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# Sleep Number Corp. (SNBR)

Q3 2020 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

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

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## OTHER PARTICIPANTS

### Peter Jacob Keith

*Analyst, Piper Sandler & Co.*

### Bradley Thomas

*Analyst, KeyBanc Capital Markets, Inc.*

### Bobby Griffin

*Analyst, Raymond James & Associates, Inc.*

### Seth Basham

*Analyst, Wedbush Securities, Inc.*

### Atul Maheswari

*Analyst, UBS Securities LLC*

### Curtis Nagle

*Analyst, Bank of America Merrill Lynch*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Welcome to Sleep Number's Third Quarter 2020 Earnings Conference Call. All lines have been placed in a listen-only mode until the question-and-answer session. Today's call is being recorded. If anyone has any objections, you may disconnect at this time.

I would like to introduce Dave Schwantes, Vice President of Finance and Investor Relations. Thank you. You may begin.

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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 third quarter 2020 earnings conference call. Thank you for joining us. I am Dave Schwantes, Vice President of Finance and Investor Relations. With me today are Shelly Ibach, our President and CEO; and David Callen, our Chief Financial Officer.

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 thank you for joining our 2020 third quarter earnings call. My SleepIQ score was 88, last night. Quality sleep has the power to improve lives and because of our team's dedication to our mission and our relentless focus on innovation, Sleep Number is at the forefront of delivering this life changing benefit. We have now improved nearly 13 million lives and counting. This is particularly important in this time of extreme stress and disruption in everyone's life. In the face of significant ambiguity caused by the pandemic, the Sleep Number team is helping our customers achieve an unparalleled sleep experience with our 360 smart beds. I'm grateful every day for our team's tenacity, ingenuity and the care they show to one and other and our customers. Together, we have built a beloved brand and a purpose-driven company based on individuality and wellbeing. Our years of pacing and prioritizing strategic investments have contributed to our ability to deliver superior performance despite simultaneous health and economic challenges.

We are well positioned for continued profitable growth and significant shareholder value creation. Our third quarter 2020 performance provides undeniable evidence of the strength, resilience and sustainability of the differentiated consumer innovation strategy and efficient business model we have built since transitioning to all 360 smart beds in 2018.

For the third consecutive year, our third quarter results reflect double-digit demand growth, including 16% growth this year. Record third quarter financial results include net sales of \$531 million, up 12% versus prior year, with 11% comp gain. Net earnings per share were \$1.79, up 90%. Net operating profit was \$70 million or 13% of net sales, an increase of 78%. Year-to-date cash flows were \$287 million, up 51% versus the prior year-to-date. And net debt was \$180 million lower than a year ago. These results clearly demonstrate our ability to create meaningful value for our customers, team, business partners, and shareholders. We are doing so in the short and long-term, during both robust and more challenging times while also significantly advancing our strategic initiatives.

Several important factors contributed to this exceptional third quarter performance, including, first, our efficient and effective media performance. We continue to improve our media ROI each quarter as we advance our dynamic multi-platform strategy. We began leaning into customer acquisition a year ago and have rapidly accelerated our digital capability since the pandemic began. We are finding the highest value consumers through automation, machine learning, and our own proprietary data. Digital traffic has already surpassed all of 2019 and we delivered 80 basis points of leverage in our media spending in the quarter.

Second, our highly productive and sustainable sell from anywhere model. We've developed an agile go-to-market approach that leverages our sleep professional skills in building customer relationships and aligns seamlessly with how our customer wants to shop, in-store, online or by phone. Results are evident in our strong average revenue per unit and unit performance and increased conversion of digital traffic. During the third quarter, even as store sales recovered, our online and phone sales continued their triple-digit growth.

Third, our exclusive direct-to-consumer competitive advantage, our integrated approach to promotions, financing, selling process, media and proprietary innovations are enabling us to increase sales and margin in a disruptive

environment. And fourth, our new m7 and i10 360 smart beds, featuring temperature balancing layers and technologies for greater comfort, are exceeding expectations.

