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Sleep Number Corp. (SNBR)

Q4 2019 Earnings Call

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John Allen Baugh

Analyst, Stifel, Nicolaus & Co., Inc.

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Analyst, Piper Sandler & Co.

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Sleep Number Q4 and Full Year 2019 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 fourth 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 Radue Ibach

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

Good afternoon and welcome to our call. My SleepIQ was 82 last night. Consumer response to our revolutionary 360 smart beds has been exceptional driving six quarters consecutively of double-digit demand growth including acceleration in the fourth quarter. Our differentiated consumer innovation strategy drove record results in 2019, which were near the high end of our expectations including 11% net sales growth to \$1.7 billion with the 6% comp gain and 5 points from new stores, 21% growth in net operating profit, 41% growth in earnings per share to \$2.70 and 44% growth in operating cash flows to \$189 million. We've executed our ambitious vision over multiple years focusing on three performance drivers; increasing consumer demand, driving business leverage, and deploying capital efficiently.

Building lifelong relationships with our customers while investing to ensure broad consumer relevance has resulted in sustainable profitable growth including a five-year EPS CAGR of 17% and five-year total shareholder return of 85%. As a purpose-driven company, we remain committed to investing in the initiatives that deliver meaningful value for our customers, teams and communities and we expect our advantaged and efficient business model combined with near and long term investments will continue to deliver superior returns for our shareholders.

For 2020 we anticipate our performance driving initiatives will result in EPS of \$3.10; a 15% increase over our record 2019 performance. We've continued our positive momentum with a strong start in 2020. Here are the catalysts behind our performance drivers. First, we are driving consumer demand through five integrated competitive advantages; proprietary sleep innovations, longitudinal data, lifelong customer relationships, brand communication, and exclusive direct-to-consumer distribution. We've awakened the consumer to the importance of sleep and with our 360 smart beds; we've provided a solution to effortlessly achieve proven quality sleep.

Our SleepIQ technology platform delivers over 10 billion biometric data measurements each night. These inform our innovations and result in integrated advancements that seamlessly act on our sleeper's behalf. We will continue to evolve our Sleep Number 360 smart bed at a pace that keeps consumers highly engaged with our brand. Our SleepIQ software advancements are benefiting all customers who own this technology which we first introduced in 2014. Informed by more than 700 million sleep sessions, and sleep and wellness research, these ongoing updates add meaningful value to our customer's sleep experience and overall well-being. Our customers' daily engagement with our brand via SleepIQ technology reinforces this value with personalized insights. The result is increased customer retention and future revenue from referral and repeat sales. The lifelong relationship with our customers is an important strategic moat that is strengthened through our ability to link smart sleep to individualized health and wellness.

Last month at CES, the largest consumer innovation event in the world, we unveiled our next generation of 360 smart beds which help solve significant sleep challenges and effortlessly deliver proven quality sleep. Our smart beds were honored with 12 awards during CES including the best of innovation in the smart home category. We will begin introducing our new 360 smart bed portfolio in the second quarter, with advanced SleepIQ capabilities that include monthly wellness reports, sleep circadian rhythm insights and heart rate variability measurement.

In addition, our new smart beds feature temperature balancing layers and proprietary comfort technologies to provide a cooler, drier sleep environment. According to Sleep Number research, temperature during sleep is an issue for 83% of people. Our new Sleep Number Climate360 smart bed available within the next 12 months is designed to help people fall asleep faster and stay asleep by creating smart individualized microclimates. The bed adjusts throughout the night, warming and cooling each side and working with the sleeper's natural sleep cycles to provide deeper and more restful sleep.

