

22-Feb-2023

Sleep Number Corp. (SNBR)

Q4 2022 Earnings Call

CORPORATE PARTICIPANTS

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

Christopher D. Krusmark

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

Shelly Radue Ibach

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

OTHER PARTICIPANTS

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Seth Basham

Analyst, Wedbush Securities, Inc.

Peter Keith

Analyst, Piper Sandler

Atul Maheswari

Analyst, UBS Securities LLC

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone. Welcome to Sleep Number's Q4 and Full Year 2022 Earnings Conference Call. All lines have been placed in listen-only mode until the question-and-answer session. Today's call is being recorded. 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. Please go ahead, sir.

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

Good afternoon and welcome to Sleep Number Corporation's fourth 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 Chris Krusmark, our Interim CFO and Chief Human Resources 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'll now turn the call over to Shelly for her comments.

Shelly Radue Ibach

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

Good afternoon and thank you for joining our 2022 year-end earnings call. My SleepIQ score was 83 last night. Before providing details about our 2022 results, I'd like to express my appreciation to David Callen for his many contributions to Sleep Number and wish him well in his future endeavors. Chris Krusmark, Sleep Number Executive Vice President and Chief Human Resource Officer has assumed the role of Interim Chief Financial Officer as we conduct a search for a permanent replacement. Chris has been a Sleep Number team member since 2005 and has held a variety of financial and operational leadership roles during the past 18 years. Prior to joining Sleep Number, Chris served as a CPA in the assurance and advisory practices of EY and Arthur Andersen.

During today's call we'll review our 2022 financial performance, share early observations about the 2023 business climate and our outlook for the year, and highlight 2022's strategic milestones that underscore our long-term orientation and position Sleep Number to capitalize on profitable growth opportunities when the economic environment improves. Fourth quarter net sales increased 1% to \$498 million, with an 18% decline in demand for the quarter, which was offset by the servicing of our excess backlog. Our Q4 loss per share was \$0.24. For the full year, results included net sales of \$2.1 billion, down 3% year-over-year, and earnings per share of \$1.60. Our 2022 performance reflects the sustained impact of external business and economic disruptions that began early in the year. Constrained microchip supply, the spread of Omicron, the war in Ukraine, and skyrocketing costs drove record low consumer sentiment, which significantly reduced demand and pressured profits. Yet, as we navigated a steady stream of macro challenges, commitment to our purpose galvanized our passionate team to find creative solutions to enhance our customers' experience.

We completed two important milestones that strengthened our sleep health and wellness technology leadership for the future. We introduced the Climate360 smart bed with our new technology platform, the greatest innovation in our company history, and we completed our five-year transition to a single assembly and fulfillment network.

With the start of 2023, we are experiencing early signs of improvement in our business, associated with the following advancements. For the first time in 18 months, we have adequate chip inventory to support our full line of smart adjustable bases, including FlexFit 1 and FlexFit 2, which have been unavailable since September 2021. This enables us to offer our entire range of good, better, best to customers in an environment where price sensitivity remains high, and we are operating with normal delivery times, thanks to improvements in our microchip inventory. In addition, we are seeing somewhat more favorable economic indicators, including improving consumer sentiment. Although still near historic lows, consumer sentiment rose to nearly 65 in January, a 5 point sequential improvement versus December.

With these improvements, we cautiously increase our planned media spend to capture near-term market opportunity. We are encouraged by the related improvements in demand, traffic trends and media efficiency since taking this action. Our quarter-to-date demand is down high-single digits against our toughest 2022 comparison period and represents a notable sequential improvement from the fourth quarter. While these early 2023 trends are encouraging, we remain prudent in our planning with assumptions for 2023 reflecting continued uncertainty in the environment. We are prioritizing demand and margin improvement initiatives that support both the short- and long-term, while also controlling expenses. This combination positions us for a strong rebound when consumer

sentiment improves, although we are also prepared to execute additional contingency actions should conditions warrant.

For the full year, we expect EPS in the range of \$1.25 to \$2, and at the midpoint of our range, net operating profit growth of at least 20%. We expect to generate more than \$100 million of cash from operations in 2023, including positive free cash flow. Our recent strategic accomplishments directly contribute to our 2023 performance and benefit our business long-term, further strengthening our leadership in consumer innovation and wellness technology. For example, since its introduction last October, our Climate360 smart bed has outperformed our sales expectations, and customers are raving about how the smart bed's temperature benefits, comfort and design are improving their sleep quality. Here are a few customer comments.

