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Sleep Number Corp. (SNBR)

Q1 2022 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.

OTHER PARTICIPANTS

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Matthew McCartney

Analyst, Wedbush Securities, Inc.

Atul Maheswari

Analyst, UBS Securities LLC

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Curtis Nagle

Analyst, BofA Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Sleep Number's Q1 2022 Earnings Conference Call. All lines have been placed in a listen-only mode until the question-and-answer session. Today's call is being recorded. If anyone has any objections, you may disconnect at this time.

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

Dave Schwantes

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

Good afternoon, and welcome to the Sleep Number Corporation first quarter 2022 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 2022 first quarter earnings call. My SleepIQ score was 74 last night. I want to start by expressing our deep concern for the devastating impact that the war in Ukraine is having on so many lives. We are driven by our purpose to improve the health and well-being of society through higher quality sleep. As always, our primary focus is the safety and well-being of our team, serving our customers, and ensuring business continuity.

Since the onset of the pandemic more than two years ago, external factors have elevated business complexity and volatility. In this dynamic environment, we remain focused on deepening consumer relationships and innovating for broad relevance while taking decisive actions to address near-term pressures. Our teams are highly engaged and resilient. Our competitive advantages are strong. And we have ample cash generation and liquidity to support the execution of our strategy. We remain steadfast in our commitment to fulfilling our purpose and creating long-term shareholder value.

While we expected Q1 results to be significantly below last year due to supply constraints and related cost pressures, performance was additionally affected by other external factors in the quarter. The start of the war in Ukraine in late February, combined with a sharp increase in gas prices and broad-based inflationary pressures affected consumer shopping behavior in March, including demand for our smart beds.

While our team promptly leveraged risk mitigation plans to stimulate demand and reduce costs, first quarter performance was lower than expected. Demand for the quarter was down 3% year-over-year. Net sales declined 7% to \$527 million and earnings per share were \$0.09. Customer preference for the features and benefits of the Sleep Number smart bed was at the high end of our line, and that led to a 20% increase in underdelivered backlog in the first quarter.

Reflecting these results and greater macro pressures, we are revising our full year 2022 EPS guidance to a range of \$5 to \$6. This outlook assumes flat to low-single-digit growth for demand for the balance of the year and benefit from deliveries against our excess backlog. David will elaborate on our financial performance shortly. I will highlight how we are keeping consumers engaged as we service our large backlog and prioritize important strategic advancements.

We are utilizing the operational levers of our advantaged model to engage consumers effectively in this inefficient marketplace. With our vertical model and integrated demand planning, we are able to rapidly test, learn, apply, and refine our actions. As a result, we are adjusting website and digital messaging, media promotions, and financing. Recent media changes are showing improved digital traffic, and we are reallocating our investments to drive even more impactful outcomes.

Our brand leadership and growth flywheel, based on the advocacy of lifelong relationships with our smart sleepers remain strength. Our insiders are highly engaged with our brands. We've adapted and pivoted quickly and continue to gain new insights as we respond to changing consumer shopping behaviors. I have great confidence in our passionate Sleep Number team and their tenacious pursuit of solutions that reach and serve our customers in this and all environments.

In addition to demand-generating tactics, we immediately reduced media and other planned spending by \$10 million in the quarter. We continued to pursue additional contingencies to further drive demand and adjust costs in support of a broad range of macro scenarios. We also continue to deploy creative sales to fulfill our demand on a timely basis while retaining customers' trust and loyalty. As we shared during our year-end earnings call, the global impact of the Omicron variant in January resulted in ship delays that constrained deliveries at the high end of our line. For the first quarter overall, our supply allocation was in line with the expectations.

The global supply environment remains fluid and challenged with minimal electronics inventory. These conditions require us to maintain constant focus and real-time agility across our business. For example, in April, our digital tools flagged a signal from a large third-tier global supplier affected by China's highly restrictive COVID lockdown in Shanghai. They are currently operating at about 60% of capacity, which has resulted in a delay of chips used in our smart bed Firmness Control systems.

While we were not able to avoid business disturbance entirely, our vertically integrated digital capabilities enabled us to immediately adjust customer smart bed delivery times to align with the new expected timing of chip receipts. In this way, our integrated business model and our real-time supply visibility enabled us to discern and respond quickly to external challenges. As a result, we can continue to generate demand, manage customer expectations and retain their trust and brand love. This is a significant competitive advantage.

