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Sleep Number Corp. (SNBR)

Q2 2020 Earnings Call

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OTHER PARTICIPANTS

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Bobby Griffin
Analyst, Raymond James & Associates, Inc.

Seth Basham
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Bradley Thomas
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Atul Maheswari
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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Sleep Number's Second Quarter 2020 Earnings Conference Call. All lines have been placed in a listen-only mode until the question-and-answer session. 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.

Dave Schwantes
Vice President-Finance, Investor Relations & Decision Support, Sleep Number Corp.

Good afternoon and welcome to the Sleep Number Corporation second quarter 2020 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 Chief Financial Officer. The three of us are social distancing in our Minneapolis offices for the call today.

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 Radue Ibach

President, Chief Executive Officer & Director, Sleep Number Corp.

Good afternoon and welcome to our 2020 second quarter earnings call. My SleepIQ score was 75 last night. The mission of Sleep Number to improve lives through individualized sleep experiences has never been more important or more relevant than it is today. Our unwavering belief in our company's purpose and our resourcefulness in finding ways to serve our customers have enabled Sleep Number to effectively navigate one of the most challenging periods in our nation's history. I'm grateful for our team's dedication to our mission and unrelenting focus on ensuring business continuity as we continue to create opportunities for market share gains, profitable growth and significant shareholder returns over time.

Our better than expected second quarter performance in the face of monumental global health, economic and social concerns demonstrates the significant competitive advantages of our integrated business model and is a testament to the resilience, passion and commitment of our Sleep Number team.

The swift and bold actions we have taken to combat the impact of the pandemic, including keeping our team safe, serving our customers and maintaining our financial flexibility, underscore the strategic financial and operational agility we have built over the past several years.

As a reminder, we took immediate actions to increase liquidity and reduce expenses. We prioritized investments and initiatives to drive near-term performance, aid our recovery and speed our return to long-term growth. We quickly scaled digital CRM solutions that retain the value of our relationship-based selling approach through a blend of phone, chat, online, selling from home and private appointments.

We seamlessly pivoted to remote headquarter operations, customer service and innovative sales and delivery options, and we prioritized our marketing efforts on loyal insiders and brand advocates, a powerful competitive advantage which represents our most efficient source of sales.

As a result, second quarter financial results exceeded our expectations, including: net sales of $285 million, which were 20% below prior year with an average of 53% of our stores open during the quarter; net loss per share of $0.45; year-to-date operating cash flows of $87 million, up 24% versus the prior year to-date; and net debt of $226 million, which was $54 million lower than a year ago. Overall, we experienced improving sales trends throughout the quarter with high-single-digit demand growth in May and June combined compared to 2019.

Several factors contributed to our better than expected performance, including: our pivot to virtual relationship selling nationwide with impressive results, which mitigated the closed store impact; stellar growth in our online, chat and phone sales, up more than 200% from the prior year second quarter. Year-to-date, we have surpassed 2019's total revenue from these touch points. Effective reopening of stores aided by referrals and repeat sales from our lifelong relationships with Sleep Number customers, an immediate shift in our approach to customer acquisition.

We increased our media mix into digital resulting in a step-up in digital traffic from Q1. We also placed increased emphasis on financing and promotions while significantly reducing overall media spending. Growing engagement with our brand as consumers respond favorably to the proven quality sleep of our 360 smart beds, and the agility, real-time visibility and controls inherent in our vertically integrated business model, which enabled us to quickly translate insights into operational and strategic advancements as we worked in lockstep with our partners and suppliers.

Throughout the intense disruption of the pandemic and civil unrest, we have taken decisive actions to drive near-term results while advancing our pioneering innovations, enhancing our culture of individuality and broadening our relevance to consumers.

In the second quarter, we began providing new proprietary software features, including circadian rhythm insights and personalized sleep wellness reports to all of our SleepIQ customers. Through our research-informed 360 smart beds, Sleep Number is delivering proven quality sleep supported by science-based evidence that links quality sleep and overall wellness.

