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SNBR - Q3 2019 Sleep Number Corp Earnings Call

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OVERVIEW:

Co. reported 3Q19 net sales of $475m, operating income of $39m and EPS of $0.94. Expects 2019 EPS to be $2.45-2.75.

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PRESENTATION

Operator

Welcome to the Sleep Number Q3 2019 Earnings Conference Call. (Operator Instructions) Today's call is being recorded. If you have 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 Third Quarter 2019 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 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, and thank you for joining our third quarter earnings call. My SleepIQ score was 86 last night.

As the leader in sleep innovation, our unique and differentiated 360 smart bed experience is clearly resonating with consumers. We have delivered double-digit demand growth since completing our transition to all 360 smart beds in mid-2018. As expected, this momentum continued in the third quarter as we advanced our initiatives and lapped the double-digit sales order growth from the prior year.

Third quarter results against prior year included record net sales of $475 million, up 14% with a 10% comp; operating income of $39 million, up 55%; and earnings per share of $0.94, up 81%.

Year-to-date results included net sales growth of 12% with an 8% comp; operating income up 46%; EPS up 63%; and return on invested capital for the past 12 months of 18.4%, up 470 basis points versus a year ago.

This record performance is the outcome of our transformation. We are where we expected to be and are doing what we said we would do. Our multiyear initiatives have resulted in double-digit earnings per share growth since 2015.

We are excited to have nearly completed the first part of our strategic journey, which enables our future growth as we become the hub for consumers' health and wellness.

With the performance strength across our business, we have increased our full year EPS guidance to a range of $2.45 to $2.75. My comments will focus on sales orders, which were not affected by the shift in deliveries from Q3 to Q4 last year. The 5 initiatives we outlined on our second quarter earnings call contributed to third quarter sales order growth of 11% on top of double-digit sales order and unit growth from the third quarter of 2018. We are actively advancing these proven integrated growth catalysts in a manner that is relevant to the consumer in the fourth quarter and beyond.

First, we achieved record levels of customer satisfaction with our 360 smart bed. This drives customer engagement, retention and loyalty. Our customers interact with our brand daily as they use their SleepIQ data, understanding their sleep quality is a powerful reminder of the ongoing value of our beds. We've integrated our InnerCircle digital loyalty program into our SleepIQ app experience. Having digital at the core of our product strengthens our individualized communications. This is producing incremental referral and repeat sales that now account for approximately 45% of our business.

Second, we expanded brand reach and consideration. We launched the next evolution of our This is Not a Bed campaign in support of the Labor Day selling period. This contributed to our double-digit digital traffic growth, which strengthened through the quarter along with unit growth. The 11% sales order growth included a 3% growth in mattress units. Notably, this was on top of double-digit order and unit growth in Q3 of 2018. Our media investment in the quarter also drove higher-quality traffic, higher conversion, improved media ROI and significant profit growth in the third quarter. We continue to methodically test, learn and evolve our proprietary processes. We are applying our learnings in the fourth quarter to once again build on top of double-digit order growth from the prior year.

Third, we amplified brand engagement by deepening our NFL involvement in the second season of our unprecedented partnership with over 1,800 active players on our beds. Adding to our productive relationships with the Dallas Cowboys and Minnesota Vikings, we established partnerships with the Pro Football Hall of Fame and the Kansas City Chiefs. We also added a new highly persuasive national ad featuring Dallas Cowboys quarterback Dak Prescott. We are further engaging consumers by amplifying players' authentic stories on a broad scale through the NFL and other media partnerships.

Fourth, we progressed our award-winning cohesive digital in-store experience. The powerful combination of our benefit-driven innovations and best-in-class selling processes continue to drive performance. Average revenue per mattress unit was up 9% in the quarter, and average revenue per store was up 8% for the trailing 12 months. Our disciplined and highly productive local market development strategy surpassed the 600 store milestone as we further advanced our national footprint. Continuous improvements of our online experience contributed to a 20% year-over-year increase in our online phone and chat sales. These competitive advantages will be an ongoing source of growth.

Finally, we have made our vertically integrated business more efficient. This resulted in a 55% increase in operating profit in the third quarter, including 200 basis points of gross margin rate improvement. Initiatives contributing to these results include new analytical and mobile applications for inventory manufacturing, logistics and routing, which are improving our effectiveness; the evolution of our outbound logistics operation, which is on track and will be a source of improvement over the coming years. We are leveraging the advantages of our vertically integrated model as we bring new innovations to the marketplace. Specifically, our engineers are working upstream with suppliers and manufacturing to innovate for collective productivity gains. We've also built on these relationships to take swift and effective actions to mitigate ongoing tariff pressures.

