

**S&P Global**  
Market Intelligence

# Sleep Number Corporation

NasdaqGS:SNBR

## *Earnings Call*

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# Call Participants

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## EXECUTIVES

**David W. Schwantes**

*Vice President of Finance, Investor Relations & Decision Support*

**Francis K. Lee**

*Executive VP & CFO*

**Shelly R. Ibach**

*CEO, President & Chair*

## ANALYSTS

**Atul Maheswari**

*UBS Investment Bank, Research Division*

**Bradley Bingham Thomas**

*KeyBanc Capital Markets Inc., Research Division*

**Peter Jacob Keith**

*Piper Sandler & Co., Research Division*

**Robert Kenneth Griffin**

*Raymond James & Associates, Inc., Research Division*

# Presentation

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## Operator

Thank you. Welcome to Sleep Number's Q3 2023 Earnings Conference Call. [Operator Instructions] 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.

## David W. Schwantes

*Vice President of Finance, Investor Relations & Decision Support*

Good afternoon, and welcome to the Sleep Number Corporation Third Quarter 2023 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 Chair, President and CEO; and Francis Lee, our Chief Financial Officer. This telephone conference is being recorded and will be available on our website at [sleepnumber.com](https://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 R. Ibach

*CEO, President & Chair*

Good afternoon, everyone. My Sleep IQ score was 91 last night. I'm pleased to be joined on this call by our new CFO, Francis Lee, who brings significant relevant experience to Sleep Number as we evolve our operating model and maximize our competitive advantages to drive long-term shareholder value. The third quarter was challenging. As the demand trajectory abruptly changed in August and September, we acted quickly, taking immediate actions to recalibrate our sales and marketing approach, further reduce costs and strengthen our balance sheet. As a result of these broad-based actions, we are better positioned to navigate a range of economic environments next year and fulfill our purpose of improving the health and well-being of society through higher quality sleep. During today's call, I'll focus my comments on steps we have taken to build a more durable operating model for efficient growth, increased profitability and cash flow generation. Then Francis will provide further details on Sleep Number's financial results and guidance.

As context, macro volatility continues to pressure consumers. The bedding industry has now been operating at recessionary levels for 2 years. We estimate that industry demand was down double digits in the quarter, and mattress units on a trailing 12-month basis are below 25 million units, down nearly 20% from 2019 and at their lowest level since 2015. With sequential improvements in Sleep Number demand trends through the first 7 months of 2023, we expected to benefit from stronger year-over-year demand trends in the back half of the year. However, industry demand weakened significantly in the quarter as consumers purchasing power moved to the lowest on record. Consumer behavior shifted from spending selectively to scrutinizing their spending and price to value took on heightened importance in their purchasing decisions. Our marketing, digital and sales promotional strategies were not optimized to address this increasingly value-seeking and price-sensitive consumer behavior. Despite consumers' continued strong desire for our products perceived affordability of the Sleep Number smart bed became a real barrier. Our year-over-year demand for the quarter declined low double digits, similar to estimated Q3 performance for the industry. This decline in demand weighed on our third quarter results and 2023 outlook.

Net sales of \$473 million were down 13% from the prior year, representing a meaningful departure from our expectations of a low to mid-single-digit net sales decline. We have lowered demand expectations for

the fourth quarter to a mid-single-digit decline, and we are revising full year earnings guidance to a loss of up to \$0.70 per share, including \$0.35 per share of estimated restructuring costs. With the change in consumer mindset and behavior, our teams assess, tested and activated sharper communication of our value and differentiation to convey more clearly the affordability of our smart beds. The first iteration of our new advertising campaign was implemented in mid-September, and we are seeing progressive improvement in digital traffic as a result. The new messaging focuses on Sleep Number's differentiation. The individualized experience of sense and do adjustable firmness and temperature starting at entry-level price points. After completing additional market studies, the second iteration of this new advertising program will be implemented this week. We also simplified the online experience to allow for easier comparisons between our different smart beds. And we adjusted our promotional strategy and in-store experience to ensure each customer identifies and selects the smart bed that fits their household budget before we sell the entire solution. These changes contributed to improved sales conversion in October.Â

