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SNBR - Q1 2019 Sleep Number Corp Earnings Call

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OVERVIEW:

Co. reported 1Q19 net sales of $426m and EPS of $0.80. Expects 2019 net sales growth to be 6-10% and EPS to be $2.25-2.75.

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PRESENTATION

Operator

Welcome to Sleep Number's Q1 2019 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 and IR*

Good afternoon, and welcome to the Sleep Number Corporation First 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 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 contain certain forward-looking statements. These forward-looking statements are subject to a number of risks and uncertainties outlined in our earnings news release and discussed in some detail in our annual report on Form 10-K and other periodic filings with the SEC.

The company's actual future results may vary materially. I will now turn the call over to Shelly for her comments.

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

Good afternoon, everyone. Thank you for joining the first quarter -- our first quarter earnings call. My SleepIQ score last night was an 88. I will provide an overview of our quarter and the initiatives that are driving our performance. We are proud of our progress, the life-changing sleep we are providing our customers and the related total shareholder returns.

Results for the first quarter included: net sales growth of 10% to a record $426 million; operating income increased 22%; operating cash flows increased 38% and earnings per share increased 54% to a record $0.80.

We continue to advance our 3 EPS drivers: demand creation; business leverage; and efficient capital deployment, to drive growth and profitability. On the demand side, our purpose-driven brand, differentiated products, engaging marketing and relationship-based retail experience resulted in a 5% comp gain and 5 points of growth from new stores.

Our revolutionary 360 smart bed resonates with consumers as they deepen their understanding that sleep is at the core of performance and well-being. It is the only bed that delivers proven quality sleep by automatically adjusting to your individual comfort and support.

Our initiatives resulted in steady high-qualified digital traffic throughout the quarter with high store conversion. Strong sales execution is resulting in customers attaching adjustable bases, bedding and temperature solutions to their smart beds.

As we previously communicated, we expect growth from both ARU and units for the full year. We will have quarterly fluctuations in these metrics as we lap closeouts and other actions. We expect the following initiatives to extend our brand reach, deepen consumer engagement and deliver sustainable, profitable growth.

First, driving highly qualified traffic to our website and stores. Media percent of sales was flat year-over-year in a heavy spending competitive marketplace.

At a high level, there are 4 main components that are contributing to our marketing effectiveness: creative expression of our brand; our proprietary econometric model; internal digital capabilities that enable real-time media adjustments; and our skilled and engaged retail team's conversion. Collectively, these competencies build brand engagement as they move consumers from awareness and consideration to purchase.

Second, advancing our highly productive retail and digital experience. Continuous evolution of our store and online experiences keeps us relevant as indicated by our ongoing growth from both comp and new stores. Our purpose-driven culture and engaged team delivered high conversion and ARU. Our lifelong relationships with our customers begin in our stores and ultimately result in referral and repeat sales.

We are on track with our disciplined market development execution. 26% of our comp stores are now over $3 million annually. We opened 15 new stores in the quarter. 8 of them are relocations from mall to nonmall and 7 were incremental.

Importantly, we continue to improve our online experience. With our agile methodology, we are running multiple experiments that we then scale. Examples include: application of mobile test, which are resulting in greater conversion; simpler store locator functionality; and our engaging digital loyalty program.

These actions are reducing friction while offering a more personalized experience for our customers. Third, activating our customer community for brand advocacy. Lifelong consumer relationships are an important source of ongoing efficient growth for our brand. Our award-winning digital loyalty program is delivering compelling results.

We are integrating this program with our SleepIQ technology platform later in the second quarter. This will simplify our insider's experience and grow brand referrals.

Referral and repeat sales represent more than 40% of our business today and we expect this strategic strength to grow in importance.

Fourth, increasing brand engagement. Our brand health metrics are at record levels. Our partnerships with the NFL, the NFL Players Association, Professional Trainers' Association and Thrive Global amplify our brand consideration. Specifically, these partnerships are generating increased brand buzz and word of mouth about the life-changing benefits of our 360 smart beds.

Throughout these broad digital networks, we link smart quality sleep to improve wellness and performance, which in turn boosts consumer interest in research of our brand. These initiatives have been in early stages of development this past year, and we are now applying tested actions beginning with our activation and storytelling during the NFL draft at the end of April.