One customer said great first night, perfect bed for a couple with different sleep settings and temperatures. Another stated Climate360 has greatly improved my ability to fall asleep and stay asleep throughout the night. And a third noted, I bought this bed a month ago and it's so worth it. While the Climate360 smart bed is still a small percentage of our total sales mix, better-than-expected demand is resulting in current deliveries being scheduled into late March. Our suppliers have increased component output to consistently support the higher Climate360 sales volumes and we expect to be on normal delivery times for this fabulous smart bed by the end of next quarter.

Consumer response to the Climate360 smart bed is encouraging, ahead of our planned introduction of our next-gen smart bed line, which is on track for the beginning of the second quarter. These next-gen smart beds incorporate the new technology platform, which not only supports our customers' adaptive sleep experience and related health and wellness benefits, but it also reduces supply chain complexity due to utilization of more readily available components.

In addition to our next-gen smart bed line, we plan to introduce a new lifestyle furniture collection in April, which extends our customers' sleep benefits. This furniture optimizes sleep and wake routines through ambient lighting designed to complement your circadian rhythm, and embedded speakers that create a sound blanket to minimize noise disruptions. The collection also includes optional accessories that support changes in life stages and health conditions. Early in-home testing is showing very high satisfaction.

And later this year, we will transition to our new Sleep Number app. This next evolution of our current SleepIQ app will integrate all Sleep Number digital touchpoints for a simpler experience for our millions of smart sleepers and further advance our connected health strategy. We are supporting demand initiatives with strategic partnerships, new brand marketing and media. Since restoring our [indiscernible] (10:51) portfolio, we've seen sequential demand and media efficiency improvement. We also plan to introduce the next generation of smart beds with a new marketing campaign.

World-class partnerships amplify the performance and recovery benefits of Sleep Number smart beds with impact and scale. At Super Bowl LVII, we announced a five year renewal of our partnership with the National Football League as their official sleep and wellness partner. The NFL is one of the world's largest audience engagement platforms. Our brand health and digital engagement metrics from the past five years underscore the benefits of this partnership, which includes broadening our brand reach and deepening our brand relevance. Our partnership has felt unparalleled product adoption with 80% of NFL players owning Sleep Number smart beds.

In addition to demand driving initiatives, improving gross profit is a top priority. We expect to begin realizing meaningful gross margin improvement in 2023 due to some easing in commodity cost, reduce cost premiums from using broker parts and fewer expedited deliveries, and operating efficiencies from a more even flow of

microchips. We will also begin to benefit from operating with a single, more flexible and scalable assembly and fulfillment model.

Our integrated network enables greater visibility and control of product quality that will contribute to improved service and gross margins through increasing delivery, reliability and expanding opportunities for new in-home services, providing greater supply chain flexibility and disruption optionality, and more balance in our manufacturing and distribution process, which reduces waste and drives cost savings. Each of these strategic advancements strengthens our competitive advantages, supports profit margin improvement, and enables long-term value creation for all our stakeholders.

Now, Chris will provide additional detail on fourth quarter and full-year 2022 performance and our outlook for 2023.

Christopher D. Krusmark

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

Thank you, Shelly, and good afternoon everybody. I am pleased to join you today as Interim CFO of Sleep Number. As we lead through this transition, we are fortunate to have an incredibly talented finance team, including Dave Schwantes, Vice President of Investor Relations and FP&A who will join Shelly and me for Q&A. It is a privilege to lead this experienced team during the active search for our next Chief Financial Officer.

In 2022, external factors had a significant impact on both our fourth quarter and full-year results. Reported net sales for the fourth quarter were \$498 million, up 1% versus the prior year. Our Q4 loss per diluted share of \$0.24 was at the lower end of our guidance range. We delivered 93,000 smart bed units in the fourth quarter, consistent with expectations shared in our third quarter earnings call. Our delivered ARU increased 1%, primarily due to net pricing actions.