Finally, to strengthen our competitive positioning, we reworked our media strategies and plans to focus on greater efficiency and improved ROI from our media spend based on the current marketplace dynamics. We aggressively renegotiated media deals to lower our costs while generating greater impressions among our target customers. With these changes in additional test in market, we are holding our media spend below prior year levels and will selectively add back media dollars as we gain traction with the cautious consumer. Collectively, these actions yielded improvement in October demand to a mid-single-digit decline, which is consistent with our revised fourth quarter demand expectations. In addition to these sales and marketing initiatives, we have taken further cost actions to improve profitability and drive incremental cash flows.Â

These actions include targeting approximately \$50 million of operating expense reductions in 2024 on top of the \$80 million of reductions we expect to realize in 2023. We have implemented a reduction in workforce across all areas of our business, including corporate and R&D. We don't take this action lightly, but we believe these reductions are important and necessary to align our cost structure with the ongoing challenging market conditions. We are rationalizing and optimizing our store portfolio in slowing the rate of new store openings and remodels, reducing our 2024 capital expenditures. We expect depreciation to be significantly greater than CapEx next year as we focus on cash flow generation and reducing our outstanding debt balance. And we are advancing procurement initiatives and cost efficiency strategies to lower our cost of goods sold and accelerate gross margin improvements. These initiatives include optimizing our supply chain and manufacturing operations to improve efficiency. Additionally, we have taken further steps to strengthen our balance sheet. We worked with our bank group to amend our financial covenants to provide greater flexibility through 2024.Â

In summary, the actions we have taken position our business to generate positive free cash flow in a range of scenarios in 2024 and support our return to double-digit EBITDA margins in the next few years. Furthermore, to support effective and efficient stewardship of our resources in the current demand environment, we have also initiated targeted cuts to our R&D spending. As you know, innovation is one of our core strengths, setting new standards in the sleep industry.Â

Over the past decade, we have built a best-in-class retail experience and introduced groundbreaking sleep solutions that transformed our company from a specialty mattress direct marketer to a digitally connected sleep wellness platform. With over 800 patents and patent applications pending worldwide, our renovation pipeline remains robust. The combination of our trademark, individualized comfort and adjustability features with AI, biometric analysis and other digital tools creates the sleep wellness platform, which is the foundation of our long-term value proposition across the continuum of care. We already have nearly 3 million connected sleepers with an average of 80% monthly active smart bed users. This high engagement leads to increased customer lifetime value and higher referrals of new customers. We believe we can expand our market relevance beyond the traditional mattress space into wellness technology and data, where there are many untapped consumer opportunities to solve persistent issues with sleep.

The Sleep Number team is intently focused on improving our business performance. We are also evolving our Board to broaden its mix of skills and experience to support our team's efforts. We are pleased to welcome 2 new directors, Steve Macadam, and Hilary Schneider to our Board. Steve and Hilary, our accomplished public company executives and directors with extensive experience in growing and

transforming businesses for value creation. We look forward to working with them towards our mutual goal of delivering superior shareholder value over time. I am deeply grateful to all our team members, especially during this challenging time for their agility and resilience and want to express my appreciation for their unrelenting commitment to our purpose. In addition, I want to congratulate our passionate sleep professionals on the well-deserved recognition for their exceptional service.Â

Last week, Sleep Number earned the J.D. Power #1 ranking in customer satisfaction for mattresses purchased in-store and J.D. Power's top brand for price, variety of features and warranties. I also want to acknowledge and thank our business partners and suppliers who continue to support Sleep Number as we build a more agile and flexible business. Their dedication, together with our talented team, streamlined operations and innovation pipeline position us to capitalize on future market opportunities and deliver meaningful value for our shareholders. Now I'd like to welcome our CFO, Francis Lee to his first earnings call with Sleep Number. Francis has extensive experience in corporate finance and strategy and a track record of evolving business models, increasing cash flow and growing profitability at consumer-facing and technology companies. We welcome his expertise and fresh perspectives as we enter this exciting period of transformation to support sustainable profitable growth. With that, I'll turn the call over to Francis, who will provide additional details on the quarter's results and full year guidance.

