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Sleep Number Corp. (SNBR)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Sleep Number's Q3 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 now like to introduce Dave Schwantes, Vice President of Finance and Investor Relations. Thank you. You may begin.

Dave Schwantes

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

Good afternoon and welcome to the Sleep Number Corporation's third 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. Please refer to the details in our news release to access the replay. Please also refer to our news release for a reconciliation of certain non-GAAP financial measures and supplemental financial information included in the news release or that may be discussed on this call.

The primary purpose of this call is to discuss the results of the fiscal period just ended. However, our commentary and responses to your questions may include certain forward-looking statements. These forward-looking

statements are subject to a number of risks and uncertainties outlined in our earnings news release and discussed in some detail in our annual report on Form 10-K and other periodic filings with the SEC. The company's actual future results may vary materially.

I will now turn the call over to Shelly for her comments.

Shelly Radue Ibach

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

Good afternoon and welcome to our 2021 third quarter earnings call. My SleepIQ score was 87 last night. The value of our Sleep Number purpose to improve the health and well-being of society through higher quality sleep is evident in our record third quarter top and bottom line performance. We improved more than 225,000 lives during the quarter.

Before sharing greater performance detail, I'll highlight three key takeaways for today's call. First, we continue to drive sustained demand and market share gains for our life-changing smart beds, including delivering our fourth consecutive third quarter of double-digit demand growth. Second, global supply chain shortages continue to challenge our business. I'll discuss how we navigated this disruptive environment in Q3 and the implications going forward. And third, robust demand and operating leverage are producing record financial results as we continue to advance key initiatives within our proven strategy to deliver sustainable profitable growth.

Third quarter results exceeded our expectations. Net sales were up 21% versus prior year and were 35% higher than 2019. And earnings per share were \$2.22, 24% higher than our record 2020 third quarter and up 136% from 2019. Our third quarter performance was particularly gratifying given the significant global supply chain disruption. Our teams' dedication, tenacity, and agility once again made a meaningful difference, enabling Sleep Number to service the growing demand for our life-changing 360 smart beds.

The year-to-date financial performance results demonstrate the power of our advantaged business model and our teams' stellar execution. Earnings per share of \$5.63 for the first 9 months of 2021 is greater than our record 2020 total year results and more than double our 2019 annual EPS.

We are driving strong leverage across our business with a year-to-date net operating profit rate of 10.6%, up 200 basis points from prior year, and up 430 basis points versus 2019. Year-to-date cash from operations was a record \$293 million, with a trailing 12-month ROIC of more than 34%. These results are being driven by heightened levels of consumer demand, a deep affinity for our brand, and clear operating efficiencies associated with our strategy, business model, and execution.

With our unique competitive positioning at the intersection of well-being and technology, the worldwide shortages of semiconductors and other electronic components became a problem in Q3 and continue to be a challenge for us. Our performance in this unpredictable environment is a testament to the years of investment in our vertically integrated, exclusive direct-to-consumer business. By utilizing multiple levers across our sourcing, product design, fulfillment, sales and service operation, we are mitigating the impact of the current supply chain constraints.

Our business model has also enabled us to shape demand fulfillment and manage supply, even with minimal inventory. And with our teams' dedication to our mission, we have earned our customers' trust and built enduring relationships. As a result, we generated impressive net operating profit leverage during the third quarter, despite input cost pressures and freight inefficiencies.

Over the years, we have built strong partnerships with an increasingly diversified set of suppliers. These relationships have contributed to additional supply sources and help align our tight inventory with scheduled deliveries, but haven't reduced the risk of electronic component shortages in the near term. We have aggressively pursued a range of solutions, including working directly with second- and third-tier suppliers, employing market brokers, bots, and other digital tools, and expedited shipping, including airfreight.

In addition, we have quickly qualified new component suppliers, certified alternative components, and developed, validated, and applied product changes. We have shaped demand through promotional planning and our selling process, implemented additional price increases and thoughtfully managed customer deliveries and expectations through increased communication, home delivery staffing and overtime. We have also partnered top-to-top with large global electronic and technology companies for the near and long term, integrating our work and sharing resources as we strive for sustainable outcomes.

We continuously advance key initiatives and use multiple levers within our proven strategy for consistent demand creation. Our digital ecosystem drives relevance and engagement, which leads to lifelong brand relationships. Automation and personalization are also improving the quality of our customers' experience, which builds trust. Both new and existing customers are actively engaged at record levels.