Sleep disorders have been declared a public health epidemic by the US Center for Disease Control. One in three adults suffer from a lack of adequate sleep. As a company with purpose, we are dedicated to our mission of improving lives by individualizing sleep experiences. We are taking on big challenges like sleep deprivation. Based on our proprietary research and analysis of more than 25 million sleep sessions, sleepers who routinely use their 360 smart bed features including SleepIQ technology can improve quality sleep by nearly 100 hours each year. This matters. Studies have shown that even 15 minutes more quality sleep per night can increase the body's ability to stave off weight gain, prevent a cold and enhance productivity. We are committed to making quality sleep the new badge of honor for society.

With the significant opportunity, we have to improve people's lives through higher quality sleep, we recently entered into an extensive collaboration with the Mayo Clinic to advance sleep science and cardiovascular medicine. By providing our unparalleled sleep knowledge and technology to world class clinicians and researchers, we're poised to make meaningful advancements to the science of sleep and health. This collaboration is a good illustration of the value of our longitudinal data; one of our competitive advantages, and reinforces the efficacy of our smart beds.

Investing in partnerships with organizations like Mayo Clinic, the nation's number one hospital, and NFL to extend and amplify our brand in a proprietary manner is an important aspect of our strategy. Our brand metrics indicate especially strong affinity with our broad NFL audience. With innovation leadership and strong fundamentals across our vertically integrated business, we began leaning into our brand campaign and media spending in the third quarter of 2019 to drive increased highly qualified traffic to our brand. We have successfully converted this traffic and driven double digit demand for the last six quarters including the back half of 2019 which was up against double digit growth from the prior year.

Our integrated initiatives including media, social, digital engagement and selling process advancements are key drivers of the double digit demand growth which has continued into 2020. Since December, more than half of our demand growth has been driven by unit growth. We expect our initiatives to drive increases in both units and ARU with a greater performance contribution from unit growth in 2020.

Moving to our second performance driver; business leverage. With our tightly integrated vertical model and a culture that drives innovation and continuous improvement, it is exciting to be realizing accelerating benefits from our investments and initiatives. Business leverage priorities include advancing technology in automation to support growth; enabling innovation with an agile, flexible and cost advantage supply chain; strengthening our logistics network to gain efficiencies, and effectiveness and implementing total quality management. These multi-year initiatives are delivering both margin expansion and improved customer experience.

Our third performance driver is deploying capital efficiently which we have also advanced over multiple years. We've generated nearly \$900 million of operating cash flow over the past six years, including a record \$189 million in 2019. Our top capital deployment priorities remain, investing in high confidence, high return growth and profit drivers; maintaining appropriate liquidity and investing in Sleep Number stock where we continue to see meaningful value.

Our consumer innovation strategy has resulted in a strong foundation for growth and profitability. We are excited to begin the next chapter of our journey as a purpose-driven company in the health and wellness space with a more broadly relevant brand, expanded competitive advantages and an integrated vertical business model with digital at our core.

Thank you to our talented and highly engaged Sleep Number team and partners for your dedication to improving lives by individualizing sleep experiences which is having a meaningful impact on society. Your passion, integrity, innovation, courage and teamwork are resulting in record financial performance and superior shareholder value creation.

Now David will share more details on our financials and outlook.

David R. Callen

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

Thank you, Shelly. Tenaciously strengthening our business over several years enabled us to run clean in 2019. In the four years since introducing our long term \$2.75 EPS target, we've delivered 9% compounded annual net sales growth and 29% compounded annual growth in earnings per diluted share. We significantly advanced our competitive advantages, the face of our financials and the sustainability of our performance. We've invested to acquire and build growth enablers like our technology platforms. We've increased spending to support our growth drivers like our revolutionary innovations, optimized retail and agile marketing capabilities and we've methodically evolved our capital structure while prioritizing liquidity to support our plans. These disciplined decisions drove a 660 basis point increase in our return on invested capital in four years to 17.8%, more than double our weighted average cost of capital.

The great news we've got millions more lives to improve. Running clean in 2019 did not change our long term mindset. Leaning into our near and long term growth drivers enabled our 2019 performance including 11% net sales growth, 130 basis point improvement in gross margin, 21% operating profit growth and a 41% increase in earnings per diluted share. Top and bottom line growth at the higher end of our expectations allowed us to accelerate spending on innovations and marketing. As our results demonstrate executing this way is good for shareholder value creation.