**Francis K. Lee**

*Executive VP & CFO*

Thank you, Shelley, and good afternoon, everyone. Before I begin, I wanted to share a bit about my background in joining Sleep Number. I spent the last 15 years of my career in a variety of finance and strategy roles at leading consumer product, retail and technology companies. Most recently, I served as CFO of Wise Labs, an AI-powered smart home technology company, where we transformed the company's model from hardware to software solutions. Before that, I spent 13 years at NIKE, including as CFO of NIKE Japan, where we reset the business to deliver double-digit growth and significant margin expansion. And in global finance roles leading profitable growth initiatives across the enterprise. Sleep Number is undergoing a period of intense change. I believe that my background is well suited to help us through the current restructuring and to generate long-term shareholder value. As we transform our operating model, we will pursue sustainable, profitable and capital-efficient growth. We are taking a disciplined approach to strengthening our business through expense management and resource allocation that drives strong returns on invested capital. We are focused on paying down debt while assessing our optimal leverage to strengthen our balance sheet and enhance the durability of our operating model.

Now let's move on to the results from the third quarter. Third quarter net sales of \$473 million were down 13% versus last year and below our expectations of down low to mid-single digits for the quarter. We leveraged our fulfillment network to deliver incremental smart beds from our existing backlog to help offset a portion of the demand decline. Our third quarter gross margin of 57.4% was up 130 basis points year-over-year and included the benefit from pricing actions taken over the past 12 months and improvement in commodity prices, partially offset by fixed cost deleverage from the year-over-year unit decline and a higher mix of smart adjustable basis versus prior year. Focused spending controls drove a \$25 million reduction in operating expenses versus the prior year's third quarter with year-to-date operating expenses down \$60 million versus last year. Expense reductions were across all areas of the business, including reduced marketing spend to further align our cost structure with the challenging demand environment. G&A and R&D spend were down a combined 12% for the quarter, reflecting ongoing discretionary cost management.Â

For the quarter, we generated net cash from operating activities of \$13 million, demonstrating the cash flow generation of our business even in a difficult demand environment. Net operating profit of \$5.4 million was down \$7.3 million versus prior year. Demand-driven gross profit shortfalls were largely offset by operating expense savings year-over-year. Our third quarter results include a \$0.10 net loss per diluted share versus earnings per share of \$0.22 last year. Since the abrupt change in demand trends in August, we have been diligently executing our contingency plans. We have identified additional opportunities to streamline our operations to adapt to market changes in the bedding industry that may remain under pressure in 2024. These initiatives and programs are well underway and will augment actions we have already taken this year. The additional cost actions we have identified include approximately \$50 million

in operating expense reductions next year on top of the \$80 million of reductions expected for 2023. We have engaged an external firm to provide program management and support to help us fully realize the benefit of our efforts and accelerate outcomes. We look forward to moving through this work with speed and care.

Our restructuring actions include a reduction in workforce by around 10% or approximately 500 team members. We have been aggressively managing our costs, and this initiative is in addition to a significant reduction in headcount over the past 18 months. With the recent actions, we expect to enter 2024 with total team members 20% below 2021 levels and 5% below 2019 levels. We are also rationalizing our store portfolio to align with the current demand environment. Specifically, we expect to close 40 to 50 stores through 2024. While closing stores will create some demand pressure next year, we will minimize the impact by focusing on effective sales transfer, both digitally and to stores within the same markets. Depending on the timing of store closures, we expect the net impact to be a 1- to 2-point headwind on 2024 net sales growth. We are also accelerating our value engineering and cost optimization strategies to further lower our cost of goods sold as we target a 60% or greater gross margin rate for next year. While we have not finalized all of our plans, we do anticipate up to \$20 million of onetime costs related to our restructuring efforts. We expect approximately \$10 million of the onetime costs to be recorded in the fourth quarter of this year and the remainder next year.

These recent actions are part of our overall cost management strategy, which we have been progressively executing against as we respond to a changing consumer in a dynamic macro environment. Over a 2-year period from 2023 through 2024, we are targeting a cumulative operating expense reduction of approximately \$130 million or an 11% reduction versus 2022. To drill down on the cost actions mentioned, of the \$80 million of operating expense reductions we expect in 2023, approximately \$25 million are fixed. Of the approximately \$50 million of incremental cost reductions targeted for 2024, we expect around 75% to be fixed. From this more streamlined base, we will be disciplined in allocating resources toward our highest return initiatives. We have also worked with our bank group to amend our bank agreement to provide increased flexibility to enable us to restructure the business and adapt to market conditions. We revised covenants to provide increased flexibility through the end of next year. This includes revisions to our net leverage ratio covenant calculation to utilize our balance sheet definition of lease liabilities as opposed to the prior calculation, which utilized 6x rents. Please refer to Page 9 of our news release for more details on how the new calculation differs from the prior version, which was in effect through the end of the third quarter. We have rightsized our credit facility to \$685 million, which aligns with the size of our business. We also worked with our banks to exclude up to \$30 million of onetime cash costs from our covenant calculations.

