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# Sleep Number Corp. (SNBR)

Q4 2021 Earnings Call

## CORPORATE PARTICIPANTS

### Dave Schwantes

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

### Shelly Radue Ibach

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

### David R. Callen

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

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## OTHER PARTICIPANTS

### Peter Jacob Keith

*Analyst, Piper Sandler & Co.*

### Seth Basham

*Analyst, Wedbush Securities, Inc.*

### Bobby Griffin

*Analyst, Raymond James & Associates, Inc.*

### Atul Maheswari

*Analyst, UBS Securities LLC*

### Curtis Nagle

*Analyst, BofA Securities, Inc.*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Welcome to Sleep Number's Q4 and Full-Year 2021 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.

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### Dave Schwantes

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

Good afternoon and welcome to the Sleep Number Corporation fourth quarter 2021 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.

This telephone conference is being recorded and will be available on our website at [sleepnumber.com](http://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.

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## Shelly Radue Ibach

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

Good afternoon and welcome to our 2021 year-end earnings call. My SleepIQ score was 96 last night. In 2021, our 360 smart beds drove double-digit demand growth and record earnings for the third consecutive year, even with pandemic-induced global supply chain disruptions. The fourth quarter proved to be the most challenging, as we ultimately did not receive a semiconductor component soon enough to fulfill our planned deliveries in the quarter.

Electronic supplies remain constrained near-term, as semiconductor demand is still overwhelmingly global – is still overwhelming global supply capacity. The suppliers are adapting as they enter the third year of difficult operating conditions. As we navigate the disruptive constraints from this industry, we have been agile in retaining our customers and generating demand. Strong demand for our smart beds reflects the life-changing wellness attributes of our innovations. As evidenced by the events of the past two years, our purpose to improve the health and well-being of society through higher quality sleep has never been more urgent or important.

Highlights of our 2021 performance as compared to 2020 results adjusted for the 53rd week include net sales growth of 20% to \$2.2 billion. Earnings per share rose 34% to \$6.16. Cash from operations increased to a record \$300 million, and our return on invested capital was nearly 28% more than three times our cost of capital. Over the past five years, we have delivered an EPS CAGR of 41%, nearly four times the 11% compounded average sales over that timeframe. We also generated a five-year EBITDA CAGR, of 14% further demonstrating the superior cash-generating ability of this business.

Now, let me elaborate on the capabilities that are enabling us to navigate supply chain challenges while driving demand growth. We are utilizing numerous levers of our vertically integrated business model to anticipate and respond to dynamic business conditions and drive sustained demand. Digitization efforts are enabling real-time inventory visibility, scheduling, communication and customer fulfillment. For example, we can adjust first available delivery date for customers based on when a constrained component has left a supplier's overseas factory. As a result, delivery windows are easily adjusted and aligned with the soonest smart bed availability, reducing the risk of waiting too long to schedule or needing to reschedule.

Currently, more than 60% of our smart beds are available for delivery in one to two weeks, while others are requiring a 6 to 11-week lead time due to a semiconductor delay related to FlexFit adjustable smart bases. Our individualized communications delivered digitally via our customer engagement platform and personally by our sleep professionals, are building trust with customers and increasing retention. We continue to advance our digital tools, such as self-scheduling and self-service, that simplify our customer's experience.

In addition, by the end of 2022, we expect to complete the migration of our outbound distribution network, which will enable us to operate with a single enterprise-wide manufacturing and assembly supply chain. This network design enables scale and agility to support volume expansion and market share gains.

Temporary supply shortages are not unique to Sleep Number. Our ability to navigate the complex dynamics, fuel continued demand growth and retain customer trust and loyalty, are strengths of our vertically integrated model and support the long-term sustainability of our consumer innovation strategy.