Our pioneering innovations are linking sleep quality to individual health and wellness. With data from nearly 1 billion sleep sessions, we now provide individual nighttime heart rate variability to our smart bed sleepers. This biometric data focuses on cardiovascular resilience and provides insights about activity levels and energy for the following day. With society more health conscious than ever, these new sleep and wellness features are increasing engagement to new highs, which translates to even stronger brand advocacy. All of these growth-driving initiatives will continue to progress in the coming quarters.

Through smart and efficient use of capital, we have improved our operational efficiency and strengthened our competitive advantages. For example, even with the hyper V-shaped recovery in the third quarter demand, the integration and coordination of our sales and service operations, planning, production, fulfillment and delivery have enabled us to effectively manage a challenging global supply chain and logistics environment, including constrained inventory and cost pressures.

Strengthened partnerships and devised creative solutions with suppliers and kept everybody safe, while also meeting new standards for localized responsiveness. This kind of tenacity and dedication led Sleep Number to be recognized recently by Supply Chain Insights as a Supply Chain to Admire (sic) [Supply Chains to Admire] (00:08:56) for the second consecutive year. In addition to superior metrics from our digital transformation, we were highlighted as having one of the most customer-centric supply chain designs. Given our team's learnings during the past seven months, I am most excited about what is yet to come, the impact our continued improvements will have on long-term outcomes.

Our financial and operational flexibility afforded by our strategic foresight in long-term planning horizon and aided by the immediate capital preservation actions we took when this crisis began, secured our ability to pivot swiftly and deliver exceptional sales and profitability in the quarter. Although the COVID-19 pandemic continues, we are maintaining appropriate liquidity to continue investing in innovation, digital tools and mechanism to build incremental flexibility into how we operate.

The pandemic has pressure tested our business model and we have demonstrated greater than expected agility and operational efficiency as we leverage the digital technology and data we've been investing in for years.

Our differentiated innovations, vertically integrated business model, learning, agility and deep understanding of consumer trends are hallmarks of Sleep Number and they position us well for the balance of 2020 and longer term. We are now experiencing the two structural consumer shifts we anticipated at the inception of our consumer innovation strategy. We see them as important for the foreseeable future.

Consumers are prioritizing their home as well as their own wellbeing. They understand the strong connection between sleep and overall health and wellness. Consumers are also adapting digital products and services at a much faster and higher rate.

Our life-changing innovations have never been more relevant. Here are highlights of our strategic advancements in linking sleep to overall health and wellness. Our 360 smart beds effortlessly deliver proven quality sleep and the connected health experience created by individualized SleepIQ data drives daily engagement with our insiders, our customers. The meaningful value delivered by these Sleep Number innovations deepens customer loyalty and inspires increasing referrals of our brands. This strong affinity is intensifying demand, it's driving greater efficacy and new customer growth.

In turn the expanding scale of our profitable core business is providing the foundation for us to pursue new adjacencies and opportunities in the vibrant sleep health economy. We are accelerating our authority and expertise in connected health through our investments in sleep science, research, and selective partnerships.

Through our analysis of nearly 8 billion hours of longitudinal sleep and biometric data, we are fueling new research insights and technologies. These outcomes deliver on our purpose of improving the health and wellbeing of society through higher quality sleep and health-related metrics like heart rate variability.

Sleep Number has established an important new consumer-based research project aimed at identifying underlying populational health trends. The new sleep research capability within SleepIQ technology provides the company's smart sleeper community the opportunity to help advance sleep science. Learnings will contribute to insights about the impact of sleep on holistic health as well as inform the development of new products services and partnerships to advance the science of sleep.

2020 has demonstrated the relevance, resilience and sustainability of our differentiated strategy, innovations and integrated business model. As we enter the fourth quarter, our business momentum remained strong. For the full year 2020, we expect EPS of at least \$4 compared to 2019's \$2.70. This would reflect a five-year EPS growth CAGR of more than 30% in addition to our five-year total shareholder return of greater than 100%. Driven by our mission, culture of individuality and capital flexibility, we are accelerating our competitive advantages, moving society forward by delivering life-changing sleep experiences and creating superior long-term value for all of our stakeholders.