Levers include: digital storytelling to attract and engage; NFL media and ads are driving record digital traffic; in-house digital capabilities to personalize message by media, audience and platform in real-time; SleepIQ technology advancements to strengthen engagement and improve customers' wellness; and customer advocacy, which is driving record referrals and repeat sales growth.

Results produced by our innovation and initiatives include four consecutive third quarters of double-digit demand growth and 2-year demand growth versus 2019 of nearly 30% for the quarter as we lap last year's robust 16% demand increase.

Our teams are highly engaged and passionate about improving life for all our stakeholders. In our annual engagement survey, our teams' performance intensity, which is a measure of effort; and their commitment intensity, which measures their intent to stay with Sleep Number, were at best-in-class levels. This shows up in how we continue to overcome the many challenges associated with this global pandemic.

We are targeting full-year 2021 earnings per share of \$7.25, reflecting our strong demand and leverage and the impact of supply chain constraints. We continue to employ and refine the strategies that were effectively used in the third quarter to fulfill demand and deliver exceptional performance.

However, the timing of receiving electronic components could ultimately elongate when we can deliver our customers smart bed. As a result, it's still possible that we will have a shift of expected fourth quarter deliveries into the first quarter of 2022. While global supply chain issues will likely continue through next year, there are indications that supply will improve from current levels.

Suppliers have made stronger commitments for electronic component deliveries in Q1 than we've had in the back half of 2021. In addition, suppliers' scaling initiatives are expected to favorably impact their output as the year progresses. Longer term, the necessity of understanding the customer and their purchasing behavior is essential to supply chain management. This is already a hallmark strength of Sleep Number.

Operational decisions and scenario planning are informed by real-time data and analytics. Digitization enables both immediate actions and our ability to be more responsive in the future, moving from connected to intelligent

speeds end-to-end orchestration from manufacturing to customer delivery. Regional assembly allows fast action. Relationships with suppliers through multiple tiers are essential to weathering disruption.

As we prioritize our customer-centric supply chain design for a dynamic global environment, we are adding two directors, Phil Eyler and Angel Mendez, will join our board effective January 2. Their experience in transformational global supply chain and purpose-driven leadership will augment our board's strategic capabilities.

We are leaning into our purpose and utilizing the levers of our vertically integrated business to deliver sustainable, superior value for all stakeholders. And I am grateful for our teams' ongoing resilience and passion for improving lives and extremely proud of their exceptional accomplishments while navigating high uncertainty in rapidly changing conditions.

The strength of our demand drivers continues to support mid- to high single-digit demand growth in 2022, driven by our life-changing innovations, pricing actions, advancement of our digital ecosystem initiatives, retail expansion including 40 to 50 incremental new stores, and online evolution.

Now David will provide additional financial details on our third quarter 2021 performance and Q4 outlook.

David R. Callen

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

Thanks, Shelly. The fundamentals of our business remain strong. Managing business risks amid global COVID disruptions is bringing out the best in great companies like Sleep Number. Our teams' resilience and ingenuity are driving exceptional financial performance because we embrace our common goal to improve lives through proven quality sleep. The technology embedded in our 360 smart beds is driving strong and steady double-digit demand growth now into our fourth straight year. In fact, our demand creation has exceeded our net sales year-to-date by more than \$50 million. Our Q3 ending backlog was comparable to the balance at the end of Q2. These booked orders provide confidence in future net sales.

Unfortunately, the electronics that enable our smart technology and steady double-digit demand growth are also creating uncertainty in fulfillment, timing and costs. While we believe these electronics supply constraints are temporary, we know the highly differentiated, life-improving benefits of our smart beds are enduring. Customers recognize this and are choosing Sleep Number. Our record referral and repeat business, engagement scores and low cancellation rates are all indicators of our customers' passion for Sleep Number innovations.

So what has changed? The three supply challenges noted on the Q2 earnings call were resolved as expected. Since August, our teams have been working directly with two very large electronics vendors, three layers deep in our supply chain after they abruptly decommitted against our open purchase orders. We recaptured some of that supply from them directly and some electronics through higher cost, open-market purchases. These rapid actions enabled record weekly deliveries in Q3 and relieved pressure on deliveries previously expected in Q4.

To achieve our full year EPS target, we need to deliver Q4 net sales of approximately \$600 million to \$610 million versus the \$640 million in Q3. The timing of electronics supply to support these deliveries has been misaligned versus our demand, sometimes resulting in longer delivery windows. Like in Q3, our teams are closing electronics supply gaps and reducing lead times. Our teams are employing all the tenacity, ingenuity and passion they applied to deliver extraordinary Q3 results to improve many more lives in Q4 and beyond.

