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PRESENTATION

Operator

Welcome to Sleep Number's Q3 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 Third 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. 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. Good afternoon, and thank you for joining our third quarter earnings call. My SleepIQ score was an 80 last night. My normal practice is to start with our standard quarterly performance metrics. Today, however, I will focus on providing granularity on the run rate of our highly differentiated business, since we completed the transition to all 360 smart beds. To this end, my remarks will reference sales orders, which are recognized and reported net sales when they are delivered to our customers. David will cover financial details after my remarks.

Our business gained significant momentum in the back half of the quarter following the completion of the transition to all 360 smart beds. Sales orders grew 19% year-over-year in the last 7 weeks of the quarter, including double-digit unit growth and mid-single digit ARU growth. Due to the timing, this acceleration was not fully reflected in our third quarter reported results.

Robust year-over-year sales growth has continued in October. Our 13-week sales order growth, our best indicator of current business trends, is up 16% through last week, including 12 points of comp sales and 4 points of growth from new stores. Unit and ARU growth remained strong as well. We are confident in our business performance for the fourth quarter and reiterate our 2018 full year guidance midpoint of $1.85 of earnings per share. The 4 primary initiatives driving our top line momentum include; Sleep Number 360 smart beds, which are delivering proven quality sleep; our new marketing campaign called "This is Not a Bed"; brand amplification through our NFL partnership; and our differentiated direct-to-consumer retail experience. With all the 360 smart beds available, we began investing in our new marketing campaign focused on proven quality sleep starting at $999 in early August.

Our top line growth accelerated significantly as this strong value equation resonated with consumers. We expect this to continue. Key metrics for the August through September period included: double-digit growth in digital traffic, as measured by qualified unique visitors to our website; significant increase in conversion with our streamlined selling process; growth from both units and ARU, and high ratings and reviews for our 360 smart beds at 4.7 stars.

Our media buying effectiveness is another key contributor to our strong performance in the quarter. On our second quarter call, I highlighted our intent to increase media spending to compete more aggressively with our new campaign and other media buying tactics.

In the third quarter, we increased media spending by 13% over the prior year. In an environment of high competitor advertising spend and clutter, with search cost escalating over 250%, we are confident we took significant market share, while levering on a sales order basis compared to the prior year.

We also intend to increase our year-over-year media spending in the fourth quarter to drive our double-digit growth expectation. Our partnership with the NFL extends our reach into the NFL fan base, which has a high affinity for our brand. It also amplifies the benefits of our 360 smart beds by linking smart sleep and performance. Here are a few examples. The latest national ad in our new campaign features NFL Vikings quarterback Kirk Cousins and highlights how the 360 smart bed improved his performance on the field and in his everyday life. Significant increases in digital traffic with strong engagement followed these in-game ads.

In August, our team visited over 20 NFL training camps and worked directly with NFL players and trainers to ensure they understood the benefits of our 360 smart beds.

In September, active NFL players began to receive their 360 smart beds as part of the league's investment in their wellness. They are powerful influencers as they share their enthusiasm for their 360 smart beds on social platforms.

Our exclusive Sleep Number retail experience remains an important competitive advantage, because of the brand control we have in addition to our direct-to-consumer relationship. Four key performance drivers are: one, strong brand engagement and action. We develop and manage a value-added omni-channel retail experience. Our 360 smart bed initiatives are driving both traffic and conversion improvements; two, compelling benefit-driven value starting at $999. We are excited about the improved quality and comfort of our c2 smart bed and its consumer value compared to the competition. Our unique store selling process focuses on solving individual sleep issues with the benefits of our full assortment of differentiated products at various price points.

The result of our strategy and unique model is growth in both units and ARU; three, lifelong customer relationships. Our mission-driven team establishes a trusting relationship between our brand and customers. The result is strong customer loyalty and an ongoing revenue stream with over 40% of our sales generated from referrals and repeat sales; four, highly productive real estate strategy. During the last 7 years, through 2018, we have rebuilt over 90% of our stores to improve the location and brand experience, while growing our store base from 381 to an estimated 580 stores by year-end.