The execution of our consumer innovation strategy is driving double-digit sales growth in a marketplace where the cost for basic category search terms is 30% higher than prior year.

Our proprietary tools and strategy continue to effectively drive performance ahead of the competition. Our 3 competitive advantages: proprietary sleep innovations; exclusive distribution; and lifelong relationships, enable growth from both ARU and units, which resulted in 10% net sales growth in the quarter.

We are very excited about the combination of our benefit-driven products, the effectiveness of our sales and marketing and the value of our customer loyalty strategy.

Turning to business leverage. We are advancing initiatives to drive operating margin. In the quarter, we eliminated transition cost and benefited from manufacturing and sourcing efficiencies and improved return rates.

We continue to manage home delivery rate pressures and have mitigated tariff headwinds. We remain on track with the evolution of our supply chain network, including the move to pre-assembled mattresses. We expect that nearly half of our mattresses will be delivered pre-assembled by year-end. This will contribute to a simpler experience for our customers and increase efficiency in the final mile.

Our differentiated business model and strategy execution is generating strong cash flow and return on our investments. We generated $68 million in cash from operations in the first quarter, and our trailing 12 month ROIC was 16.5%, well above our weighted average cost of capital. Our capital priorities remain investing in high-confidence, high-return growth drivers, maintaining financial liquidity and returning excess cash to shareholders through share repurchases.

In summary, we are taking market share and delivering superior shareholder value. We are excited about the momentum of our initiatives and are on track with our full year EPS guidance range of $2.25 to $2.75.

Thank you to our Sleep Number team for your passion and strong execution. I also want to thank Andy Carlin, our Chief Sales and Services Officer, for his 11 years of stellar leadership and dedication to our mission. Andy will retire in June. And Melissa Barra, who has been leading our Consumer Innovation Strategy since 2013, is expanding her role to include Sales and Service. This evolution brings together all customer-facing teams under another talented and experienced leader as we continue to improve our customers lives through better sleep.

I'll now turn the call over to David, who will provide more details on the quarter and our outlook.

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

Thank you, Shelly. We continue to benefit from taking the long view with the execution of our consumer strategy. Our investments are delivering accelerated performance and reinforce the importance of prioritizing our growth drivers, innovation, marketing and retail.

We are also realizing benefits from our operating efficiency programs, and the evolution of our capital structure has generated double-digit returns on the shares we've repurchased.

Our trailing 12-month return on invested capital of 16.5% reflects an 80-plus percent premium to our weighted average cost of capital. Our capital priorities are clear and consistent. This integrated approach is delivering top-tier total shareholder return and positions us well for the future.

Net sales in Q1 of $426 million grew 10% over the prior year. Comp growth and new stores each contributed 5 points of growth in the quarter. ARU increased 9% and units grew 1%. We continue to expect quarter-to-quarter fluctuations in these metrics and growth from all four in 2019.

Our operating efficiency initiatives are also delivering results, which combined with our growth drivers, delivered 15% incremental operating profit flow-through this quarter. As a result, our net operating profit margin improved 80 basis points over the prior year to 7.7% of net sales.

As we highlighted on the last call, we are managing meaningful tailwinds and headwinds in 2019. I'll take a minute to walk you through the puts and takes that netted to a 40 basis point gross margin rate improvement over the prior year. We realized 70 basis points of lift by eliminating transition costs and 90 basis points from efficiency gains and pricing. These improvements were partially offset by 70 basis points of rate pressure from higher attach of our adjustable bases; 30 basis points from higher tariff costs; and 20 basis points of delivery cost inflation given continued tightness in that part of the labor market.

We expect sourced product attach pressure and cost inflation factors to continue throughout 2019, while we drive to improve our full year gross margin by up to 100 basis points.

We also delivered approximately 40 basis points of year-over-year operating expense leverage in Q1, while continuing to support our growth drivers. We increased our research and development spending 21% and our sales and marketing costs 9% in the quarter versus the prior year.

Prioritizing our growth drivers continues to deliver leverage for our business model. With 10% top line growth for the quarter, we delivered a 22% increase in our net operating profit, a 24% increase in our net income and a 54% increase in our earnings per diluted share. First quarter earnings include $0.05 more year-over-year benefit from stock comp accounting on the higher stock price. We expect a 25% income tax rate the balance of 2019.