Let's take a deeper look at that Q3 performance now. Q3 net sales were up 21% versus record 2020 performance and up 35% over 2019. Results exceeded the expectations we outlined during our Q2 earnings call due to the

resilience and problem-solving by our teams. For example, with new electronics shortages emerging in August, we launched an alternate FlexFit base in just 30 days. We rapidly validated alternate resins and electronic components, employed integrated digital tools to schedule deliveries ahead of supply confirmation, and levered efficiencies throughout our vertical business to more than offset significant cost inflation.

Q3 sales metrics reflect this performance, with 15 points of 1-year growth from units and 5 points from ARU; 16 points of comp growth and 5 points from new stores. And more than 11% of sales came from e-comm, phone, and chat versus about 7% historically.

Q3 net operating profit of \$73 million or 11.4% of net sales is 4% higher than last year when we hadn't yet rebuilt our infrastructure following COVID cutbacks, and 86% higher than 2019. Since 2019, we have increased operating margin 320 basis points. Q3 EPS of \$2.22 also exceeded expectations for a 50% increase over 2019, coming in with earnings 136% stronger than 2 years back.

Year-to-date, we have delivered net sales of \$1.7 billion, up 35% since 2019 with \$100 million more net operating profits. That's 24% 2-year incremental profit flow-through. Operating margin of 10.6% is up 430 basis points since year-to-date 2019, while absorbing 30 basis points of gross margin pressures.

Rapid increase in input costs to buy and ship components and labor to produce and deliver our smart beds is pressuring results as seen in the 140-basis point 2-year decline of our Q3 gross margin. We are offsetting \$140 million of annualized cost pressures with \$140 million of annualized pricing actions, while continuing to benefit from volume leverage and digital efficiency gains across the business.

For example, we have levered our year-to-date selling and marketing costs 470 basis points versus 2019. This derives from highly integrated growth drivers working synergistically to deliver year-to-date growth through both ARU and units, up 4% and 28%, respectively, versus 2019.

Specifically, digital tools and interconnections across functions leverage our marketing and retail resources to efficiently drive and process significantly more sales volume. One proof point is the \$3.7 million average ttm sales per store including e-comm, up 29% since this point in 2019. Another is that half our comp stores generated more than \$3 million in ttm sales through Q3. The number of these highly productive stores is up to 90% in 2 years. We ended the quarter with 632 stores and expect to end the year with about 650.

Investing in our innovations, marketing and retail continue to drive value creation and provide steadiness in performance over time, while navigating temporary electronic component disruption. These investments include direct spending through the P&L, like the 72%, 2-year acceleration in year-to-date R&D; and through capital spend, like the \$49 million invested year-to-date to expand retail reach, expand manufacturing and assembly capacity and to create digital solutions that enable profitable growth.

Our 2021 year-to-date EPS of \$5.63 is 3 times the \$1.88 earned year-to-date just 2 years ago. Execution of our disciplined capital deployment strategy offset 50 basis points of year-to-date 2-year income tax rate headwinds with 17% fewer weighted average shares outstanding and lower net interest costs of more than \$4.5 million.

After investing in the business and maintaining strong liquidity, our final priority for capital deployment is investing in Sleep Number shares. With our strong performance and the value we see in Sleep Number, we have repurchased \$364 million of our stock year-to-date. This nearly equals the \$374 million repurchased during all of 2019 and 2020 combined. Still, we are maintaining a relatively conservative leverage stance and ended Q3 with a

debt-leverage ratio of 2.2 times EBITDAR. Longer term, we expect to operate with leverage of 2.5 to 3 times EBITDAR.

Given the strong growth in the business and currently favorable banking conditions, we are opportunistically rightsizing and extending our debt facility here in Q4. We expect to increase our total facility by \$200 million to \$800 million with a renewed 5-year term and similar conditions.

Using all our performance levers over the years has enabled us to navigate challenges, while driving exceptional earnings expansion. As we target EPS of \$7.25 in 2021, we will employ our strong demand generation, tenacious supply pursuits and efficiencies across the business to deliver performance. We operate the business for the long term and remain confident in its fundamentals. We continue to expect longer term top line growth of mid- to high-single digits with twice that growth in EPS.

