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SNBR - Q2 2018 Sleep Number Corp Earnings Call

EVENT DATE/TIME: JULY 25, 2018 / 9:00PM GMT

OVERVIEW:

Co. reported 2Q18 net sales of $316m and EPS of $0.10. Expects 2018 EPS to be $1.70-2.00.

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PRESENTATION

Operator

Welcome to Sleep Number's Q2 2018 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 - *Sleep Number Corporation - VP of Finance, IR & Decision Support*

Good afternoon, and welcome to the Sleep Number Corporation's Second Quarter 2018 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 Senior Vice President and CFO. 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 R. Ibach - *Sleep Number Corporation - CEO, President & Executive Director*

Thank you, Dave. Good afternoon, and thank you for joining our second quarter earnings call. My SleepIQ score was 75 last night. Last week, we completed an important milestone for the company, our transition to all 360 smart beds, including the most recently introduced c2 model. This is the culmination of a lot of heavy lifting over the last few years to position our brand for accelerated top and bottom line growth, including margin expansion. In an increasingly commoditized environment, we remain highly differentiated by offering quality sleep through technology. The Sleep Number 360 smart bed is improving our customers' lives through proven, more restful sleep. And our lifelong relationships are an important source of ongoing growth for our business, as they translate into new customer referrals and repeat sales to the brand.

Our second quarter net sales, up $316 million were up 11% versus last year. Our earnings per share were $0.10 versus the prior year's $0.02 loss per share. Note, the prior year's second quarter sales were impacted by an inventory shortage, which shifted $25 million to the third quarter. This year's earnings per share also included a onetime $0.08 tax benefit. Our results were slightly better than our expectations for the second quarter. David will review the financial details in greater detail. I will focus on the performance drivers for the back half of the year. We are on track to deliver our 2018 guidance of $1.70 to $2. We expect to build further sales momentum in the back half through one, our Sleep Number 360 smart beds, delivering proven quality sleep; two, our new marketing campaign called This is not a bed; three, brand amplification through our NFL partnership; and four, our differentiated direct-to-consumer retail experience. In a marketplace, where consumers are inundated by a proliferation of brands and aggressive promotion on commoditized mattresses, we are delivering a strong value equation of proven better sleep, now starting at $999. Our investments have strengthened our competitive advantages for the long-term, and the consumer is showing increasing interest in quality sleep. The 360 smart bed integrates our firmness adjustability with sleep tracking technologies, to create a bed so smart that it adjusts automatically through the night to keep you comfortable.

With SleepIQ data analytics, we've proven that our response aware technology improves sleep. Our brand metrics, product ratings and customer loyalty are all strong, as we fortify our competitive position with smart sleep.

Brand awareness metrics are at record high, smart bed ratings are 4.7 stars, and our referral and repeat business continues to be over 40% of our sales. Our new advertising campaign called This is not a bed, focuses on how our 360 smart bed will improve your sleep, and therefore, your overall well-being starting at $999. You can see the ad on the investors site.

Our media effectiveness remains steady, which in this environment is significant. Second quarter results included a 110 basis points of leverage versus last year on comparable media spending. We are certainly facing headwinds here as there are currently hundreds of mattress brands fighting for the consumers' attention with significant spending in advertising. This is driving up search costs. We have effectively navigated this environment with constant testing and advancement of our media-buying initiatives to keep a competitive edge.

During the quarter, traffic and conversion were in line with our expectations, and we saw promising test results to invest behind in the third quarter.

Also important for the back half of the year is our partnership with the National Football League. We will amplify our brand messaging by linking smart sleep and performance. We are excited to realize benefits from the NFL players engagement in conversations about their smart beds. For example, here is how a fan responded to Minnesota Vikings Terence Newman's tweet about his Sleep Number bed. "I pulled the trigger on the Sleep Number bed a few months ago on your recommendation, haven't slept this well in years."

Turning to our direct-to-consumer retail experience, our healthy and highly productive store portfolio expansion is on pace to end the year with approximately 585 stores. New stores are contributing 3 points to sales growth this year. Now that we are fully transitioned to the 360 smart bed, we will also increase our store actions. We have about 40 new stores planned for the back half compared to the 24 we opened in the front half. We remain on track with our target of 600 to 650 stores in 2019, with a complementary online business growing at a faster rate.