Now David will provide additional financial details on our third quarter performance and fourth quarter outlook.

## David R. Callen

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

Thank you, Shelly. Throughout this pandemic, our teams demonstrated urgency and agility while advancing our initiatives. The superior execution in Q3 delivered record performance, cash generation and tremendous shareholder value creation. These results are an outcome of the structure we have been building for several years. Both our capital structure and capital deployment are oriented for maximum flexibility. Securing liquidity early in the pandemic enabled us to focus quickly on cost controls and performance driving initiatives. Those decisive actions led to exceptional performance in Q3 across the P&L and record operating cash generation of \$287 million year-to-date, up 51% versus the prior year to-date, despite the impacts of COVID.

While macro uncertainties remain, including possible COVID resurgence, distracted consumers due to the presidential election and possible recessionary pressures, our performance reflects a dramatic improvement in our risk profile. In accordance with our capital deployment priorities, we retired six months early the \$75 million one-year term loan taken out as insurance in the early days of the pandemic. Along with the loan repayment, we also removed the related share repurchase and LIBOR floor restrictions from our \$450 million revolving credit facility. We are leaning into our initiatives and now expect our 2020 full year CapEx to be approximately \$45 million.

Third quarter net sales of \$531 million grew 12% versus the prior year. As expected, units drove all 12 points of growth in the quarter, while generating a healthy \$4,800 ARU, \$14 greater than the prior year. Consumer shopping preferences largely normalized in Q3 with 98% of our stores open on average.

Our brand reach expanded demand 16% in Q3 leading to sizable growth both in stores and online. 14% of our Q3 net sales were transacted online, about twice our historic norm. Comp sales made up 11% of our growth in Q3, while new stores added one point. Our unique go-to-market approach employs multiple sources of growth over time. Whether growing in-store or online, through units or ARU, or from comp or new stores, we have created powerful advantages and flexibility with our business model. We now expect Q4 net sales to increase 20% to 25% over the prior year, including 8 points from the extra week in the quarter.

Also of note, we expect to eclipse another milestone by year-end with average sales per store, including online, of \$3 million or more. Remember that this important milestone would be more than 3 times the average sales per store of the traditional mattress retailers highlighting the impressive productivity of our 596 stores. Further, the average four-wall profit of our stores at these sales levels are expected to exceed the average sales of traditional mattress retailers.

Our COVID action slowed our store portfolio expansion this year, but this delay is temporary. We continue to expect 4% to 5% average annual expansion of our store portfolio through 2025, while growing online and phone sales.

Our Q3 P&L benefited from growth prioritization and spending control. We leveraged total operating expenses 420 basis points in Q3 while investing in R&D and media and accruing to support higher than expected broad participation incentive comp costs. We are confidently ramping up spending in Q4 to support our growth initiatives, especially programs driving innovations across the business and expanding customer reach.

Our Q3 record net operating profit of \$70 million, or 13.1% of net sales was up 78% and 490 basis points versus the prior year. Incremental operating profit flow through rate in Q3 was an exceptional 54%. Double-digit top line growth, spending controls, execution efficiencies and volume benefits across our fulfillment operations were the key drivers. They delivered a 70-basis-point improvement over prior year in our Q3 gross margin to 63.1% and a 590-basis-point sequential improvement since COVID affected Q2.

The hyper V-demand recovery has certainly stressed our fulfillment capacity, stretching our suppliers, freight carriers, manufacturing, and home delivery operations. Strong partnerships and resilient team members worked diligently to deliver superior Q3 results significantly ahead of expectations. This performance is a tribute to the tremendous efforts by our teams and partners despite very difficult conditions as supply chains globally struggle to restart. While supplies are tight, we didn't experience meaningful disruption for our customers in the third quarter.

Our record third quarter EPS of \$1.79 is up 90% versus the prior year. This Q3 performance brings our 9-month EPS to \$2.73, reflecting a 45% increase over the prior year-to-date despite the \$0.45 Q2 loss this year due to COVID shutdowns. Our year-to-date EPS also exceeds the \$2.70 earned for the entire year in 2019. This performance velocity in 2020 demonstrates the compelling value creating power of our business.