At this point, operator, please open the lines for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. We will now begin the question-and-answer session. [Operator Instructions] Your first question comes from the line of Peter Keith with Piper Sandler. Your line is open.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Thank you. Good afternoon, everyone. And nice results here for the quarter. We've gotten a couple of questions on the guidance for \$7.25. So it's kind of a subtle change, but you took out the words, at least, with regards to \$7.25. Seems like the demand trends are pretty strong, so it's kind of a two-part question. Has there been any change in your demand expectations? And is the removal of, "at least", more a function of just some of the backlog and some of the potential carryover into 2022?

Shelly Radue Ibach

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

A

Yeah. Hi, Peter. Thanks for the question. Absolutely, what you've just described. We certainly have sufficient demand and backlog to deliver a number higher than \$7.25. We're clearly constrained by the electronics supply, so it is a timing issue. We entered Q4 here with strong demand and that's after delivering four consecutive third quarters, up double-digit demand and lapping the 16% growth here in the third quarter from 2020 with another double-digit growth. So we're bullish on our demand.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Okay. And so, I guess, we've had some questions, too, just sort of on like the implied backlog maybe going into the new year. So you said, Q4 revenue implied at \$600 million to \$610 million. I guess do you have an estimate on like how much backlog would then carryover into 2022, you wouldn't be recognizing in the fourth quarter?

David R. Callen

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

A

Peter, that's a hard one to gauge. I would say, because our demand is very strong and we don't yet know what that's going to actually tally up to be for the full year, but I would say, I highlighted that this year, we've added about \$50 million net sales equivalents that haven't yet been delivered where our demand exceeded our net sales. That's in addition to what we talked about as we came into the year. I'd say probably in the order of magnitude of about \$100 million excess net sales equivalents, at some point, are going to come through.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Okay. All right. That's helpful. I'd like to sneak in one more question.

Shelly Radue Ibach

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

A

Sure.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

You did throw in a comment, Shelly, that caught my attention just on the 2022 that I think you expect demand growth of mid- to high single-digit. So that would exceed the current sales estimates out there today. And I'm guessing you'd probably have some pricing on top of that for sales growth, maybe more high single-digit, low double-digit. Could you give us maybe your some – let me just say, maybe unpack that a little bit. So help us understand why you're so enthusiastic about that level of demand growth as we look out to next year?

Shelly Radue Ibach

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

A

Well, we've had continued strength of demand, and the demand for our smart beds remains strong. We've just had the fourth consecutive quarter. We lapped the 16% growth here in Q3. And Peter, we've been advancing key initiatives every quarter since we transitioned to all smart beds. And this drives a consistency each quarter and it's around the engagement, the digital ecosystems, the innovations, and we're really pleased with how formulaic this is in the ongoing strong demand. And the in-house capabilities and the AI gives us such real-time progression, it helps us within the quarter. And then, we have clarity of the advancement of the initiatives each quarter.

Going back to what I said about 2022, I was speaking about the demand and mid- to high single-digit growth for our 360 smart beds that includes innovation, pricing, the digital ecosystem initiatives, the retail expansion and online evolution.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Okay. So to make sure I'm clear with that, that would include pricing within the mid- to high-single.

Shelly Radue Ibach

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

A

Right.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Okay. Very good. Thanks for the clarification and the insights. I appreciate it.

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

A

Absolutely. Thank you.

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.*

Q

Good afternoon, everybody. Thanks for taking my questions. And congrats on a strong quarter in a very difficult supply chain environment.

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

A

Thank you, Bobby.

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

A

Thanks, Bobby.

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

Q

So I guess, first, I just wanted to touch on the electronic side of things that you're talking about. Your beds include a lot of technology in it, and it's very common out there that electronic shortages happen. But what parts of the bed is it impacting? Is it just the adjustable bases or is it the motors and some of the other controls for the adjustable bladder? I mean what parts to help us visualize where on your products you're getting hung-up at?

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

A

Well, the main challenge has been semiconductor chips and other electronic components associated with our smart beds and smart bases.

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

Q

Okay. So both. So inside the bases as well as some of the other smart bed components for just the mattress itself.

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

A

Yes.

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

Q

Okay. That's helpful. And then, Dave, I just wanted to clarify, you mentioned the backlog comparable to 2Q. But when we look on the balance sheet, you had customer deposits down quarter-over-quarter. And I know those

don't include the financing side of the business, so it can get a little funky from different quarters. But just to ask you directly, did deliveries this quarter outpace demand so we actually worked down a little of the backlog?