Our initiative to build a scalable, flexible and responsive supply chain that prioritizes customer experience is essential to our speed and agility in overcoming customer disruptions. We now have completed the migration of nearly 75% of our outbound logistics network. By the end of this year, we expect to complete our multiyear transition to an enterprise-wide manufacturing and assembly supply chain. This is fundamental to improving our efficiency and customers' experience.

Though external challenges are creating near-term complexity and significant inefficiencies, our innovative sleep solutions continue to gain relevance with consumers. The health and wellness benefits of sleep are increasing in value. Sleepers using our 360 smart beds and FlexFit technology are benefiting from almost 30 minutes more restful sleep per night or up to 170 more hours of restful sleep per year. We are excited to share this exclusive Sleep Number benefit with consumers.

Last month, we also achieved another significant milestone on our road map to connected health. We publish findings from a recent study that confirmed that our 360 smart bed technology is comparable to the gold standard polysomnography for sleep tracking and measurement. Because of this data reliability, our smart bed could, in the future, be used for early risk-detection purposes and long-term monitoring. This validation underscores our data's value to the medical and research community and strengthens our brand reputation.

Later this year, we plan to implement our newest, most dynamic 360 smart bed technology platform with the introduction of the Climate360 smart bed and subsequent new line of 360 smart beds. While the external environment is certainly more challenging than we expected, we are effectively managing near-term risk and simultaneously creating long-term value by capitalizing on our competitive advantages, including introducing new innovations that support smart sleepers' changing needs and provide the highest quality sleep, sustaining Sleep Number's sleep innovation, health and wellness, and sleep science and research leadership position; completing the transition to our more responsive and flexible enterprise supply network; strengthening our digitization efforts to improve operating efficiency and customer experience; managing price elasticity in an environment with rising costs and promotional intensity; and proactively managing our capital and liquidity with disciplined, metric-driven decisions.

Our team's perseverance, resilience and unwavering commitment to our purpose has resulted in more than 14 million lives improved, and we are building a future where your smart bed will play an increasingly important role in your overall health and wellbeing.

Now, David will provide additional financial details on our 2022 first quarter performance and outlook for the remainder of the year.

David R. Callen

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

Thanks, Shelly. Today, I'll focus on three areas: first, our financial results, macro factors affecting performance and mitigating actions we're taking to offset pressures and risks; second, the importance of supporting our innovations and demand drivers for the long term in the face of near-term adversity, while taking actions to maintain maximum flexibility; and third, a review of key assumptions underlying our revised 2022 EPS guidance for \$5 to \$6, given the dynamic and challenging macro and consumer environments.

Let's start with a review of macro factors that changed since our Q4 earnings call on February 23 and implications on our performance. Russia's invasion of Ukraine the day after our earnings call triggered international sanctions and significant spikes in the cost of petroleum, adding risk for derivative commodities like foam and plastics. This has led to approximately \$20 million of additional input cost pressures this year from commodities, fuel, and inefficiencies caused by the uneven flow of chips.

Consumer confidence has been impacted by the rapid inflation in gas and food prices, pressuring demand in March. This, coupled with Omicron-affected demand in January, resulted in a 3% year-over-year decline in Q1 demand. We are managing the business through changes in consumer behavior, challenges of inefficient supply flow, and higher input costs while navigating geopolitical events and low consumer confidence.

As a result, we have lowered our expectations for 2022 demand growth and our EPS guidance. However, our differentiated strategy is more relevant than ever, and Sleep Number teams are highly engaged in our mission to improve lives. We remain committed to long-term shareholder value creation through our highly differentiated strategy.

Now, let's review first quarter net sales and financial details. Net sales in the first quarter of \$527 million were down 7% versus the prior year on constrained electronics supply and lower-than-expected demand. Mix of Sleep Number smart beds ordered in the quarter, which we call demand, was significantly more profitable than the mix of smart beds delivered. This dynamic meaningfully impacted our Q1 financials as seen in our metrics. We delivered 108,000 smart beds in the quarter, down 5% versus the prior year, with ARU of \$4,905, which was down 2%. Contrast this with the ARU of our Q1 demand, which increased nearly 10% versus the prior year, that is a 12-point swing in these ARU measurements, most of which is in our undelivered backlog.

During the quarter, we added approximately \$50 million of net sales equivalents to our excess backlog, bringing that total to approximately \$200 million. Q1 gross margin of 57.3% exceeded internal plans by more than 100 basis points as deliveries were level-loaded throughout the quarter and benefited from pricing actions taken to-date.

Pressures causing the 530-basis-point decline versus the prior year included the absorption of \$140 million of annualized cost increases, lower overhead absorption on 5% fewer smart beds delivered, and 25% fewer adjustable bases delivered in the quarter than the prior year due to current year chip supply constraints.