In recognition of our innovative, operational and digital leadership, Sleep Number was recently named one of the country's Supply Chains to Admire. We continue to strengthen our unique competitive advantages of proprietary sleep innovations, exclusive distribution and direct lifelong customer relationships. These competitive advantages and our consumer innovation strategy are generating the performance we expected. Our revolutionary 360 smart beds are delivering effortless, proven quality sleep and provide a strong foundation for ongoing value creation.

With our ambitious vision of becoming one of the world's most beloved brands by delivering an unparalleled sleep experience, we continue to prioritize investments in R&D. We plan to introduce the next generation of our 360 smart beds in the back half of 2020. With this new portfolio, we will incorporate the advancement of our data science, design, software and hardware engineering for more breakthroughs in sleep health and wellness. These smart beds will have superior comfort, adjustability and temperature attributes in addition to an evolved SleepIQ experience featuring heart rate variability analytics and circadian rhythm insights.

In summary, we remain bullish about Sleep Number's trajectory. We are creating a future where our 360 smart bed will be the hub for consumers' health and wellness with individualized digital health as core to our business. To borrow a line from our partners at the NFL, we are playing to win. Our consumer innovation strategy supports our vision and company purpose of delivering life-changing sleep. Our investments ensure relevance and profitable growth over the long term. Our team is highly engaged, demonstrating performance intensity that ranks best in class. Building and operating this vertically integrated business requires holistic execution excellence at every level across the enterprise.

Thank you, Sleep Number team, for exceeding an important milestone of 12 million lives improved. Your passionate dedication and teamwork to drive our performance with unsurpassed innovation is courageous and important.

I'll now turn the call over to David, who will provide additional details on the quarter and expectations for the remainder of the year.

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

Thank you, Shelly. I believe two words describe our Q3 and year-to-date performance: execution excellence. Consumers continue to embrace proven quality sleep driving significant demand growth for Sleep Number, and our engaged Sleep Number teams are performing at high levels, delivering superior financial results.

Third quarter net sales grew 14% year-over-year and are up 12% year-to-date. Remember that double-digit demand in the back half last year shifted approximately $24 million of deliveries from Q3 to Q4. Please refer to the 2018 Q4 non-GAAP reconciliation tables on the Investor Relations page of our website.

Compared to the adjusted net sales last year, net sales grew 8% this year in Q3 and 10% year-to-date. Our demand drivers are delivering as expected and support our continued assumption for up to 10% revenue growth for the year. Comp sales as reported grew 10% in Q3 and 8% year-to-date. New stores added 5 points of growth to both the quarter and year-to-date.

During the last 12 months, we've added 42 new stores, plus relocated 25 stores. Combined, this is 72% more actions than the prior trailing 12 months when we prioritized rolling out our game-changing 360 smart beds. We ended Q3 with 602 stores and expect to end 2019 with approximately 610 stores across all 50 states.

Our market development pace has been planful yet opportunistic. By year-end, we will have grown our store portfolio an average of 6% per year since early 2015, in line with our previous long-range growth assumption of 5% to 7%. Today, our portfolio is 30% larger, healthy and productive.

Consumer shopping preferences, including online sales also continue to change and we will evolve with them. Through 2025, we expect average annual store growth of approximately 4% to 5%, while continuing to advance all our retail shopping experiences. Let's take a minute to examine the interplay and outcome of various elements of our local market development approach.

First, we relocate stores within markets to address shifts in consumer shopping preferences. We've shared a recent example of our Woodbury, Minnesota store where we had sales and profits well above the portfolio average. Our disciplined approach led us to relocate to a location nearby where new retail was beginning to dominate. Within 6 months, that relocated store saw a 30% lift in sales. Importantly, sales from relocated stores like this are reported as growth from new stores rather than comps.

Second, when we add incremental new stores, we experience about 20% average cannibalization at comp stores within that market. These actions grow our market share, sales, units and profits but pressure comp dollars and units by about 100 basis points.