We now expect 2020 earnings per share of at least \$4. This implies Q4 EPS of \$1.25 to \$1.30 including approximately \$0.25 from the 53rd week or about 24% growth, excluding [ph] that (00:21:45) benefit. Adjusting the full year net sales and EPS to exclude the 53rd week would mean a year-over-year EPS growth of 39% on 5% to 6% net sales growth. This is on top of 41% EPS growth last year and more than 30% compounded annual EPS growth since 2015. We've been delivering strong performance for several years by investing in our business and using all our EPS levers. Our pursuit of breakthrough performance and the momentum of our initiatives provide confidence in the compelling value creation yet to come.

Our trailing 12-month ROIC through Q3 of 20.8% is up 240 basis points versus the prior 12 months. These outsized returns are a direct outcome of our cash generation and capital deployment actions. We have put to work approximately \$400 million in highly productive capital projects and invested more than \$800 million in Sleep Number stock, the last six years. We are bullish on our path forward and expect to accelerate investments in our innovations across the business. We also see tremendous value in our stock and plan to resume our share repurchase program here in the fourth quarter.

We currently have \$437 million remaining authorization from our board. We ended Q3 with a leverage ratio of 1.9 times EBITDAR. Over time, we expect to return to our operating leverage target of 2.5 to 3 times while maintaining our bias for liquidity preservation.

We continue to actively balance near-term business risks with our commitment to sustain our advantaged strategy. This orientation enabled us to rebound with pace and to carry this momentum into the coming quarters. Our sleep science leadership is delivering breakthrough value creation for all Sleep Number stakeholders.

I'd like to again thank our Sleep Number team and business partners during these challenging times. Your passion to improve lives is making a difference while driving exceptional performance. Well done.

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

## QUESTION AND ANSWER SECTION

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

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Hey, good afternoon, everyone. Congrats on the nice quarter. I wanted to just get a little more insight on the demand shifts or revenue recognition shifts from Q3 to Q4. I know in the last call you thought there might be \$10 million of shift from the late Labor Day, but you're saying on the call that you didn't experience any meaningful consumer disruption. So we still add a \$10 million shift, or is that number bigger now that we're in Q4, you have better visibility?

**David R. Callen**

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

A

Yeah. Hey, Peter, thanks for the question. It is bigger. Our explosive growth in the quarter, 16% demand certainly led to a bit of a higher backlog at the end of the quarter, but it's about offsetting the benefit that we had coming into the quarter.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

All right, [indiscernible] (00:25:38) that \$30 million benefit coming in and get fully offset?

**David R. Callen**

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

A

Right.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Okay, that helps. And then I want to ask a broader question on the new product launches. So you noted you're pleased with the new products that have the temperature balancing technology and those are at the high-end of the price spectrum, although your ARU didn't really show much year-on-year growth. And so I'm wondering if there was maybe an offset from higher Internet sales, or if potentially these higher-end product launches maybe weren't fully recognized in the third quarter and some of that will not show up in the fourth quarter?

**Shelly Radue Ibach**

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

A

Yeah, Peter, thanks for the question. This is such an important area of our strategy that is unique to our business model and competitive advantages, our ability to drive both units and ARU and as you know, we look at these metrics on an annual basis while we have quarterly shifts. So in the quarter, it represents both some close-out from our older models as well as the introduction of new. We introduced the m7 and i10 of the new Sleep Number smart beds here in the quarter and then just recently in October introduced the i8. So when we look at driving our ARU growth and in this case, for the quarter, we're up about \$14. So we're really happy with delivering a very big average revenue per unit, while also driving units that represented 15% of the 16% growth in the quarter.

But the ARU is driven by a combination of our innovations, our selling process and the promotions that we put forth, all designed to deliver the utmost in customer benefit. So we have lots of different ways to go at this. Of course, repeat sales contribute to that, too. So we have many levers to work with and we have high confidence in our ongoing ability to drive both ARU and unit growth as we have these last number of years and certainly expect to continue too into the future.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Okay.