Turning to full year guidance. For 2023, based on our demand trajectory exiting the third quarter, we are now forecasting a net loss per diluted share of up to \$0.70 per share, including \$0.35 per share of onetime restructuring costs anticipated for the fourth quarter. Let me unpack some of the underlying assumptions in our revised outlook for the year. For the full year, we expect net sales to be down low double digits. For the fourth quarter, we also expect net sales to be down low double digits, including 8 to 10 points of pressure from year-over-year backlog changes. As a reminder, last year's fourth quarter included 40 -- around \$40 million of benefit from backlog service. We expect approximately 100 basis points of gross margin rate expansion for 2023, aided by pricing, commodity prices and manufacturing efficiencies, partially offset by unit deleverage and increased smart adjustable base attach. We expect \$42 million of interest expense for the year. As mentioned earlier, we continue to moderate costs in alignment with our demand outlook and expect full year 2023 operating expenses to be down around \$80 million versus prior year. We will provide our detailed 2024 guidance on our year-end call.

In the meantime, here are some early thoughts on how our restructuring actions support our planning for next year. We are focused on generating positive free cash flow next year across a range of scenarios, benefiting from the operating expense reductions we have taken year-to-date and other actions we are executing. We also expect a significant reduction in capital expenditures next year. With the restructuring actions we announced today and long-term opportunity intact, we remain confident in our ability to generate sustainable, profitable growth and value for our shareholders. Operator, please open the line for questions.

## Question and Answer

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### Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. [Operator Instructions] Your first question comes from the line of Bobby Griffin with Raymond James.

### Robert Kenneth Griffin

*Raymond James & Associates, Inc., Research Division*

I guess first up for me, I just wanted to more understand kind of the progression of the quarter and what exactly kind of changed from your -- the consumer perspective. I fully understand the industry is not great right now and things might have slowed sequentially. But looking back, this is probably the lowest unit number out of Sleep Number since 3Q of 2013 or 2014, depending on if my data is correct in the model. So what exactly from speaking in July changed? Did the financing not resonate? Did the marketing message when we are tooling with marketing dollars, did that not resonate? Like what exactly changed in the store base was about 200 stores less back then. So it's a very significant unit decline is, I guess, what I'm getting at here.

### Shelly R. Ibach

*CEO, President & Chair*

Yes. Thanks for the question, Bobby. Yes, this is clearly not the quarter we expected. And no doubt, it's a very tough environment to predict consumer behavior. We had been making progressive improvement for the first 7 months of the year and exited July at flat to prior year performance. So the abrupt change in August to down double digits, which persisted through September was certainly not our horizon. So clearly, a number of things happened. And our performance was consistent with what we forecast the industry performance to be for the quarter. But as you know, I mean, we expect to not just hold share but take share and perform better, especially with all of our big drivers in the marketplace and at work. So a couple of things. We dug into the consumer in depth, and the consumers' purchasing power moved to its lowest level on record. That's when we saw the behavior shift and they shifted from a spending selectively to really scrutinizing their spending, making very prudent decisions. And this led to the severity of the demand change.Â

We assessed everything in our business and especially with the consumer. And we did research on those customers who interacted with our brand. We call them leads during this time frame. Those leads who did not buy yet. And they had a perceived affordability barrier for our smart bed. That is the #1 factor across the board. Our execution was too focused on selling the overall smart bed system, meaning both the smart bed and the smart adjustable base driving a very high ARU. So for example, our selling process presented the entire solution upfront and customers fell in love with it, but they weren't willing to spend that much at this time when they're scrutinizing their spending. So we pivoted and changed our execution in a coordinated manner across sales and marketing. We changed our messaging to focus on our differentiated value proposition, adjustable firmness, comfort and temperatures starting at our competitive price of \$1,000. We changed our online and in-store experience to focus on selling the smart bed first. And making sure that we were first and foremost, fitting the customers' budget, then we introduced the smart adjustable basis, and we reworked our media strategies and plans for greater impressions against our target customers for lower cost. And these changes all went into place in the last couple of weeks of September, early October and performance improved to down mid-single digits.Â So concurrently, while we were making these changes, we also began our restructuring to strengthen our model to make sure that we're more enduring through this volatility and certainly have a laser focus on driving incremental cash flows.