Highlights of how we are continuing to advance our digital and store experience include; in the second quarter, we implemented an online bed model compare tool that is driving effectiveness in online purchase and store visits; online sales and phone sales grew 19% in the quarter. We expect this tool to be even more effective now that we have simplified our experience with only 360 smart beds. In August, we will open our new Manhattan store in the Flatiron District, with a unique retail experience, showcasing our 360 smart beds. This location is 1 of 3 net new stores we are adding to the New York DMA this year and we expect to have approximately 23 stores in this market by year-end.

The many advantages of our exclusive distribution are apparent in store metrics and our referral and repeat business. These metrics are outcomes of our direct-to-consumer brand and mission driven team, which is focused on building lifelong relationships with our customers.

We expect that our 360 smart beds, supported by our marketing and retail initiatives, will drive second half sales momentum. The 360 smart bed is the largest innovation investment in the company's history. We've made major upgrades to our entire product line, manufacturing, supply chain, supplier base, and logistics network. We expect increased profitability from operating efficiency, improvements in supply chain and logistics, starting in the back half.

We will have many opportunities to expand margins as we build a more efficient network in support of long-term profitable growth. The transition costs and related margin pressures will dissipate through the balance of the year. In addition, we have been diligently advancing lean productivity, cost containment, and cost cutting initiatives while prioritizing innovation investments that make us a stronger competitor. Our management team and Board of Directors believe our capital deployment priorities of investing in our business, maintaining financial flexibility, and repurchasing shares will deliver superior, shareholder value over the long-term. Our year-to-date share repurchases of $140 million reflect the ongoing value we see in our shares.

Our capital structure will continue to be conservative, maintaining a liquidity position of approximately $100 million. Our strategy has generated an ROIC of 14.3% for the trailing 12 months, which is well above our cost of capital.

In summary, we expect that we took significant market share with our second quarter performance. It is an unprecedented time in the industry, in retail, and in the country. Today's marketplace is dense with commodity products. And right now, ease of purchase can be viewed as equal to or even more powerful than product quality. This is evolving, and we are confident that sleep quality will prevail as a more important measurement of value. In fact, new sleep research reveals that 51% of U.S. broadband households are interested in buying Sleep Tech.

Tracking sleep has helped awareness, but the big question is what you do about it? Our technology goes a step farther. In addition to effortless tracking and communicating highly accurate results, our 360 smart bed takes actions by adjusting the firmness for improved quality sleep.

We've made important investments to strengthen our competitive advantages. Our innovations deliver proven quality sleep and daily customer interactions through our proprietary smart technology. Our direct-to-consumer exclusive distribution model is highly productive and integrated with a strong online experience.

The consumer is moving fast and quickly adapting health-related data and products that truly contribute value to their fast-paced life. And this is where we are focused, quality sleep and quality data.

And finally, a few words about our team, a tough-to-replicate competitive advantage. Last week was our national sales and service conference, it is inspiring to see our frontline's confidence and commitment to our mission and vision. Thank you to all of our highly engaged and talented team, which embraces our values of integrity, passion, innovations, courage and teamwork. I'll now turn it over to David who will provide more details on the quarter and our expectations for the remainder of the year.

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Thank you, Shelly. At our Investor Day in November 2016, we highlighted how the transition to 360 smart beds and evolution of our supply chain will unlock significant profitability well in excess of the onetime transition investments required to get there. Fast-forward to today, we've realized the bulk of the transition spend in our advancing the growth and profit acceleration we planned. In the second quarter, we achieved the sequential sales growth step-up from Q1 we forecasted.

Net sales grew 11% over the prior year or 2% adjusted for the estimated $25 million of deliveries that shifted from Q2 to Q3 last year, due to a temporary inventories shortage.

In Q2 this year, value customers responded to our C series closeouts leading to 7% company controlled unit growth. We expect the value packed c2 smart bed to also contribute to full year unit growth in 2018. In addition, our ARU increased 5% as customers continue to embrace the benefits of our 360 smart beds complete with SleepIQ technology and adjustable base. We continue to see ARU growth opportunity in the back half of 2018 and beyond, as more customers opt for a complete package of sleep innovations.

Comp sales grew 9%, again reflecting a step-up from Q1. We continue to forecast low to mid-single-digit comp growth for the year as we benefit from the full price range of 360 smart beds. New stores contributed 3 points of Q2 sales growth as planned, ending the quarter with 565 stores operating in all 50 states. Our trailing 12-month average sales per store, including online is up 4% year-over-year to $2.6 million. Growing this metric toward $3 million is a compelling profit driving opportunity through the 30% to 40% incremental 4-wall profits in those stores. Transitioning to our 360 smart beds and evolving our supply chain has required investments to support our growth and profit acceleration plans.