**David R. Callen**

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

A

Peter, I would add one other aspect of this is generally, there is a pretty strong correlation between our ARU growth and gross margin rate and that wasn't the case. We were able to drive both a solid \$4,800 ARU while generating 70-basis-point year-over-year improvement in our gross margin rate in the quarter. The 12% unit volume velocity is certainly part of that as well.

**Shelly Radue Ibach**

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

A

Peter, one part of your question, I did not answer was on the – was regarding online sales. And you're absolutely right, 14% penetration, which is about 2 times prior year results in a lower ARU growth. So there is some impact there and at the same time you can see our stores certainly performed very well and grew along with a triple-digit growth in our online and phone sales.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Okay. That's helpful. And if – I wanted to ask one last question, sticking on new products. Very intrigued with the Climate360 products that you guys have announced in January this past year. So we're getting closer to 2021, do you have any sense on timing and when that might actually be available in the market?

**Shelly Radue Ibach**

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

A

Yeah, Peter, as you know, with the onsite of the pandemic, we pushed the launch of our new 360 beds and instead of beginning the introduction in Q2, we just started it here in the third quarter. So we plan to do that over the next few quarters and then Climate360 will most likely launch early in 2022.

**Peter Jacob Keith**

*Analyst, Piper Sandler & Co.*

Q

Okay. Very helpful. Thank you so much.

**Shelly Radue Ibach**

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

A

You bet.

**Operator:** Our next question comes from Brad Thomas with KeyBanc. Your line is open.

**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Hi. Good afternoon, Shelly and Dave. Congratulations on the quarter and the momentum here. I wanted to ask about – thinking about margins and costs in the fourth quarter, as I do some rough math on the strong revenue that you're setup to generate here in 4Q, it looks like the margin expansion [ph] or the (00:30:37) contribution margin that you're implying in your guidance may only be about half what you saw in the third quarter. Can you just talk about what's changing from an expense standpoint or margin standpoint that limits you from getting [ph] as strong a (00:30:51) flow through going forward, is that what we just saw here?

**David R. Callen**

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

A

Yeah, Brad, thanks for the question on that. It's really important as you've seen how we operated this year at the onset of COVID late in Q1. We made big changes to our business model and we took about \$80 million sequentially out of our operating – out of our sales and marketing expenses, in particular from Q1 to Q2. And then here in Q3 we've rebuilt some of that and added about \$80 million back into the business and – but yet aren't where we need to be to support the business that we expect to have going forward. So we are continuing to rebuild our structure in Q4 and that's some of the costs that you're seeing in Q4 relative to Q3. However, we're very excited about the opportunity to deliver \$4 or more in EPS while absorbing \$0.45 loss in Q2 and know that we have momentum beyond that.

**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

That's helpful. And I know that you're not here to give formal 2021 guidance yet, but I was curious if you could give us any initial takes on how to think about modeling next year. Obviously you wouldn't have an extra week, so that we know you would take out – you got easy comparisons in 2Q, but how are you thinking about what growth for the company might look like next year as we lap an unusual 2020?

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

A

Right. It is going to be an interesting comparison on a quarter-over-quarter basis, all year, next year. That's not new for us. We've done that kind of thing in the past, and we will certainly provide you lots of color on the February call. Your call out, Brad, about the \$0.25 we expect from the extra week and the 2 points of growth is correct. Those should be considered adjustments to take down our 2020 numbers on which to build from. But you can count on us using all of our EPS drivers, meaning growth on the top line, leveraging the business model and deploying capital efficiently if you continue to drive EPS growth and value for shareholders.

**Bradley Thomas***Analyst, KeyBanc Capital Markets, Inc.*

Q

Great. Thank you so much.

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

A

Yeah, you bet.

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

**Bobby Griffin***Analyst, Raymond James & Associates, Inc.*

Q

Good afternoon, everybody. Thank you for taking my questions. I hope everyone is staying safe and healthy.

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

A

Thank you.

**Bobby Griffin***Analyst, Raymond James & Associates, Inc.*

Q

I guess to follow up on Brad's question really Dave, really interesting year with all the moving parts in the pandemic, you had costs coming out, costs coming in back into the business. You guys have been working on the supply chain from some interesting things too, throughout the last couple years. So, if we take maybe a high level look at the business model versus pre-COVID, has the fixed variable costs nature of the model changed drastically?