We are also opportunistically adding stores in certain markets affected by competitor closures. With our synergistic retail experience, we also grew our average sales per store by $700,000 to an average of over $2.6 million. We are on track to end 2019 with 600 to 650 Sleep Number stores. The disciplined execution of our real estate strategy is paramount to sustainable profitable growth.

In summary, we have performance momentum from our 360 smart beds and integrated marketing and retail initiatives. Our marketing focused on proven quality sleep is driving increased traffic and our sleep professionals are converting this traffic to sales at a higher rate. We are improving lives and taking market share. The steadiness and progression of our business since the transition to all smart beds, is compelling. We are also experiencing the expected profit improvements since the completed transition. For example, in September, our first full month of delivering only 360 smart beds, our gross margin rate was within our more normalized range of 61% to 62%. Going forward, while there are headwinds related to tariffs and increasing freight cost, we still expect the benefits from the absence of transition costs, operating efficiency improvement, pricing power and sales growth to drive leverage in both the short and long-term.

Our logistics network evolution, which will support our longer-term margin expansion and improve the reliability of our delivery experience is making good progress. We are opening the third assembly distribution center in Baltimore next month to advance production of our preassembled mattresses.

Over the next 2 years, we expect to open 3 to 4 additional centers to more effectively and efficiently serve customers across the country. Our robust sales performance since the full transition to all 360 smart beds is a result of our commitment to consumer innovation and strong execution by our highly engaged team. We are excited about our trajectory, the life-changing value we are delivering to our customers and the resulting superior shareholder value creation.

In 2019, we expect high single-digit top line growth from our highly differentiated product and retail, accelerated profitability from our margin-enhancement initiatives, and strong ROIC and cash flows from our vertical business model.

Thank you to our talented team. Your perseverance and dedication to our purpose-driven innovation is improving the lives of our customers. And now David will provide additional financial details from the third quarter.

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

Thank you, Shelly. We have invested to derive advancements in our business to be highly relevant with consumers while strengthening our operations for the long term. These investments include both capital projects and costs absorbed directly in our P&L. This painstaking work has positioned us now to deliver the accelerated sales growth and profitability foreseen at our Investor Day in November 2016.

As Shelly highlighted, strong demand for our 360 smart beds clearly demonstrates that our differentiation is breaking through in a crowded commoditized marketplace.

Demand has accelerated significantly; reflecting the completed transition to all 360 smart beds. Inter-quarter net sales shifts in the prior year and this year are masking the real increase in underlying demand. Importantly, these sales shifts only impact quarterly reported comparisons and do not affect our annual results for either year.

We provided non-GAAP financial measures reconciliation tables on Page 10 of the press release that disclosed our quarterly net sales and earnings per share as reported for 2017 and 2018, along with estimated quarterly shifts we have called out each year.

For the current quarter, the reconciliation tables highlight a $24 million shift from Q3 to Q4 due to sales order growth acceleration in the back half of Q3 during an already high-volume quarter.

On an "apples-to-apples" basis, our Q3 adjusted demand grew 12% and adjusted earnings per share grew 34%. Our full-year EPS guidance midpoint of $1.85 assumes 6% net sales growth, implying that adjusted Q4 demand will grow 10%, and adjusted Q4 earnings will increase 52%. This earnings growth step-up versus Q3 is largely due to $0.06 of expected benefits in Q4 this year from lower year-over-year transition costs. Now I will discuss the 60.4% gross margin rate reported for Q3, and what we expect for the year and beyond. While the Q3 gross margin represented a 70 basis point sequential improvement, it was about 100 basis points lower than we expected.

In the first half of the quarter, the Classic Series closeout pressured our Q3 gross margin rate 50 basis points more than we expected. We also realized 50 basis points more pressure than expected from stronger demand for our FlexFit adjustable bases and other source products that integrate well with our 360 smart beds.

For the full year, we now expect our gross margin to be about 60.5%, reflecting the transition impacts we've absorbed in 2018.