When compared to adjusted 2018 results our current year Q4 net sales grew 14% and EPS grew 41%. Our reported fourth quarter net sales grew 7% and EPS grew 1%. Please refer to the 2018 fourth quarter press release non-GAAP reconciliation tables for details of the \$24 million of deliveries that shifted from Q3 into Q4 last year. Our full year 2019 comps contributed 6 points of growth while new stores added 5 points. We ended the year with 611 stores across all 50 states. During the year, we opened 59 new stores and grew average sales per comp store plus online 6% to \$2.9 million. Our revolutionary innovations and proprietary retail selling process drove a 9% lift in our ARU while units were up 2% for the year. Operational improvement initiatives drove a 130 basis point lift in our full year gross margin rate to 61.9%. This was at the high end of our internal expectations while absorbing higher than expected tariff and final mile delivery costs during the year.

Favorable product mix, elimination of prior year transition costs and improved operations and customer experience contributed to the strong gross margin rate in 2019. Outsized top line growth and gross margin expansion enabled additional funding of our growth initiatives throughout 2019. For example, we ratcheted our R&D spending 21% for the year, including accelerated growth of 25% in Q4. This funding to support longer term growth is leading to life changing innovations like the new 360 smart beds we will begin introducing next quarter. While delivering a 21% increase in our net operating profit to \$112 million in 2019, we also absorbed more than

100 basis points of pressure across the P&L from higher incentive compensation, medical claims and legal expenses.

This NOP growth was nearly double our 11% top line growth and reflects a 60 basis point improvement year over year. We generated 44% more cash from operations in 2019 to a record \$189 million and funded 30% more high value capital projects this year to a total of \$59 million. We also realized double digit internal rate of return on the \$146 million we invested to buy Sleep Number stock. Our ending leverage ratio of 2.7 times EBITDAR is within our target operating range of 2.5 to 3 times as planned.

Performance momentum has continued into 2020. Our EPS guidance of \$3.10 represents a 15% increase over record 2019 earnings while absorbing 5 points of EPS growth headwinds from higher expected income tax rate and \$4 million of estimated transition costs. We continue to run the business for full year and long term performance.

Here's some color on performance drivers and the expected shape of 2020. We expect consumer sentiment this year to be similar with 2019. However, we believe it's prudent to plan for some consumer distraction from the Olympics and Presidential Election in the back half of the year. The coronavirus has blanketed headlines recently. While we don't have immediate supply exposures, we continue to work closely with our handful of China based suppliers to build contingency plans. We expect this dynamic situation to become clearer over the coming months.

For the 2020 fiscal year, we expect high single digit top line growth including 2 points from the extra week. We expect our initiatives in 2020 to again drive growth from ARU and units as well as through comp and new stores. The strongest year-over-year sales and earnings growth are expected in the first and fourth quarters. The first quarter is up against the easiest two year compares and the fourth quarter will benefit from a Labor Day calendar shift of approximately \$10 million plus the extra fiscal week of sales of approximately \$30 million. We expect continued advancement of our integrated initiatives to deliver 25 to 50 basis points of incremental gross margin in 2020 on top of the 130 basis point gain in 2019. We intend again to accelerate our R&D spending as we progress through the year causing 30 to 40 basis points of deleverage for the year. With our clear data driven insights, it's the right time to invest a good portion of the estimated \$0.15 extra week benefit to support our future innovations.

