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SNBR - Q4 2017 Sleep Number Corp Earnings Call

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OVERVIEW:

Co. reported 4Q17 net sales of $363m and EPS of $0.39. Expects 2018 net sales to grow mid-to-high single digits and EPS to be $1.70-2.00.

CORPORATE PARTICIPANTS

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Shelly R. Ibach *Sleep Number Corporation - CEO, President & Executive Director*

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PRESENTATION

Operator

Welcome to Sleep Number's Q4 2017 and Year-end Earnings Conference Call. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time. I would like to introduce Mr. Dave Schwantes, Vice President of Finance and Investor Relations. Thank you. You may begin.

David W. Schwantes - *Sleep Number Corporation - VP of Finance, IR & Decision Support*

Good afternoon, and welcome to the Sleep Number Corporation Fourth Quarter 2017 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.

Please also note that we have posted an updated investor presentation on our website at sleepnumber.com.

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

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Thank you for joining our 2017 earnings call. My SleepIQ score was 90 last night. Our consumer innovation strategy is delivering superior shareholder value. Our innovations, differentiated retail experience and more efficient operations are reflected in our top-tier total shareholder returns. We continued to invest in and operate our business for the long term. I'll begin today's call with an overview of our full year and fourth quarter results. I will then provide more detail on our performance drivers and conclude with our outlook for 2018.

Our record results in 2017 included net sales of $1.4 billion, which were up 10%, with positive comp sales for the fourth consecutive year. Net operating profit of $92 million was up 20%. And earnings per share of $1.55 were up 41%, including $0.06 of tax reform-related benefit.

Our performance demonstrates the strength of our strategy and business model. We generated record cash flow from operations of $173 million, up 14%, and record free cash flows of $113 million. We also returned $150 million in cash to shareholders through share repurchases, up 20% over the prior year.

Fourth quarter results exceeded our internal plans. Net sales of $363 million were up 16% from the prior year, with 12 points of comp growth and 4 points from new stores. Net operating profit of $20 million was up 31%. And earnings per share of $0.39 were up 56%, including $0.06 of tax reform-related benefit.

I'll now provide more detail about our drivers of EPS, starting with demand. We have invested to strengthen our competitive advantages to become a more broadly relevant brand, with a more profitable vertical business model. We've established Sleep Number as the innovation leader, defining a new category called "Sleep Tech". Last month, at The International Consumer Electronics Show, Sleep Tech was singled out as the hottest new category, and our brand dominated the digital health hall.

Out of 3,900 brands at the show, Sleep Number ranked 15th for the most remarkable brand exhibit. This recognition was driven by our user experience, which capitalizes on the convergence of powerful consumer trends in sleep, technology and health.

Consumers are increasingly focused on holistic well-being. They want to interact with authentic brands that can effortlessly provide individualized pathways to better living and may expect digital efficiency. This is exactly where we are focused. Simply stated, our innovations are delivering life-changing value to our customers through measurably better sleep.

Our revolutionary Sleep Number 360 smart bed, which we launched in 2017, effortlessly adjusts the firmness throughout the night to improve sleep quality. SleepIQ technology provides personalized insights to our customers daily and cultivates a strong brand relationship. Our SleepIQ platform is enabling a deeper understanding of the correlation between sleep and wellness, with over 4 billion biometric data points gathered every night. We expect that we gained market share in both dollars and units in Q4 and for the full year. The 360 smart bed is proving to be the growth driver that we anticipated. We are also benefiting from increased attach of adjustable bases. We plan to complete our phased rollout of the 360 smart bed line by mid-year. As we convert the 4 remaining models, we expect to further strengthen our competitive positioning with increased value at the low end of our price point. The 360 smart bed is also generating increased brand interest as measured by our internal brand health surveys. In 2017, our brand awareness reached a 4-year high, with steady levels of purchase consideration.