Looking beyond this year, we are targeting gross margin of 61% to 62%. This range contemplates several headwinds and meaningful tailwinds. Headwinds we're responding to include; tariffs, freight and trucking inflation, and stronger attach of sourced products, including our adjustable bases and bedding. The latest tariff rate hikes affect about 5% to 6% of our overall COGS.

We are working with our global sourcing providers to mitigate the potential for 40 to 60 basis points of margin rate pressures arising from this fast-changing tariff landscape.

Tailwinds include 50 basis points of benefit from eliminating $8 million in transition costs, and 25 to 30 basis points each from supply chain efficiency gains and no Classic Series closeout sales.

We also expect to benefit from volume-based leverage, improved logistics operations and benefit-driven pricing. We've historically taken about 3% annual pricing and see this as an ongoing opportunity for our business model.

Our Q3 reported operating expenses de-levered 100 basis points as we leaned into our sales and marketing spending that drove mid-teen sales order growth.

The inter-quarter sales shifts were the primary reason for the reported deleverage in the third quarter. For the full year, we still expect to lever our operating expenses about 100 basis points. At our 2018 guidance midpoint, we expect about 50 to 60 basis points of operating profit deleverage as we've absorbed significant transition pressures necessary to position us for accelerated growth and profitability now.

So far this year, we have generated $134 million of operating cash flows and invested $34 million year-to-date in high-value capital projects. We've continued to see substantial value in our shares and repurchased $195 million of our shares year-to-date. At the end of the third quarter, we had $91 million of inventories and $165 million of open net liquidity, excluding letters of credit to service our business initiatives and capital priorities.

In the updated Investor Relations deck posted on our investor page of our website, we added a slide on Page 9 that provides a financial assumptions to bridge from our 2018 EPS guidance midpoint to our 2019 EPS target of $2.75.

In addition to a slow-growing economic backdrop, important assumptions include; high single-digit sales growth from our 360 smart bed business, meaningfully above predictions for low-single-digit mattress industry growth; improved gross margin to the targeted range of 61% to 62% discussed earlier; modest operating expense leverage as we continue to lean into our demand-driving innovations, marketing and retail, the lifeblood of our sustainable business model, while controlling cost elsewhere.

Approximately, 100 basis point improvement of our net operating profit margin. Our operating profit expectation reflects our #1 capital priority, which is to invest in the business to stay relevant for the long term.

And finally, at least mid-teen ROIC, which compares with our current high single-digit weighted average cost of capital. We will provide more details for next year when we report on our 2018 full year results early in 2019.

Let me add my thanks to our dedicated teams for executing this major business transition. We are entering our financial harvest after investing more than $0.5 billion to build out the sustainable sleep technology business for the long-term. We are accelerating sales and improving operating profitability now to deliver superior shareholder value. Christine, at this point, we'd like to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Bobby Griffin with Raymond James.

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

Congratulations on the strong uptick in demand with the new products. I guess, my first question was more of a high-level question, not really about the quarter, but just about as you work your way towards this $3 million per store goal, roughly 20% or so of your store base is already there. What are some of the differences you see in those stores versus the $2 million stores? And kind of help me bridge how you bring the average up to that $3 million goal?

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

Well, Bobby, first of all, one important point is that all of our stores are continuing -- we continue to see growth across all of our markets. So we don't have a ceiling on where we are. That's a key contributor along with the maturity in the marketplace, and of course, the store location itself. And as you know, we've made significant investment across our entire portfolio to improve our locations and both look at the marketplace as an individual store and the total DMA.

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

I appreciate that color. And I guess, on the quarter itself, and with the big surge in demand towards the end of the quarter, was there any change in kind of the timing of deliveries that caused some of it to be pushed back into the fourth quarter? Or was all the backlog pretty much just the uptick in demand as a result of these new impressive products?

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

You nailed it, Bobby. It was the latter. I mean, it was explosive growth in the back half of the quarter, during the period where it's already very high volume.

I just -- it's important for me to also say that it represented about a week's worth of deliveries and those have already been made here in October.

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

Okay, you took -- yes, that was my next question. Is there going to be any issues getting those deliveries back out on time, yes. And then, lastly...