A great example of this is the sales and marketing advancements we've made since the onset of the pandemic. Our digital ecosystem is driving efficient demand creation, including nearly 400 basis points of leverage, which we see as sustainable. Our 2021 performance includes record retail productivity, with average sales per store of \$3.6 million, including a 13% contribution from online sales. Nearly half of our Sleep Number stores average over \$3 million annually, with eight stores generating sales of more than \$7 million, including two stores at the \$9 million mark. We expect average sales per store in 2022 to approach \$4 million, while adding 35 net new stores. In addition, our metrics, including customer engagement, high-quality traffic, conversion, referrals, cancels and returns signaled continued strong demand growth. More than 40% of consumers surveyed indicate they intend to purchase a new bed within the next 12 months. Our digital ecosystem, which broadens consumer engagement and deepens our smart sleeper engagement and referrals, is a growth flywheel.

Sleep Number's consideration has increased since September and referrals are at record levels. Innovative, life-changing sleep solutions are the ultimate driver of sustained performance. At the International Consumer Electronics Show in January, we revealed our newest most dynamic 360 smart bed technology platform, which will provide advanced monitoring, personalized insights and be capable of health evaluations, all from the comfort of your home. We plan to introduce the Climate 360 smart bed near the end of 2022, followed by introductions of our all-new 360 smart beds and smart furniture throughout 2023.

As we navigate in an inflationary marketplace, we remain focused on actions, including pricing that offset higher input costs without dampening demand. Benefited by our vertical model with exclusive direct-to-consumer distribution, examples include managing price elasticity as we communicate the value of our smart beds with different promotional offerings, leveraging the entire P&L and continuing to find efficiency gains from our digitization efforts and actions and applying our disciplined capital and liquidity management, including contingency preparedness, metric-driven decisions and steady investment in our near and long-term growth drivers. While there is no doubt that Sleep Number like nearly every other business is operating in a challenging and dynamic environment, we are addressing the temporary disruptions, while advancing our long-term strategy. In the near-term, we will create value with our new innovations that are designed to support smart sleepers changing needs at every life stage and provide the highest quality sleep through efficiencies from our single enterprise supply network and by capitalizing on opportunities as the global supply chain improves.

Longer-term, we are positioning Sleep Number for continued market expansion through new sleep health and wellness revenue streams, including subscription programs. We are also continuing to augment and accelerate our strategic progression into connected health.

At the heart of our purpose is our remarkable Sleep Number team with a dedication to our mission that is unmatched. Our strong retention and staffing are driven by a world – by a workplace culture that celebrates individuality and prioritizes wellbeing. Every day, this team finds smart ways to increase consumer value, manage risk and utilize our advantaged business model to effectively navigate the ongoing global challenges. Because of their efforts, we have improved nearly 14 million lives and are improving the health and well-being of society through higher quality sleep.

Now, David will provide additional financial details on our 2021 performance and 2022 outlook.

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## David R. Callen

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

Thanks, Shelly. Here are four things I will cover today. What happened in Q4, how our long-term bias drives performance, risks we are addressing and Q1 implications and 2022 guidance assumptions and long-term expectations.

Our teams and partners have applied all the tactics in Q4 that successfully closed supply gaps and led to very strong Q3 financial performance, including leveraging supplier relationships, component redesigns, finding alternate components and expediting shipments. Despite these efforts, a large, well-known global electronics supplier delivered one component too late in December. This moved more than \$125 million of net sales, about two-and-half weeks of deliveries out of the quarter.

Q4 net sales were \$492 million versus the \$600 million to \$610 million needed to reach full-year EPS of \$7.25. While this demand is not lost, the shift caused temporary inefficiencies across the business and lowered delivered volume to leverage infrastructure. Margin rate pressures in Q4 were significant, unusual and temporary. Importantly, 30% or more of these cost pressures are temporary, while our pricing actions and efficiency initiatives are sustainable and will drive profit rate improvements over time. We took three 2021 pricing actions with \$140 million of annualized benefit to offset \$140 million of cost pressures. This strategy protects demand generation and gross profit dollars, but pressures gross margin rate by 440 basis points. This was the largest driver of the 580 basis point Q4 gross margin rate decline versus the prior year.