As planned, our capital deployment decisions also benefited our Q1 earnings per share, including $0.11 from lower share count net of interest costs. We repurchased $41 million of our stock in the quarter at an average price of $39.36 per share. We continue to see value in our shares as we execute planned repurchases of $125 million to $145 million in 2019.

We generated $68 million of cash from operations in the quarter, up 38% versus the prior year. We invested $20 million in high-value projects and ended the first quarter with leverage of 2.8x EBITDAR, which is within our expected operating range of 2.5 to 3x EBITDAR. We may operate slightly below or above this range for short time periods in support of our business initiatives and seasonality.

We are reiterating our 2019 EPS guidance range of $2.25 to $2.75, representing 17% to 43% year-over-year EPS growth and 30% at the midpoint.

During our last call, we provided detailed assumptions in support of our 2019 guidance range. A few reminders: we expect higher sales growth in the first half than in the back half with 6% to 10% net sales growth for the full year.

We plan to invest $50 million to $60 million in capital projects in 2019, including the opening of 60 to 70 new stores. We continue to manage meaningful operating and capital deployment headwinds and tailwinds as we deliver top tier earnings growth and at least mid-teen ROIC in 2019.

As you're modeling the balance of the year, please keep in mind that we operate the business for full year and long-term results. The second quarter is our seasonally smallest quarter for both revenue and earnings. We expect Q2 operating profit to be up year-over-year but for EPS to be lower. This is primarily due to a prior year onetime tax benefit of $3 million or $0.08 per share. We also expect our 2019 second quarter G&A, R&D and interest expense to be similar to the amounts incurred in the first quarter this year. This is consistent with our original plans for the quarter and contemplated in our 17% to 43% EPS growth guidance for the year.

We continue to be bullish on our business following the robust growth and earnings delivered in the first quarter. We expect to deliver top tier earnings growth and shareholder value in 2019 and beyond. Christine, at this point, we'd like to open the line for questions.

QUESTIONS AND ANSWERS

Operator

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

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

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

I guess just in terms of momentum in the business, could you share some more color with us on the underlying trends you saw month-to-month in 1Q? And how you're thinking about comparable revenue as we model 2Q?

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

Sure, Brad, we -- this -- first of all, starting with, this is our third sequential quarter of double-digit growth since we completed the transition to all 360 smart beds. So we're excited about our consumers' response to our innovations and our other initiatives. We saw strong growth in traffic throughout the quarter with the strongest period being during the important President's event.

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

And then as far as Q2, Brad, you had highlighted about that. We also highlighted that we expect stronger growth in the first half of the year than the back half and 6% to 10% net sales growth for the full year.

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

Great. And then, obviously, you all are reiterating the full year guidance relative to our model, share count's coming in at a lower rate than we would've expected, and then the tax rate's more favorable. But it does feel like perhaps there's some headwinds on the margin front that are maybe a little bit worse than what you thought 3 months ago. Is that the right way to think about kind of maybe the 2 changes versus how you initially guided the year? Or is there anything else we should be thinking about here?

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

Yes, Brad. There are a lot of moving parts that we're managing through as we've highlighted with our guidance for the year. And I think you're onto the right things that we saw about $0.05 more benefit in the tax line and a little more pressure on the gross margin rate. But we have great confidence in the initiatives that we're driving and expect even more than the 40 basis points of margin expansion the balance of the year.

Operator

Next question comes from John Baugh with Stifel.

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

It was a tough quarter, it struck me as -- for the consumer in general. And you mentioned your traffic was good throughout. What -- and you mentioned, I think, also your media spend was flat. So I guess the first question I have is just, help us understand the media spend strategies for the rest of the year without giving away competitive information, I guess. And how you see the year unfolding? And has the tone gotten any better in the last few weeks versus some of the post, I don't know, December market meltdown, government shutdown, et cetera, so traffic's been very steady.

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

Yes. Well, thanks for your good questions here, John. Let me give a little color on the media as you requested. First of all, the media spend year-over-year was up. It was the percent -- media percent of sales was flat, and the spend was actually up 10% in the quarter, which drove 10% top line growth.