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

Yes, those deliveries have been made and I would also love to just take this opportunity to give a shout out to our home delivery teams for not only having a record performance in the September time frame but also delivering high -- our record-high NPS scores across the country.

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

And I guess lastly from me, it was just about the tariffs. And I appreciate the 5% to 6% of COGS data that you gave us. You mentioned you're talking to your suppliers and whatnot, but would you guys be willing to adjust pricing if the tariff did go through and there wasn't -- and there still was kind of an impact for you? How do you -- how are you thinking about that?

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

Yes, Bobby, we do have a pricing power especially with our exclusive distribution and proprietary products.

Operator

The next question comes from John Baugh with Stifel.

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

Jumping right in. The quarter obviously had some of the legacy products, and then, the full reset before Labor Day. And so you gave us some feel for the orders and then, some color around ARU. I guess, I'm trying to understand, what did you see in terms of mix of mattress price points, once you got the lower price? I guess, C2s on the floor. How did the whole, kind of, order ARU look post kind of full reset?

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

Great question, John. We've been really pleased with, I think, in particular the steadiness of the performance, not only in the top line, but also on units and ARU. So whether you look at the last 7 weeks of the quarter or the 13-week trend performance, we were seeing -- we've experienced a double-digit growth in units and a mid-single digit growth in ARU throughout both of these time frames. So very consistent and we're really happy about that. We see great market share opportunity across our price points, and that's what we're going after and getting here with our 360 smart beds.

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

And Shelly, is that ARU or is that simply taking dollars over units? So I guess I'm trying to get a little more granular in the sense that if you sold a lot of additional attached bed frames, for example, that would drive ARU. I'm trying to get a kind of a pure mattress only ARU, and whether that changed appreciably?

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

Yes, we look at it in total when we report out our average revenue per mattress unit. But I will say that the combination -- I mentioned this in my remarks, the combination of our selling process and the compelling value at $999 for the c2 Smart bed as well as the mid price point and the high-end, our team does a great job in our stores of selling to the customers sleep issues and delivering against those benefits and moving customers through the line. So importantly, we're seeing the growth and the performance across our good, better and best pricing within premium.

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

Great. And customer acquisition cost. You've mentioned that, I think you said up 250 -- percent or something year-over-year, if I heard you right. I'm curious, what you're seeing in that metric from your competition? And whether the rate of increase is slowing at all? Or we know a lot of the competition is struggling, and yet it sounds like that continues to escalate though.

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

Yes, the metric I cited was the cost of key search terms up 250% in Q3. So we specifically -- we have our digital buying in-house, so we're able to be highly responsive and agile based on what we're seeing in search terms and find efficiency and balance that between buying some terms at a higher price and finding other terms that are more efficient, but yet highly effective. Overall, in the quarter, when we look at our media spend, we did lever against our sales orders in the quarter, and we're pretty excited about that considering the overall media investment being made. And keep in mind, I mean, you're absolutely right, there are a lot of players, I mean, it's all you've heard about, is everyone struggles in the quarter. And obviously, our growth looked very different than everybody else's, delivering 19% growth the last 7 weeks in the quarter. And you have to remember, there's literally hundreds of players increasing their spending and that's what's driving the overall spend. It's not just one, it's a combination.

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

Yes. And then lastly, quickly. The color you gave around, I think it was modest operating expense leverage next year. So just so I'm clear, we're going to take media spend up fairly materially, maybe what -- as much as double-digit, year-over-year in dollars spend, but the combination, I guess, of expected sales growth and maybe other SG&A expenses not rising as much allows for that modest leverage. Any more color maybe David on that?

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

Yes, I would point you to Slide 9 of the new investor deck, John, and how we're thinking about 2019 at this point. We'll provide a lot more color about 2019 assumptions when we announce our formal guidance for 2019 on the Q4 call.

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

And, John, regarding the media comment. I think the third quarter can be illustrative of a double-digit increase over the prior year, up 13%, but yet levering in the quarter on sales orders. So it doesn't necessarily imply a deleverage. In fact, on Slide 9, we highlight operating expenses at 54% to 55% of net sales.