This dynamic converts to 220 basis points of NOP rate pressure explaining half of that Q4 rate decline versus the prior year. The remainder of the gross margin and NOP rate declines were driven by logistics inefficiencies and lowered leverage due to the net sales shift. We continue strong demand – with continued strong demand and liquidity, we have positioned our infrastructure to drive accelerated financial performance when supplies improve.

We employed this approach in 2020 and delivered rapid profit acceleration following the temporary COVID shutdowns. Our business fundamentals are intact. We intend to drive through these temporary global supply constraints and accelerate results as supplies improve. Our strategic steadiness and long term bias have driven superior shareholder value over time, including 41% five-year EPS CAGR through 2021. Within that timeframe, 2020 included an extra fiscal week that benefited that year by \$41 million in net sales, \$11 million in NOP and \$0.30 of EPS. 2020 also included significant COVID-related fluctuations in demand and cost structure. To provide additional context, I will highlight our 2021 performance versus 2020, excluding the extra week and versus 2019.

Our technology-enabled smart beds drove 2021 demand 24% higher than the adjusted prior year and 36% higher than 2019. Q4 two-year demand growth of 32% was a sequential acceleration from Q3. Even with the Q4 delivery constraint, 2021 net sales were \$2.2 billion, up 20% versus adjusted 2020 and up 29% versus 2019. The productivity of our go-to-market strategy is highlighted by the two-year 25% increase in average comp store sales, including online, now \$3.6 million.

Smart bed units increased 22% in two years, with 5% increase in average revenue per smart bed to \$5,100. Throughout 2021, we continued to prioritize our drivers of sustainable value creation. This bias drove volume velocity and operating efficiencies that significantly levered our infrastructure for the year. Gross profit expanded 17% versus adjusted 2020 and 25% since 2019. 2021 net operating profits grew 11% versus adjusted 2020 to 8.9% of net sales and are up 73% versus 2019, up 230 basis points in two years. Life improving innovations, efficient demand generation and strong retail conversion has driven 450 basis points of SG&A leverage in two years, more than offsetting 68% higher spending on sleep science-focused R&D. This prioritization more than doubled EPS in two years. It also drove \$580 million of operating cash flow generation in two-years. Over that time, we invested \$104 million in capital projects, repurchased \$593 million of Sleep Number stock and grew our 2021 ROIC to nearly 28%.

Now, let's talk about supply risks we are seeing and implications for 2022 especially Q1. The onset of the Omicron variant in late December had an abrupt impact on society, factories and global supply chains. This is reflected in current weekly commitments from our electronics suppliers for the first half of 2022. That schedule includes delayed receipt of a semiconductor for our FlexFit adjustable bases that will constrain Q1 deliveries. As a result, we expect our backlog to further increase in Q1 and benefit deliveries and profits the balance of the year. We also now have quarterly supply commitments for the back half of 2022. Our teams continue to work with suppliers to get weekly back-half visibility while pushing for greater volumes. While the global supply chain appears to be more stable in 2022 than last year, supply continues to be a fundamental limiter of our deliveries. As a result, our 2022 EPS guidance assumes no benefit from backlog reduction this year. With constrained, Q1 deliveries of our most profitable smart beds, we expect Q1 net sales will be within 5% of the prior year, with gross margin of about 56%.

Continuous improvement initiatives like our outbound logistics evolution, increased velocity, additional modest pricing actions and an easing of commodity costs are expected to improve Q2 gross margin to about 58% back half to 60% and meaningful upside in the years ahead.

Here are more of our assumptions for 2022 supporting our guidance for 10% to 15% EPS growth for the year. Overall, we expect a stable consumer environment with cost pressures easing later in the year. We expect to drive mid to high-single digit demand growth versus 2021 to translate to low-double digit net sales growth, with 4 to 5 points from new stores and contribution from pricing actions.

We continue to prioritize support of near- and long-term initiatives, including a third more R&D to support breakthrough sleep science innovations. The timing of these investments in concert with constrained deliveries will pressure Q1 financials, while catalyzing performance acceleration thereafter. We expect full year net operating profit rate of approximately 8% despite Q1 constraints resulting in low-single digit Q1 NOP rate with high-single digit rates the balance of 2022.