Actions taken to support these initiatives resulted in 230 basis points of year-over-year gross margin rate pressure in the second quarter.

Despite this, we managed our other cost to deliver a 16% incremental operating profit flow-through rate in the quarter. I'll provide details today on items affecting our year-over-year gross margin and outline why we're expecting at least 50 basis points of sequential improvement in the back half versus the first half.

Our 59.7% gross margin rate in Q2 was impacted versus the prior year by 120 basis points from inefficiencies of operating 2 product lines and closeout sales, both of which are expected to wind down by year-end, and 110 basis points from higher mix of source products like FlexFit adjustable basis, and inflation impacts.

With a compelling value of the c2 smart bed at $999, we expect some downward mix pressure in the back half. We also expect adjustable base attach at the higher end of the line to continue to be strong in the back half. Both products are expected to provide sales and gross profit dollar gains while pressuring gross margin rate. We also expect about 20 basis points of net inflation impacts to continue in the back half.

Both Q2 this year and last year included approximately 90 basis points of specifically identified transition charges in our cost of goods.

We expect the remaining transition costs in the back half this year to be approximately $2 million. Relief from onetime transition cost is expected to provide a profit tailwind in 2019. We expect to improve our gross margin rate in the back half this year by at least 50 basis points sequentially versus the 60.5% in the first half.

In 2019 and beyond, we expect to further improve gross margin another 100 to 200 basis points. Meaningful margin lift is expected from eliminating the transition charges and inefficiencies we've absorbed, and by advancing our outbound logistics to support in-home delivery of preassembled beds. We are on track to exit 2018 with about 25% of our deliveries being preassembled as we ramp our third assembly distribution center. Our plans call for a total of 6 or 7 such centers over the next couple of years. During the second quarter, we also invested in sales and marketing and R&D initiatives, while holding other costs flat, year-over-year. These prioritized spending controls across the business enabled 400 basis points of Q2 operating expense leverage versus the prior year.

Our spending and investment priorities are aligned to support our growth and profit targets, including up to 50 basis points of overall operating expense leverage in the back half.

Q2 performance demonstrated the value of using all our levers to drive EPS growth. We completed a tax project that generated $3 million or $0.08 per share of onetime tax benefits in the second quarter. We expect our tax rate the balance of the year to be 25%. We have invested $21 million in high confidence projects, year-to-date. As planned, we repurchased $140 million of our shares year-to-date, ahead of having our full line of 360 smart beds in stores. This compared to $75 million of repurchases the same period last year.

Our investments to sustainably grow the business resulted in a 14.3% trailing 12-month ROIC at the end of Q2. This is 70 basis points higher than the prior year while growing our average invested capital by $15 million.

We continue to expect to deliver mid-teen ROIC, which meaningfully exceeds our weighted average cost of capital. Our $29 million in year-to-date operating cash flows compared to $89 million of the prior year-to-date.

Company-wide compensation payouts accounted for $20 million of the year-over-year comp comparison, while $30 million of the change was primarily due to the prior year Q2 inventory shortage and delivery shift. Our $120 million liquidity cushion and $180 million ending net debt excluding letters of credit reflect our plans to prioritize investing in the business, while evolving our capital structure over time.

Our leverage ratio of 2.7x our trailing 12-month EBITDAR compared to our 4.25x covenant.

We expect to maintain a conservative capital structure including approximately $100 million of liquidity cushion. The completion of our 360 smart bed introduction in July was a major milestone for Sleep Number. With it and our other initiatives, we expect to generate mid-single-digit back half net sales growth. Adjusted for the prior year delivery shift, this means high single-digit growth for the half, including mid- to high single-digit growth in Q3.

Our 2018 EPS guidance of $1.70 to $2, reflects a 19% increase year-over-year at the $1.85 midpoint. Year-to-date, we've earned $0.64 of EPS while investing purposely in our business. We expect to deliver our 2018 full year guidance based on the progress we've made against our growth and efficiency initiatives. We entered the back half of 2018 with an arsenal of differentiated sleep innovations that improve lives to win in the marketplace. We are executing against our value-creating initiatives with urgency and discipline, while continuing to prioritize our customer. Christine, at this point, we'd like to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Bobby Griffin with Raymond James.

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

Congrats on getting the whole smart series beds rolled out. So I guess the first question I want to ask was may be just a little help on unpacking kind of what's changed since we last spoke at the end of 1Q on -- within reference to the full year guidance? And this quarter offered some upside, but the full year was kind of left the same, so it implies a little bit of shift and downward -- downward shift on the EPS for 3Q and 4Q. I guess, just help me connect the dots on what's driving that is it inflation? Change in consumer behavior? A little different ramp, the new products and prior expectations? Any help there would be appreciated.