COVID-19 has heightened individuals' concerns about their immunity and resilience. There is increased understanding that sleep is vital for healthy living and quality sleep actually boosts one's immune system. Our data shows that SleepIQ sleepers are sleeping better. Since the pandemic began, our SleepIQ sleepers have gained an average of 11 minutes of restful sleep per night. This improvement is in sharp contrast to surveys about sleep within the general population which indicate that 58% of individuals who reported a change in their sleep since the pandemic are sleeping less.

We are working closely with our new Scientific Advisory Board, an interdisciplinary group of physicians, clinicians and researchers with expertise in sleep science and health. The Advisory Board is providing counsel as we mine our longitudinal data, which includes over 800 million sleep sessions. We are bullish on our scientific accuracy and our ability to utilize the data elements with the highest impact on sleep quality.

In August, we plan to commercialize individual heart rate variability insights as the next advancement in proactive health and wellness. 360 smart bed sleepers will benefit from understanding how their nighttime heart rate variability impacts their activity level and energy each day. With the reopening of our stores, we are excited to introduce our new m7 and i10 360 smart beds in the coming weeks. With more than 80% of consumers challenged by temperature concerns during sleep, our new 360 smart beds feature temperature balancing layers. These beds are designed to more closely contour to the body for greater support and spinal alignment, increased pressure relief and reduced motion transfer.

While we temporarily halted most discretionary capital spending in the second quarter, we've maintained our investment in life-changing innovations that ensure our continued long-term success. For example, we recently acquired a patent portfolio from Gentherm, the global developer of thermal management technologies. These patents support the cooling and heating technology for our beds and bedding and further strengthen our competitiveness. We plan to introduce our Climate360 bed in 2021, and these additional patents will embolden our longer term innovation roadmap.

The current environment remains dynamic and we expect continued disruption due to COVID-19 and the US presidential election in the second half of 2020. We've demonstrated our agility and perseverance, and will continue to benefit from our culture of innovation, strategic advantages and execution discipline. Our strategy is designed to deliver growth through customer acquisition and retention, net operating profit leverage, and to drive strong cash generation and mid-teens ROIC, and we expect this strategy to drive solid financial performance through these challenging times, as we have for multiple years.

Today, more than 95% of our stores are open, and we continue to drive triple-digit online chat and phone growth. Our brand metrics are at all-time highs, customer satisfaction, engagement, digital traffic, and conversion are all exceeding prior year. Our balance sheet remains strong and we have significantly more liquidity than a year ago. We expect the powerful combination of our proprietary innovations, data and digital communications, direct-to-consumer distribution, customer loyalty, and mission-driven team to drive demand during the second half.

In addition, the pandemic has served as a catalyst for positive longer-term change and reinvention. In the wake of our necessary immediate actions to reduce costs and preserve our financial flexibility, we have identified new ways of doing business, such as virtual relationship selling and digital lead management, and we are accelerating other initiatives, such as connected health. These opportunities are leading us to reallocate head count and strategically invest in new capabilities that will support our future growth. Consistent with our past, we will use our experience and learnings to strengthen our competitive moats and advance our purpose.

The structural shift in consumer attitudes and behaviors related to health and safety, which have been accelerated by COVID-19, is likely to continue. Consumers are increasingly prioritizing the well-being of their family and home, with more than 25% of consumers expecting to purchase a health-related product before year end, according to a recent Nielsen global survey.

Quality sleep has the power to improve health and wellness, and Sleep Number is at the forefront of delivering life-changing benefits to individuals and the world. The tenacity and ingenuity of our team, the disciplined execution of our differentiated strategy, and the effective use of our capital position us well to deliver long-term profitable growth.

Now, David will provide additional financial details on our second quarter.

David R. Callen

Senior Vice President & Chief Financial Officer, Sleep Number Corp.