Our 2022 EPS guidance for 10% to 15% growth assumes Q1 EPS of \$0.30 to \$0.40. And about 80% EPS growth over the prior year, the balance of 2022, with the strongest growth in Q2 and Q4. For 2023 through 2026, we expect to drive mid- to high-single digit average top line growth with 15% to 25% average EPS growth, though it may not be a straight line. We expect to generate about \$300 million of cash in 2022. We plan to invest \$70 million to \$80 million in capital projects to support retail expansion, open two new ADCs, drive solar initiatives in California, Texas and Minnesota, build digital enablers and acquire equipment for future innovations. We have nearly \$403 million remaining share repurchase authorization and see tremendous value in our stock. The benefit from accretive share repurchases is expected to more than offset headwinds from higher interest rates and an effective tax rate of 22% to 23% in 2022.

The external constraints from global electronics supply challenges are temporary. Demand and the fundamentals of our business are strong. Our team's resilience and ingenuity are driving exceptional performance over time as we embrace our common goal to improve lives through proven quality sleep. At this point, Josh, please open the lines for questions.

## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] Your first question comes from the line of Peter Keith of Piper Sandler. Your line is open.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Hi. Thank you. Good afternoon, I guess, I just want to follow up on the guidance commentary. So David, just in the last remarks, it sounds like you're calling for demand growth of mid- to high-single digit, I think. Can you confirm that would be in line with what you guys were talking about last quarter? And then you're -- correspondingly, you're not factoring in a reduction of this backlog. So you're basically carrying about an excess of \$125 million of demand on the balance sheet through the year. That -- that's what's factored into the guidance at this point?

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Hey, Peter, thanks for the question. You're right about the demand generation, we do expect the same demand growth in 2022 as we were thinking about last quarter for 2022. In terms of the excess backlog that we're carrying into 2022, it's far more than that \$125 million. As you know, our demand meaningfully exceeded our net sales for the year. However, with the supply constraints that we are managing our way through and the visibility that we currently have, we're basing our EPS guidance for 2022 and the color we provided on the shape of the year, largely on the commitments that we've got now from our electronic suppliers.

**Shelly Radue Ibach**

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

A

And Peter, I'll add that we largely expect to have the same level of backlog at the end of this year, as we did at the end of 2021.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Okay. And then just a clarifying point, it sounds like the shortages are specifically with the FlexFit adjustable bases. So, you're not making any deliveries whatsoever if a base is part of the purchase? Or couldn't you just deliver the bed initially and then follow on with a base at a later date?

**Shelly Radue Ibach**

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

A

Yeah. Peter, in the fourth quarter, the semiconductor component that came late impacted all. Here in the first quarter, the delay is related to a chip that is associated with our high-end FlexFit 3 smart adjustable base. So it's that one that has either a delivery right now of 6 weeks or 11 weeks. So we are delivering. Right now, if you purchase that bed, it would be 6 weeks or 11 weeks, depending on the specifics of the combination, whether it's a queen or a king. Over 60% of our smart beds, including our opening price point FlexFit adjustable base is available within one to two weeks.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Okay. And I want to slip in one last question, just kind of outside the quarter, more big picture. So you've talked in the past about having all of this sleep science data with the Sleep 360 technology, you're leaning into that further. Could you tease out any plans to monetize this information or maybe provide some type of subscription service to your customers? It seems like you have something fairly proprietary. There's a number of other competing devices on the market that are doing this type of subscription dynamic. How are you guys thinking about this on a go-forward basis?

**Shelly Radue Ibach**

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

A

Well, thanks for that question, Peter. Absolutely. That's a future of – a future revenue – new revenue stream for the company. We're really excited to introduce Climate 360 smart bed, late this year and then our new – all new 360 smart beds our full line the following year.

