \$999, we are confident in our ability to take share and convert those customers and give them a quality night sleep with our smart beds.

Operator

I would now like to turn the call over for closing remarks.

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

Thank you for joining us today. We look forward to discussing our first quarter 2019 performance with you in April. Sleep well and dream big.

Operator

This concludes today's conference. Thank you, again, for joining today's conference call.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2019, Thomson Reuters. All Rights Reserved.