Funding our initiatives and growth drivers is expected to result in modest operating profit leverage for the year. We expect about 5 points of EPS growth headwind from a 22% estimated full year income tax rate. This estimate includes about \$3 million of full year excess tax benefits from equity accounting primarily in the first quarter. We expect to generate approximately \$190 million in cash from operations and to deploy approximately \$60 million on capital projects primarily to expand our store portfolio 4% to 5% in 2020. The balance of our free cash flow is expected to be invested in Sleep Number stock as we continue to see meaningful value there. We expect to deliver high teen ROIC while operating within our targeted leverage range of 2.5 to 3 times EBITDAR. The enthusiastic consumer response to our life changing innovations shows consumers understand there is no compromise needed when choosing the 360 smart bed. Each sleeper gets what they want. They each feel the benefit of the bed actually using data to effortly adjust on their behalf to deliver deeper higher quality sleep. Who wouldn't want 100 more hours of proven quality sleep each year? We look forward to raising the bar on behalf of our customers again in 2020 and to delivering strong value creation for Sleep Number investors.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Bobby Griffin with Raymond James. Your line is open.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Good afternoon, everybody. Congrats on a good quarter and a good year and I appreciate you taking my questions.

Q

David R. Callen

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

Hey Bobby.

A

Shelly Radue Ibach

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

Great. Thanks, Bobby.

A

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

So I first wanted to just take maybe a high level question. And when you guys look at the business today, do you think the actual natural contribution margin of the business has changed because of dynamics of the industry whether higher investments are required, more R&D spending or is the mid-teens type contribution that we've talked about in the past something that the underlying business is achieving is just getting offset by maybe one-time transition costs?

Q

David R. Callen

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

Hey Bobby. It's really about where we are in our journey and the opportunities that we see. We've highlighted that investing in our growth drivers and having a long-term bias is the way we operate this business and with the clarity that we have from having 10 billion biometric measures every night from our sleepers is informing our future innovations and give us great visibility as to what we should be spending behind. So the flow through rate that we're talking about, I think, in 2019 was 12% operating profit flow through. We see that it'll be slightly less in 2020 as we lean into these growth drivers for the long-term benefit.

A

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Okay. I appreciate it. That's helpful. And then from the cadence of the new product introductions, is there anything that we should keep in mind in our models as you guys roll these out and help us think about the size of them or the new products going on the floor as it updates just to the app and SleepIQ system. What exactly should we be thinking as we roll through the year from a cadence standpoint for those?

Q

Shelly Radue Ibach

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

A

Yeah, Bobby, we're really excited about the advancement of our 360 smart beds. As you recall, it was six-and-a-half quarters ago that we transitioned to all 360 smart beds and this will be our first advancement since we've made that big transformative move for the company. These are absolutely new 360 smart beds. These are the beds that we revealed and won so many awards with at CES and they have numerous advanced features from both a comfort and a cooling. And then also the SleepIQ technology has advanced too and every time we make advancements in the technology that will go to all the customers who have SleepIQ technology back to 2014.

David R. Callen

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

A

And then just to tack on, Bobby, I think you asked about the timing. We're planning the rollout to start next quarter in Q2 and be completed here in 2020.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Thank you. I appreciate the detail. I'll jump back in the queue. Good luck in the first quarter.

David R. Callen

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

A

Great. Thanks, Bobby.

Shelly Radue Ibach

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

A

Thank you.

Operator: Thank you. Next we will hear from John Baugh with Stifel. Your line is open.

John Allen Baugh

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thank you. Good evening, and likewise congrats on a great Q4 and start to 2020. Jump right in, the transition costs, I think you called out \$4 million. Is that new product launch or what specifically are you referencing there?

David R. Callen

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

A

That's exactly right. That's related to the rollout of our new products.

Shelly Radue Ibach

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

A

Primarily in Q2 and Q3.

John Allen Baugh

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. And then, Shelly, you've had a lot of experience with this. How do you think about the election specifically and there was commentary around Labor Day shifting and I believe that's when we'll see some election impact. So could you walk us through a little bit how sort of Q3 looks and what you're maybe anticipating as a possible headwind from the election spend on advertising?