Q1 operating expenses increased nearly 7%, reflecting the challenges of operating a business in this fast-changing environment. In the face of worsening macro challenges in March, we curtailed Q1 planned spend by about \$10 million, while prioritizing near and long-term growth drivers. Despite these cost-cutting actions, the efficiency of our Q1 demand driving spend was negatively impacted by Omicron in January and by geopolitical events and low consumer confidence in March. Still, demand in the quarter exceeded deliveries due to constrained chip supply, leading to a 20% increase in backlog since December. Constrained deliveries of our most profitable sales resulted in EPS of \$0.09 for the quarter compared with expectations for \$0.30 to \$0.40.

We have responded to the changed macro-environment by trimming our spending plans and being conservative with capital deployment as we continue to support our innovations, brand support and market expansion initiatives. Our commitment to drive long-term performance is evident in the 23% increase in R&D as our teams create game-changing innovations to be launched later this year and next. We expect these new sleep solutions to fuel future demand and improve future supply by using newer chip technology and fewer components.

Our differentiators plus efficiency-driving digitization and an evolved logistic network lay the foundation for superior shareholder value creation in the years ahead. However, the current operating environment is dynamic and challenging. Our updated guidance reflects lower demand, additional cost pressures, and service of our backlog as we continue to chase electronics supply.

Let's review key assumptions supporting our updated 2022 EPS guidance. The \$5 to \$6 range is based on flat to low-single-digit demand for the growth balance of the year. Sufficient chip supply to service a portion of our excess backlog within the year resulting in low-double-digit net sales growth, and commodity and inefficient operating cost pressures arising from the uneven flow of chips that prevent us from level loading deliveries. This will be particularly challenging in Q2 when the delayed supply of chips due to the Shanghai lockdown will constrict weekly deliveries the first seven to eight weeks to about half the volume expected the final weeks of the quarter. In total, we expect to deliver fewer smart beds in Q2 than Q1, but with a much stronger profit profile, which will be partly offset by the inefficient flow of deliveries.

As a result, we now expect Q2 gross margin of 57% to 58% with improvements in the back half to 58% to 60%. We also expect to generate approximately \$200 million of cash from operations in 2022 as changes in demand, backlog and working capital are less favorable than the prior year. Year-end debt leverage is expected to be approximately 3 times EBITDAR.

We are actively managing all the levers in our control to balance near-term financial risks with our opportunity to create superior value long term. Our approach is to preserve maximum flexibility to move quickly as business conditions change. The fundamentals of our strategy and our balance sheet are strong. We continue to drive to improve lives through proven quality sleep as the means to create superior shareholder value.

Operator, please open the lines for questions.

QUESTION AND ANSWER SECTION

Operator: [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

Hi. Thank you. Good afternoon. To start off, I guess, I had a fairly simplistic question just on the Q1 results. So you did miss the EPS guidance by a fair amount, but it sounded like the supply chain played out as you expected. Demand got worse in March, but I would have figured you've been servicing the supply chain as sort of an offset. So what was the, I guess, the reason for the EPS miss relative to mid-February when it was provided?

David R. Callen

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

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Thanks, Peter. A couple of things. One, the demand in March was less than we expected. That was – we saw that change really starting February 24 associated with the beginning of the war in Ukraine. The other factor was the demand that we did generate skewed very high end, and that ended up in the backlog and contributed to what I highlighted, the 20% increase in our backlog since December, and the addition of \$50 million net sales equivalent to our excess backlog at the end of the quarter.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Okay. So maybe next, just on the guidance, you're calling for demand growth of flat to low-single-digit for the remainder of the year, but you were negative 3% for Q1. I think with a pretty good February sort of implies March was worse than negative 3%. So why would you be expecting the demand to be getting better for the balance of the year versus where you landed the last month or two?

Shelly Radue Ibach

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

A

Yeah. Peter, thank you for the clarifying questions around demand. We've made good progress in a rapidly evolving marketplace since the onset of the war. Immediately following the start of the war, we were experiencing sales that included down – double-digits versus prior year and we took actions in response to the changed consumer marketplace and with the last couple of weeks of March, we had moved that trend to down 3% to prior year and continue to make advancements and improvements as a result of the adjustments to support this particular consumer environment where the consumer is still challenged with inflation.

So April's a small sample size, but we feel our guidance of flat to low-single-digit growth for the balance of the year is appropriate based on what we've seen and the actions we've taken and the response from the consumer to the actions.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

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Shelly, as a follow-up to that, could you provide maybe an explicit example of an action you've taken where the consumers reacted positively here?