Our media strategy is having the desired impact as we advance our machine learning tools and in-house digital media buying while continuing to benefit from our econometric model. Results include high-quality traffic to our website and stores and a high return on marketing investments. In this environment of aggressive, competitive spending and escalating search term costs, we delivered record media ROI.

In 2018, we plan to invest in media while continuing to advance our initiatives to break through the noise and win market share. We are excited about our progression with predictive tools that individualize experiences through SleepIQ technology on our website and in our direct-to-consumer outreach. Our actions are leading to increased brand engagement from potential customers and our loyal insiders.

Referral and repeat customers represent more than 40% of sales and are our most efficient sales. These all remain important initiatives in 2018.

Sleep Number's recent announcement of a groundbreaking partnership with the National Football League is a great example of how we are amplifying our brand, our analytics and our loyal customer base. Sleep Number is the official sleep and wellness partner of the NFL, which recognizes the importance of smart individualized sleep to athletic performance. We will help players compete more effectively by measuring, understanding and maximizing the benefits of a great night's sleep. Through this partnership, we expect to generate broader consumer awareness of how Sleep Number's adjustability and SleepIQ technology improves sleep and, therefore, performance.

We will also continue to advance the robustness of our sleep data and linkage to overall health. Our strategic decisions in investments have also supported exclusive distribution and an extraordinary retail experience, which are clear points of differentiation and an increasing competitive advantage.

In fact, all three of our competitive advantages, proprietary products, exclusive distribution and lifelong relationships, are working together in an integrated manner with our vertical model. Since 2012, we've grown our store base 46%, which is a 7% CAGR while remodeling and relocating existing stores. We have a comprehensive integration of online and physical stores, with retail leading conversion and productivity. Our healthy retail business has resulted in a 12% net sales growth CAGR and 7% average comp growth during this time.

Looking forward, we still have significant market development opportunities in front of us. We ended 2017 with average sales per store of $2.4 million and continue to target an average of $3 million per store, including online sales. We expect our online sales growth to continue to outpace overall growth as it did in 2017 and remain on track to end 2019 with up to 650 stores.

Turning to our business leverage, our investments are enabling faster, more integrated and efficient customer experiences in operations. This is a top priority in 2018. Our teams have embraced lean and Six Sigma methodologies, implementing process improvements across the business to improve service, reduce costs and eliminate waste. We are driving increased profitability across our business while absorbing transition costs. In recent quarterly calls, we'd discussed the latest stage in our multi-year plans to evolve our supply chain. We remain on track to realign our logistics network to ultimately fulfill 80% of our orders from 30 to 40 assembly and delivery distribution centers. In 2017, we successfully completed 2 important pilots to manufacture and deliver fully assembled beds. These pilots validated the efficiency, reliability and value improvements that we expected.

We continued to advance our third EPS driver, deploying capital efficiently. With our long-term orientation, our top priority remains high confidence, high ROI investments like our retail stores. This approach has resulted in an ROIC of 14.3%, which was well above our 7.7% cost of capital in 2017.

We announced today an increase in our revolving credit facility from $153 million to $300 million. In addition to our accelerated cash generation, this facility provides significant financial flexibility and results -- and reflects our commitment for continued evolution of our capital structure.

We also remain committed to returning cash to shareholders through share repurchases, which were up 20% in 2017. Over the past 6 years, we've repurchased $459 million of shares at an average cost of $24.39.

In summary, we are on track with our commitment of delivering superior shareholder returns. In 2018, we expect to generate full year earnings per diluted share of between $1.70 and $2. This assumes mid- to high single-digit sales growth in a choppy, slow-growth consumer environment. We expect quarterly fluctuations while we invest in our initiatives in the first half, and we won't be at full strength with our 360 smart beds until the back half of the year.

Our innovations are delivering better quality sleep to millions of Sleep Number customers. Thank you to our passionate and talented team members who are anticipating and adapting to the changing consumer, constantly looking for opportunity to improve our customers' experience. Our team's relentless focus on innovation is vital to our long-term success.