As you look at the media spend for the balance of the year, we continue to have great confidence in our overall business. We're hitting on all cylinders. We have a revolutionary product that is delivering proven quality sleep for our customers. Our marketing is effective. Our brand metrics are high. Our stores are highly productive, and we have great innovative suppliers working with us and our manufacturing is improving and delivering some nice leverage. And we have a highly engaged team. So we're definitely leaning in at a time when the overall industry is providing a fair amount of weakness.

So we're taking share. We intend to continue to take share. And coming from a place of strength, we intend to lean in. And as you think about media as a percent of sales, we've continued to say to model around the 14%, last year, we came in at 13.7%. So somewhere in that range. But I definitely would indicate that we're leaning in.

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

Okay. And then 2 other quick ones. One, the G&A was higher. And I think if I heard right, Dave, you said that the stock comp piece because the stock price going up was a big part of that. Could you quantify that? Was there anything else going on there?

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

John, the impact of the stock comp was in our tax rate that I highlighted, and that's just for that new accounting treatment for stock comp. The -- as we indicated on our last call, we expect pressure from broad-based participation in our incentive comp programs in G&A, and that was what the primary driver of the higher G&A in Q1.

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

Okay. And will that persist through the whole year, David?

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

Yes. We certainly hope so. Yes. And we'd hope so for our team.

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

And we think, as I highlighted, I expect G&A in Q2 to be similar to what it was in Q1, for example.

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

Okay. And lastly, quickly. I appreciate that units are lumpy as we look at quarters. Could you refresh for us quickly the lumpiness by quarter last year, or in other words, what the unit comparisons are like for the 4 quarters this year in terms of that lumpiness?

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

Yes, John. Well, let me start with indicating that we continue to expect growth in both ARU and units for the full year. And as you indicated and we highlighted, we will have quarterly fluctuations. So if you look at last year, 2018 by quarter, we were down 9%, up 7%, up 3%, up 8%. For full year, up 2%.

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

And part of that shift, John, you might be talking about was in the week of deliveries that moved from Q3 to Q4 last year that we highlighted, and that was within the year. But just keep that in mind as you're looking at the comparisons year-over-year.

Operator

The next question comes from Matthew McClintock with Barclays.

Jordana Hailey Cooper - *Barclays Bank PLC, Research Division - Research Analyst*

This is Jordana Cooper on for Matt. So as there are a lot of store openings planned for this year, can you talk a little bit about your real estate strategy for the year, particularly given the high degree of mattress store closures that have occurred over the last several months? Specifically, how did the strategy help drive a strong 5% sales growth from new stores during the quarter? And how sustainable is this?

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

Yes. Well, we see it as very sustainable and it's really the premise of our entire strategy is to drive sustainable, profitable growth. And we have deployed a consumer innovation strategy, starting in 2012, to be highly relevant with the consumer over time. And part of that strategy has been investing in the business and strengthening our 3 competitive advantages: proprietary innovations that deliver meaningful benefits to our customers in a commoditized industry; and secondly, exclusive distribution, and we have very highly productive stores. And we've moved our average revenue per store from prior round -- around $1 million per store to targeting -- well, now at the end of this quarter, over $2.7 million per store and targeting $3 million and beyond; and then our third competitive advantage being lifelong customer relationships with over 40% of our sales being driven from referral and repeat sales.

The new stores are performing ahead of expectations for the year. We have a destination approach, we look at a total -- we look at the entire country, we're in all 50 states but then we take a local market development approach. And our radius is 20 minutes or 10 miles on average. And we pay close attention, very disciplined execution of rebuilding our store portfolio since 2010. And we've moved a good share of our stores from mall to nonmall. And today have about 64% of our stores in nonmall locations.

All in all, this is about having a very healthy retail footprint with mission-driven team members who are dedicated to improving customers lives and selling products that deliver life-changing sleep.

Jordana Cooper - *Barclays Capital - Analyst*

Great. And then can you talk a little bit about some of the changing dynamics in consumer behavior for smart health technology? Have you seen really any changes in traction for the sleep health category overall in 2019?