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

A

No. And that's why I was compelled to say that our backlog at the end of Q3 was comparable to Q2 because that's one of the dangers of making the assumption based on customer prepayments. That number fluctuates with the kinds of offers that we're providing, the timing of when things happen, both in terms of the orders and the delivery. So it's not a perfect proxy for backlog.

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

Q

Perfect. That's helpful. That's what I was afraid of by doing that math, so it's helpful to clarify. And I guess, just lastly for me. When you kind of back into the implied EPS for 4Q and compare it to last year, obviously, last year had an extra week \$0.30 benefit, there's clearly some pressure coming on gross margins. But when you look inside the sales and marketing side, what's happening there? Is that still leveraging and flowing through as expected or is there another round? Are you stepping up investments in media or anything there in the fourth quarter to get the EPS to kind of shake out to where the guidance is implying?

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

A

Well, last year, we did benefit from additional operating profits from the extra week, and that was reflected in how we adjusted out our \$0.30 from our total results from last year, Bobby. We do expect some pressure on our gross margin rate in Q4. That's temporary, I think, as we balance out the cost pressures with the pricing actions that we've taken and the efficiency gains that we're getting.

What we're relying on is we're leaning into our efficiency gains through the sales and marketing the rest of the P&L effectively to deliver strong overall performance. We expect for the full year still consistent with how we started the year, Bobby, to deliver more than 300 basis points of net operating profit margin expansion versus 2019.

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

Q

Okay. I appreciate the details and letting me sneak in an extra one, and best of luck during the fourth quarter.

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

A

Great. Thanks a lot, Bobby.

Operator: And your next question comes from the line of Brad Thomas with KeyBanc. Your line is open.

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

Q

Hey. Good afternoon, Shelly, David and Dave. Thanks for taking my question. Nice results and demand. I wanted to ask about the guidance and gross margin. Maybe first on the guidance, just to clarify. So is the \$7.25 that

you're targeting, does that align with the prior sales guidance, which if I remember correctly, was 35% growth versus 2019? Is that how to back into that \$7.25 number?

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

A

Yeah, it is. And on top of that, I gave you the \$600 million to \$610 million in net sales for Q4 that supports us getting to the \$7.25.

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

Q

Great. Great. And David, do you have line of sight to the components to hit that number today or is that in question? Or is it possible you may get more of that? I know it's still early in the quarter, but any more color on your line of sight to hitting or beating that number would be of interest.

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

A

Well, just like we saw in Q3, if you'd asked me the same question at that point in time, we had no idea what happened in August, was going to happen. And yet, our teams were resilient and found ways to overcome those challenges and got the supply we needed to deliver record results in Q3, including record deliveries for the last 8 weeks of the quarter.

As we sit here today, there is some misalignment between our demand and the supply. And we're solving that. But as Shelly highlighted in her comments, it's possible that some of those components could come too late in the quarter and then cause a shift in deliveries into Q1. We feel great about the expectations for components next year relative to the back half here. But we are working every lever to get there.

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

Q

That's really helpful color. And then just at a high level, could you share a little bit more insight into just how you think about sort of your product margins today? I know your gross margin can have an element of leverage to it and the strong productivity per stores can help you have a higher gross margin. But how are you thinking about product margins, given that we're seeing inflation in so many areas of the world right now?

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

A

A great question, Brad. I love that because there are trade-offs we make all the time between, for example, financing and discounts and that affects different parts of our P&L. And so, as we give greater discounts, then it affects our gross margin rate. If we give greater financing, it's also a closing mechanism, but that affects us in our operating expenses.

So in total, we love what we're seeing with the business. The fundamentals are very strong. The selling process, the marketing efforts, the innovations are all working together to drive people into the store, onto the website or onto the e-comm platforms, and then converting at very high levels. So all the way around, really excited about the performance and fundamentals of the business.

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

Q

Great. Very helpful. Thank you so much.

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

A

Yeah. Thanks, Brad.

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

Atul Maheswari*Analyst, UBS Securities LLC*

Q

Good evening. Thanks a lot for taking my questions. So just to clarify on the \$600 million to \$610 million revenue guidance for the fourth quarter. So for you to achieve that range – or rather, will you be able to achieve that range even if the supply remains constrained as it is today? Or will the supply have to improve for you to hit that range?