### Robert Kenneth Griffin

*Raymond James & Associates, Inc., Research Division*

Okay. One follow-up on and then additional nonrelated question to the top line. But did the Synchrony partnership changed during the quarter where they tightened rates, and that was part of the reason

you weren't -- you guys weren't able to successfully sell the whole package, the financing aspect as a percentage of sales changed drastically during the quarter that we need to understand?

**Shelly R. Ibach**

*CEO, President & Chair*

Yes. Thanks. I meant to touch on the financing. We dug deep into financing to try to understand with that having any of the changes we've made was having a negative impact on our demand and conversion. And we do not believe that our financing strategy had a disproportionate negative impact. It was very clear that our biggest opportunity is perceived price value of our smart beds.

So the financing actions we have taken have helped mitigate significant financing cost pressures that we've faced all year. But during this time and during the Labor Day in particular, we had consistent year-over-year financing offers. So we did not see that as a factor here. And the relationship hasn't changed. We've actually made adjustments to make sure that we are neutralizing this and that to rule it out as a factor.

**Robert Kenneth Griffin**

*Raymond James & Associates, Inc., Research Division*

Okay. Thank you. And then, Francis, welcome to the team and nice to meet you over the phone. I guess my question is just on the OpEx reductions and the store closures. Are the 40 to 50 store closures that we're targeting, are they negative 4 to wall EBIT or EBITDA stores? And if not, can we talk about a little bit of like what's implied in the recapture rate because then they are generating EBIT and EBITDA in that emeriti would have to have some type of recapture to make it net out and be a positive impact.

**Francis K. Lee**

*Executive VP & CFO*

Bobby, thanks for the question. It's nice to meet you, too. So as we thought about which stores we're looking to close, we are definitely looking at stores that are lower profitability within the portfolio and also ones that have naturally expiring leases so that we're minimizing additional lease buyout purchase costs. The recapture rate for these stores, we're also looking at are ones that we can effectively transfer and have performance within the DMA that could basically be absorbed within the market effectively. So again, we're looking to -- in this abrupt change of this demand environment, reduce some of our fixed costs, adjust our store base to align with the demand environment out there. And when we do come out of this position off of a lower fixed cost position, be able to accelerate in a more profitable way off of our store base.

**David W. Schwantes**

*Vice President of Finance, Investor Relations & Decision Support*

Bob, just to add to that, Bobby, this is Dave. So if you look collectively at the stores we're closing, they do, on average, have positive 4-wall profit. Where we pick up incremental profit is as we transfer those sales to other stores, and eliminate the fixed cost of the stores we're closing, that is absolutely going to be a net positive. So we're not looking at a situation where we're necessarily closing a significant number of stores that are 4-wall negative.

**Robert Kenneth Griffin**

*Raymond James & Associates, Inc., Research Division*

Okay. So when I look at the \$50 million for next year is the largest portion of that \$50 million, the corresponding lease and employee expense of those closed stores? Or are there other areas inside the operation that are getting cut as well?

**David W. Schwantes**

*Vice President of Finance, Investor Relations & Decision Support*

The \$50 million of operating expense reductions for next year is that \$50 million you front.

**Robert Kenneth Griffin***Raymond James & Associates, Inc., Research Division*

The large portion of that, the corresponding lease expense and store and employee cost that comes to those store closures? Or as there other areas of the operations that are getting cut as well or getting rationalized, I guess, to say.

**David W. Schwantes***Vice President of Finance, Investor Relations & Decision Support*

It will be a holistic view of our overall cost. But certainly, the stores action is a piece of it.

**Shelly R. Ibach***CEO, President & Chair*

Yes. It's broad-based, Bobby, from G&A, R&D, headquarters, stores, changes in manufacturing and also our logistics network.

**Robert Kenneth Griffin***Raymond James & Associates, Inc., Research Division*

Okay. I appreciate the details on the extra question. I'll jump back in the queue.