Shelly Radue Ibach

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

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Yeah. We did a significant amount of testing and iterating and adjusting throughout the month of March. And one thing that we clearly see is strength from our insiders, as well as our – the premium consumer being less affected but yet wanting an extraordinary value. So the activation is there with a strong value to the premium consumer. And, of course, we play broadly in the good, better, best. Now, I don't want to share exactly the specific tactics obviously for competitive reasons, but yet I've given you some good color there in the adjustments.

And then, I would also say, the media adjustments that we've been making moving to more productive media in this marketplace and we're seeing strong conversion, higher conversion than prior year on some of the tactics that we've been advancing and then, of course, the improvement in our demand.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Okay. Very good. Thank you so much.

Shelly Radue Ibach

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

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You bet.

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 question.

David R. Callen

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

A

Hey, Bobby.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Just wanted to quickly maybe understand a little bit more of the earnings guide for the year better. The top line stayed unchanged, but obviously we're going to service more of the backlog with the change in demand. But even excluding the first quarter miss, there's still a pretty big cut of over \$1 plus to the earnings number for the year. And I know you called out \$20 million of incremental commodities. But just any other big buckets that you can help size for us of what's driving that change in profitability?

David R. Callen

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

A

For sure, Bobby. Glad to do it. Q1 was softer than we expected both from a net sales perspective and lower EPS as you saw. So that's contributing partly to the change in the full year. We also – we do expect lower net sales for the year, but the benefit of backlog will help support that to be low-double-digit growth over the prior year, whereas in our previous guidance, we were expecting high enough demand during the year that we wouldn't actually use the backlog to benefit the current P&L.

You've highlighted, again, the \$20 million of cost pressures that we talked about, there are a bunch of inefficiencies that are new in terms of the timing of when chips arrive and are able to support deliveries. I highlighted that in the weekly delivery schedule that we expect here in the second quarter. That's an expensive way to run the business, but it's necessary and is appropriate to prioritize serving the customers in the kind of market that we're in. So those all-in impacted our thinking for the balance of the year.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Okay. And then, David, maybe just help us understand how servicing the backlog drives the difference in profitability? I mean, I was looking back and the net sales guidance is still up double-digits in the prior report versus now; you're getting more from the backlog versus demand. But how does letting the backlog flow in end up impacting profitability more than just having organic demand?

David R. Callen

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

A

Well, it's a couple of points lower, a few points lower, double-digit growth, first of all. So the actual number has come down...

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Okay, all right.

David R. Callen

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

A

The growth rate is lower than what we were talking about previously, Bobby.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Okay. That makes sense. Okay. Yeah. I was looking at double-digit versus double-digit, but I understand those mean two different things...

David R. Callen

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

A

Yeah. There's...

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Okay.

David R. Callen

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

A

...a range. Yeah. Yeah.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.



Yeah. Okay. That now makes sense. [indiscernible] (00:29:46). Sorry about that. I got two other follow-ups then. One, Shelly or David, or whoever, does the supply chain challenges potentially delay the launch of Climate360 and kind of the big launch that we were talking about in 2023?

And then, my second question, [indiscernible] (00:30:04) I can jump back off, but this is David. I mean, we're looking at gross margins in the 57-ish range versus the old range of 61% to 62%. Clearly, a lot going on in the numbers. But can you maybe size in a few buckets, what in your view is temporary pressure, and then what should we consider as more long-term pressure that will take time to gain back?

David R. Callen

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



Very good.

Shelly Radue Ibach

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



Bobby, I'll start with the response on Climate360 and then the subsequent new 360 line. We remain on track targeting late this year for Climate360. This is an important move both strategically – in all aspects strategically for us getting to this new expanded platform with a really – a game-changing innovation for the consumer. It also enables as we fully move to the new platform a reduction of the number of components and moving to more advanced semiconductor chips. So there is a lot of benefit to moving to our new innovations, and we're working very hard to stay on track with those innovations, and we are at this point.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.



Thank you, Shelly.

David R. Callen

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



And Bobby, on gross – yeah, great. And then on the gross margin question, this is fundamental to where we're headed longer term, the – and fundamental to how we thought about the pricing adjustments that we've taken to-date. We identified last year \$140 million of annualized cost pressures and took about \$140 million of pricing. That alone – just the math, that pressures gross margin rate by about 400 basis points. But the components of those cost pressures and then we added an incremental \$20-million-ish that we're seeing about this year. So about 30% of that \$160 million, we think of as temporary. And within that bucket, it would be things like using brokerage services to find components. That's a very expensive way to buy components and that's not something that's a permanent part of our cost structure.