This will be a new platform, our most dynamic platform that has expanded monitoring of additional factors such as temperature, which temperature and weight and other factors. And that enables, even a much broader deliverable to our customers – all of our customers. And that then puts us in a position not only for monitoring, but also the potential to do health assessments. And as we expand that monitoring and things like health assessments, those are all important components for a subscription series.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

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Okay. Thank you very much.

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Thanks, Peter.

**Operator:** Your next question comes from the line of Seth Basham with Wedbush. Your line is open.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Q

Thanks a lot and good afternoon. I just wanted to better understand the backlog situation again. I think you said it was over a \$100 million exiting the third quarter, and expected to be the same range exiting the fourth quarter, with \$150 million shifting from the fourth to first quarter and beyond. Is the backlog exiting the fourth quarter now \$250 million? And you expect to carry that through the entire year 2022?

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Hey, Seth, we haven't quantified the exact dollar amount in the backlog, but it's safe to assume that its the excess backlog is north of \$150 million of net sales equivalent.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Q

It's north of \$150 million, so it expanded only some \$50 million or so from the third to the fourth quarter.

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

That's right.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Q

Got it. Okay. And then as it relates to improving that backlog through 2022, it's just a matter of the supply of the chips more than anything else. And would you expect to make more significant progress later in the first quarter? Or is it really going to be later down the line?

**Shelly Radue Ibach**

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

A

Yes, Seth. Absolutely. Our guidance includes the allocation we have today from those big global technology manufacturers. And this remains a challenged industry for semiconductor components. And we fight for additional allocation every single day. I would characterize it as a bit more stable than the back half because of the weekly allocations and less disruption around them as we head into the balance of the year. And our guidance includes what we expect to receive at this time. We do see these -- this industry being a little more stable.

There's certainly a lot more capacity coming on board through additional factories in the back half. But by the time that flows through, we -- it's probably 2023. So we really don't expect to have any meaningful reduction in our backlog until 2023. It will increase here in Q1 with the delays, but then we will be getting after that in Q2. By the end of first-half, we expect it to be about where it was at year-end and then exiting this year. So, the cut-in will be in 2023 as we sit here today. Now, obviously, if we're able to procure more, we'll update you on that on our next call.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Q

All right. Thank you. And just to follow up, making sure I understand the dynamics in the fourth quarter, if your backlog expanded by \$50 million more than you expected and you missed sales expectations by over \$100 million, what's the missing piece there?

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Well, some of the excess backlog that went into the fourth quarter was going to be contributing to our delivered sales in the quarter. So, we're talking about the cumulative ending backlog at the end of 2021. The excess portion of that based on the larger size of the company and the larger volumes of demand that we're generating is now in that neighborhood of north of \$150 million of net sales equivalent.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Q

Okay. I'll let [indiscernible] (00:32:50). Thanks.

**Shelly Radue Ibach**

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

A

And Seth, I'll just add about the demand in the fourth quarter, so I think that's a really important part. We – our demand is strong and does not seem to – does not appear to be impacted by the supply constraints that we've experienced. We had a high single-digit demand in the fourth quarter. It was the demand that we needed to be able to hit the \$7.25, and it was only the last two weeks of deliveries that ended up moving that \$125 million equivalent at the end. And then, importantly demand continues to be strong here in this quarter.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Thank you.

Q

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

Thanks, Seth.

A

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

**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

Good afternoon, everybody. Thanks for taking my question, I guess the – first, I want to clarify -- make sure we got the details. But you said within 5% for 1Q. Are you talking plus or minus 5% or you just want us minus 5% in revenue and can you just clean that up real quick while we're on the line?

Q

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

Yeah, sure. Yeah. Within 5% means we're – the constraints are keeping us from getting to that point. So it's on the downside as opposed to plus or minus.

A

**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

Okay, that's helpful. I figured it was that. But I figured it's better to ask now than have questions later.

Q

**Shelly Radue Ibach**

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

Yeah, absolutely. Thank you.

A

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

Yeah, that's a pretty big range, if it were plus or minus, I would have called it out that one.