Gross margin rate for the quarter was 54.7%, down 220 basis points from the prior year. We came in short of our gross margin rate expectations for the quarter as we faced modest downward pressure on delivered product mix and inefficiencies due to the uneven supply of chips. We offset most of this gross profit pressure with spending controls.

Our 2022 full-year results included net sales of \$2.1 billion. Full-year EPS of \$1.60 reflects a 3% net sales decline, a 350 basis point reduction in our gross profit rate and operating expense deleverage from the sales decline. We reduced planned operating expenses more than \$150 million during the year, and ended the year with operating expenses up 1% year-over-year. In 2022, we prioritized investments in long-term initiatives, including our product innovation pipeline, while reducing spending across the organization.

Interest expense impacted 2022 EPS by more than \$0.40 versus the prior year, primarily due to the average interest rate on our revolver increasing by over 200 basis points year-over-year. Despite the challenging environment, we generated \$36 million of cash from operations and EBITDA of \$148 million. We ended 2022 with \$359 million of liquidity under our revolving credit facility and a leverage ratio of 4.4 times EBITDAR, below our amended 5 times covenant.

Now let's turn to our outlook for 2023. We are excited to have had our full smart bed and base assortment in place since the end of December, benefiting from an improved flow of semiconductors. The improved chip supply has allowed us to normalize delivery times for our customers and will provide greater predictability for our manufacturing and fulfillment teams. We will also benefit from a full year of Climate360 smart bed sales

introduced in October 2022 and our next-gen smart beds and lifestyle furniture, which we will begin introducing in the second quarter.

For 2023, we expect full-year diluted EPS of between \$1.25 and \$2. Here are specific assumptions included in our 2023 outlook. We assume consumer sentiment will remain at or near current levels at least through the first half of 2023. The outlook assumes net sales are flat to down mid-single digits versus the prior year. This includes the expectations of a low- to high-single digit net sales decline in the first half of the year as we face tougher compares.

We expect improvement in the back half of the year with net sales down low-single digits to up mid-single digits when we face easier comparisons and benefit from next-gen smart bed introductions. Our net sales guidance assumes 2 to 3 percentage points of headwind from year-over-year backlog changes.

We expect our gross margin rate to improve by over 150 basis points in 2023 driven by modest improvements in commodity costs and avoidance of brokerage part premiums and expedited delivery costs, which impacted us in 2022. The improved supply of semiconductors entering the year is also expected to significantly improve our labor utilization and enable production and delivery efficiencies across our manufacturing and fulfillment operations. Pricing actions taken in 2022 including \$30 million of annualized actions taken in December of 2022 will provide ARU and gross margin rate benefit in 2023.

We are carefully prioritizing our spending in the current environment, which is reflected in our guidance for the year. At the low end of our outlook, we expect operating expenses to be down more than \$30 million versus 2022. At the high end of our guidance, operating expenses are expected to be up less than 2% year-over-year. Our guidance also includes approximately \$0.80 of pressure to fund broad-based participation incentive compensation programs. We expect next-gen smart bed launch costs of approximately \$6 million to \$7 million in 2023. At the midpoint of our guidance range, we expect to grow our operating profit by at least 20% in 2023 and our operating profit rate by approximately 100 basis points, most notably from the expected improvement in our gross profit rate. We expect 2023 EBITDA to grow more than 20% versus 2022, at the midpoint of our range, with at least 150 basis point improvement in our EBITDA margin.

Our outlook assumes interest expense of approximately \$35 million for 2023, with an expected borrowing rate on our credit facility of 7% compared to an average rate of under 4% in 2022. We are planning for an effective tax rate of 27% for the year, including discrete tax expense in the first quarter, primarily due to stock compensation accounting.

We intend to generate more than \$100 million in cash from operations in 2023 and positive free cash flows and plan no share repurchases for the year. We expect to end 2023 with debt leverage below 4 times EBITDAR. For the first quarter of 2023, we expect net sales to be flat to up low-single digits versus the same quarter last year and expect to deliver approximately 90,000 smart bed units.

I will now turn the call back to Shelly for a few closing thoughts before turning to Q&A.

Shelly Radue Ibach

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

Prioritizing innovation leadership and maintaining thoughtful strategic progress while prudently managing cost positions Sleep Number to capitalize more quickly on profitable growth opportunities in the future. It is inspiring to engage with Sleep Number team members throughout our company. I have been touched by their selfless

courage and commitment and so truly grateful for their hard work and their passion for our life changing sleep innovations, which are creating a more sustainable future for all of us.