Thank you, Shelly. The second quarter was all about agility and progression. We demonstrated agility by acting with urgency based on the real-time performance metrics we use to run the business. We learned to do things differently under extremely challenging conditions, and we levered the technology and growth-driving capabilities we built the past few years. While our selling-from-anywhere capabilities helped us reach customers throughout the quarter, the progression of our sales has certainly benefited from being allowed to reopen our stores.

Today, more than 95% of our nearly 600 stores are open. In April, just 23% were open on average, followed by 47% in May and 81% in June. While uncertainty remains regarding future impacts of COVID-19, we have demonstrated our ability to improve lives even in the toughest conditions. Our financial performance for the second quarter was significantly better than the models we used to inform our cost and capital deployment decisions.

April demand was down 48% versus the prior year, followed by high-single digit growth in May and June combined. This hyper V-shaped change in demand understandably stressed our fulfillment capacity, resulting in more than $30 million incremental deliveries carrying forward into Q3. Looking forward, the Labor Day timing shift is expected to move about $10 million in deliveries from Q3 into Q4, and we expect Q4 sales will also benefit by more than $25 million from an extra fiscal week this year.

Net sales in Q2 of $285 million were 20% lower than the prior year, compared with a 50% reduction assumed in the scenario used to support our cost and capital allocation decisions. More than 27% of our sales in Q2 came from online and phone sales, compared with 7% the prior year. Despite this, ARU was just 4% lower than the prior year on mix shifts, partially offset by higher bedding sales. COVID-19 closures resulted in delivered mattress units 17% lower than the prior year.

The mix shift and operational inefficiencies from COVID-19 closures and lower unit volumes pressured our gross margin rate in Q2 by 380 basis points versus the prior year to 57.2%. Managing the dynamics of extreme demand changes in Q2 has certainly been challenging. Through the fast actions of our teams and agility of our global supply partners, we had no significant supply disruptions during the quarter.

Constraints in COVID-related uncertainties that affect the flow of goods globally continue to be top of mind and managed day-to-day by our team and partners. One specific example of this during Q2 is our newest distribution center in the Los Angeles area. We opened in May, as planned. However, we managed very real COVID-19 challenges to staff and operate it properly. As a result, we elected to run it temporarily as a hub rather than a mattress assembly location. We've leveraged learnings from operating previous distribution centers and love this location. We expect to convert it to our fourth assembly distribution center after we manage through Labor Day volumes. For similar reasons, we also postponed the opening of our fifth planned ADC in Dallas until next year. These decisions were necessary to mitigate COVID-related business risks. We will continue to provide updates each quarter on this multi-year initiative.

During our first quarter earnings call, I highlighted scenarios that if realized would consume about $50 million of free cash flow from operations in the first half. Our sales in Q2 were stronger than modeled, and our early and aggressive actions resulted in $35 million lower operating expenses than in Q2 the prior year, this while continuing to support our performance-driving initiatives and absorbing severance and year-to-date incentive compensation true-ups. Our year-to-date financial performance also reflects the agility of our business model in the face of extreme challenges.

We reduced expenses 3%, in line with year-to-date net sales change, while investing 14% more to support our innovations. Despite the impacts of COVID-19, our gross margin rate in the first half is 10 basis points higher than the prior year-to-date, and our net operating profit is up 2%. Our first half EBITDA was equal to the prior year, and we generated $65 million of free cash flow year-to-date, up 79% versus the first six months of 2019.

Our commitment to efficient capital management and this performance enabled us to pay down nearly $300 million of our revolver at the end of the quarter. We ended Q2 with $226 million of net debt, down $54 million compared to a year ago, while increasing liquidity by $129 million, including the addition of the $75 million one-year term loan. Our 2.8 times ending leverage ratio improved from 3 times EBITDAR for the same period last year. Remember that our covenant maximum is 4.5 times, and our targeted operating leverage range is 2.5 to 3 times EBITDAR.