A

**Shelly Radue Ibach**

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

Yeah, thank you.

A

**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

Q

Yeah. So and I guess, Shelly I want to circle back, on how you're kind of managing the customer relationship, given that this is a longer lead time to get beds than typically for Sleep Number. I guess, are you guys pulling back on media because you're kind of stripped out on capacity right now? Are you still kind of running the media strategy as normal? And are you giving some discounts to customers who have to wait for 11 weeks? And what is what's going on to protect the brand value and protect the backlog? Because the one thing I think that is unique to your business is your backlog is more real than maybe some other backlogs because they have customer deposits and it's a close controlled distribution network.

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**Shelly Radue Ibach**

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

**A**

Yeah. Thanks for the question, Bobby, absolutely the backlog is real, this demand is not lost. And while we talk about a backlog level similar at the end of the year, as you know, we ended this year with it's a different backlog. We are servicing our customers and in fact, over 60% of our smart beds are available within 7 to 14 days right now.

So, the advantages of our vertical model Bobby really allow us to stay very tight with our customers, whether it's online or in-person in the stores and the relationship our team members develop with our customers, as well as the selling process and being able to meet the customer's needs based on, the right match for them. And also that right match includes when they need the smart bed by. We are full steam ahead driving our demand. This is such an important strength of our business. For us to be in this situation where we're constrained by supply but yet we're not losing demand because of the supply.

Our demand is strong. And we talked about on the third quarter call that we expected mid- to high-single digits here in the 2022. And as we sit here today with February, we just, completed our all-important Presidents weekend. We had an outstanding weekend with record performance. And we're – here at high-single digits in February month to-date with that performance. And it's really exciting and it speaks to the strength of all these attributes of our business model. We have steady returns, cancels. We don't see an increase there, in fact, a slight favorability. We have strong conversion and record level of traffic, and that speaks to the advantages of this business model and the importance of our smart beds and the value of health and wellness that they provide our customers.

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**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

**A**

Yeah. Bobby, I'd add on. Shelly highlighted one of the great benefits of this vertical model and that is in this digital capability and the visibility that we're creating now to be able to manage our way through this and we can see where that inventory is deep into the supply chain. That's different, that's new. And that's helping us make better decisions on behalf of our customers while they're standing at the cash register. And that makes a big difference when they just want us to do what we promise and that's we can commit to it, if it's, several weeks. And these are life changing improvements. They've proven that they want to – that they're willing to wait.

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**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

**Q**

Okay. That's helpful. And just lastly, we think about the supply chain and the new products, and you have some compelling new products with the climate control bed coming out and stuff. Are the new products, the new system is going to be a simpler global supply chain or is this kind of risk? And understandably, hopefully, the world gets back close to normal. It's just kind of be embedded in how these beds are assembled and where you have to source from going forward.

**Shelly Radue Ibach**

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

A

We're working with the top global electronics suppliers in the world, and our team is working closely with their software developers on the necessary semiconductor chips for our new platform as well. So there's, top to top and close relationship in the developers for our future. It's really important to both our company and their company and then we also have a fairly robust, significant around 30% reduction in actual component SKUs as we transition to our all new line, and that will obviously be helpful as well.

**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

Q

Thank you, Shelly. That was exactly what I was looking for. That's very helpful. Best of luck here in this environment.

**Shelly Radue Ibach**

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

A

Thank you.

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Thanks, Bobby.

**Operator:** [Operator Instructions] And your next question comes from the line of Atul Maheswari with UBS. Your line is open.

**Atul Maheswari**

*Analyst, UBS Securities LLC*

Q

Good evening. Thanks a lot for taking my question. Shelly and Dave, based on what you know today, what is the risk that the supply chain is worse than what you've incorporated into your 2022 guidance that could cause you to miss? I'm basically, just trying to understand how conservative you were with respect to your expectations around supply chain when resetting this guidance?