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

Well, this is such an important consumer trend. Consumers are understanding that sleep is a key component of their overall wellness. And that is helping people connect with really thinking about their sleep. And the connection is still not quite apparent to consumers broadly between the mattress and quality sleep, and this is where we over index in delivering a smart bed that ensures and delivers proven quality sleep by reading individuals biometrics and automatically adjusting the firmness to ensure that the consumer achieves their highest quality sleep. And smart technology is becoming a given. Research has shown that over 55% of broadband households have an interest in purchasing some type of smart technology related to their sleep.

Operator

The next question comes from Keith Hughes with SunTrust.

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

Really a couple of questions. Number one, the strong numbers from the ARU in the quarter. It's been a hallmark for you for several years. Can you just talk in more detail how much of that was driven by any increased ticket from the 360 launch? And how much of it would be from things such as the attach rate in adjustables and other accessories?

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

Keith, about 3% was driven through pricing. And that's been consistent over a number of years now. So it's fairly good number to think about. As we move forward and what we're seeing with the 360 smart bed, its consumers and our selling processes resulting in attaching the adjustable base across all models at a higher rate along with our other innovative bedding products, such as temperature balancing products and some of the advancements we've made in pillows. And also, I think importantly, this is an average revenue per unit, it's not average price per mattress. So average revenue per unit with the mattress as the mattress unit as a denominator. So it does include repeat purchases by existing customers coming back and purchasing additional products.

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

Okay. But the 3% number you quoted, would that be pure price? Or would that include any mix changes among the mattresses of somewhat up -- the mix moving up to a higher price unit?

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

Yes. We took $100 on our mattresses that were above the -- in the i and p series in October last year. That's what it is. That's the gross price increase. And of course, then we have promotional cadence as well that you have to take into account.

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

Okay. Now second question on units. They're up 1%. I believe you said, which would mean they were negative on a same-store sale basis. So I was a little surprised by that given some of the optimism on units coming out of the fourth quarter with final push of the 360 in the stores. Could you talk more about what's going on there?

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

Well, just to start out, we continue to expect growth in both ARU and units for the full year, and we repeat -- we consistently repeat that quarter-by-quarter, we will have fluctuations. We continue to see great strength in our selling process in the stores and converting at a higher level up the line and with additional products, which has been driving more ARU growth. We believe, we took market share in both sales and units again this quarter according to the various reports that we've seen from sell-side analysts and other indicators. And we continue to feel strongly about being able to drive growth in both metrics for the full year.

Sean Matlock - *Kennedy Capital Management, Inc. - Research Associate*

So have you -- as the 360 launched has it lost some unit momentum as we moved into the first -- you had initial excitement about it, is this the normal move down into a normal path?

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

No. We're still seeing overall momentum with the 360 smart bed.

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

Okay. Final kind of easy question on tax. With the 25% tax rate for the year, you're obviously going to have higher rest of the year, you discussed the second quarter. Would I put that kind of ratably in second, third and fourth quarter, to get to the 25%, or am I going to see peaks and valley from the second half of the year?

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

For modeling purposes, putting 25% each of the 3 quarters is fine.

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

Okay. Well, that would give me below 25% for the year though.

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

It will.

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

It would have to be above that. Yes. So I guess my question is, to your comment in the press release. You're saying, that is 25% for the year or is it 25% for the remaining quarters of the year?

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

It's for the remaining quarters of the year.

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

25%. So that means your tax rate is going to be below 25% for the year, right?

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

That's correct.

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

Okay. Could you give us an estimate of what the tax rate will be for the year?

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

I think that depends on what you model for earnings and that's up to you guys. I can -- we can handle any modeling questions on the after calls.

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

What does it have to do what we assume for the year? I mean borrowing, big losses or something like that but tax rates remain the same, should it not?

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

But the proportional tax rate has an impact relative to the first quarter. So if you just model 25% the balance of the year, you're good to go.

Operator

The next question comes from Bobby Griffin with Raymond James.

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

Hope you can hear me now.

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

Yes.

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

Yes.

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

Sorry about the technical difficulties earlier. My first question though, I just really want to try to understand the trends better. We exited January when we spoke last with kind of double digit, above double-digit sales growth. Presidents' Day in February was the strongest period. Does that imply March slowed down pretty drastically? Or am I missing something there?