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

A

There are some elements of our changes that are certainly changing, Bobby, but we're also – in terms of getting some efficiencies out of several areas. At the same time, we know that our innovation pipeline is tremendous and we need to lean into that lever to make sure that we are protecting the future. Our bias is to support the long-term profitable growth of the business and that's what we'll continue to do.

One other element that I meant to comment on in the prior question about the gross margin, the overall profitability in Q4 versus Q3, the gross margin rate we expect in Q4 is likely to be directionally about flat to prior year, which is about 50 basis points or so less than it was here in Q3. That's a reflection of some of the inflation

factors that we're starting to see in logistics, operations as well as foam costs and home delivery, tech, labor. Just thought I'd share all of that for your modeling purposes.

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**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

Okay. That's helpful. And then...

Q

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**Shelly Radue Ibach**

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

In fact, we...

A

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**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

I'm sorry, Shelly, go ahead, yeah.

Q

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**Shelly Radue Ibach**

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

I'll maybe just jump in too, just from an overall perspective of driving performance. As I highlighted, this is the third year, the third consecutive year that we've put up a double-digit growth demand. And we're still bullish on the initiatives that we have in place in our ability to continue to drive growth quarter-after-quarter and year-after-year. And yes, we'll continue to invest in our innovations to ensure we have the sustainability for the long-term. But I think this is a quarter where it's really evident that a lot went right. We took hard fast actions in Q2 and we cut expenses deeply to ensure our continuity. And through this we have found new more efficient ways to reach customers. We've enabled digital solutions across the business in marketing, sales, home delivery and fulfillment. Those efficiencies and that agility will all stay with us as we move forward.

A

And while we'll bring back some expenses to be able to support the business and the long-term nature of it, there are going to be investments in some different and new capabilities, while also hanging on to the efficiencies. And I would just say that we're still learning on the efficiencies. This is a – you can see it in the tremendous flow through here in the third quarter. There's a lot to learn and take forward. So it's a little too soon for us to say exactly how this is going to model out for the next year. But we'll certainly do that in the coming months. We're really excited with what we've uncovered, how we're reaching consumers and delivering life changing value to them and we see greater opportunity than we had probably otherwise in the past on a number of fronts. And I think the consumer trends around health and wellness is a big part of that as well. It's giving us the foresight to really lean into some future areas faster than we otherwise would have.

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**Bobby Griffin**

*Analyst, Raymond James & Associates, Inc.*

Okay. That's helpful. And that's kind of exactly where I was trying to dive in there, because you take 2Q out of it and you look at 1Q and 3Q of this year, the flow through has really stepped up versus some historical standards. So it makes me wonder, as some of these efficiencies gains change the fixed variable structure, I mean, David, I guess just to follow up lastly on, I mean, you look at the sales and marketing line this quarter, the 80 points of deleverage from media, Shelly called out, but it also implies over 400 points of leverage from the non-media portion, which is really the first time that we've seen that type of performance on that line item in a long time?

Q

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

A

Yeah, for sure. We were operating significantly differently in this environment. And as Shelly said, we've got some learnings that we're applying and we expect to hang on to some of those efficiencies as we go forward. But stay tuned, we're going to have a lot to talk about on the Q4 call in February.

**Bobby Griffin***Analyst, Raymond James & Associates, Inc.*

Q

All right. [ph] Sounds (00:39:04) very good. Well, I appreciate the details and going through kind of the line items. Best of luck in fourth quarter.

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

A

Thanks a lot, Bobby.

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

**Seth Basham***Analyst, Wedbush Securities, Inc.*

Q

Thanks a lot and good afternoon. My question is also around the expense line. It seemed like you had some unprecedented sales and marketing leverage this quarter; primarily, it seems because you had pulled back on expenses during the pandemic. If you think about the fourth quarter going forward, your expected leverage there is much more limited, especially when you back out the extra week. Are you thinking that Q4 is going to be more normalized from an expense standpoint going forward?