I'll now turn the call over to David, who will provide more details on the year, quarter and the outlook.

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Thank you, Shelly. The journey of an innovator rarely involves a straight path. While we've realized risks in 2017, we overcame challenges through steadfast yet responsive execution of our performance drivers. Our cumulative investments in the business, including our highly differentiated Sleep Number innovations, delivered accelerated financial results in 2017: 10% net sales growth, 20% operating profit growth, 41% EPS growth, record cash from operations and free cash flows and ROIC of 14.3%, which is 85% stronger than our weighted average cost of capital. This performance is also reflected in the 66% TSR. Our shareholders appreciated in 2017. These are the early results we expected while building this business. While we have work to do, we are executing the actions required to accelerate toward our 2019 commitments and beyond.

Before covering the financial details, I'll briefly discuss the effects of recent tax legislation on our financials. Revaluing our deferred tax assets and liabilities at year-end and other smart tax optimization actions led to $0.06 of benefit in Q4 of 2017, bringing our full year tax rate to 28.5%. Many elements of the tax code have changed, including less benefit from the manufacturing tax deduction and limited federal deductibility of certain costs and state income taxes. All in, we are guiding for a 25% overall effective tax rate going forward.

Now I'll provide details on our Q4 financials. Our initiatives delivered stronger-than-expected fourth quarter net sales of $363 million, up 16% versus the prior year. Consumers reacted strongly to our 360 smart bed p6 model launch and closeout values during the quarter. Favorable weather across the country in Q4 also benefited our delivery performance. We may have also recouped sales impacted in Q3 by the 2 weeks of hurricanes. However, this is difficult to parse out as the growth came evenly across the country.

Q4 sales metrics include company controlled units and ARU that each increased 8%, including strong attach rates for FlexFit bases and SleepIQ technology. As a result, our 2017 initiatives drove full year unit growth of 5% and ARU growth of 6%. We had 12% comp store growth in Q4 and net new stores added 4%. For the full year, comps grew 4% and new stores contributed 7 points of our annual growth.

At year-end, we operated in all 50 states through 556 retail stores, up 3% from last year and up 20% since we issued our long-term guidance 3 years ago. It's worth noting, for retail companies, in general, that 2017 marked a record year, with about 7,000 retail store closures and more than 300 retail bankruptcies across the country.

In an environment where direct consumer customer relationships, differentiated experience and product exclusivity are clear advantages. We continue to see opportunity for online sales growth and up to 650 stores by 2019. Our $2.4 million trailing 12-month average sales per store included 22% of our stores with sales over $3 million. That's up 600 basis points from just 3 years ago.

Our online business also grew a healthy 16% as we improved our experience to serve customers wherever she wants to shop. Including online sales, our combined average sales per store in 2017 were $2.6 million. Our ability to grow comp sales and our referral and repeat business continue to be strong profit driving opportunities.

While our Q4 sales initiatives, transition costs and incentive compensation pressured our year-over-year costs across the P&L, we increased our net operating profit 31% versus the prior year Q4, with a 60 basis point rate improvement.

Diligent cost controls contributed to this performance, including 270 basis points of media leverage in the quarter.

Earnings per diluted share in Q4 were $0.39, up 56% year-over-year. Excluding the $0.06 from tax reform and related benefits, EPS would have grown 32%, which is twice the 16% net sales growth rate. We remain committed to use each of our EPS drivers to grow demand, yield operating leverage and generate share count accretion.

Our new $300 million revolving credit facility provides highly flexible capital with attractive terms. The amendment extended it's maturity 2 years to 2023 and provides expansion capacity up to $450 million. We intend to maintain a conservative posture as we evolve our capital structure. We ended the year with $25 million drawn against our revolver and expect modest balance sheet debt to be part of our financial model going forward.