Now, Chris, Dave and I will be happy to take your questions. Kellyanne, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll hear first today from Bobby Griffin with Raymond James.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Good afternoon, everybody. Thank you for taking my questions.

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Hey, Bobby.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

I guess first I want to touch, it seems like a bit of the outlook here to get a little bit better and profitability does center around the recovery in gross margin. And with this business it really does tick around having gross margins is close to above 60% as you can get. So can we just unpack a little further for everybody here the visibility into the 150 basis points plus? I understand there's been a lot going on the supply chain, but is it more on things now that you actually have visibility into, you have the chips, you have the costs under control, you kind of have the delivery aspect or is there still some variability in there for us to keep in mind?

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Hey, Bobby, this is Dave. Thanks for the question. Certainly improving our gross margin rate, it's a big priority for us for 2023. And as Shelly mentioned, we're looking to improve that by over 150 basis points during the year. As we've talked about over the last couple of years, we've absorbed significant commodity pressures in our cost of goods sold along with really inefficiencies that we've also taken on because of the uneven flow of chips. So the good news is that as we enter 2023, it's the first time since really September of last year that we've had the full product assortment in place and the even flow of chips that we really need to get efficiencies.

So, maybe turning to some of the specific drivers that we look for, for 2023, starting with we expect about \$15 million to \$20 million of benefit from the easing of commodities. So we've seen some modest easing of commodities here late in the year, specifically in foam. And we also are excited to no longer be procuring parts in the broker markets, which we paid premiums in those markets during last year to procure some of our components. And also we were paying expedited delivery costs. So, if you combine the commodity easing with some of avoidance to some of those costs, we see that worth about \$15 million to \$20 million of year-over-year benefit, which is about 80 basis points.

The second area that we look for is really pricing. So we did take pricing in August of 2022. We also took about \$30 million worth in December of 2022. And as you look at those pricing actions benefiting our 2023 results, we expect that to be worth about 80 basis points of benefit as well.

The third area would really be around mix. So we're excited to have our Climate360 now in our lineup. It was introduced in October, had really strong demand for it during the fourth quarter, and several of those units are sitting in our backlog as we enter 2023. And we look for those units along with a full year of Climate360 sales benefiting our gross margin rate for the year. And we do expect maybe to throw one item going the other direction, some modest deleverage from expected lower unit volume for the year. So that's going to create some fixed cost deleverage across our business. So, really kind of three main buckets with really one headwind being deleverage from unit volumes.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Thank you, Dave. That was that was very clear. I appreciate all the details. I guess, secondly, for me, you guys talked a little bit about the shape of the year with back half revenue a little stronger than front half revenue given the comparison, is there any issues on the shape of profitability as it relates to the covenants? I know you guys did some more work to I think take it up to 5 times as the ceiling for the covenant. Anything we have to think about for the first or second quarter covenant related?

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Yeah, so Bobby, as we look at the shape of the year, we certainly expect the net sales performance to be a little bit stronger in the first half of the year, part of that is just the compares we have are going to be much tougher, particularly in Q1. So we do see if you think about the proportionality of sales, a little more sales volume in the first half of the year and a little less – a little less in the first half, little more in the back half, sorry. And if you look at the EPS split, I'll say at the midpoint of the guidance, I probably think about our EPS kind of being 40% to 45% in the first half of the year and the rest of it being in the back half of the year. Relative to the covenants, we did have an amendment that we did back in October that did amend our covenants to be up to 5 times leverage through the second quarter. And our forecast had as well within those leverage covenants through the second quarter and through the balance of the year.

Bobby Griffin

Analyst, Raymond James & Associates, Inc.

Q

Thank you. That's exactly what I was looking for. I appreciate all the details. Best of luck here navigating this.

Operator: We'll hear next today from Peter Keith with Piper Sandler.

Peter Keith

Analyst, Piper Sandler

Q

Hey. Thanks. Good afternoon, everyone. Looking at the sales guide, there is a lot of puts and takes, and I was hoping you could kind of break it down for us, just in terms of how you're thinking about demand versus pricing versus backlog recognition and then the other factors that I may not be thinking of.