Shelly Radue Ibach

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

A

Yeah, well, I'll just start with where we are and move through the year. We love our brand momentum right now and how well received our smart beds are from both the potential new customers as well as our existing customers and how life changing this sleep is. So we're really excited on the demand side and to be in our seventh quarter of double digit growth. And as we look at the full year, we expect our guidance of \$3.10 contemplates a high-single digit growth, as David said, primarily our strongest quarters we expect to be Q1 with the easiest two-year compare and then Q4 with the extra week and, yes, Labor Day is like five days later in September so it rolls very late so that will have a little bit of impact on when deliveries are made between the two quarters so you'll see a little movement there between quarters. We stay focused on the full year, operate the business for the full year, and the long term.

Regarding the election, this is always a consumer distraction. I think that's the biggest thing, John. From a media perspective, we have a lot of agility and there're lots of moves to make. Yes, you could get into some specific local pressure in certain areas, but you can navigate around things. It's really how distracted the consumer becomes, how resistant they are to behaving normally. Is that going to impact the Labor Day results? I don't know, but it's more probably a little later in the third quarter and you know early fourth quarter where we're going to see that distraction from the consumer.

John Allen Baugh

Analyst, Stifel, Nicolaus & Co., Inc.

Q

And so, not to put words in your mouth but you've embedded in your guidance, some level of impact potentially.

Shelly Radue Ibach

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

A

Absolutely.

John Allen Baugh

Analyst, Stifel, Nicolaus & Co., Inc.

Q

And then my last question was just around your comment. And maybe it was David about the year starting out had, I think, better than 10% pace and we're on the back end of Presidents' Day, which I believe it's a huge event in Q1. So my presumption would be that event went well and you kind of track in for a quarter towards that 10%-plus, or did I misread something?

Shelly Radue Ibach

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

A

No you did not. We consider this our seventh quarter of double digit growth and you're right, we're deep in the quarter through the Presidents' Day.

John Allen Baugh

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thank you 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.

Thanks, John.

A

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

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Hi. Thanks everyone. Congrats from me and good afternoon.

Q

Shelly Radue Ibach

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

Hi, Peter.

A

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Maybe just to follow on John's question. So the sales growth outlook, it's been increased modestly to high-single digit. And last time when you spoke in Q3, it was mid to high-single digit was the outlook for 2020. So it's a small change, but an interesting one. So, is there anything behind that beyond the strong start to the year that's maybe reshaped how you think about 2020?

Q

Shelly Radue Ibach

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

Yeah. I would say Peter as we have continued to progress our initiatives in each quarter, these are initiatives that are integrated and we constantly are advancing them. And in December, we had acceleration in the fourth quarter and in December we began to realize at least half of our growth from units. And that has carried through here in 2020. But I would say most importantly, we had a terrific Q4 and year and what really matters is our long term track record and the sustainability of our performance. And we have high confidence in being able to continue to advance our initiatives as we have been.

A

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Okay. And you had mentioned around some of the strengthening unit growth trends. And so just to go back to the prepared remarks, you had commented that unit growth in 2020 would be stronger than ARU growth which would be a change from the last couple of years. Could you just kind of help shape that for us. Is there something behind this unit growth pick up or conversely maybe is the mix shift slowing with ARU to cause that shift with stronger units?

Q

Shelly Radue Ibach

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

Well, I think you know illustrating from the double digit growth you know here again in the fourth quarter and in the first quarter, it's safe to say that both metrics are strong for us. And the unit growth is absolutely a result of what we've been talking about since July with all of our fundamentals so strong and the great response from consumers on our innovations that we would begin accelerating our brand communication and media spend to be able to get after more customer acquisition in addition to the strong customer retention that we have. And our

A

business model and strategy is designed to benefit from both ARU and unit growth over time. We continue to put up growth in these metrics on an annual basis and we've obviously had stronger growth from ARU with our innovations and selling process, but as we said in Q2 and Q3, we're putting this additional spend against our media and we expected that to materialize to unit growth and now it is.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Okay. That's very interesting and helpful. I'll leave it there. Thank you very much.