Our priorities for the use of capital remain unchanged. Our first priority continues to be for high confidence, high ROI investments. Second, we endeavor to maintain appropriate liquidity, including debt capacity, to support our business initiatives and downside risk.

And finally, we expect to continue to return cash to shareholders through share repurchases. In 2017, we repurchased $150 million of shares at an average price of $28 per share. Our clear priorities and capital stewardship are creating value for our shareholders. This can be seen in the 30% year-over-year increase in our EBITDA per diluted share and the 34.5% increase in our free cash flow per diluted share in 2017.

Our 2018 EPS guidance range of $1.70 to $2 represents 19% EPS growth at $1.85 midpoint, which we believe would represent top-tier earnings growth. Key assumptions supporting our guidance range include above market mid- to high single-digit net sales growth in a slowly growing economy. Specific sales assumptions call for our initiatives to deliver annual growth from a combination of ARU, units, comp and new stores. We expect quarterly fluctuations in our metrics as we use different drivers at different times during the year. Completing the phased launch of the 4 remaining Sleep Number 360 smart bed models by mid-year is expected to drive stronger sales growth in the back half of the year than in the first half.

For gross margin, we expect modest annual rate expansion in 2018 following a 110 basis point improvement the last 2 years. Specifically, our 360 smart bed model launches and closeout sales are expected to cause quarterly margin rate fluctuations while driving performance overall for the year. Costs from managing product launches, supplier transitions and logistics migration in 2018 are expected to be $6 million to $8 million compared with $10 million in 2017. About three quarters of this is expected to be absorbed in the first half of 2018 largely in cost of goods sold.

And our lean and continuous improvement initiatives are expected to at least offset low single-digit cost inflation in labor and commodities. We also expect up to 25 basis points of operating expense leverage in 2018 and continue to see opportunities for leverage across all lines of our P&L long term.

As you think about the shape of 2018, it's important to remember significant quarterly call-outs from 2017. For example, in Q1 2017, net sales grew 12% and EPS grew 107%. Considering the timing of our various business initiatives, we expect Q1 2018 net sales and EPS to be about flat to 2017.

Component supply shortages in Q2 of 2017 shifted $25 million of net sales from Q2 into Q3 of 2017. And hurricanes in Q3 of 2017 impacted Q3 sales by $12 million to $15 million and may have been partially recouped in Q4 of 2017. We expect approximately $50 million of capital projects in 2018 and expect to deliver mid-teen ROIC as we continue to reap profits from nearly $0.5 billion of investments since 2012.

And finally, we entered 2018 with $465 million of remaining share repurchase authorization. The business is generating the returns and shareholder value we planned. Our priorities are clear, and we continue to execute with passion and perseverance. We remain committed to deliver $2.75 of earnings per share in 2019, using all our EPS drivers and continue to assume a slow-growth economy.

Christine, at this point, we'd like to open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from John Baugh with Stifel.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Congratulations on a nice finish to the year.

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Thanks, John.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Could we talk maybe at the outset about, I believe, with your $2.75 EPS guide for '19, and that was done, if I'm not mistaken, with the assumption of a higher tax rate, is there any update on that figure? Or is that still to go? Or does it go higher with a lower tax rate?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes, John, it's an important question. Thanks for that. When we issued our guidance for $2.75 for 2019 at the beginning of 2015, our commitment was to generate superior shareholder value. We believe that the the 77% increase in our EPS from the 2017 performance we just announced over the next 2 years does exactly that. We expect to use all our EPS levers to get there, and the $2.75 is the hurdle that we're committed to.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. So you're not going to adjust that higher with a lower tax rate, just stay with the $2.75. Is that the right takeaway?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes, that's right.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And then maybe we can delve into the gross margins a little bit. And I heard, I think, some clearance event. I'm curious what were the puts and takes on gross margin and then how we think about that line into 2018.