The fundamentals of our business and balance sheet are strong. We are well-capitalized to support our initiatives with pace and confidence while navigating through ongoing COVID-19 related challenges. We are pleased with the performance of the business. We also acknowledge that uncertainties remain for the back half of the year from COVID-19, the presidential election, and possible recession pressures.

As a result, we built our spending plans for the balance of the year based on demand, approaching flat to the prior year, including the extra week benefit this year. Our long-term bias favors continued prioritization of our innovation and marketing initiatives. We intend to lean more heavily into these growth drivers in the back half of 2020 and beyond.

We expect somewhat less gross margin rate pressure from mix shifts in the back half of the year, as consumer shopping preferences include both in-store and online purchases an advantage of our vertical business. We continue to actively balance near-term business risks with our commitment to sustain our advantaged strategy. Our orientation for long-term performance embraces an approach now that enables us to rebound with pace over the coming quarters.

In closing, I'd like to add my thanks to the Sleep Number team and business partners across the country who have worked tirelessly to drive performance and to improve lives through proven quality sleep. Thank you.

Chantelle, at this point, please open the line for clarifying questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Peter Keith with Piper Sandler. Your line is open.

Peter Jacob Keith
Analyst, Piper Sandler & Co.
Q

Hi. Thanks. Good afternoon, everyone. Thanks for taking the question. I was hoping you could just expand upon the comments around the $30 million of backlog from the quarter that got pushed to Q2 – to Q3. I think you had commented that you don't have any supply chain issues. So, what exactly caused that backlog and was it maybe demand-related in the final weeks of the quarter?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.
A

Sure. Hi, Peter. We have been giving a little more color intra-quarter than normal here since COVID-19, and this is really an example of us doing that. If you think about where we were in April, down nearly 50%, and at that time, we had an average of 23% of our stores open. And in May, we had an average of 47% open, and in June, 81% open, and now, nearly all of our stores open. And if you think about the progression of the sales, down nearly 50% in April, and then, high-single digits for May and June. That did become a big swing in our overall performance during that time. And I also mentioned that our sales performance has been progressive and – throughout the quarter. So, that gives you a good indicator of how that flowed, how it built through the quarter. And there is also a very strong correlation with us opening our stores and our performance growth. So naturally, because of May's significant performance and June, both very strong months, it built an increase in the backlog.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.
A

Peter, I'd just add on, having the kind of demand change that we're talking about, with April down 48%, and then, sudden and dramatic growth in May and June, that causes some pretty big fluctuations for us to manage through, and that's part of what you're seeing with $30 million of additional business to be delivered in Q3.

Peter Jacob Keith
Analyst, Piper Sandler & Co.
Q

Okay. Fair enough. And I guess to clarify, I wanted to – on that, is both May and June were up or was it just the balance of the combined were up?

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Yeah. Each of those months were up...

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Were up.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

...versus prior year.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Yeah. Okay. And so, you had mentioned you had pull back on advertising during the quarter, which I think makes a ton of sense and not very different from other players in the industry. How are you thinking about advertising now going into Q3? Is that something that you want to increase and lean into or are you still a little bit hesitant with some of this backlog?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

No. We're leaning into this, Peter. We did have a significant decrease in our media spend in Q2. And I also have to say that the precision of our media strategy has really been a significant advantage for us, that, and the fact that we have internal digital buying. In the quarter, we had the ability to pivot and shift our spending to reach and find an engaged customer, even with these significant media reductions. And that combination with our virtual relationship selling helped us build. When you look at May, and to think that we were up over last year with an average of 47% of our stores open, it's a pretty remarkable progression. And so, we're definitely adding back media at pace and we expect to navigate around many hurdles here in the back half as well, both around the COVID-19 pandemic and also around the political environment.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Okay. Fair enough. Thanks for the answers and good luck.

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Thank you.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Thanks, Peter.

Operator: Our next question comes from Bobby Griffin with Raymond James. Your line is open.