There is expediting costs across both getting it into the country and then to get it around the country to get it to the customers timely; that's been very inefficient. The operations from our manufacturing operations, logistics operations and our home delivery operations are highly inefficient in a market where you can't – where the flow of chips is uneven and you can't level load your business. And so those are also contributing to the temporary elements. Things like labor are going to take us longer to – I call them quasi-permanent.

Over time, we will gain efficiencies through our major strategic initiatives and find ways to offset those as well. We believe that getting back into the 60s is definitely a priority and will happen, I think, as an exit rate even this year.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Thank you, Dave. I appreciate the details. Best of luck.

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David R. Callen

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

Hey, thanks a lot, Bobby.

A

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

Matthew McCartney

Analyst, Wedbush Securities, Inc.

Hi. This is Matt McCartney on for Seth. We're just wondering – just a couple of quick questions here, we're wondering how you plan on managing the advertising expense and personnel costs in a slower demand environment. And then, also wondering with leverage at 3 times, 3.4 times and worsening from the end of last year, this seems to suggest you don't have as much room to buy back stock at this point. With that in mind, should we expect muted repurchases here in the near to medium term?

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David R. Callen

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

Well, Shelly, do you want to handle the advertising part of that?

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Shelly Radue Ibach

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

Sure. We take an action here in the first quarter rapidly and pretty decisively around aligning our media dollars to the demand environment that we're in. And then, of course, testing in different ways how to utilize the media differently for higher productivity and have found some good solutions to be able to move to more productive actions in this environment. So it's a combination of cutting back but also changing and reallocating what we're doing to the more productive ways. And then, also as a result of where the demand was, we made adjustments to our staffing overall, working to continue to optimize for both our team members as well as our shareholders.

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David R. Callen

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

Very good. And, Matt, I'll add on. I just want to remind you, as you go back in time and look at how we acted when – at the onset of the pandemic back in March of 2020, we – our strategy at the time was to take actions to protect the business and also have a bias toward being able to rebound with pace. And had we not done that, we would not have been able to accelerate growth and profitability the subsequent six quarters the way we did.

A

We are approaching the current situation in a similar kind of way in the sense that we know that our innovations are game-changing and that consumers really are drawn to Sleep Number 360 smart beds. And so we want them to have improved quality sleep, and our mission is to improve lives. So our bias is to protect the future and to invest in our long-term and near-term growth drivers to go there.

So at the same time, we also have layers of contingency actions that we will activate as needed as we progress through the year. As it – this is all part of that whole leverage conversation as well, because, it all starts with demand creation for this business model. Cash comes from – cash is an outcome of that as well. And we

suspended share repurchases when we saw a tougher demand environment in March. In fact, March – early on in March, it was down double-digits. And so that was a appropriate response to the metrics that we were seeing at the time.

As we said, we have – we're expecting to end the year with 3 times EBITDAR leverage and generate about \$200 million in cash from operations. We have a substantial amount of liquidity available on the revolver. And so there is room within that guidance for share repurchases and we will keep you updated as we progress through the year.

Matthew McCartney

Analyst, Wedbush Securities, Inc.

Thanks. That's really helpful.

Q

David R. Callen

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

You bet.

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Operator: Your next question comes from the line of Atul Maheswari with UBS. Your line is open.

Atul Maheswari

Analyst, UBS Securities LLC

Good evening. Thanks a lot for taking my questions. Dave, I think and please correct me if I'm wrong here, but I think demand was up around mid-single-digit quarter-to-date when you guys like reported the first quarter. So really for you to in the quarter at down at down [ph] 3% if (00:38:18) March was down low-double-digit or even worse. So is that a right estimate of where March was on a demand basis?

Q

David R. Callen

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

Yeah, Atul. Let me just set the record straight. We had double-digit declines pretty much immediately following the invasion of the Ukraine and the pressure on consumers. We finished March with an exit rate of minus 3% for the last couple of weeks and that's in line with where we ended the quarter.

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Atul Maheswari

Analyst, UBS Securities LLC

Got it. And are you able to share how you're tracking in April thus far on demand basis?

Q

Shelly Radue Ibach

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

Yeah, Atul. April is a really small sample period with inclusive of an Easter shift as well, but we feel our guidance of flat to low-single-digit growth for the balance of the year is appropriate.

A

Atul Maheswari

Analyst, UBS Securities LLC

Okay. So then my follow-up question is really like one of the key questions that really folks in the investment committee have been trying to figure out for Sleep Number or some of its peers is what's really a reasonable floor

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for earnings. So basically, the question is, with the new guidance [ph] called (00:39:48) and the lower end of \$1.05, how do we get confidence that this does not get revised further in the next few quarters?