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes. In Q4, John, we had a couple of things that pressured our margin rate. One of them we called out last year in Q4 and again last on the Q3 call that incentive comp was going to put some pressure on our year-over-year margin rate. It impacted the current quarter by 70 basis points year-over-year. We also had stronger-than-expected demand of our p6 closeouts in the quarter, which implied -- have a higher level of discounts on the closeout side. And we had stronger-than-expected attach rate of our FlexFit bases and SleepIQ, which come at somewhat lower gross margin rates because those are sourced products than our mattresses. So the last 2 elements of this really drove accelerated sales in the quarter and accelerated gross profit dollars and as you could see pretty strong performance on the net operating profit line.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And then how do we think about those, Dave, in 2018?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Right. So as I think about 2018, we're talking about various puts and takes, that we expect modest improvement in our gross margin rate in 2018 overall. However, we are expecting to see quarterly fluctuations in our gross margin rate as we use different levers to drive performance on a quarter-by-quarter basis.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And then, I guess, Shelly, maybe for you, I was curious, it sounds like you gave out a couple of metrics about, I think, return on investment on marketing being a record in 4 years or something. Could you just maybe give us a little more color without giving away trade secrets, I guess. Because it may not be cash for so much today, but at least there is somebody else. We've continued to see the onslaught of dollars thrown at marketing. What you're doing specifically? And what's working? It sounds like you have some confidence going forward in that as well.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Great. Well, John, you're absolutely right. There is a pretty crazy amount of advertising dollars being thrown at this category right now across the board. And it's doing two things. First of all, it's creating a fair amount of noise. And secondly, it's driving up search term costs. So we've been up against this all last year and it continues. And if you recall, we defined some very clear advancements in our media strategy in the back half of 2016, and we've been advancing those initiatives each quarter, and we're very pleased with the outcome. When you look at the performance we delivered last year while holding media essentially flat and levering over 100 basis points in that kind of competitive environment, clearly, we've made some real inroads with our initiatives. Having said that, the environment is dynamic and is constantly moving. So it is very important to continue to advance these initiatives each month, each quarter. And as we look at the year ahead in 2018, we do plan to invest in media. We went into last year knowing that we had some leverage to deliver, and we delivered a little more than we expected on this line. And we will be competitive and will take share again this year. As far as the initiatives, they are advancements of the ones that we've been executing against. And our econometric model keeps us steady in the background of the advancing. And specifically, you asked the highlights of those initiatives, and one is the fact that we've moved our digital media buying in-house, which gives us a lot of nimbleness to be able to make adjustments very quickly, especially with things like search terms. And then we've been quite effective in advancing our referral and repeat with our loyal customer base and then, again, having that econometric model in the background.

Operator

The next question comes from Peter Keith with Piper Jaffray.

Peter Jacob Keith - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Great results. I wanted to just put up the context of 2018 guidance with the implied $2.75 for 2019. I know there are some moving parts with launch costs and tax rate changes. But I'm just doing some back-of-the-envelope math. Roughly, it looks like kind of a normalized earnings like 20% earnings growth this year accelerating up to 40% in 2019. And I guess, I'm going to assume you're not calling for sales acceleration in 2019. So could you walk us through the changes in the model that would allow for that type of EPS acceleration as we go into next year?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes. Glad to, Peter. We've been talking about positioning the business with launching the 360 smart beds. And having the benefit of the whole line launched by mid-year and getting the benefit of those in the back half of this year and then into 2019 does provide us at least some opportunity for high single-digit sales growth in 2019, which is aligned with our long-term guidance for sales growth. So that is a little bit higher than the mid- to high single-digit assumption that we have for 2018. Then on top of that, you've got transition costs of $6 million to $8 million this year that are helping us position both the launch of those products and the evolution of our network, our logistics network, which provides us some profitability acceleration into 2019 as well.