Shelly Radue Ibach

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

A

Thanks

David R. Callen

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

A

Operator, do you have another question for us?

Operator: Yes I do. I apologize for the delay. Our next question comes from Seth Basham with Wedbush. You may proceed.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Thanks a lot and good afternoon.

David R. Callen

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

A

Hey, Seth.

Shelly Radue Ibach

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

A

Hi, Seth.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

I missed part of the call. But if you could help us understand what's implied in your high-single digit sales growth for 2020 from a comp standpoint that would be helpful?

David R. Callen

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

A

Yeah. You should expect about an even split between comp and new store contribution in the year.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Got it. Okay. And then in that high-single digit, you're expecting units to increase more than ARU and therefore [ph] thinking entire comp (00:35:58) is going to be driven by units?

David R. Callen

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

A

We expect somewhat higher unit growth than ARU, but we do expect contribution from both in 2020.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Okay. I think I'm following you. And then lastly, just thinking about the ARU opportunities going forward, can you dimensionalize whether or not we're going to see any benefits from pricing or mix or attachments relative to 2019?

Shelly Radue Ibach

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

A

Yeah. Seth, this is a really great question. When you look at ARU overall, first of all, our strategy and business model certainly warrants. We have pricing power with our exclusive distribution and proprietary innovation. And at the same time, you can see that we're clearly able to drive unit growth without pricing as well. And I think the fourth quarter is a great example of that where we had fully lapped any pricing from 2018. And in the fourth quarter, we drove another 7% ARU growth. And this is an outcome of how we integrate our initiatives specifically, our innovations, our selling process and other factors in our store process. That leads to ARU growth, specifically both attach and mix, and yes we didn't expect continued attach and mix. We see opportunity. We're excited about our new line and how that will contribute.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

And the new line will come at higher prices than the existing lines?

Shelly Radue Ibach

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

A

We haven't specifically shared the pricing of the new line yet, but it's absolutely our favor to focus on attaching and mix so that we're able to sell more to each customer and also repeat and drive our overall performance at a higher level.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Got it. And lastly relating to this topic, a question that we frequently get from investors is, what is your attachment rate of adjustable bases right now on your mattress sales, because there's a concern that it can't go much higher from these levels after some really, really strong improvements over the last couple of years. Do you care to share any comments on that topic?

Shelly Radue Ibach

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

A

Yeah, yeah. I will share with you that we continue to see growth in this area. This is a strength of ours. It has been a strength of ours for many years now and we have great sightline to being able to continue to drive attach of our FlexFit bases. Obviously, it's an important contributor in the fourth quarter with our 7% ARU growth and we expect it will continue to be in the future.

Seth Basham

Analyst, Wedbush Securities, Inc.

Thanks a lot and good luck.

Q

Shelly Radue Ibach

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

Thank you.

A

David R. Callen

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

Thanks a lot.

A

Shelly Radue Ibach

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

Operator, next question?

A

David R. Callen

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

Hello, Sheila, are you there? Okay. I apologize. It seems we are having some technical difficulty with our operator. Just please hold on the line for one minute as we get this resolved and we'll continue with the Q&A.

A

Operator: This is the operator. Once again I do apologize for the delay. We are ready for our next question. Our next question will come from Bradley Thomas with KeyBanc Capital Markets. You may go ahead.

Andrew Efimoff

Analyst, KeyBanc Capital Markets, Inc.

Hey, good afternoon. This is Andrew on for Brad. A question we've been getting a lot recently is basically on competition and how you're viewing Mattress Firm's re-partnership with Tempur-Pedic. Clearly, it doesn't look like this is a significant issue in 4Q given your strong performance but we were wondering how you're thinking about the partnership over the next few quarters and how that could impact your business?