Bobby Griffin
Analyst, Raymond James & Associates, Inc.

Q

Good afternoon, everybody. Appreciate you taking my questions.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Hey, Bobby.

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Hey.

Bobby Griffin
Analyst, Raymond James & Associates, Inc.

Q

I first just wanted to clarify your comments earlier about the back – your spending plans for the back half, and I think you mentioned something of revenue or demand kind of equal to last year. Can you maybe clean that up for me where I understand it? And I guess I'm just putting in context, since you're running up in orders now and you're shifting in $30 million worth of deliveries in 2Q, as well as you got the extra week, I was just – I'm getting a little confused on, I guess, having revenue flat versus the back half of last year.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Right. I understand...

Bobby Griffin
Analyst, Raymond James & Associates, Inc.

Q

It is conservative and uncertainty out there, whatever you might want to put around that to help me think about it.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Right. Good. I'll do that. We're not providing guidance, first of all, and this isn't guidance, and we're trying to talk through how we're thinking about running the business in a very challenged environment where there is a lot of uncertainty still to be absorbed. I mean, you look at the changes even this week in California, we don't have control over when jurisdictions are going to close stores or what have you. So, we're navigating through a pretty challenging environment. And in that environment, we're talking about how we're thinking about our spending in the back half of the year, and we're basing our spending based on sales growth versus the prior year that's flat to the prior year, including the benefit of the extra week. That's just how we're thinking about it in this environment. That's how we're managing the business. I'd hope you'd think that that was appropriate, given the uncertainties ahead.

Bobby Griffin
Analyst, Raymond James & Associates, Inc.

Q

Okay. That makes sense. Thank you. Yeah. That makes great sense. I guess the second part of my question, Shelly, I was just curious, as you've seen your stores reopen, have you noticed anything different about customer behavior inside the store versus kind of pre-COVID levels? And you guys have a pretty unique selling process there at Sleep Number. So I'm just curious, any tidbits you've picked up for customers as they return into your stores?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Bobby, we see, I would say, a wide variation of consumer behavior based on state and county and how the pandemic has played out in different areas, and we're all about being individualized – it's all about individualization for us in all aspects of our business, including our beds with the individualized comfort, and we individualize the experience, and this is where having our talented frontline team connect with the customer, and same with our home delivery team, they're connecting with the customer, they're weighing out and understand the sensitivity where the customers at and they meet them in a way that helps make the customer feel very comfortable and safe and meet their – and we're able to meet their needs and deliver a really stellar experience, and it's exciting to see such high customer satisfaction scores during such a challenging time.

Bobby Griffin
Analyst, Raymond James & Associates, Inc.

Q

All right. I will jump back in the queue. I appreciate the – you answering my questions.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Thanks, Bobby.

Operator: Your next question comes from Seth Basham with Wedbush Securities. Your line is open.

Seth Basham
Analyst, Wedbush Securities, Inc.

Q

Thanks a lot and good afternoon.

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Hey, Seth.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Hey, Seth.

Seth Basham
Analyst, Wedbush Securities, Inc.

Q

You commented on some of the recent trends in May and June. Perhaps you give us some color around how sales are trending in key markets like Florida, Texas, and California, where we've seen rise in coronavirus cases in recent weeks?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Yeah. Again, we're seeing very – more variation than we normally would across regions and counties where you see the COVID-19 flare-ups or concentrations. Yet, I would also share with you that as we've opened stores, all of our stores throughout the country have quickly become productive, certainly some more than others. But I think this is a good example of the ongoing relationships our frontlines building with their long-term customers and benefiting from that repeat and referral. It helps us to have a jumpstart right from the beginning. And then, also our digital lead management is helping with that as well, so it ensures a strong start.

Seth Basham
Analyst, Wedbush Securities, Inc.