Peter Jacob Keith - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Okay. I guess, I was trying to adjust all those transition costs for '17 and '18, and it still does look like pretty meaningful acceleration. Maybe as a follow-up, as you guys are working to improve your supply chain, could you walk us through maybe the steps of what you accomplished in '17 and where the opportunities are then in '18 and '19 and how that might flow through the model overall?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Sure. We've been highlighting those efforts all during the year in 2017. We opened 2 assembly plants that are now producing fully assembled mattresses, which is still a relatively small proportion of our overall volume maybe around 10% or so. But as we continue to go forward, we're expecting to move that to closer to 6 of those facilities and deliver fully assembled mattresses to the majority of our customers. The other evolution that we achieved in 2017 was, we talked about the challenges that we have with what we call our cross-docks, the hubs. And we have, in our plan, the reduction of moving from 70% of our business today being supported through the hubs to moving to just 20% of our business being supported through the hubs. Those are major opportunities for us. And we've got -- excuse me, through our spokes. I was talking about our cross-docks as those our spokes, not hubs. But in any event, the point is, we reduce the number of handoffs and handling. There is great efficiencies that come with the evolution of our logistics network, and we opened 3 distribution centers this year that take out some of the excess handling of the spokes.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Peter, one other highlight that I would make that will help contrast where we stand, where we are right now to the back half of 2018 and beyond is that we do have 2 lines in place right now. We have 3 of our models in the 360 smart bed and then the rest of our models are still our prior core lines. And that adds a level of complexity throughout our supply chain with both suppliers as well as the actual logistics network. And once we have the full line of 360 smart beds in the marketplace by mid-year, then we will be operating more efficiently.

Peter Jacob Keith - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Okay. That's good color. Just one last question for me quickly. Do you have any share buyback in the 2018 EPS guidance?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes. But we don't typically provide that level of detail. But we have, over the last couple of years, been buying back shares at the level -- at least our free cash flow level. And with the revolver in place, you will see us use probably some of that. It gives us an opportunity to use a little bit of that as well.

Operator

The next question comes from Brad Thomas with KeyBanc Capital Markets.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Let me add my congratulations as well. Wanted to follow-up on some of the commentary about the first quarter. David, if I heard you right, it sounded like you said that earnings in the first quarter are expected to be about flat year-over-year. If I heard you right, I think that would imply that maybe the EBIT is down around 15%. Just any color, additional color on the first quarter expectation would be greatly appreciated.

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Sure, Brad. You know I highlighted on my prepared remarks that we have $6 million to $8 million of transition costs in the first half of the year. 75% of that will impact the first half of the year. And you will recall that last year, in the first quarter, we didn't have any transition costs. So that is a year-over-year negative impact item on the EBIT line. And then it's just a matter of -- we're up against very strong comps in the 2017 Q1. And with the pacing of our initiatives, this is just the right kind of guidance for how we're seeing Q1 shape up. At the end of the day though, we feel great about our business initiatives. And just like you saw in 2017, there was -- there were fluctuations on a quarterly basis, but strong results for the full year. We expect to do the same thing in 2018.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Great. And then to just follow up on the kind of mix of business geographically in the quarter, you all have done a great job of repositioning your real estate. I'd be curious, any color on how some of the mall locations performed versus the nonmall locations?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

We continue to see mall locations and nonmall locations having very similar economics.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

And in terms of sales performance in the quarter, was there anything interesting that you saw?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Nothing. Nothing significant, Brad. The malls we're in are very strong performing stores for us, and we have less of them in total and greater penetration of nonmalls at this point. But we continue to be pleased with both mall and nonmall.