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

Well, Bobby, I think just starting with our full year guidance [said] we're on track to achieve our full year guidance of $1.70 to $2, which represents a midpoint of full year 19% EPS growth, and see that as appropriate, especially in this environment.

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes, just to add on to that, Bobby, too, it's 23% increase in the back half in our EPS at the midpoint, and that's a pretty healthy rate as well.

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

All right. I followed that I was just kind of -- I mean, maybe I didn't understand, but did the $0.08 tax benefit, was it always included in the full year numbers? Because that's where I was kind of trying to understand. If the full year numbers weren't adjusted for the $0.08 tax benefit that does imply a change versus the last time we spoke. That's what I was trying to dig into?

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

And Bobby, we had both headwinds and tailwinds, and this would be a good example of a tailwind, and gross margin pressure was a headwind in the quarter, as we outlined.

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

Okay, okay. Fair enough. And then, I guess, lastly from me, when I think about the inventory balance that I'm seeing on the balance sheet today, what are the kind of the expectations where you expect that to kind of end up, as you work through kind of this new product introduction now behind you, and you start to -- it starts to become more of a normalized cadence, I guess?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes, Bobby, I would say that the $90 million on our balance sheet of inventory is about $5 million higher than where we would otherwise expect it to be, and it reflects where we are with the transition between the 2 product lines. And we're still closing -- delivering out some of the legacy products, and look forward to operating one product line, and gaining some efficiencies as we go through the back half.

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

Appreciate that. And then, I guess, Shelly, just more of a kind of a high-level thought. The attachment rate called out in some of your prepared comments, seen that all the way down to the C series beds, it's pretty impressive. Is that just kind of more emphasis on the selling process? I guess what do you think is driving some of that from a consumer preference?

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

I missed the very first part.

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

I was referring to kind of the comments you had in your prepared remarks about the higher attachment rate, and really seen that go through the product offering. And I was just curious if what exactly in your opinion from a high-level standpoint is driving that, is it change in the selling process a little bit, just more of an emphasis on it et cetera?

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

Sure. Well, it's a great question and it goes back to the core design of the smart bed. And the design concept was to provide a customer the ultimate smart bed, which is inclusive of SleepIQ as well as our adjustable firmness technology and of course, the benefits that come with our adjustable base. And doing so in a manner that is highly attractive to the consumer with all the benefits it provides. And I think the FlexTop mattress is a great example of one of those benefits that our customer really enjoys to, which works perfectly with the adjustable base. So we do expect growth from both units in ARU for the full year. And I do think that's a good way to look at the ARU and units. We're going to have quarterly fluctuations but certainly, expect some great growth there, and we're really excited to be in the marketplace with the c2 smart bed at $999, and how that is going to compare from strong value equation to similarly priced beds that do not give the proven quality sleep that this bed will, and at the same time, is continuing to drive ARU with some of the attachments that you touched on. And this is part of the reason why, as we head into the back half, we're excited to invest in some media behind our initiatives, and to be able to support that 360 smart bed and we want to make sure that we use our full power here in the back half, and that's part of why we're keeping our guidance where it is and being committed to it.

Operator

The next question comes from John Baugh with Stifel.

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

I guess, the first one is on the revenue guide, has that changed? I recall the year revenue guide was up mid- to high single digits. I think the revenue guide I see now is for the back half is mid-single digits, and that I believe would equate to roughly mid-single digits for the year. Am I getting something confused?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

No, John, you've got it exactly correct. When we talked about the back half, we're talking about mid- to high single digits, but on an adjusted basis, that's high single digits. That's adjusting for that $25 million shift last year with Q3 at mid- to high single digit growth, and Q4 at high single-digit growth.

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

Okay. And then, help me with the media spend. So maybe you could equate it, give us the percentage of revenue in the first half of versus where you think you might be in the second half? I guess I'm trying to get a sense for now that we've loaded the -- or reset the product line, and we're in front of Labor Day, that's a big event. Just kind of curious how the -- your media spend is going to change?

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

Right. Well, as I indicated in my remarks, we've held our media spend fairly flat so far this year. So similar rate as prior year. And then, as we move into the back half, I indicated that we will be investing behind some of the initiatives we've tested and also, now that we have our entire 360 smart bed lined out there. We've in the past talked about good percent of sales to look at on an annual basis, maybe around 14%. And I will probably just hold it there given how competitive this particular part of the marketplace is.