**Operator**

Your next question comes from the line of Peter Keith with Piper Sandler.

**Peter Jacob Keith***Piper Sandler & Co., Research Division*

So Shelly, I just want to come back to Bobby's first question because we're really trying to understand this drop-off of demand in August and September. And I'm not sure if it's coincidental, but it does align with when you relaunched a large amount of your new product line. And I'm wondering if there was issues that you ran across with pricing of that line, maybe some of the new features didn't resonate? Did the marketing not resonate? And then as you've pivoted the sales strategy here in October, I guess, are you now reducing prices? Or is it just a lower ticket that's going to maybe reduce the ARU sequentially?

**Shelly R. Ibach***CEO, President & Chair*

Yes. Peter, thanks for the question and the opportunity to clarify. So it really was around 3 different things. In all consistent with the perceived price perception as the consumer moved into a place where she was very scrutinizing of how much to spend. I'll use the example of the selling process in the store when you came into our store during that time frame, we were selling the full smart bed system first. So the selling process showed the consumer or the customer in the store, both the smart bed and the adjustable base and she fell in love with that full system and the quote ended up being very high because it was inclusive of the smart adjustable base. So one of the big changes we've made since that time is to sell the smart bed first, which is what we historically have done. When we introduced Climate 360 a year ago, the Climate 360 comes with the smart adjustable base. And we had great success with selling it that way. As we introduce the full line, we also included that full system for that full solution for our customers. And we have found that since we went back to, first and foremost, understanding where the customer's budget is and selling the smart bed and meeting her budget that has made a significant difference in conversion.Â

In a similar manner, our online experience now compares the smart beds first and then go through a later step of adding a base. So that the price doesn't get too high, too fast, especially for the consumer in this environment. And then third would be messaging. Our marketing messaging, getting back to just our very simple value proposition around adjustable firmness and temperature starting at \$1,000, so that we're very competitive and helping reduce that perception of the smart beds way more expensive than it really is.

**Peter Jacob Keith**

*Piper Sandler & Co., Research Division*

Okay. That is helpful clarification. So I appreciate that. I guess the -- I understand the effort to reduce the cost base, but it sounds like if you've adjusted the sales process, sales have gotten somewhat better. I guess why the pivot to now closing a bunch of stores. And then does this cap what would be a future store opportunity where maybe we won't be growing stores anymore?

**Shelly R. Ibach**

*CEO, President & Chair*

Yes. No, it absolutely doesn't cap the future opportunity, hey, the macro volatility continues to pressure consumers. We obviously were surprised by the shift in consumer behavior in August and September. It's difficult to predict these changes. And we need to make sure that our operating model is more durable for a broader range of macroeconomic situations. I don't -- sitting here today, we -- I mean, we went into back half expecting a recovery in the mattress industry. And that's not what we're experiencing. And we want to make sure that we have the business model in a place that is greater -- has greater durability and that we're completely focused on generating cash, paying down our debt, returning the business to a strong, profitable position and at the same time, being well prepared for the future rebound in getting back to double-digit EBITDA. So these are the actions we're taking now to get our fixed cost structure down, and they're not at all going to keep us from realizing greater sales and stores in the future. We're being opportunistic on the stores that we're selecting. And the lower performers. We also have developed some really great digital sales tools that over the last couple of years since the pandemic has started, and we expect to utilize those in our other stores and our online operations to be able to generate a greater transfer of sales than we historically have done, even though it was very high historically, spent over 30%.

We expect these tools to help us make that even greater. And again, opportunistic in our approach. We're looking at all the DMAs and really making sure that we have other ways to serve our customers in these markets.

**Peter Jacob Keith**

*Piper Sandler & Co., Research Division*

Okay. I appreciate that explanation. I'll pass it on to the next person.

**Operator**

Next question comes from the line of Brad Thomas with KeyBanc Capital Markets.

**Bradley Bingham Thomas**

*KeyBanc Capital Markets Inc., Research Division*

The first, I just want to ask about a follow-up on sort of pricing. And I know Shelly, you've explained that you've changed how we're selling. But can you talk a little bit about the need or the potential need to do more promotionally and how necessary that might be for you now and what your plans are from a promotional standpoint?