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

Yes. We saw strong performance throughout the full quarter with the greatest strength during the Presidents' event.

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

Okay. Did that carryover in April? I think there is some fear out there just with everything that happened in 1Q, tax refunds, weather, what's going on at the high-end spending. So that strength carrying in to April, Shelly?

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

Yes. We normally do not go into intra-quarter trends.

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

Okay. I thought I'd at least give it a shot. But all right. So...

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

I think -- here's what I would say, Bobby. We're reiterating our guidance and we delivered the quarter that we needed to and expected to, to achieve our full year guidance. And we're on pace, we're excited with our initiative, we're leaning into them. So those are good indicators of how we feel about the overall marketplace and our opportunities in it.

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

Okay. Is it fair -- is it safe to say that you feel no different about the consumer -- the health of your underlying consumer today versus you did -- versus how you felt kind of during the first quarter as well?

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

That is safe to say, yes.

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

Okay. Okay, that's helpful. I appreciate that. And then lastly for me, Dave. We talked about the pressure of adjustable, the higher mix of adjustables at the end of the fourth quarter call. Is some of your commentary pointing that the attachment rate has been even higher now than your expectations going into the year? And that's why the percentage headwind is getting called out again?

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

That's exactly right.

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

Okay. And when did that really -- is it -- did it take a step up here in 1Q? Or did it start to step up in 4Q and 3Q of last year? I'm just trying to get a better sense of how to model in when we will lap the big step up in attachments.

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

We've seen a higher attach rate ever since we launched 360 and that has continued to grow our professionals in our stores and the selling process, selling by number process is exceptional. And we do a very good job in store of getting people into the product that best meets their needs. And we've seen a lot more of our customers really interested in taking more complete package.

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

Okay. Perfect. I appreciate that detail. And then lastly for me. And I apologize if it was asked already, I had to get back on the line. But if the 10% tariffs go away, can you give us some color on maybe what the tailwind would be? Or if it's just going to be neutral because you've already made changes in your supply chain just help to us model out the back half of the year?

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

Right. We have some of our components that are in the 25% bucket on list 2 already. And then there are others that are on the list 3 that are 10% that could go to 25%. In any event, we've taken actions already because we felt that it was prudent to lock in our supply and lock in pricing. So some of that action has already been taken to mitigate some of the exposures. But if all of the tariffs were completely rolled back to zero kind of immediately, we would see about a $2 million tailwind in the back half of the 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*

Given that units were up 1%, you grew units 5 -- you grew numbers of stores around 5%. Should we think about units at same stores down in the kind of mid- to high single-digit range?

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

Yes, that's right.

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

Okay. And then...

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

It's important, Michael. We should talk about this a little bit because we are not your traditional retailer, and with our strategy and the expansion of our local market development, we have a lot of stores that come into existing markets that cannibalize the existing stores. We also have -- when we relocate a store it comes out of our comp base, and so that looks different. So looking at total unit growth is really more important for our business model than focusing in on same-store comp growth.

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

What do you think the...

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

Cannibalization.

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

Market growth -- yes, cannibalization was in the period?

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

I think our estimates of about 20% still hold true.

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

Okay. And Shelly, you said you expect units to be up for the year, or they were up 1%, yet the unit comparisons get a lot tougher, and presumably they get tougher on a same-store basis. You've been -- I know that's -- maybe that is not necessarily the way you look at it. So do you -- are you going to have to sharply increase your advertising as a percentage of sales to drive some of those -- that unit growth you're expecting over the next several quarters? And that $2 million benefit from tariffs going away, Dave, could you reinvest that back into business or would you let that fall to the bottom line?

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

Yes. Importantly, we have a significant initiative to drive our overall performance. And every quarter, we have various fluctuations by design in our promotional plans and how we go to market. I'll use the example of the first quarter during the Presidents' event, our primary focus was on a limited addition Innovation Series bed, which drove incremental traffic towards that high end of our series, overall. At other times, we may focus more on the $999 price point. We didn't do that as much in Q1. And this is why we talk about, we'll have fluctuations by quarter. Keep your focus on the full year metric of driving ARU and unit growth and that this is a key advantage of our business model that we can drive both ARU and unit growth. Ideally both, which we did in this quarter and expect to for the full year. But the benefit of being able to achieve top line growth whether it's through ARU or units or both, is a key advantage of our business model. And in the end, it's about total revenue and total profit dollars and total shareholder return. And units is a component of that along with ARU, and they're both important. And we expect to grow both annually and, over time, as we have been in the past.