So have you assumed – in your expectation of demand being flat to slightly up going forward, have you assumed an improvement in the max backdrop in this guidance? But have you built in some slack over and above what your suppliers are seeing right now given all the uncertainty?

Shelly Radue Ibach

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

A

Yeah. Well, Atul, well, certainly this is a challenging environment to operate in. And we recognize that and have been working on finding ways to overcome all necessary in our demand that gives us the confidence in flat to low-single-digit growth for the balance of the year. So much of this is how to make the adjustments to be able to reach and activate the premium consumer in this new environment. And that's how we have viewed it.

And we continue to test and learn, and we're a few weeks, less than 2 months into this new environment. And we've – we're looking forward to applying our tactics in a bigger demand period like the Memorial Day period as we move forward. Q1 had really two acute external events. It had the Omicron variant in January. And then, of course, it had the onset of the war late in February. So if you – and we delivered a demand of down 3% in the first quarter. So thinking about the remainder of the quarters, we don't expect two acute external events to start within another quarter in the balance of the year. But we do consider the current environment as prolonged.

The second part of your question was how we're thinking about supply. Clearly, we have been dealing with different delays in supply. But thus far for the year, we have been steady on the allocation, although the challenges have been – timing have been different, which of course drives some inefficiencies in the business. But yet, we're still staying close with our customers who are loyal and steady, and our cancels and returns remained steady.

And the overall brand sentiment and brand leadership is strong. And we continue to navigate those delays with pretty strong outcomes, were very strong outcomes based on the advantages of this vertical model. So what we contemplate in the guidance is the allocation that we were given for this year. No, we're not baking in more than that, but we also recognize that there are delays and thus a fairly wide range in our guidance.

David R. Callen

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

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Atul, I will add on a little bit. There's another way to think about our growth expectations as well. And that is pricing and new distribution, new stores combined would add normally mid-single digits type of growth. So we're actually thinking about this in terms of having negative units, lower unit volumes this year than last. And so, that's something that you should be aware of.

And then the benefit of coming into the year with a significant backlog helps us stay steady. And in fact, helps us with our financial results for the year. We've mentioned in the past that we have the equivalent of about – we came into the year with the equivalent of about \$150 million worth of net sales in our excess backlog. As we get through the year, as long as we are able to get the supplies we need, that would – we have that as a backstop against our performance for the year as well.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Got it. That's all very helpful. Just one quick question on the pricing. When was the latest round of price increases taken? And what was the amount of the increase, if you can share, please?

David R. Callen

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

A

Yes. So we've taken – last year, we took about, call it, \$140 million worth of annualized price increases. The last one was based in October. But we took a smaller one at the beginning – sometime in the middle of Q1, as well, a very focused one. So in total, it's about 150, call it, million dollars' worth of annualized price increases. And those will – those are being actualized now. As we create new demand, those are all at the new pricing, of course.

Atul Maheswari

Analyst, UBS Securities LLC

Q

Got it. Thank you very much. And good luck with the rest of the year.

David R. Callen

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

A

Thanks, Atul.

Shelly Radue Ibach

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

A

Thank you.

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

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Good afternoon, Shelly, David and Dave. Just a follow-up on some of the recent demand trends. The timing where you've had some weakness does seem to also coincide with the big months last year for stimulus payments. Have you all had a chance to look at that more closely? And how much do you think that's been an issue for you?

David R. Callen

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

A

Well, we certainly looked at it, Brad. And with our demographic of our customer, we didn't really see a big benefit. There's – it's hard to discern, frankly. When somebody comes in and they're buying a Sleep Number smart bed, they're not necessarily telling you that they're doing it because they got a stimulus check. But we don't typically see activity surrounding when those checks got issued, just like when around April timeframe when people started getting their refunds from the IRS, we don't tend to see a lot of spike in our performance.

Shelly Radue Ibach

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

A

Brad, what we did see was a very acute change in the consumer behavior that timed perfectly with the start of the war. And that progressed. And then it also showed up in the consumer sentiment and the inflation numbers in March. And that did improve slightly at the start of April in the overall consumer sentiment. But that correlation was the strongest we could see.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

That's helpful. Just along a similar vein, are you seeing anything different of late in terms of the interest in or the uptick of your financing options with Synchrony. And can you talk a little bit about if there's been any change in approval rates? And how perhaps the cost of that financing may change for you with interest rates being higher?