Third, we also continue to innovate our products and our selling processes to generate comp, ARU and unit growth. Through Q3, 28% of our comp stores had annual sales over $3 million versus 10% just 6 years ago. Our Q3 average annual revenue per comp store, including online, was $2.9 million compared with $2.3 million back then. Our initiatives drove a 9% year-over-year ARU lift in both Q3 and year-to-date, while growing total units 5% in Q3 and 3% year-to-date.

Consistently driving annual sales and profit growth from both ARU and units is a distinct advantage of our business model, so is the pricing power from proprietary innovation and exclusive distribution, which has historically driven 3 points of our average annual ARU growth. Each of these elements, including our online advancements has meaningfully -- meaningful upside potential to drive performance and take market share north of the 8% we occupy today.

Our operational improvement initiatives are also delivering results. Predictive planning tools are improving inventory accuracy by item and location across the country. This meant we were the most efficient we've ever been during our busiest sales and delivery periods. We minimized product handling and expediting between our fulfillment locations, delivering much better customer experiences. Investments in capabilities like these delivered wins in Q3 and provide significant efficiency opportunities for our teams and customers going forward.

Our 200 basis point gross margin rate improvement to 62.4% in Q3 reflects this progress. Year-to-date, gross margin improved 130 basis points as expected as we've now fully lapped the prior year transition pressures. We remain confident in our expectation for about 100 basis points of gross margin improvement in 2019. We again prioritized our near- and long-term growth drivers in Q3 with meaningful increases in media and R&D. We also absorbed higher incentive comp, medical and tariff costs in the quarter.

Execution excellence across the business drove a 210 basis point improvement in our Q3 net operating profit margin and an increase of 140 basis points year-to-date. It also led to a 24% increase in our year-to-date EBITDA and a leverage ratio of 2.6x EBITDAR at the end of the third quarter. We've evolved our capital structure methodically and progressively with a conservative bias to support our strategy. We expect to end the year within our targeted debt leverage range of 2.5 to 3x EBITDAR.

The $0.94 of Q3 EPS is up 81% year-over-year, bringing our year-to-date increase to 63%. When compared to the prior year EPS adjusted for the delivery shift, diluted Q3 EPS this year grew 25%, with year-to-date EPS up 37%. Both grew more than 3x the top line growth as we effectively employ all three of our EPS drivers.

Execution excellence and disciplined investment decisions also generated 42% more free cash flow year-to-date and an 18.4% ROIC on a trailing 12-month basis through Q3, more than double our high single-digit weighted average cost of capital. We have again raised our full year EPS guidance to a range of $2.45 to $2.75. As you're modeling Q4 this year, please remember that the delivery shift last year moved approximately $0.23 of earnings from Q3 to Q4. A couple of other assumptions of note include Q4 G&A and R&D expenses that are similar to Q3. Full year sales and marketing expenses will be approximately 45% of net sales. And our Q4 income tax rate is assumed to be 25%. The $2.60 EPS guidance midpoint implies full year EPS growth of 35%, including Q4 growth of 24% against adjusted Q4 EPS last year.

While we plan to provide detailed 2020 guidance on our Q4 call early in 2020, here is some general color about our expectations. Assuming a consumer environment like 2019, we expect to grow net sales mid- to high single digits in 2020 with approximately 2x that growth in earnings per diluted share. We will continue to prioritize investing in our growth and profit drivers; maintaining an appropriate liquidity, including our revolver to support our plans with targeted leverage of 2.5 to 3x EBITDAR; and finally, returning cash to shareholders through share repurchases. We expect the renewal of our $500 million share repurchase authorization to support our plans for multiple years as we continue to operate with a conservative balance sheet bias.

The power of this business model is clear. Our focus on customer relationships and improving lives by executing our consumer innovation strategy is delivering top-tier financial results. This is what we meant when we said we're running clean in 2019. The future is bright for Sleep Number's customers and stakeholders. Brandon, at this point, please open the line for clarifying questions.

QUESTIONS AND ANSWERS

Operator

Our first question is from John Baugh with Stifel.

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

Great results. Could you perhaps provide just a little more color on the various drivers on gross margin, which clearly came in better? It was -- and I'd love it if you could talk about either pricing or mix as well as inputs and the efficiencies you talked about, all that kind of color.

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

Yes. Thanks, John. We had eliminated the transition impacts from the prior year, that was about 100 basis points of improvement. The remaining 100 basis points was a combination of the elements that you described: pricing, mix benefits and operating efficiencies, which more than offset the about 50 basis points of pressures that we're also absorbing from additional tariffs, labor costs that we highlighted and things of that nature.