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

A

Yeah, Atul. As I was highlighting in my previous answer, we have great line of sight to every single day, week in terms of deliveries and are working the levers to pull in some of that supply earlier into the quarter to support our deliveries. This is very similar to what we did in Q3 and had to do in Q3. And our teams are – I have to give a shout out, I mean, working magic, finding different solutions and keeping our customers – or getting life-improving benefits of our Sleep Number smart beds into our customers' homes.

Atul Maheswari*Analyst, UBS Securities LLC*

Q

Okay. And then on the EPS guidance of \$7.25, it does seem like in the next – even backing out the extra week, it seems like a little bit more pressure in the fourth quarter relative to the third quarter. So are you baking in more cost inflation in the fourth quarter? And if so, what are the sources of those pressures?

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

A

Yeah. Atul, this is Shelly. Just highlighting the constraints that we – the constraint we have in the fourth quarter on our deliveries is due to the electronic supply shortages. Those constraints are constraining our ability to deliver. So our demand and our backlog certainly is sufficient for a much higher number in the fourth quarter, but the actual inventory is not. So that's the constraint that you're seeing.

And in the fourth quarter, we're continuing to drive our demand, of course, being very focused on the long term and ensuring that our customers benefit from the life-improving benefits from the smart bed, and we're leaning into our demand drivers as you would expect us to for overall value. And constrained on the supply, and that's why we've taken some of the risk and moved it out of the fourth quarter because of that overperformance in Q3. And this is what we have to do yet in the fourth quarter to hit our \$7.25 target.

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

A

Atul, let me just add one more thing. I don't know whether you're making comparisons only to 2020. But as I highlighted, as it pertains to the Q3 comparison, last year was a year when we had taken significant cost cuts post-COVID and we hadn't yet rebuilt our infrastructure through Q3 and into Q4. We expect operating profit margin expansion in Q4 versus 2019 just like we've done all year long. And as we've said, we expect top and bottom line performance increases over 2019 for each quarter of 2021. So hopefully, that helps you calibrate properly.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Yeah. That definitely helps. Thanks a lot, Shelly and Dave. And good luck with the rest of the year.

David R. Callen

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

A

Yeah. Thank you.

Shelly Radue Ibach

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

A

Thank you.

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

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Thanks a lot and good afternoon. I was just hoping to get a little bit more color on two items that you guys mentioned. One, the efficiency gains that you're leaning into. What are those specifically? And what's giving you the ability to drive them earlier than anticipated? I presume they're not just volume-based.

David R. Callen

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

A

Well, Seth, it starts with volume. And creating more demand for your business is the best way to generate leverage, and we've been doing that. We've been – as I highlighted, the synergy between our selling and marketing efforts are tremendous. And being vertically integrated the way we are, we can share those insights across those platforms digitally and engage with customers in a way because of that lifelong relationship, we're driving a lot more volume with a given set of resources.

I highlighted two specific examples pertaining to our store productivity, the \$3.7 million average sales per comp store including e-comm, that's up 29% since 2019. And then having more than half of our comp stores with more than \$3 million in sales that they're processing trailing 12-month, that's incredible volume that's going through those resources. And so, that's generating a significant amount of efficiency gains.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Okay. And then secondly, in terms of the price actions that you mentioned to offset some of the cost pressures. What's the timing of those? And how broad-based were these?

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

A

They were across the product offerings and they've been – there are three different pricing actions that we've taken during the year. One was in the spring; one was in July; and one, we just took last week.

Seth Basham*Analyst, Wedbush Securities, Inc.*

Q

Got it. Okay. And just to recap, relative to your prior guidance of 35% plus sales growth versus 2019 and \$7.25 in earnings at least, you're now just going for those specific points rather than seeing the upside. The upside is less likely because of some of the dynamics in the environment that you're talking to now, correct?

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

A

Well, yeah, I mean, not because of demand. There's plenty of demand, and there's plenty of efficiencies in our business. It's just really dependent on the electronic supply. And yet again, I'm just going to make that comparison back to what we did in Q3. We had similar kinds of challenges and delivered record performance. So the opportunity for us to deliver upside is still there. We just feel like it's pragmatic and appropriate for us to call it as targeting \$7.25.

Seth Basham*Analyst, Wedbush Securities, Inc.*

Q

Understood. Thank you, guys.

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

A

Okay. Thanks a lot.

Operator: And that concludes today's question-and-answer session. I will now hand the conference back to the company for closing remarks.

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

Thank you for joining us today. We look forward to discussing our fourth quarter 2021 performance with you in February. Sleep well and dream big.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for joining. You may now disconnect. Have a great day.

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