Shelly Radue Ibach

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

A

Great. Thanks for the question, Peter. I'll start and Dave can provide some additional color here. First of all, I'll just start with we're really pleased with the sequential demand improvement that we've experienced since restoring our full line of smart adjustable bases with normal delivery timelines as a result of having the semiconductor chip inventory. So we're well positioned with our chip inventory for the balance of the year. And February represented another step up from January. So we're happy to see that against our most difficult compares. And at the same time, we know that as we progress through the year, the compares get easier. So that's a little bit on the shape.

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Yeah. I think, Peter, maybe add a little bit of color on both ARU and units, which I think is embedded in your question. So we are looking at ARU being up at least mid-single digits for the year. There's a few areas that we think are going to be benefiting us in the year. Number one, pricing, so the pricing I mentioned in the gross profit question, that's going to be a plus up as well as really the benefit of mix. So the Climate360 smart bed, it starts at about \$10,000 for that product. And as that gets in our mix, it really helps with ARU as well. So that's how we see the ARU side of the business.

Implied in our guidance of being flat to down mid-single digits for net sales would imply we expect units to be down year-over-year. I think as we progress through the year, we do expect the greatest challenges in the first quarter and then expect those to moderate, particularly as we're up against the easier compares the balance of the year. So maybe just to touch on quickly on the industry, the industry data isn't out yet for the year, but we actually believe that, like others, that I think the bottom is probably [indiscernible] (29:39) units in 2022, but we're just not frankly expecting any significant improvement in units in 2023. And we really think it's prudent just based on how we see the metrics in our business to be cautious about the top line and not get ahead of ourselves in terms of the unit expectations for the year.

Peter Keith

Analyst, Piper Sandler

Q

Okay. And within that, I think maybe Chris said it, but I didn't get it then, but how much backlog revenue would be recognized in 2023?

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Yeah. So Peter, we ended the year with about \$40 million of excess backlog and largely we expect that to benefit the first half of the year. So we talked about year-over-year we still expect a drag because of year-over-year backlog changes. So we did get more benefit from backlog in 2022 than 2023. But specifically that backlog that we have at the end of the year, we do expect it to largely benefit the first half of the year.

Peter Keith

Analyst, Piper Sandler

Q

Okay, great. And another topic that's getting more attention is just financing costs with the rise in interest rates. So, you guys through a third-party, finance about 50% of your beds. What are you guys seeing with financing costs and maybe are you – or is that going to show up in the P&L at all or do you have to cut back on the months of interest-free financing provided?

Shelly Radue Ibach

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

A

Yeah. Peter, that's a great question. We utilize both discounts and financing as conversion tools in our business. And we think about them as a total bucket and have pretty creative approaches depending on the current environment to be about to execute in different ways. Financing is definitely more costly and in fact added about 100 basis points of pressure in 2022. So as we are here in 2023, we're actively managing the financing cost along with our discount bucket, so we're thinking about it in totality. I think a good example would be during the President's event, we had 24 months financing on the low end of our line that carries a lower gross margin and then 36 months on the balance of our line. So just being creative in our approach to be able to mitigate that cost while still driving the performance.

Peter Keith*Analyst, Piper Sandler*

Okay. Thank you very much. That's helpful.

Operator: We'll hear now from Brad Thomas with KeyBanc Capital Markets.

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

Hi. Thanks for taking our questions. The first is around the assortment. And I know that you had limited or no availability of some of your popular selling adjustable bases. I was wondering if it's possible just to frame up for us and I know you have to estimate in the puts and takes, but how you maybe think of what kind of headwind you had from an assortment standpoint from not having products available and when we think we could get to the point where they're all available with the assortment that you want to have here for this year.

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

Great. Thank you for the question, Brad. We had the constrained microchip challenge for the past 18 months. And that resulted in us not having the FlexFit 1 and the FlexFit 2 adjustable base in our assortment up until December 26, 2022. So, at first it didn't appear to be hurting our demand. But once the consumer sentiment fell last May, it really had an impact on our performance from what we could see, and we could see that on the digital behavior from customers. And so, we are so excited to be in this position of having the microchip inventory, not only for our full assortment, which means we have good, better and best smart adjustable bases to support our full line, but also having the normal delivery time periods.