Q

Shelly Radue Ibach

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

Yeah. Andrew, this is Shelly. We're in our seventh quarter of double digit growth that is associated with our Sleep Number 360 smart bed and all the other initiatives that we've been driving over multiple quarters, we see great strength and have confidence in our own ability to continue to bring consumers into our brand and drive our performance.

A

Andrew Efimoff

Analyst, KeyBanc Capital Markets, Inc.

Great. Great. Understood. And I guess my last question here is wondered what your outlook was for input costs for 2020 and how you expect these trends to impact the margin outlook for the year?

Q

David R. Callen

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

A

You know, Andrew, it's kind of a push. We've got some things that are going against us, like some of our labor and so forth but we do have some favorability in some of our commodity costs. So we expect it to be basically flat impact overall.

Andrew Efimoff

Analyst, KeyBanc Capital Markets, Inc.

Q

All right. Great. Thanks. That's helpful. That's all for me.

David R. Callen

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

A

Okay. Thanks, Andrew. Okay, I'm almost afraid to ask but Sheila, are you with us? Sounds like we're having trouble...

Operator: This is the operator. Are you ready for the next question?

David R. Callen

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

A

Yes. Thanks.

Operator: Thank you. It comes from Atul Maheswari with UBS. You may go ahead.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Good evening. Thanks a lot for taking my question. My question is also on units and given the strong ARU growth in fourth quarter, it would appear that units probably declined on a same-store basis, but then it looks like unit growth has improved thus far in 2020 and that should ramp further. So, I'm just trying to better understand what has changed with respect to your strategy thus far in 2020 that's driving this improved growth?

David R. Callen

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

A

Yeah. Hey, Atul. I'll handle that one because it's a fairly easy one. You need to remember that we had \$24 million of deliveries in 2018 that shifted from Q3 into Q4, and that's kind of messing up your analysis. Our adjusted growth against the adjusted 2018 numbers in Q4 is 14%, and half of that was from units.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Okay. That's very helpful. Thank you so much. And then as a follow-up, how are trends in your mall versus non-mall stores, and is there any meaningful performance gap that's worth calling out and is that gap any wider than it's been in the past? Thank you.

Shelly Radue Ibach

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

A

Yeah, nothing meaningful to call out. We've continued to progress our strategy with stores outside of mall with now over 60% of our portfolio in non-mall.

David R. Callen

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

A

Yeah. Generally speaking, the malls that we're in, we like, and we see strong performance both in our mall and non-mall locations.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Thank you.

Operator: Thank you [Operator Instructions] Our next question is from Curtis Nagle with Bank of America. You may go ahead.

Curtis Nagle

Analyst, BofA Securities, Inc.

Q

Yeah. Thanks very much. Just wanted to go back to Seth's question on the breakout of sales growth. If I heard you correctly and maybe I didn't, I think you said that the contribution from comp and stores would be even and if that's the case and store growth is about 4.5%, the extra week is 2%, wouldn't that imply comps of 4.5% and total sales growth of 11% not high-single digits or do I have my math wrong?

David R. Callen

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

A

So look we're guiding to high-single digit top line growth with about 2 points from the extra week. We highlighted that that was about a \$30 million impact. The math that we're providing is about directionally equal contribution from comp and new stores. I'm not going to split the contribution by 0.5 point.

Curtis Nagle

Analyst, BofA Securities, Inc.

Q

Okay. And if you could just clarify how much EPS benefit you get from the extra week.

David R. Callen

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

A

As I highlighted on the call, my comments, I expected about \$0.15 benefit from that extra week. However, we're intending to invest that back into the business with accelerated spending in our R&D.

Curtis Nagle

Analyst, BofA Securities, Inc.

Q

Okay. Thanks very much.

David R. Callen

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

A

All right. You bet.

Operator: Thank you. I will now turn the conference back over to the company 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 first quarter 2020 performance with you in April. Sleep well and dream big.

Operator: Thank you. That does conclude today's conference. Thank you for participating. You may disconnect at this time.

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