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

My last question is on attach of adjustable bases. Over the last few years, within the industry, there's been a sizable move to adjustable bases. It seems like some of the growth from that's probably going to tap out as the penetration of that attachment will reach levels that you just can't go any further. So where are you in the penetration of your sales that include an adjustable base?

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

I love this question because I think it was 5 years ago, someone said that very same thing to us and we're still growing. We're still growing our attach and this is why with an innovation strategy, when we're delivering meaningful benefits to consumers and continuing to evolve this product to be able to drive benefits, it's exciting to us. And this is where the ARU measurement is so important for our business. It's not an ASP measurement, it's ARU. And we still see great opportunity, and will continue to lead the marketplace with our attach of adjustable bases.

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

So you think you still have significant growth? Can you give us like a measure that -- closer to 50% of transactions, closer to 75%?

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

Yes. We haven't shared this metric. I'm confident we're the leader in the marketplace. And this is a combination of the innovation. Our adjustable bases are unique to us, have benefits that are unique by price point. And also our selling process and how we've innovated and developed the smart bed to be complementary and integrated with our adjustable bases. Those are unique attributes and differentiation that we provide at Sleep Number, and we expect to continue to lead the industry with this.

Operator

(Operator Instructions) The final question comes from Curtis Nagle with Bank of America Merrill Lynch.

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

So apologies if I missed this, but would you guys be able to give the specifics on the margin rate guide for the full year like you did last quarter? I think Dave, you said, we saw gross margin up to 100. I think the prior top was up to 120, and you mentioned some of the drivers. But if you could just give by line what the guidance is, it would definitely be appreciated.

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

Sure. And I guess you probably have a copy of the investor deck that had all of the assumptions in it from last quarter. And in that deck, it did say 80 to 120 as the range of potential gross margin expansion this year. We -- after the quarter, we just had -- I did highlight in our comments that we did see a little bit more margin rate pressure here in Q1 than we expected that we offset with about $0.05 of benefit on the tax line. So we have -- but we have great initiatives in play to deliver gross margin expansion of up to 100 basis points for the full year, including the 40 basis points in Q1. We're managing a significant number of tailwinds and headwinds. They include -- there were $16 million worth of transition impacts last year, which is $8 million of hard costs and another $8 million combined of inefficiencies and closeout sales. Those are major tailwinds for us, and our initiatives and pricing initiatives as well give us some tailwinds.

Headwinds include the -- this item we've been talking about quite a bit, which caused some pressure in Q1, which is the attach rate of our FlexFit adjustable bases and other sourced products. It caused us 70 basis points of pressure in Q1. And we expect that there to be some pressure going forward. But I think we will get more benefit from our other operating improving initiatives, the balance of the year to drive much stronger gross margin rate improvement on a year-over-year basis for the balance of the year.

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

Okay. Would you be able to give EBIT rate guidance or you're not providing that anymore?

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

I'm sorry, can you -- could you say your question again, I'm sorry.

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

Sure. Yes, yes. Would you able to give the EBIT rates guidance? So prior range was approximately 6.5% to 7%. Is it maybe 20 bps below that now? Or how should we think about that?

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

Yes. We don't -- we -- not while I've been here, we haven't given any guidance about EBIT or that. We provide top -- we provide EPS guidance, and then we provide you a lot of color about how we're thinking about delivering that EPS. But we're committed to using all of our EPS drivers, growth, business leverage and then capital deployment.

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

Okay. And then just a quick follow-up. Can you confirm that EBITDA will be up on a year-over-year basis in 2Q? I think I heard that.

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

For the year, we are expecting...

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

For 2Q, not the year.

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

In Q2, I said that we expect operating profit to be up but EPS to be down.

Operator

At this time, there are no further questions. And I would like to turn the call back to your host for closing remarks.

David W. Schwantes - *Sleep Number Corporation - VP of Finance and IR*

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

Operator

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