I guess the best way I can describe how big of an impact it had would be the sequential improvement that we've had from December in fourth quarter, having demand down 18%. And then, right now, quarter-to-date, down high-single digits. That's a pretty significant improvement that we saw right away with the change. And then the media effectiveness has been real strong as well. And then here in February, another step up in performance during our most difficult compare.

So we're super excited to be operating on all cylinders again and having the effectiveness of our selling process with good, better, best and then the Climate360 on top of that. And then, heading into the balance of the year with introducing our next generation of smart beds with new creative and lots of initiatives to be able to drive performance, especially as that consumer environment or when the consumer environment improves.

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

That's helpful, Shelly. And to dovetail off of that, can you talk a little bit about the approach you'll be taking with advertising and with operations kind of tightening up here, given that the world is hopefully getting better than it was during the height of the pandemic. How are you feeling about perhaps putting more into advertising here to see if you can drive some greater traffic?

Shelly Radue Ibach

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

A

Well, we started doing this when we returned to our full assortment and normalized delivery time periods at least against our plans, and at the same time we're driving media effectiveness, and I think that's important to highlight. So we're going to be prudent in our approach and continue to drive performance and cautiously take steps forward that we're definitely making some good progress and we have new creative to support our next-gen smart beds.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

I appreciate it. Thank you, Shelly.

Operator: We'll hear now from Seth Basham with Wedbush Securities.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Thanks a lot and good afternoon. My first question is if you could add some more color on the improving demand trends quarter-to-date? What was the decline in demand in each of January and February? And if you look at on a two-year stack basis, was there much improvement from January to February?

Shelly Radue Ibach

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

A

Hey, Seth. As I highlighted, we're down a high-single digits quarter-to-date with a step up in February. If you look at last February for the President's event, we were up high-single digits against a record year the year before. And so definitely a step-up in our performance here this year and against tougher compares.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

That's good to hear. But you're still anticipating no material improvement for the remainder of the quarter despite the fact that compares eased?

Shelly Radue Ibach

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

A

As we look at it, the backdrop is still a very cautious consumer with inflation and drawn-down savings and higher interest rate variability. So, we're just entering that very in a very prudent manner. Consumer sentiment has the highest correlation to our trends overall. So, well, we'll see. We're going to continue to take steps forward and at the same time be very prudent.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Yeah. Thank you. And then my second question is on SG&A. Just thinking about some of the moving pieces in 2023, you talked about advertising before. Should we think about advertising being a point of leverage? And then on incentive compensation, that seems like a pretty big leverage point. Are there any other big moving pieces to think about? Thank you.

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Yeah. Hi, Seth, this is Dave. Thanks for the question. I think if you look at SG&A kind of broadly, we would expect modest leverage from SG&A in total. And really that's primarily due to the fact that we are guiding to sales being flat to down mid-single digits. So, at the midpoint of our guidance, I think in total, you're looking at total operating expenses pretty flat year-over-year, but with some modest leverage because of where we have the sales pegged.

As you kind of move through the different elements of SG&A and you look at sales and marketing, we would expect some leverage in marketing overall and some deleverage in selling. Again, we have more fixed cost in the selling side, so they do tend to deliver a little bit more and we do expect to see improved marketing efficiency as we benefit from having our full product assortment, normalized delivery times, and then we're excited about the next-gen products that we're introducing here in the second quarter. So, we think that all is going to lead to some improved marketing efficiency year-over-year.

We are expecting some modest deleverage if you think about G&A and R&D combined. I think if you look at base spending, base spending would actually be down slightly. But then when you do bring in the funding of very important variable comp programs for the broad-based employee set, that does bring in some pressure relative to just the overall leverage in G&A and R&D.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Got it. That's helpful. And the pressure from higher financing interest costs, that flows through the selling component of SG&A?

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Yeah, so the financing expense itself that we utilize at the time of purchase, that runs through our sales and marketing line. The interest and cost obviously related to our revolver runs through the interest expense line, which is [indiscernible] (41:42).

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Got it, all right. And you expect that line to deleverage in 2023, the financing cost associated with promotional financing programs?

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

A

Actually we expect financing to be relatively flat. I think Shelly mentioned that we had about 100 basis points of deleverage in 2022. But we aren't expecting that to be a big source of deleverage in 2023, in part because of how we're going to manage the programs.