Q

Got you. And looking, for example, at the group of stores that were already reopened at the beginning of June, how do those progress through the month? Did you see some trail off in year-over-year growth trends as we got later in the month over the course of the 4th of July holiday weekend with the rise in coronavirus cases?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Yeah. As – we shared the progression through the second quarter and it continued to progress in a positive way throughout the full quarter, and we saw the consistency or correlation to the opening of our stores. So, we averaged 81% of our stores open in June, Seth, and now, we're at about 95% and we've seen the progression of sales match the progression of openings.

Seth Basham
Analyst, Wedbush Securities, Inc.

Q

Yeah. I'm sorry, just to clarify and my follow-up question there, if you look at stores that are opened earlier, say, the group of stores that was already opened at the beginning of June, how did sales in those stores progress over the last six weeks?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Well, I'm not going to get into detail on the third quarter, but as I've stated, we've seen a good strong progression of our business and that also includes stores that have been opened.

Seth Basham
Analyst, Wedbush Securities, Inc.

Q

Got it. Thank you very much.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Thanks, Seth.

Operator: Your next question comes from Brad Thomas with KeyBanc Capital Markets. Your line is open.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah. Thanks for taking my question. I wanted to first ask about the strength you're seeing in the direct business, and I was curious if you could talk a little bit more about if you think this is going to be sort of a permanent shift for you. Do you think this is going to be sticky as a growing percentage of sales, or do you think as you reflect on the last few months, perhaps, there were individuals that visited the store or they hadn't closed yet and they decided to end up finally converting online, I'd be curious more of the insights you're seeing here?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Well, let me start with the fact that we're 100% direct-to-consumer, which is very unique to Sleep Number. All of our distribution comes through either our stores online, chat or phone. And this is what we've designed the strategy for, for the customer to be able to interact with us however she wants. We see the customer interact through multiple touchpoints generally, and we've certainly been pretty aggressive in our digital communication, as well as our digital lead management, to be able to serve her, particularly during this time in a different way. As David highlighted, the online, phone and chat sales were 27% of our business, and I mentioned we've already surpassed 2019 numbers. I expect this business to continue to be a larger part of our total as we move forward.

As our stores have reopened, we've continued to see triple-digit growth in our online sales and we know there's still going to be a lot of fluctuation around COVID-19 here in the back half. So, it's hard to provide clarity about what this is going to look like. I think importantly, we're going to be very fluid and we've shown our ability to pivot and be agile and be responsive to the consumer where she wants to shop. In the end, maybe this is double the penetration it was in the past. We absolutely see it as additive and complementary to our stores in the long-term.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

That's very helpful, Shelly. And if I could ask one of David, recognizing you're not giving guidance, it's not going to stop us from trying to get more color out of you, I guess, in a world where you're planning for the demand growth including the extra week to be flat, can you help give us some insights into maybe puts and takes to think about from a gross margin and expense standpoint?

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Okay. I will do my best. How we're thinking about it, Brad, is we're planning the expenses based on, as I said, demand that's about even with the prior year including the extra week. However, we also plan to lean into our innovation drivers, our long-term growth drivers, and our near-term growth drivers through marketing capabilities. So you'll see a little bit of an uptick in those areas in the back half of the year relative to prior year.

In addition to that, I guess, on the gross margin side, the mix shift with higher mix of our sales coming from online, phone and chat, the natural tendency is for the mix to move a little bit down the line. You saw that that impacted us by – impacted our ARU by about 4% and it had a pretty reasonable impact on our gross margin rate. We expect less of an impact on our margin rate in the back half as we expect to have more of our stores open the majority of the back half. But again, we don't know for sure what that's going to look like. And so giving you guidance on or giving you kind of color on what to expect on gross margin is really tough, but that's how we're thinking about it.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great, very helpful. Thank you all so much.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

You bet.

Operator: Your next question comes from Curtis Nagle with Bank of America. Your line is open.