**Shelly R. Ibach**

*CEO, President & Chair*

Yes. As I said, we're very focused on the differentiation and the value. So making sure that consumers understand that our c2 starts at \$1,000. And that is highly competitive, especially when you consider the adjustable firmness and the temperature benefits that are now -- that now come with our c2 as of August when we introduced the new line. So you'll see us focus on temperature claims, our adjustability at an affordable price as well as great deals at the high end.

**Bradley Bingham Thomas**

*KeyBanc Capital Markets Inc., Research Division*

Okay. Maybe just a couple of follow-ups on some of the earlier questions. Just -- I was wondering if you have the numbers on the financing side of things. I know that's just an important part of your business. Is that higher or lower as a percentage of sales than a year ago? Again, we just get the question a lot that we're hearing some tightening from the credit providers. And I'm just trying to understand, is that a smaller portion of sales here now for you?

**Shelly R. Ibach**

*CEO, President & Chair*

Well, we shared this number on an annual basis. What I will hone in on is that we don't believe that our financing strategy adjustments have really had a negative impact in the demand results. We've looked at this 100 different ways. And we see the greatest opportunity as the perceived price value of our smart beds, and that's where we're honing in on our messaging, and we like the improvement that we've seen in the demand trajectory since we've made the changes. So we continue to iterate and test different actions as the consumers very constrained in this macro environment. We are focused on 0% for longer duration periods than we had been earlier this year to drive units while using the APR offers for other periods, but we're making sure that it's not a barrier to entry for our brand.

**Bradley Bingham Thomas**

*KeyBanc Capital Markets Inc., Research Division*

Got you. Okay. Maybe asking a little bit of another way. And again, we know there are many other companies that have called out slower results here of late. But as you look at the financing side of things, you don't think that's material for the pressure we've been seeing on sales here, the ability to offer the financing you don't think that's material.

**Shelly R. Ibach**

*CEO, President & Chair*

We don't, Brad. I mean we've done in-depth analysis and both internally and third party to fully understand this. As a matter of fact, we have used 3 different external resources on the consumer, understanding the consumer behavior during this time period as well as our internal -- and everything ties back to the value and the perceived value and the changes we've made, we've seen that reverse. So we went back out and researched it again with the changes. And then, of course, we have the results of -- by focusing more on our differentiation at a price. We're seeing the digital traffic improvements. We're seeing unit growth in October. So it's moving in the right direction with the changes we've made.

**Bradley Bingham Thomas**

*KeyBanc Capital Markets Inc., Research Division*

I appreciate it. Maybe I can squeeze one here for Francis and Francis welcome. Just as we think about the covenants, anything in particular we should be focused on in terms of any metrics that might reduce the capacity that you have? And how should we think about kind of the run rate here on interest expense? Any help for us would be great.

**Francis K. Lee**

*Executive VP & CFO*

Brad, thanks for the question. It's nice to meet you. I think thinking about the covenants, it's -- we're really thinking about the abrupt shift in the demand environment and the ongoing uncertainty in the future. And we work closely with our bank teams to create a lot of capacity and leverage for us over a longer period of time to create flexibility for us. So when we think about the covenant and the bank agreement, that's really been the goal is to create flexibility over a longer period of time for us to work through our restructuring, generate cash and pay down debt. And we're pleased with the additional clearance that we have to operate with more flexibility through the end of next year.

**Bradley Bingham Thomas**

*KeyBanc Capital Markets Inc., Research Division*

All right. I'll follow up with you all afterwards.

**Operator**

[Operator Instructions] Your next question comes from the line of Atul Maheswari with UBS.

**Atul Maheswari**

*UBS Investment Bank, Research Division*

Shelly, I know the industry is challenged. But if we look at your performance versus your larger competitor, there has been a pretty material gap that has now existed for the last several quarters. So earlier the thought was maybe this was because of the supply chain issues and the chip shortage that you had last year, maybe early this year, but that's in the rare remitter as well. So even as of now, why do you think this underperformance exists? And what do you think you need to do to address this performance gap.