**Shelly Radue Ibach**

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

A

Yes, Atul, thank you for the question. Our guidance contemplates what we know today on our supply chain. We have weekly allocations of the semiconductor chips that we've talked about here in the first-half. I would – and then we have quarterly for the back-half. There is widespread belief that this industry starts to strengthen in the back-half. We didn't build that in. We built in steadiness and delivery on the commitments and we've built in delivering the demand we're able to create this year, but we did not build in any expectation to be able to reduce the backlog on top of the demand.

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Yeah. Atul, I'd add, look 2021 had some fits and starts in terms of COVID, and we saw with Omicron late in the year, that variant had a pretty big impact globally on people's performance and that was new information.

Something like that could happen again. We don't have that built into our guidance for 2022, but those are real risks that still remain.

**Atul Maheswari**

*Analyst, UBS Securities LLC*

Q

Got it. And see if I have to frame the upside potential to your guidance, can demand be stronger and that can cause upside or you really need supply to get better for there to be upside to the guidance?

**Shelly Radue Ibach**

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

A

The answer is supply. We're going to continue to drive strong demand and we're not – we're leaning into the demand. It's important, strong demand, strong cash flow these are strengths of our business model and our strategy. But the upside short-term, near-term comes from supply. Now, obviously, any demand we create, it will be delivered. So, there's still future upside by greater demand than our expectations as well.

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Yeah. And whether that happens in 2022, that'd be great. That's not built into our assumed EPS guidance, but we'd love – we're trying to make that happen for sure.

**Atul Maheswari**

*Analyst, UBS Securities LLC*

Q

Got it. And then a final question from me is on inventory was up 20% plus even as you call out inability to fulfill demand. So it seems a bit of a disconnect, so could clarify what this inventory increase was related to.

**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

For sure, about 60% of that was in components other than the electronic chips that we're talking about constraining our performance and the remainder the 40% is really tied to the cost inflation that we had pretty, pretty significant PPV, which is part of why Q1 gross margin rate is so low.

**Atul Maheswari**

*Analyst, UBS Securities LLC*

Q

Understood. It's very helpful, and good luck with this year. Thank you.

**Shelly Radue Ibach**

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

A

Thank you very much.

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

**Curtis Nagle**

*Analyst, BofA Securities, Inc.*

Q

Thank you very much. So just wondering, I just confirm the comment – it sounds like, over the past couple quarters, you guys have not seen any cancelation, is that correct? And then just – I don't know – maybe forgive

me for being a little obtuse here. I'm still not sure I fully understand why the backlog would – I think, fully carry through to the end of the year. Maybe that's not right – is that just due to the semi issue? How do I reconcile it's such a big number?

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**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Right, so on the cancellation rate, we have not seen any appreciable increase in the cancellation rates despite the lengthening of time that people are sitting in the backlog. Part of that as Shelly highlighted is the new communications that we have with our customers on a regular basis, keeping them warm while they're – and excited about their purchase. And that's another benefit of this vertical model that we've been talking about.

So cancels are not higher and we've been actually seeing some indications that could go in our favor because of these new capabilities. So in terms of the backlog, how do I describe this? We're planning to drive demand growth. We talked about that. We want to drive through these short-term supply challenges. And what I mean by that is we're continuing to invest to drive demand. We're still spending against driving greater demand, which will increase our backlog in Q1 and to the benefit of our performance, the balance of the year and how we're thinking about our guidance is we have not baked in to our 10% to 15% EPS growth for the year any benefit of taking our backlog that we're carrying into the year, reducing that in any way in 2022. If we can get more supply, we will certainly do that, but that's not what we've assumed for our guidance.

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**Curtis Nagle**

*Analyst, BofA Securities, Inc.*

Q

Okay. Thank you.

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**David R. Callen**

*Executive Vice President & Chief Financial Officer, Sleep Number Corp.*

A

Okay.

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**Operator:** There are no further questions at this time. I'll turn the call back to the management team for any closing remarks.

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**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 2022 performance with you in April. Sleep well and dream big.

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**Operator:** This concludes today's conference call. Thank you for your participation. You may now disconnect.

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