Operator

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

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

I was hoping to just check in on the supply chain network update and get a sense for where you were? How many markets? How that's going? And how you think you'll expand that in 2019?

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

Yes, great, Brad. It's -- we are opening our third assembly distribution center here in the fourth quarter and expect to open 3 or 4 more of those over the next 2 years. We currently have 7 of our distributed -- distribution centers that out of 30 to 40, ultimately that we expect to have. We've got this outlined on Slide 20 in the investor deck on our website. We feel great about what we're seeing so far. The experience for consumers is meaningfully enhanced when we deliver preassembled mattresses, and we are excited about what this initiative can do for both the consumer experience and our gross margin long term.

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

And as we think about the financial benefits on a 2019 versus 2018, any sense of how much that may be able to contribute next year?

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

Brad, that's all baked into how we're thinking about the gross margin of 61% to 62% for next year. And we think that there is upside potentially to that longer term.

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

Great. And then just bridging the 2019 outlook. As we close the book on the 360 transition cost, where did those come in, in total for 2018?

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

So right where we expected, the transition cost for 2018 were $8 million compared to $10 million last year, and they are now done, that part of it. So we won't have any identified transition cost called out in Q4. And so we're expecting a $0.06 of benefit in Q4 this year because of that benefit.

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

Great. And then just one last one from me. With Mattress Firm planning to close stores, I don't know if you've seen any of that yet. Are you seeing any pressure where they're closing stores? Or maybe you aren't even observing it yet. And how are you thinking about that impact potentially in 4Q? And maybe the tailwind from the closures as you look ahead?

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

Yes. Well, certainly, we see our strategy driving our performance, and that's where our focus is, is delivering meaningfully sleep -- improved sleep-benefit driven products to our customers, and we think that's what's driving our performance and will continue to. And could there be some tailwind with their disruption and some lack of confidence by the customer? Sure. We primarily focus on our own strategy to drive performance, and we're opportunistic in looking at stores in the marketplace, and will certainly take advantage of that.

Operator

Next question comes from Seth Basham with Wedbush Securities.

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

My first question is about the C series closeouts in the third quarter. You mentioned they're going to expect a negative impact on gross margins. How much positive impact did they deliver in terms of comps relative to your expectations?

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

Seth, they drove a lot of units but they don't come with a lot of dollars, and so it does pressure your margin rate, brings people into the brand, which is phenomenal and we like what that means for us longer term, but we're glad to be through that closeout process at this point.

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

Okay. It seems like you guys have great demand currently and at the tail end of the quarter. I'm curious as to why you're not projecting stronger revenue for the fourth quarter as a result? You think you pulled some sales forward or orders forward from the fourth to the third quarter? Can you help us understand how you're thinking about that trend?

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

Sure, Seth. Well, important to highlight again how thrilled we are with the consumer response to our 360 smart beds, and we have great confidence in accelerating sales and profits that are needed to deliver our guidance midpoint of $1.85 this year, and expect that momentum to continue into 2019. We of course considered all variables in our guidance, our trajectory, our prior year 16% growth in Q4, which also included some hurricane benefit from the prior year shift. And then, consumer spending, holiday behaviors and the holiday calendar as well as the broader consumer environment.

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

One other thing, Seth, that you might want to consider in your modeling is, historically, our Q4 sales are about 85% to 90% of our Q3 sales. On an adjusted basis, that's where we've targeted them in our guidance midpoint.

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

Got it. And then as you think about the attachments that you guys are seeing on the new 360 smart bed lineup, which models have seen the largest year-over-year increase in attachment rates in the couple of months after launch? In other words, are you seeing a higher increase in attachment rates for the lower end C models or some of the higher-end models?

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

We are seeing a nice improvement across our line with our 360 smart beds.

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

And is there any difference towards the high-end or the low-end?

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

Sure, they -- we tend to have a higher attach rate at the higher end of our line, but we've seen an uptick across each and every model with the introduction of the 360 smart beds.