Curtis Nagle
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks very much for taking my questions. So, first, a quick one on the store base. So I think you closed 19 in the quarter. How many of those were part of the 25 stores you had a month-to-month leases that you'd indicated were potentially closed and – or had potential to close permanently and how many were part of the basic relocation plan and how should we think about the footprint for the rest of the year?

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Yeah. The majority of those were on month-to-month leases that we were taking action on given the environment and our ability to transfer the majority of those sales and profits from those stores to other stores in the geography. We're pretty much through that part of the effort at this point, and we're really leaning into our growth drivers on all fronts. Our capitalization is very strong and we have lots of liquidity to support our initiatives, and we'll be leaning into our CapEx and our store expansion plans in the back half as well.

Curtis Nagle
Analyst, Bank of America Merrill Lynch

Q

Okay. Understood. And then just thinking a little bit more about the – so a slight downtick in revs per mattress, so you indicated that it's due to the online mix shift which makes total sense. I guess, how much is that due to perhaps attachment selling maybe not being as strong or how much is that due to an actual product mix, so people mixing a little bit lower in terms of the actual beds? So maybe more pSE beds relative to iBeds, how do we kind of think through that?

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Well, you know our business model. The more we have touch points with our customer, the more often we reach out to have a contact with them. If they only have a transaction online, it generally comes in at a lower model of product and the more often we have interaction. So, if we have online plus chat, it moves up the line. And if it ends up in the store, it's got the best total solution for the customer and frankly highest satisfaction for the customer, and highest NPS scores, et cetera. So, not only does it come with higher ARU with those in-store transactions, but it's overall a better overall experience in total.

We've improved significantly through the digital capabilities that we've been talking about. So there was only a minor slippage of the ARU, down 4%. I think that's pretty minor given the mix of sales of 27% coming from these other touch points of online, phone and chat. However, that is primarily changes in model mix, not as much about lower attach.

Curtis Nagle
Analyst, Bank of America Merrill Lynch

Q

Okay. Very clear. Thank you.

Operator: Your next question comes from Atul Maheswari with UBS. Your line is open.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Good evening. Thanks a lot for taking my question. Since online and phone channels are still growing 100% even with nearly all of your stores open, does it make you rethink your store strategy going forward? Will you look to pare back on your expectation of adding mid-single-digit square footage every year or will you even potentially look to lower square footage going forward?

Shelly Radue Ibach

President, Chief Executive Officer & Director, Sleep Number Corp.

A

We've contemplated this as part of our strategy for multiple years, and we constantly go back to our real estate strategy and look at a five-year horizon with changing consumer behavior. We see this pandemic as absolutely a catalyst to not only shift consumer attitudes around health and wellness, but also how they shop. And this has been contemplated in our strategies is why we have such a high average revenue per store already and why we've held to having a distance of about 20 minutes between our stores. Having the availability for a customer to have an in-store experience we still see is very important for a brand like ours and a brand that you're going to be highly engaged with. And we see this is complementary. And, yes, we still have a triple digit, I said triple digit, not 100%. And we're excited about that and we see it as additive and we intend to grow all touch points.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Understood. And just as my follow-up, and I know this was touched upon earlier, but May and June were up high single digits, and I understand you don't want to get into too many specifics here. But how would you compare that high single digit to how the first two weeks of July has trended? Just any color directionally, have sales remained in line or have sales decelerated or accelerated versus May and June?

Shelly Radue Ibach

President, Chief Executive Officer & Director, Sleep Number Corp.

A

Yeah. This is very similar to a question I had earlier and I indicated that our sales have been progressive throughout the second quarter, and there has been a strong correlation with us opening our stores and the increased number of store openings along with our stronger overall top line performance. And as a reminder, in June, we averaged 81% of our stores open. And right now, we have 95% of our stores open.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Okay. Thank you.

David R. Callen

Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

You bet.