David R. Callen

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

A

Well, Brad, it's certainly on our mind. As LIBOR goes up or the Fed financing costs go up, obviously, that will affect our – the discount rate that we share with Synchrony. However, we have a wide range of offerings in terms of the [ph] tenure (00:48:30) of the timing of our financing offers. And we generally look at financing and promotions as a collective bucket and manage them accordingly. We also have a great relationship with Synchrony and are coming up with creative ways to offset some of those pressures. In terms of changes to approval, either dollars or rate, we have not yet seen any impacts on either.

Shelly Radue Ibach

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

A

And Brad, I'll add one more thing, just some color, some specific color on March for our total bucket of promotion dollars and financing dollars was very similar year-over-year in total. We utilized this bucket as a conversion tool versus [ph] an attract (00:49:26) in our business, which is different than most of our competitors. So keep that in mind that if you look at our year-over-year specific promotions or financing offers, they actually look pretty different than prior year, but yet, the total is the same. And that's one of the advantages of our business model and the rapid testing and learning and adjusting that we make that we reference so often. So just a little additional color there.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

That's very helpful, Shelly. Maybe just one last one for me. With the delays that we're seeing, I mean, we're really still at some pretty long levels, while much of the industry that doesn't have the complexity that your products have is pretty widely available today. When you talk to your customers and store personnel, do you get the sense that we're seeing any demand destruction or sales loss just because the customer doesn't want to wait right now?

Shelly Radue Ibach

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

A

Well, it is such an important question, Brad. And obviously, with our model and just direct relationship with the consumer, we think very close to this. And if you asked a few weeks ago, we were one to two weeks. And then with the signal of the delay with Shanghai being shut down, we did extend that and our current delivery window is five to eight weeks. And yet, in a couple of weeks when – well, probably closer to three weeks or four weeks, when we have – when we know and see the day these chips, our airfreight – come to us through air freight, the moment they leave China, we will make the adjustment back to one to two weeks.

So it does fluctuate quite a bit. For the most part, we can service a customer who is in immediate need with a solution that is closer in. So I'm talking the majority of our smart beds are right now five to eight weeks, but there still are some in shorter – closer in delivery dates to service customers. Our team members do such a great job of developing that relationship, understanding our customers' needs and servicing them, that we have a lot of confidence that we're continuing to service the customers in the way they need to be.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

That's very helpful. Thank you, Shelly.

Q

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.

Good afternoon. Thanks. Just wanted to dig in again on the question on, I think, it's a 12-point delta in pricing between the delivered and the ordered beds in 1Q. I guess it's a little surprising given you're in environment where demand was lower. People were worried about the economy. What drove that delta? Is it some of, I guess, the new sales tactics or promotions or whatever it might be that led to higher unit conversion or higher price conversion? Could you talk on that?

Q

David R. Callen

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

For sure, Curtis. And you're talking about the 12-point swing in our ARU metrics. So the metrics that I highlighted was the 2-point decline in delivered ARU versus the nearly 10% increase in the demand ARU. And so, what you're seeing is folks wanting the full gamut of our features and benefits that come with the higher end of the line.

A

And as a result, they are willing to wait a longer period of time to get that delivered, because they – we knew coming into this quarter – into Q1, that we had some constraints on chips that were needed for our FlexFit adjustable base. It's FlexFit number 3 which comes with foot warming and other benefits that consumers really embrace. And so, that was – that's what's happening. Consumers that are out shopping want value, and they're shopping at the higher end of the line.

Curtis Nagle

Analyst, BofA Securities, Inc.

Okay. And then in terms of the negative [ph] Q (00:54:30) ticket, is it just because you couldn't deliver the beds? That's a belabor point here. I just want to make sure I understand it. But you couldn't deliver those very high-end beds with the Flex 3? Or...

Q

David R. Callen

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

That's right.

A

Curtis Nagle

Analyst, BofA Securities, Inc.

...I'm just trying to figure out why there's a difference between the two – okay. All right. That's fair.

Q

David R. Callen

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

Yeah. That's exactly right. I mean, our units were down 5% and our ARU was down 2% on the delivered side. At the same time, we added \$50 million worth of net sales benefit into our undelivered backlog.

A

Curtis Nagle

Analyst, BofA Securities, Inc.

Q

Okay. Understood. And just focusing on some of your other commentary. I don't know, I was a little surprised to hear higher gas prices called out as a potential headwind or a headwind in the quarter. And you guys sell a bed that retails for many thousands of dollars, I think, to more premium consumers. So why would that be a headwind for, I guess, a more premium consumer? I just – I'm not sure how to square that.