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

A

No, I don't. I expect that we're going to have more leverage than we would normally have even excluding the extra week.

**Seth Basham***Analyst, Wedbush Securities, Inc.*

Q

Got it. Okay. Thank you. And then, secondly and thinking about the backlog here. Based on your forecast for the fourth quarter, would you expect to have caught up on the backlog, or could it extend into the first quarter of 2021?

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

A

You know we've had quarterly shifts in demand in prior years and we see this to be much the same. We – by adding the 53rd week this year, it actually gives us another week to get caught up on everything. And – but we're delivering explosive demand growth at the same time. So this is kind of the next new level. And so, yeah, this is going to be normal as we go forward as we see it.

**Seth Basham***Analyst, Wedbush Securities, Inc.*

Q

Got it. Okay. And my last question is just around media leverage, good performance this quarter. How much of that would you attribute to lower advertising rates?

**David R. Callen**

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

A

So, just to be clear, we lean – we spent more in our media year-over-year in the quarter, just like we spent more in our R&D year-over-year. We continue to support our near and long-term growth drivers. We did indeed get some favorable cost benefits in the marketplace, but our teams are leaning into the digital side of our media as well and are winning in the marketplace.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Q

Could you just provide some color on what you're seeing from advertising digital rates through the year?

**Shelly Radue Ibach**

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

A

Well, I first just need to highlight the majority of the leverage in media and again, this was another step-up in our media ROI, so it was our most efficient quarter and that has been continuous since 2014. But we also had tremendous efficiency with how we're managing our overall digital platforms and utilizing our algorithm and proprietary data and that was the source of the greatest efficiency for us because of our ability to reach potential high converting consumers and also drive increased digital traffic. So, I'm not going to split out what part came from rate and it will certainly vary by business, but we continue to secure our media as we move forward here in the fourth quarter and feel confident about our placements and our ability to drive growth and advance our initiatives even further. And we also – and maybe it's helpful to hear that we would expect leverage whether we have favorable rates or not in the fourth quarter.

**Seth Basham**

*Analyst, Wedbush Securities, Inc.*

Q

Sure. Great. Thanks a lot and good luck.

**David R. Callen**

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

A

Thanks Seth.

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

**Atul Maheswari**

*Analyst, UBS Securities LLC*

Q

Good evening. Thanks a lot for taking my question. So your third quarter demand comp was quite a bit below one of your larger competitors. Why do you think that was the case? And then versus the broader market, do you think you gained share? And if so, who do you think you gained share from? Thank you.

**Shelly Radue Ibach**

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

A

I'm so glad you asked this question because we operate our business for the long-term. And this is the third consecutive year for us of delivering double-digit growth, that's very different than any of our competitors. We've

taken share for over four years and absolutely continue to believe we're taking share and we'll take share this year.

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**Atul Maheswari**

*Analyst, UBS Securities LLC*

Okay. Good luck.

Q

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**David R. Callen**

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

Okay. Thanks.

A

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

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**Curtis Nagle**

*Analyst, Bank of America Merrill Lynch*

Good evening. Thanks very much for taking my question. I just wanted to follow up quickly on Seth's questions in terms of some of the component sourcing and where you're seeing I guess perhaps some of the biggest points of pressure and are the shortages or kind of issues you're seeing better or worse than they were at the beginning of 3Q relative to now?

Q

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**Shelly Radue Ibach**

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

Well, [indiscernible] (00:44:47) – I'll start and David can add some additional color. Certainly better than they were in Q2. There were – in Q2, we were dealing with a lot more issues where different supplier factories were shut down or they were at partial productivity and for the most part that has been resolved. And this has really been a matter of responding to a hyper-shaped V recovery when we were at fairly low inventory levels for obvious reasons as shortly after the pandemic hit.

A

And what I'm really excited about is how I would say masterful our teams have coordinated across all aspects of our integrated vertical model and how closely they work with their suppliers and business partners and how creative everyone has been together to solve and find ways to get the right inventory in the right places at the right time. I'm not sure how you would do that without this advantaged integrated business model. And so, I really put some highlight on that because it is pretty extraordinary to deliver this level of revenue, while not having disruption in our delivery times for our customers in any meaningful way.