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

Okay. And last year, if I'm not mistaken, on October 1, you took a 3% price increase. We haven't seen on like-for-like items an increase this year. First of all, is that correct or have I missed something there? And then, what -- you've introduced some new products as well. I'm just curious as to sort of maybe the SKU lineup in terms of mix and what you're seeing in terms of your sales, and it looks to me like you're less promotional than you were at least in the third quarter last year?

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

Yes. John, thanks for the additional questions around ARU, our average revenue per mattress unit. We have -- you characterized the pricing accurate. That was about a year ago. And when we look at our ARU growth over time, generally, about 3% is attributed to pricing along with benefits of the innovations. We have not had pricing increases on like-for-like in this calendar year, and we continue to drive ARU growth year-over-year in combination between our selling process and our innovations. This really speaks to our mission-driven team and their ability to connect with the consumer, but it also speaks to the broad range of innovative products we have. Again, this is average revenue per mattress unit. It's not average price. And this is reflective of us selling more items to customers and also of our repeat sales.

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

Got it. And my last question simply is around your planned introduction next year. It sounds interesting. I guess I'm trying to get a sense for how big a deal this is, I guess, Shelly, number one? And number two, does it happen in stages through '20 and '21? Or are there sort of increments or tweaks to existing products and it all gets changed whenever you make the transition?

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

Well, we are very excited and it is really interesting and speaks to the 360 smart bed foundation that we put in place mid-2018. If you think about our new line, the line we have today of all smart beds as the baseline and our innovations as we have talked about in the past will continue to evolve off this 360 smart bed. So different than when we transitioned our full line to the smart beds a couple of years ago, which required large change in suppliers and the transformation of our company, we're in a different place. Today, that's our baseline and the innovation will continue to build off it. Importantly, it is meaningful to consumers, making a difference in their quality sleep, and that's where we stay focused and we'll continue to evolve in a way that is broadly relevant for consumers.

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

Okay. So just in terms of summarizing that, not major relaunches and drops, but additional innovations that will be added to bed. So I presume there would be less cost or disruption involved?

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

It does involve our entire portfolio. Will evolve.

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

John, just in terms of our 2020 guidance, on the Q4 call, we'll provide some additional color of how we're thinking about it. But we've incorporated all of that into the color that I gave you earlier about how we're thinking about 2020.

Operator

Our next question is from Bobby Griffin with Raymond James.

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

My first question is just around the guidance for 2019. And I was hoping maybe just to get a little bit more color on what's driving maybe the low end of the range versus the high end of the range and what leaves the $0.30 range out there for -- in our numbers for the full year?

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

Well, first of all, let me just start with -- this is the second quarter in a row of raising our guidance. We're up against double-digit growth again in the fourth quarter. We have great confidence in the performance of the business and the consumers' response to our 360 smart bed and how our initiatives that I described in my remarks are working to continue to evolve and drive that performance going forward. Looking at a midpoint with the 35% increase of EPS at the midpoint, we see as top quartile, top-tier performance overall. And the guidance appropriately reflects the headwinds, tailwinds overall in the business, and we're excited to put up another great quarter.

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

Okay. Maybe just to help us connect a little bit better off of that, can we maybe just talk about or expand upon what some of the headwinds and the tailwinds are? Those typically have a tendency to change from quarter-to-quarter. It seems like the momentum of the business is pretty strong heading into the fourth quarter. But is there other uncertainty that we might not be anticipating when we think about what's driving the range out there that you have seen arise that give you a little -- that make you want to keep a little bit of a wider range with just one quarter left in the year?

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

Yes, I'll start. Nothing new that we're seeing. Fourth quarter is always different than every other quarter. That's probably one factor. But the other headwinds and tailwinds are consistent with what we've been talking about.

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

Yes. Bobby, I've called out that we have been managing some of the tariff headwinds as well as labor rate headwinds as well as our investments in our growth drivers, both media and R&D. Those will all continue into the fourth quarter. Of course, through Q3, now we have fully lapped the elimination of all the transition impacts that we had incurred the prior year. And so we are -- while we're expecting gross margin rate expansion in Q4, it will be less than what we have been seeing year-to-date. And hence, we're thinking about it in terms of about 100 basis point gross margin rate improvement for the full year.