Seth Basham

Analyst, Wedbush Securities, Inc.

Q

Understood. Thank you very much.

Operator: [Operator Instructions] We'll hear next from Atul Maheshwari with UBS.

Atul Maheshwari

Analyst, UBS Securities LLC

Q

Thank you. Good evening and thanks a lot for taking my questions. Shelly you mentioned a couple of times about normalized delivery times, even supply of chips and some of the excess cost you've incurred last year that should potentially not recur this year. So would it be fair to say that Sleep Number's supply chain has largely normalized at this point?

Shelly Radue Ibach

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

A

Has largely, I'm sorry, you cut out...

Atul Maheshwari

Analyst, UBS Securities LLC

Q

Is the supply chain...

Shelly Radue Ibach

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

A

Yeah...

Atul Maheshwari

Analyst, UBS Securities LLC

Q

...largely back to normal?

Shelly Radue Ibach

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

A

Yes. Yes, that's absolutely fair, Atul. Thank you.

Atul Maheshwari

Analyst, UBS Securities LLC

Q

Okay, great. So, in that backdrop, Shelly, you're still guiding to gross margin, which is more than 200 basis points below your peak level. I guess what is holding back the gross margin even with normal supply chain? What are some of the drags on gross margins that still exists today that you should be able to potentially recover in later periods?

Shelly Radue Ibach

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

A

Yeah, I'll start and Dave can add some additional detail. But first of all, let me just start with, we expect improvement this year of at least 150 basis points in both the easing of commodity cost is as well as having the even flow of chip inventory so that we don't have the stops and starts in our delivery timeframe and also not using

the airfreight and the expensive broker markets that we've had to these past couple of years. And then, we still have significant inflation cost on board that we took on this last year. And pricing has offset some of that and we are seeing some easing in the commodity cost, but we have more work to do to get back to the rates that we were at before. And that will take us this year and into next year.

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

Yeah. I would just add...

A

Atul Maheswari

Analyst, UBS Securities LLC

Go ahead.

Q

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

Atul, I would just add that – this is Dave, sorry, that if you think about our business, I mean, we certainly have been investing and developing the business to support our long-term trajectory. So we just completed at the end of last year a whole new delivery network which is supporting a much improved customer experience. And we're excited to as we rebuild our unit volumes, to really leverage that new network that we've established. And so, as I mentioned earlier, we think we're probably at somewhat trough-ish levels for units, for the industry and probably for ourselves. And as we rebuild our units over time, that presents huge efficiency and leverage opportunities that we can scale across the business.

A

Atul Maheswari

Analyst, UBS Securities LLC

Got it. Couple of follow-ups here, are there costs that are partly are – currently that you believe are structurally higher than where they were pre-COVID. Could you share some examples if you have? And is it realistic for us to expect, again, I'm not asking for a timeline, but is it realistic that Sleep Number can get back to 2019's gross margin level of around 62%?

Q

Shelly Radue Ibach

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

Yes. It's definitely realistic for us to get back to our prior margin levels. And as Dave mentioned, the unit leverage is an important aspect of that as well as the commodity cost and the labor cost are all elevated. And those are pressures right now. So we have headwinds that we're managing. We have key initiatives to drive our margin over the next couple of years, and we have a lot of confidence in our ability to do so.

A

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

Yeah, and keep in mind, Atul, as we think about the gross margin improvement for the year of over 150 bps, we're doing that against a backdrop of sales expectations that are kind of flat to slightly down. So I think we are going to be working – have some unit deleverage working against us, but we do expect to continue to get leverage over time and also really claw back some of the commodity pressures that we've been facing.

A

Atul Maheswari

Analyst, UBS Securities LLC

Q

Okay. Awesome. That's super helpful. Thank you for that. And good luck with the rest of the year.

Shelly Radue Ibach

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

A

Thank you, Atul.

Operator: And with no other questions at this time, I would like to turn things back to the company for closing remarks.

Dave Schwantes

Vice President of Finance, Investor Relations and FP&A, Sleep Number Corp.

Thank you for joining us today. We look forward to discussing our first quarter 2023 performance with you in April. Sleep well and dream big.

Operator: And that does conclude today's conference. Thank you all for joining us and you may now disconnect.

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2023 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.