Operator: Our next question comes from Peter Keith with Piper Sandler. Your line is open.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Hey. Thanks again, guys. So, a couple of follow-ups. David, the last call you talked about $150 million annualized cost reduction plan. So the sales have gotten better much faster than you thought. Where would you sort of peg that cost reduction plan on an annualized basis given sort of the framework you'd provided for the back half of the year to us?

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Peter, we – that plan was based on, as you recall, scenarios that included down 50% in Q2, down 25%-ish in Q3 and flattish sales in Q4. Clearly, down 20% here in Q2, there are significantly more variable costs associated with the higher sales levels. And talking about the back half being essentially flat to the prior year for the whole back half, clearly, there's going to be more variable costs that are incorporated in there. So we're not going to give an update on the overall spending cuts, but we did everything that we thought we would be doing and more. Hence, you can look at the cash generation in Q2 as an indication, and I tried to give you some kind of comparison in the sense that we expected based on those models to consume about $50 million in cash from free cash flows from operations in the first half and instead generated significantly more than that – what was it -$65-or-so million in that same period.

So, pretty significant swing in overall liquidity and performance in that first half. So we're just continuing to be appropriately conservative given the uncertainties on our spending in the back half, and we will continue to pull every lever to drive performance where those opportunities allow, and if we needed to, we can always pull back as well.

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Yeah. Peter, the add I'll provide here is, as we went into the pandemic and we took actions against all those costs, including significant furloughs and now, at this point, we have brought back our – the majority of our team. The change in business and the trajectory and challenges did result in some job eliminations along the way. And at the same time, we continue to place the business in a path that we have the financial flexibility, and yet, we want to keep building and driving our performance overall.

So it's important to make the necessary cuts and, at the same time, be able to pivot and grow or cut more depending on where we're at. So we're going to remain very agile and I think we've demonstrated our ability to do that in short periods of time and in pretty dramatic ways here in the second quarter.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Okay, fair enough. That's a good answer. Also, I want to circle back on maybe sales trends at stores that have been open for over a month or two. One thing we hear industry-wide is that the average selling price just continues to strengthen week-over-week as we moved through June and into July. Are you seeing that at stores that perhaps opened up in May and is there a sequential improvement in those stores or that tends to open up and then kind of hold steady from that, that first week?

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Well, our model is so different than most. We have quite a bit of consistency in our sleep professionals' performance with our selling process, and that delivers a very consistent and growing ARU, and that's what we've seen. So as we're now, today, now in this position of 95% of our stores open, then our overall ARU is far more normalized. But we've seen that pretty immediately as stores have opened. Our ARU is right where you would expect it, and I think that's one of the exciting things I've seen in the business, Peter, is, gosh, our second and third tier metrics have held, even with all this disruption, have held so steady in the fluctuations and they've – as things moved back, they moved right back, and that's a very encouraging for our ability to be able to navigate through all of this over an extended period of time.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Sure. Okay. One last question for you guys and I'm sorry for maybe specifically targeting June. But you've kind of used two different phrases around demand growth and sales growth, and you have this big – this backlog in June that would have impacted sales for the month rather dramatically. Were sales in June overall positive despite that that $30 million backlog?

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

So when we were talking about this demand and sales on an interim basis, we're talking about sales orders and not necessarily delivered sales – delivered net sales. But the answer is, yes, they were.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Delivered net sales.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Both.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Yeah. Okay, well, that's impressive. All right. Thanks a lot, guys, appreciate the extra insights.

David R. Callen
Senior Vice President & Chief Financial Officer, Sleep Number Corp.

A

Okay. Thanks a lot.

Shelly Radue Ibach
President, Chief Executive Officer & Director, Sleep Number Corp.

A

Yes, thank you.

Operator: There are no further questions at this time. I will now turn the call back over to the speakers for closing remarks.

Dave Schwantes
Vice President-Finance, Investor Relations & Decision Support, Sleep Number Corp.

Thank you for joining us today. We look forward to discussing our third quarter 2020 performance with you in October. Sleep well and dream big.

Operator: This concludes today's conference call. You may now disconnect.