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

Okay. That's helpful. I appreciate that. And Dave, thank you again for the color on future store growth. When we think about that 4% to 5% number, should the total number of actions decline versus what they've been going over the last couple of years and there's less remodels to be done now? Or should the level of remodels continue at the same pace?

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

The total capital will probably decline. Like we've talked about, we're expecting $60 million of CapEx this year. Going forward, while I'm not providing 2020 guidance specifically right now, over that period through 2025, it will likely be $10 million or $5 million to $10 million less than that on average through that period. As that pertains to stores, we would see less new stores and -- but would see, in all likelihood, a continuation or an increase in the relocations and the remodels that we would continue to take on. We continue to see nice lifts when we move stores from even high-performing stores to locations where consumers have shifted their preferences, and we'll continue to do that as we go forward.

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

Okay. I appreciate that. And then lastly from me, just a quick modeling one. Can you tell us what the media percentage was during the quarter or what the leverage or deleverage was for us to tune up our models?

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

Yes, we provided the color of thinking about sales and marketing at 45% for the year, and you should expect media to be up double digits for the year. Based on competitive reasons, we're not going to go into any more detail.

Operator

Our next question is from Brad Thomas with KeyBanc Capital Markets.

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

Congratulations on a great quarter and nice momentum here this year.

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

Thank you, Brad.

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

Thank you, Brad.

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

So just on the -- to clarify, on the timing shift that you all had had last year, did you think you had all of that shift back into 3Q from 4Q this year?

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

Well, that shift was all last year and it all related to about a week's worth of deliveries that we didn't get delivered in the third quarter that got delivered early in the fourth quarter last year. So that had nothing to do with our performance this year. Our performance this year was far more efficient and effective, as we've highlighted, and that drove strong top line growth and profitability across the line.

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

Got you. But as we're thinking about adjusting it and comparing it, from your best understanding, you're more normalized, everything was pretty normal here this year.

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

100%.

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

Great. And so just to ask about units, if you've got the shipments and that helped you potentially by about 6% on the units, then the total units may have clocked in slightly negative, if not for this shift. Now I understand that's not always a priority for you. Your ARU is fantastic this quarter. But I guess, does that math seem right? And as you look forward, how should we think about you guys pulling that lever to push units more going forward versus the ARU?

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

Yes. Brad, to be real clear, and this is why I stated that my comments would reflect our sales order growth so that you have a clear sense of the underlying health of the business, setting aside that shift. So our sales order growth in the quarter was up 11%, and that included a 3% growth in mattress units. And keep in mind, that is on top of a double-digit sales and unit growth from the prior year. So last year, we were closing out of the C series in the third quarter, and that drove a lot of unit growth. So that was double digits, and we drove another 3% on top of that this year.

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

Got you. I appreciate that clarification. And just a last one from me. Some of the online competitors, I think, have dialed back some of their advertising spend. I guess could you speak to the competitive landscape and some of the customer acquisition costs? Again, clearly, you're driving some very strong results here.

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

Sure. Okay. So two things. First of all, some may have dialed back and some dialed up. So overall, the competitive spend environment was very similar to what we've seen all year in the third quarter. And we, as we said we would, leaned into our media investment behind very strong creative, and that helps us get after the acquisition part of this in addition to the retention of our customers that drives referral and repeat. So we're excited about the opportunity in front of us. And as I've said, we are playing to win and have a lot of confidence in the initiatives that we're putting forth and the consumers' response to our differentiated and unique products.

Operator

Our next question is from Peter Keith with Piper Jaffray.

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

I wanted to just dig into a little bit of longer-term store growth. You guys had cited 4% to 5% growth overall. Is that net growth or would that be, I guess, like 4% to 5% would be store projects, including relos and remodels?

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

Peter, it's David. I highlighted that in the last 6 years, the growth has been around 6%. The next 6 years, we're thinking about it in terms of 4% to 5%. That includes the assumption that consumer shopping behaviors and preferences will continue to evolve. And that's not going to be a straight line. It wasn't a straight line over the last 6 years, and it won't be going forward. That is the total portfolio, so the net number of incremental stores of the total portfolio that I'm talking about.

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

Okay. Helpful. So looks like, just doing simple math, you'd be implying around 800 stores looking out to 2025. Are we thinking about that as a potential store target? And would that just be stores in the U.S. at this point?