Operator

The next question comes from Seth Basham with Wedbush Securities.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

My first question is just about the first quarter following up on Brad's question. You seemed to imply that comps will be down a couple points in the first quarter. I'm just trying to think through why that might be after such a strong report here in the fourth quarter driven partly by closeout sales. I would imagine our closeout sales for other models in Q1 as well as new product launches. Can you help me think through why comps will be weaker in Q1?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Yes, Seth. What we are guiding for the full year is a mid-high single-digit growth and that does assume a flat to slight increase for the first quarter. That performance is consistent with what we're seeing in the 13-week trend. And knowing that our initiatives continued to advance our business towards the back half of the year, knowing we're up against the 12% growth from the prior year, we took this into consideration as we guided.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Has the environment changed much since the beginning of the end of 2017 into 2018?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Yes. I would say, the environment changed from a year ago. So if I look at year-over-year, first quarter of last year was a stronger environment than it is right now. We see the environment fairly similar right now as Q4.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Got it. Okay. And then you've commented on the strength of referral and repeat business being over 40% of the mix. Can you give us a sense of how that's trended? Where was that mix, say, a year ago?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

We've been continuing to focus on this with a steady performance over many years of growth. It's been north of 35%, 38%. I don't recall exactly where it was a year ago, but it is up to the point of consistency that we're calling now that it's now over 40% of our business. We continued to see this as an important area of growth for our company and unique to our advantaged business model, with our lifelong relationship with our customers, the SleepIQ technology, which is constantly reengaging our customers on a daily basis in a digital, efficient way. We like all the initiatives and factors that help influence this, and it brings new customers to our brand more efficiently.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Got it. Okay. And last question for me. As we think about the benefit to closeout sales here in the first quarter, how would they compare to the fourth quarter with the p6?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

For competitive reasons, we're not going to talk about the timing exactly of when we're going to run our closeout sales or when we're going to actually launch which models, et cetera. But we will tell you that we're planning to work our way from the top end of the line down with the remaining models.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Understood. But the benefit to comps, would you expect that to be a little bit more limited than you -- that was experienced in the fourth quarter?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Again, Seth, we're looking at all the factors that we're seeing. We're looking at the initiatives, business initiatives and our rollout plan, and we're providing you the best lens we have as to how to think about Q1 and the balance of the year. We feel really good about what the business is doing and where we are with the business. That hasn't changed. What we're talking about is just making sure that we provide the right lens for how to think about the shape of the year. We've provided a lot of color for that.

Operator

The next question comes from Keith Hughes with SunTrust.

Judith Lynn Merrick - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

This is actually Judy Merrick on for Keith. In the guidance you talked about the fluctuation in sales going forward. Do you have any comments on the fourth quarter -- do you think the demand was steady or sort of choppy then? Or is it kind of hard to tell with all the initiatives and the new products that you had coming up as well?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Judy, we did see some choppiness in Q4, and -- I would describe the environment in Q1 is similar to what we've experienced. I've reference that our guidance here in the first quarter is consistent with the 13-week trend. And we look forward to having our full line of smart beds in the marketplace by mid-year and knowing that it will strengthen our competitive pricing at the low end of the line as well.

Judith Lynn Merrick - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

Okay, great. And also, you had the strong attachment rates of the adjustable bases. It sounds like a lot of those came from the smart bed. Do you have a sense of the overall trend for all the beds? Was that kind of similar in the quarter?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Judy, as we -- that's one of the reasons why we're so excited about getting the balance of the line out is the benefits of 360 smart bed really accrue to the customers that take the full product, which includes getting the FlexFit adjustable base and the SleepIQ technology. So yes, we're really excited about what that can do for our customers and for our shareholders.

Operator

The next question comes from Michael Lasser with UBS.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

So how much do you think some of the catch-up in demand from the disruptions that you experienced in the second and the third quarter impacted the fourth quarter? Can you quantify that for us?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Michael, I highlighted that our estimate for the impact of the hurricanes in Q3 was $12 million to $15 million. We -- honestly, we don't really have a great lens to be able to parse out exactly how much of that we might have benefited from in the fourth quarter. But given the results, the 16% growth in the fourth quarter, we feel like it's imprudent to think that we didn't get some rebound.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Okay. And then you talked about a difficult comparison in the first quarter. Your comparison, arguably, is going to be harder in the third and the fourth quarter given that you're up against the 5 and the 12 now versus the 3 in the first quarter. So how do you think the business is going to get better despite the tougher compares?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Our initiatives, Michael, continue to walk us towards a strengthening performance, and this is where our excitement and confidence comes with the business. We have proven improved sleep with the 360 smart bed. We are loving the interest that it's creating from new customers and bringing more people to the brand. And we're excited to be able to have this bed out across our entire line, which represents good, better and best pricing in premium. So by mid-year, we will have the full line deployed and our efficiency initiatives will continue to advance along with it. So we're excited with what that means, and we know, with our business model to be able to drive both ARU and units, it has a big impact on the business.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