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

Yes, just to make sure you understand my question. Just trying to understand if we've seen a higher year-over-year increase since the launch and a couple of months following the launch for the lower end versus the higher end.

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

On a like-for-like basis, we are seeing an improved attached rate of FlexFit bases across all of our 360 smart bed models compared to their previous models. On a year-over-year basis, we are also seeing an uptick in overall attach rate.

Operator

The next question comes from Peter Keith with Piper Jaffray.

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

So, I know that Mattress Firm was asked earlier, but with the bankruptcy process that's evolved here and it seems like they've called -- pulled back on advertising. It doesn't seem like it's having any impact, but is there anything from a traffic standpoint that you would call out as a positive or negative just with regard to the overall mattress industry environment?

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

Yes, I guess what I would say, Peter, is all the correlations to our performance have been directly tied to our 360 transition and the 360 "This is Not a Bed" marketing campaign.

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

Okay. And I'm curious too with -- maybe it's also -- I'm a Vikings fan. So the NFL marketing has stood out for me, and it clearly seems to be contributing to drive some interest to the brand. When you're looking out to that 2019 forecast, and obviously, the NFL season would be winding down in January, is that anything that you would contemplate as positive or negative as it just relates to driving consumer interest into the next year?

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

Well, there are great NFL opportunities throughout the year with Combine and the Draft and other types of events that have been growing for the NFL and for partners like us, and we do take full advantage of those types of events as part of what we tested out this past year and made some great progress. And this is a year-round activity, that we've certainly taken into consideration in how this progresses through the year and when to apply various tactics based on what activities are transpiring, and how to stay engaged with the fan base. I mean, it's something we're advancing and learning and evolving, but we do have great knowledge from this past spring and summer to understand how to find the best leverage throughout the full year.

Operator

The next question comes from Michael Lasser with UBS.

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

So you mentioned that the last 7 weeks quarters were up 19% year-over-year, presumably sales were slightly behind that as it took you a little while to catch up with delivering the orders. And probably you had a very easy comparison in the middle of the quarter because you were lapping the hurricane disruption from the year-ago period. Also early in the quarter, you were probably benefiting from some of the closeout activity. So to finish flat for the quarter, with such a strong finish, why were sales so soft in the beginning of the quarter?

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

Yes, well, you just touched on it, the closeouts of the C series was where our softness was. So no, that wasn't a contributor. It actually pressured the top line. And we specifically have given you the granularity of our business since we transitioned to all 360 smart beds because this is our future and this is where we're going and this is -- shows the trajectory of the business. Regarding the hurricane impact from prior year, we've clearly called that out on Page 10 of the press release, illustrating both the shift out of third quarter of prior year and into the fourth quarter of prior year. So we net out on that $10 million to $15 million from Q3 to Q4 in 2017. And the 13-week trend of 16% orders growth gives you a great illustration outside of that hurricane period so that you can see the difference, and there's about a 3-point difference between that and in the 7 weeks, which accounts for that hurricane.

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

Can you give us the sales number for that last 7 weeks?

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

I think we've provided a lot more detail and granularity than we typically provide. So that you can fully understand the impact of that sales acceleration. We did see $24 million worth of orders that are going to result in net sales shifting into the fourth quarter. And we've highlighted that as the excess that we saw in the quarter versus our plan.

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

Yes, Michael, the other add I would make is the third quarter is obviously a very large quarter for us. That quarter is also backloaded. So the accelerated growth we had was also, at a time, with the steepest sales penetration in the quarter. So it was a big explosive in a positive way impact on our performance.

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

Yes, no, that seems very fair. I guess the takeaway is that you're trying to message -- you have good momentum right now, you think you can continue that into the next year because you outlined the parameters for next year that include some robust top line growth. I guess the counterargument would be, you saw a strong dip in sales in the beginning of the quarter, the business came back in the back half, why should we believe that this trajectory is sustainable into next year, especially when marketing cost, [will continue] to be a pressure and you're taking pricing, and there is an uncertain response to pricing environment especially when there's flood of low-price mattresses in the marketplace.