And as far as the specifics of where there's some shortage, it moves around because it's very highly responsive to our demand. And keep in mind, we also layered in a complexity of introducing a new product line during the third quarter. And so, our teams have collectively managed all of that and delivered on the performance that we drove on the top end. So I'm – really a big shout out to our team all across the board, just really impressed. None of this would happen without everyone's dedication and passion.

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**David R. Callen**

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

I want also take a second to revisit the last prior question about our demand versus competitors and there is some misunderstanding. We are fully direct-to-consumer and [ph] how are (00:47:10) the three years that Shelly highlighted of double-digit demand growth is all based on real demand to end consumers. And some of our

A

competitors have – are delivering some of their demand growth through sales to independent retailers and that – they have different models. I don't know that there's another competitor out there today that is a pure DTC player anymore. So just keep that in mind as you do your comparisons.

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**Curtis Nagle***Analyst, Bank of America Merrill Lynch*

Q

One other just quick follow-up, if I may, in terms of the sourcing. I guess, any issues with some of the single sourcing components like the air pumps or is that in good shape?

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

A

We're in good shape.

---

**Curtis Nagle***Analyst, Bank of America Merrill Lynch*

Q

Okay.

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

A

Everything is tight, but we're in good shape.

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**Curtis Nagle***Analyst, Bank of America Merrill Lynch*

Q

Terrific. Thanks very much.

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

A

You bet.

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**Operator:** Our next question comes from Brad Thomas with KeyBanc. Your line is open.

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**Bradley Thomas***Analyst, KeyBanc Capital Markets, Inc.*

Q

Great. Thanks so much for letting me get in for a follow-up here. I was hoping you just talk a little bit about the demand trends. I think you told us last quarter, you're running up high single digits towards the end of last quarter, May, June. You reported 16% demand growth for 3Q. I was hoping you could give us a little more color month-by-month, how things had played out and if there were any nuances around Labor Day, for example?

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

A

We've had robust demand growth throughout the quarter both before, during Labor Day event and after and continue with strong momentum as we head into the fourth quarter.

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**Bradley Thomas***Analyst, KeyBanc Capital Markets, Inc.*

Q

Great. And so if I try to triangulate your guidance for GAAP revenues versus thinking about the demand trends, it seems to me that your guidance implied about 20% to 24% revenue growth for 4Q. You got an extra week that adds about 8%. If you had a \$30 million backlog that you work through that could be 7%. So that might imply demand revenue traction and maybe the 13% to 17% range through 4Q. Am I breaking it apart the right way, if I think about it that way?

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**David R. Callen**

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

A

Sure, Brad. I think that's fair. And what you should just keep in mind that we're delivering 7% to 8% top line growth for the full year despite having 20% decline in sales in Q2. And the performance in a rebound overall has been nothing short of stellar and we're excited about the opportunities for \$4 or more in EPS in Q4 and the momentum will stop there. We've got – our initiatives are working on all cylinders, as Shelly highlighted, and we're excited about where we're going.

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**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

If I could squeeze in one last one just on stores. I think you're down a few stores for the second quarter in a row. How are you thinking about openings and repositionings in 4Q and maybe an initial thought on 2021 and longer term as it relates store base?

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**David R. Callen**

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

A

Right. Yeah, we're expecting – as we highlighted we paused some of our initiatives because of COVID and store openings was part of that and our CapEx change \$45 million reflects that as well. We expect now to end this year with about 600 stores and then long-term we still continue to see great opportunities for local market development and store expansion. The overall portfolio is expected to grow 4% to 5% on average per year between now and 2025.

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**Shelly Radue Ibach**

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

A

And that's while driving online and phone sales increases as well, Brad.

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**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Wonderful. Thanks for letting me get back in. I appreciate it.

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**Shelly Radue Ibach**

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

A

Absolutely.

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**Operator:** There are no further questions at this time. I'll turn the call back over to Sleep Number for 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 fourth quarter 2020 performance with you in February. Sleep well and dream big.

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

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