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

We didn't quantify it as a -- we didn't do that kind of math. I think I mean I have, but I -- it's in the 700 to 700-plus range by 2025, and that is focused on the U.S. market.

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

Okay. Great. Last one for you on the same theme. Thanks for the quantification around the cannibalization rate. I think you said it impacts same-store sales by about 100 basis points. Has there been any change in that trend in recent years? And maybe even looking forward now that you're in all the major DMAs, do you think you would hold that rate of cannibalization steady or could that pickup a little bit with increased store density?

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

That number is an average across the entire portfolio as we execute this strategy. And we do see different markets react differently. And some have cannibalization that's less than that and some have more. But the overall average hasn't really changed meaningfully in a number of years. We expect that, that same level of cannibalization will likely hold as we continue to execute this strategy on a local market development approach.

Operator

Our next question is from Michael Lasser with UBS.

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

Your sales and marketing grew about 13% in the quarter. If we pick out some marketing for the new store growth, maybe it was up 6%, 7%, 8%. And I think you mentioned your same-store units were up about 3%. So should we think that, like a sustainable algorithm, your overall marketing is going to grow maybe at twice the rate of your units over the long run?

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

We've highlighted that we expect this year sales and marketing to be 45% of our net sales. That's not wildly different than our historical trends. We have not yet provided that level of detail about guidance for 2020 or any other timeframe going forward. What I would say is that Shelly has highlighted that we're playing to win. We're -- the business is performing very well, and we're hitting on all cylinders. We're going to continue to lean into our initiatives and drive growth. And leaning into those growth drivers benefits the total P&L and financial performance of the company, and we'll continue to do that.

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

And Michael, you asked about how to think about units for our business model and our strategy. It's important to think about both ARU and units. We can drive and have been driving growth from both. And it's also important to look at these metrics on an annual basis. We will have quarterly fluctuations due to promotions or how we're lapping something from the prior year. And I think this quarter is a good example, where we had a 3% unit growth over a double-digit unit growth from prior year when we closed out of the C series.

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

Helpful. Thank you, Shelly. And one more for you, Shelly. As we know, next year is going to be an election year. There's probably going to be a lot of ad spending associated with the election. In the past, how have you seen both marketing expenses and just the overall demand for Sleep Number beds chief up during what are distracting election year?

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

Well, I think this is unprecedented time from a number of factors. So for us, this is the first time that we've had all 360 smart beds in the marketplace during an election. And we know that the consumer is resonating with the proven quality sleep that these beds are delivering, and we'll continue to lean into the messaging around that. And also, our tactics and how consumers consume media today is very different than even the last time we had an election. So I think reflecting on the past for the election probably is not going to give us the right answers for moving forward and really understanding the dynamic marketplace that we're in from a media consumption and how consumers get distracted with various messages. And we've learned a lot, and this is part of why we have digital buying in-house and search in-house so that we can be nimble, agile and make adjustments in real-time.

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

And Michael, we've incorporated that the election and the Olympics and we have distractions any given year for different reasons, and we just need to outmarket through those things and we will plan to continue to do that. But we thought about that in terms of the color we provided on the top line for next year as well.

Operator

Our next question is from Seth Basham with Wedbush.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - MD Of Equity Research*

My question is just around ARU. As we think about the go-forward ARU, if you could help us dimensionalize on the drivers, that would be helpful. You're lapping the price increase. You have seen a nice step-up in the attachment rates over the last year. Do you think you'll be able to drive anything close to the level of ARU that you've reported year-to-date?

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

Seth, we do expect growth on an ongoing basis from both ARU and units, and this is an outcome of our proprietary sleep innovations, the advancements that we will have next year and beyond. It's also a result of our exclusive distribution, our mission-driven team, our selling process and how we go to market overall. Again, it's not average revenue per -- it's not average sale. It's average revenue per mattress unit.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - MD Of Equity Research*

Understood. And with these new innovations, do you expect to be able to drive price on a like-for-like basis?

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

If needed. I mean if we needed to, Seth, we are -- that's one lever that we've been able to employ for years, and historically, that's driven about a 3% benefit to our ARU growth. We haven't highlighted any indications on pricing to date, but we certainly have that lever in our quiver.

Operator

I'm showing no further questions. I would now like to turn the call back over to Sleep Number 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 fourth quarter 2019 performance with you early next year. Sleep well and dream big.

Operator

Thank you for participating in today's conference. All lines may disconnect at this time.