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

Mike, I'm really glad that you asked that question because this a perfect opportunity to reiterate the importance of understanding our business today now that we are all 360 smart beds. It's a new business. And we just demonstrated what that looks like in a very important sales time period i.e. the last 7 weeks of the third quarter with our 360 smart beds, with media pressure, with search cost of over 250%, and us effectively marketing in that environment and driving a 19% growth and a 16% growth over the last 13 weeks since we have fully transitioned to our 360 smart beds.

We have great confidence in our business and heading into the fourth quarter to be able to drive double-digit top line performance, and then high single-digit into 2019.

Operator

Next question comes from Keith Hughes with SunTrust.

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

The slide you have on the investor presentation about the 2019 goals. As you say, there is pretty healthy contribution for more share repurchase. Given how excited you all obviously are about the new beds, would you consider -- or are you considering doing an accelerated share repurchase plan? Or something to end the year here to help get that share count down, it's a pretty big number you're looking for in '19.

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

Given where we are with our business model and the strong response from consumers to our 360 smart beds, we continue to see significant value in our shares.

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

Okay. And would you be willing -- you did have some down the balance sheet really last -- really the last several quarters. Are you willing to continue that trend at higher levels? And is there a limit that the board will be uncomfortable if you're going past?

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

Yes, Keith, our posture regarding our capital structure is, it's conservative, including maintaining about $100 million of undrawn liquidity as appropriate for our business. And I think those are some good guardrails to consider as we're thinking about it right now. This is clearly an ongoing conversation with our board.

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

Okay. And final question. You've talked several times here about the growth rate the last -- order growth the last 7 weeks of the quarter. I don't know if you've said -- what was the order growth in October so far?

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

Well, I highlighted that the double-digit momentum has continued and that our 13-week sales trend is up 16%.

Operator

(Operator Instructions) The next question comes from Curtis Nagle.

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

So in terms of the explosive growth you guys have seen recently, would you be able to break out demand for each of the new lines? How much was driven by C? How much by P? How much by I?

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

We do not provide the detailed buy by model or by product item. And I think what is important, Curtis, is the consumer response to our smart beds. They're all smart. The c2 through the i10, and then of course, we provide different options on bases for our customer to add, but the total package is smart. And that's what our consumers are so excited and responding to.

Operator

The next question comes from Michael Lasser with UBS.

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

Another quick question. Dave, can you walk us through the bridge to get to 100 basis points of gross margin next year? And presumably, it's got to be more than 100 basis points as you're going to see that 40 to 60 basis points of margin drag from the tariff.

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

Sure. Again, as we look at it, we're seeing both headwinds and tailwinds as we look forward. And I think we've all been talking, and I'm sure you've heard from other companies that have talked about the tariff impact. And so that is a very real pressure that we are -- it's fairly early on and we haven't yet solved. And we see it as about 40 to 60 basis points of potential pressure. But we have great suppliers globally that we're working with to help mitigate some of that. And we talk about some of the pricing power that we have as a business if ultimately we need to lean into that lever as well. However, if we -- as we think about it, I talked about 50 basis points of benefit from eliminating the -- that $8 million in transition costs, I highlighted 25 to 30 basis points each from supply chain efficiency gains as we focus on running 1 product line, and not have the kinds of pressures of operating 2 product lines that we had this year. And then another 25 to 30 basis points of benefit from not having C series closeout sales in 2019. In addition to that, we talked about volume-based leverage and improved logistics operations, et cetera. So I think that's -- that helps you understand how we're thinking about it.

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

Okay. And one quick last one. With -- was the volatility, the sales volatility that you saw within the quarter greater than a typical quarter that you normally see?

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

Well, importantly, we did not see sales volatility since we've transitioned to our 360 smart bed. We have had steady and consistent performance, and as indicated with our 13-week trend as well as the last 7 weeks of the quarter. So since we fully transitioned, turned our marketing on to support it, it has been steady and consistent and progressive.

Operator

At this time, I would now like to turn the conference back over to the speakers for closing remarks.

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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 2018 performance with you in February. Sleep well and dream big.

Operator

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