David R. Callen

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

A

Well, there're a couple of elements where I highlighted that in my remarks. One was the impact on consumers, and in terms of what they're seeing at the pump and the inflation impact that they're seeing on food prices. And so, I called that out as, those were triggers that were highlighted in the consumer sentiment surveys, that inflation was causing them to be more cautious. And so, we saw that for sure in March in the consumer sentiment side.

On our cost structure side, we absolutely have gasoline prices as an input cost for our business. We have 1,000 home delivery technicians around the country that are using vehicles to deliver our smart beds to customers' homes. And of course, fuel is a component that – as part of that process.

Curtis Nagle

Analyst, BofA Securities, Inc.

Q

Okay. Maybe I'll follow-up offline but...

David R. Callen

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

A

Okay. Maybe I'm missing it, so be happy to talk about it after.

Okay. Josh, any other questions? Operator, are you there?

Operator: Sorry. Yes, we do have another question. We have a question from Bobby Griffin with Raymond James. Your line is open.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Thanks for letting me sneak in one more. Just one quick follow-up. Dave, understanding, and Shelly, that the – predicting demand right now is pretty tough. But when you think about, you guys are assuming flat to kind of slightly up demand. We ended the quarter a little bit lower. Is the EPS guide more dependent on demand snapping back to where you want it to go? Or is it more dependent on just these cost side of things that are also hard to predict? And I guess, said another way, if we get to the end of the year and demand's down 3% or 5%, kind of in line with 1Q trends, do we – can we still hit the guide of \$5 to \$6 or would that be [ph] enough to drive all the guidance (00:57:27)?

David R. Callen

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

A

Bobby, there are a lot of levers to drive performance, and we're going to use them all. So if demand is lower than what we expect, obviously, we have a backlog to cushion some of that. We also have the opportunity within the business to control our spending differently. And all those levers are within the gamut of what we will do. So yes,

even if demand is down, I think you said low single digits, we believe we can still get to the low end of the guidance range.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Thank you. That's very helpful. Exactly what I was asking. Best of luck here in a tough environment.

David R. Callen

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

A

Thanks a lot, Bobby.

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

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Thanks. Dave, if I could follow up on that. So the guidance does include servicing significant excess backlog. So you're running – I think, it's around \$200 million right now. Where would the midpoint of guidance land you for servicing excess backlog? Is that being about half of it?

[indiscernible] (00:58:43)

David R. Callen

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

A

It depends on – it depends.

Shelly Radue Ibach

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

A

Yes.

David R. Callen

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

A

It depends.

Shelly Radue Ibach

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

A

Yeah.

David R. Callen

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

A

So it depends – sorry, I'm not being – trying to be elusive, Peter. But like I just said to Bobby, a lot of different things can go different ways, meaning demand could ebb and flow. Our cost structure, we will certainly ebb and flow. Supply, it's certainly shown that it can be positive and challenging sometimes. So the midpoint of the guidance, I would say, is a midpoint of our – that demand is in that positive territory for the year. And that would include less use of the backlog to get to the total, which we are saying, low-double-digit net sales growth for the year. Did I make sense? I can help you with modeling in the after-call, if that's helpful.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Yeah. Maybe just one last on for this, while we're in a public forum. The sales are difficult to model for us right now. How should we think about Q2? I mean, are we negative? Are we positive? I've no idea.

David R. Callen

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

A

Yeah. Very good. Yeah, I agree. It is hard. And you probably – look, I expect our units to be less than they were in Q1 by, call it, up to – we did 108,000 units in Q1. We'll do, call it, I don't know, call it 90,000 to 100,000 units in Q2. But our ARU will be significantly higher based on the comments that we said earlier. So our sales and our profitability is going to be much bigger than what we've had in a normal Q2.

When we get to 2023 modeling, we'll have to remind you of that so that you bake that into your thinking then as well. But because of backlog service this year and flip of having now the chips that we needed for our FlexFit 3 adjustable bases, that will benefit us in Q2 deliveries. So you should model Q2 sales higher that you would have otherwise thought.

Shelly Radue Ibach

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

A

Per net sales.

David R. Callen

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

A

Per net sales.

Peter Jacob Keith

Analyst, Piper Sandler & Co.

Q

Very good. Very helpful. Thanks so much.

David R. Callen

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

A

You bet.

Shelly Radue Ibach

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

A

You bet. Thank you.

David R. Callen

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

A

All right. Josh, I think that takes us to the end.

Operator: Yes. There are no further questions. I'll turn the call back to you 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 second quarter 2022 performance with you in July. Sleep well and dream big.

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

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