And just to confirm, you -- we should model a low single-digit comp decline in 1Q. So is some of that not benefiting you as of yet, at least the rollout -- the introductions that you've already made?

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes. We are just being appropriately aware of -- we're not launching another model in Q1. We have 3 models in market already, and the closeout of our p6 is already behind us. So we're up against, on a year-over-year basis, a pretty strong performance in Q1 last year, and we're just being appropriately -- I don't know if it's conservative or not, but it's appropriate regarding our guidance for Q1 and how we're thinking about the timing of our initiatives.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

And Michael, I also indicated a few minutes ago that if I look at the consumer environment right now in Q1 versus the prior year, it's a more challenging environment. So that's your backdrop and then you layer our initiatives up against it.

Operator

The next question comes from Curtis Nagle with Bank of America.

Curtis Smyser Nagle - *BofA Merrill Lynch, Research Division - VP*

So just a very quick one. If you could provide a little bit more color on how much of the clearance in 4Q helped units. And then I guess, what was the primary driver of ticket? Was is an equal balance of mix up and adjustable bases or something else? And then a quick follow-up after that.

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Curtis, I think we've provided a lot of detail. We don't normally break down the sales breakdown by model. And we're not going to do it again on this call. Just suffice it to say that the p6 clearance did help our -- drive some incremental units in the quarter, a strong value proposition for our customers, bringing them into the brand. And we also saw some really great attraction to the p6 360 smart bed, and its performance is doing very well relative to our expectations. So we feel great about the lineup. We are eager to get into the second quarter with the advancement of that rollout and believe that these offer some tremendous value and life-changing improvements for people's sleep.

Curtis Smyser Nagle - *BofA Merrill Lynch, Research Division - VP*

Okay. Fair enough. And then just to make sure I have this straight, you will not be taking any price this year, right? Is that still the assumption?

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

ARU, over time and, again, last year, how to think about it in modeling, probably I would just look at 3% of ARU growth over time as pricing. We've been pretty consistent with that messaging.

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes. And that's typically tied to benefits for the consumer as well, benefit-driven pricing, it's not all just pricing.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Right.

Curtis Smyser Nagle - *BofA Merrill Lynch, Research Division - VP*

Understood. Sorry, go ahead, Shelly.

Shelly R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Well, keep in mind, with the 360, part of our strategy is the attach of the adjustable bases, which drives a higher ARU overall and you're seeing that in our performance.

Curtis Smyser Nagle - *BofA Merrill Lynch, Research Division - VP*

Got it. It was just more a question around, I guess -- around commodity inflation, if that was being (inaudible). But it sounds like you're going to try and drive efficiencies in the business, so I guess not.

David R. Callen - *Sleep Number Corporation - Senior VP & CFO*

Yes. We see some elements of commodity pressures going into 2018, but we have very strong lean initiatives and continuous improvement initiatives across our entire business. But -- as well in the manufacturing and logistics operations. So we expect to be able to offset those pressures.

Operator

I would now like to turn the call back to the company for closing remarks.

David W. Schwantes - *Sleep Number Corporation - VP of Finance, IR & Decision Support*

Thank you for joining us today. We look forward to discussing our first quarter 2018 performance with you in a couple of months. Sleep well and dream big.

Operator

This concludes today's conference. Thank you for your participation. You may disconnect at this time.