**Shelly R. Ibach**

*CEO, President & Chair*

I think the backdrop starts with the industry. Well, it starts with the consumer and the macro environment and then how that has impacted the bedding industry. The bedding industry has been at recessionary levels now for 2 years. And it's forecasted to have been down double digits in the third quarter, and that's where our performance was as well. We completely expect to compete more effectively than we did in the third quarter. I highlighted the area that we see ourselves where we missed, and that was on the price value -- the price value for the consumer. The consumer changed in August and our messaging was not on point with where the consumer changed nor was our selling process or our online experience. Those are the adjustments we made in the third quarter, and we've seen progressive improvement since we implemented those adjustments. In October, we delivered mid-single-digit decline, which was -- which is where we expect our fourth quarter performance with our revised guidance. We're going to continue to drive our media strategies and build on them. We've renegotiated and have greater impressions as we move into the fourth quarter. And those impressions are complemented with drive-to-store actions, and we expect to add media as we see greater traction. But for now, we're holding our media below prior year.

**Atul Maheswari**

*UBS Investment Bank, Research Division*

Right. That's helpful, Shelly. I have a couple of follow-ups, unrelated. First, on the revised governance. Does that add incremental interest expense? So are you able to quantify how much incremental interest expense it would add for next year?

**Francis K. Lee**

*Executive VP & CFO*

Thanks for the question. It will move us up on our rate ladder slightly. I can get you the specifics.

**David W. Schwantes**

*Vice President of Finance, Investor Relations & Decision Support*

Yes. I think Atul, just to add to that. So we did provide Francis to provide in his commentary specifics around this year's number, which is \$42 million for interest expense, which includes -- if you do the math from where we are year-to-date, it would signal \$12 million for Q4. That \$12 million number does include the updated rate structure where our leverage is at the end of Q3, which is the peg point for interest rates in Q4. And there was some write-off of historical credit line fees that we had on the balance sheet that have been written off as we amended the agreement. So that all rolls into the \$12 million number. We're not providing guidance relative to next year on this call. What I would say is that higher interest rate environment is going to carry into next year. I would expect interest expense next year to be north of this year's number, which is the \$42 million. And I think I would just say we'll give you more clarity on the February call. But for now, if you're doing your model, it's definitely going to be north of \$42 million. And that's a big number. It's a big weight on the P&L. And our goal is obviously to quickly pay down that debt as quickly as possible to start lowering the interest expense number and start getting our leverage to a level where we'd like it to be.

**Atul Maheswari**

*UBS Investment Bank, Research Division*

Got it. That's very helpful. And my last question, if I may, and somewhat related is there was -- I think Francis -- actually both of you mentioned the expectation to generate positive free cash flow next year. The question is, if the macro does remain challenged, and we have -- you have the incremental drag from the store closures, the 1 to 2 points. So at what level of sales decline, would it become very hard to generate positive free cash flow just so that we get confidence on the downside case scenario on free cash flow.

**David W. Schwantes**

*Vice President of Finance, Investor Relations & Decision Support*

Yes, this is Dave again. Just to give a little more color on how we're thinking about that. I think we talked in the remarks about a demand environment that may not improve next year. We're not signaling exactly where we think it's going to be. But what I would say is we certainly could generate positive free cash flow next year with a lower sales number than this year. I'm not going to peg exactly where that number is, but a couple of things to think about next year. Number one, we are expecting a pretty significant reduction in CapEx. This year, we're going to do \$60 million. I'd expect a materially lower number next year. And that CapEx number will be also meaningfully below our depreciation number. So we do have a lot of noncash items in our P&L, including depreciation, and that will help with just cash flow generation next year. Again, we gave you largely how we think about next year at a real high level. We're looking at a gross margin rate approaching 60%. We're looking at OpEx, which is \$50 million lower than this year. And I think -- and like I said, we'll give more clarity to how we probably think about the exact top line in February, but I think we've given you some good guideposts to do some modeling. And I think when you do the math on that, you'll recognize that we certainly can generate positive free cash flow with those variables next year in a lower demand, lower net sales environment.

**Atul Maheswari**

*UBS Investment Bank, Research Division*

Got it. That's very helpful. Thanks for that, Dave, and I really appreciate you taking my questions.

**Operator**

Ladies and gentlemen, there are no further questions at this time. I will now turn the call back over to the company for closing remarks. Please go ahead.

**David W. Schwantes**

*Vice President of Finance, Investor Relations & Decision Support*

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

**Operator**

Ladies and gentlemen, that concludes today's call. Thank you all for joining, and you may now disconnect your lines.

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