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

Understood. And then, I was curious on the gross margin, is there a way to help us think about how we exit '19? You mentioned that you'll be hopefully clear of all of the old legacy products by then, the transition cost I think will be more or less behind you. And yet, there's this mix shift going on which is understandable with adjustables and a good thing in terms of dollars. But I'm just curious, is there's any kind of feel when we are totally clean? Where that gross margin percentage is as we exit the year or enter '19?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes, John, so we're talking about at least a 50 basis point sequential improvement from first have to second half that would take our back have to around 61% gross margin rate. And then, we -- as we look forward, as we benefit from the tailwinds of not having transition costs, as well as eliminating some of the inefficiencies that we've absorbed this year while having 2 supply chains, 2 product lines, those will both be tailwinds expected in next year. Over some period of time, we expect 100 to 200 basis points of additional gross margin expansion is within reach.

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

Okay. And then, lastly, quickly, you don't necessarily guide? I don't think the stock buybacks or is there any help on you've done a lot year-to-date, and what our expectations should be for the back half of the year?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes, John, we had some unusual kind of fluctuations in our cash flows year-to-date in the first half we expect our cash flows in the second half to be much stronger. We're looking at accelerated sales growth and accelerated profitability, along with more normalized working capital elements to support our cash from operation generation in the back half. You can use those as a guide along with our liquidity cushion guidance of $100 million as kind of framework to work within, in terms of how you're thinking about share repurchases.

Operator

The next question comes from Peter Keith with Piper Jaffray.

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

I wanted to just maybe reflect back on the first half of the year. I know you said that Q2 came in a little bit better than your expectations. I guess, if I'm trying to adjust out the $25 million of sales shift, I won't say your first half of the year same-store sales growth is relatively flat. And I guess, I wanted to just bounce if off of you that you had 75% of the product line with a new format. It just feels like it should be a little bit better than flat same-store sales growth. So I'm wondering if there is anything, if you look back in the first half of the year that was a headwind or will things change to give us a little more confidence about the back half outlook?

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

Well, we're largely in the position where we expected to be first half, back half, and on track with our full year guidance. As you recall, in the first quarter, we were expecting flat sales and we were down 1%, and now as you indicated that we're slightly ahead here in second quarter. Obviously, second quarter is the seasonally the lowest quarter. But we achieved the step-up that we were looking for in the second quarter. And we are now, as of last week, we have our full line of 360 smart beds in the marketplace and it is supported with our new advertising campaign, talking about This is not a bed, it is proven smart sleep at $999. And illustrating what the benefits are for the consumer. And that's also supported with our NFL amplification of the brand, along with our retail initiatives, both market development and also, advancements in our selling process being much simpler with all 360 smart beds, and same with the online experience. We do expect our conversion to be stronger year-over-year in the back half. If you think about where we were last year with just 2 models at the high-end, on the floor in the third quarter, and then, adding the p6 in the fourth quarter. It's very different situation. We're really pleased with our conversion here in the second quarter, as I indicated on the last call, we did see that immediate step-up with the p5 and i8. So yes, we're on track with what we expected to see to be able to achieve the sales momentum we've talked about and planned for all year.

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

Okay, good. And Shelly, one thing I noticed within the script in it that you we're talking a lot about the commoditized products at the low-end. My perspective just felt like you were mentioning it more than normal. Do have a -- may be an evolving perspective on how that low-end is impacting the industry and perhaps, even your business at the high-end? Is it taking some traffic out of stores or making that conversion rate even more difficult?

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

All right. No, our conversion and traffic were as expected in the second quarter. I'm just -- I'm stating what I'm seeing and what we're all dealing with and I mean, you all write about it all the time too. It is a very intense commoditized marketplace, and not only in our industry, but you see it in other industries as well.

And when you have that amount of money coming into the marketplace with lots and lots of different brands, it does confuse the consumer and it does drive up search costs, and search costs continue to be pressured at a greater degree each quarter, and more and more businesses are getting into mattresses, as well as more and more brands entering, and that has continued. And It is focused on commoditized products and it's focus at the low-end. So bringing it forward, and I think all the Chinese imports that has -- have entered the space on top of that, that will be around $5 million this year, and that is all at the low end.

So how that impacts -- translate into -- how that impacts our business. First of all, we're excited, we are excited with the opportunity and the interest overall in sleep and for consumers to be able to do the research and understand where the value is at. And so for us to be out in the marketplace now with our c2 at $999, when the majority of these products, thus I'm talking about it, are at that $600 or $1,200. And to put our value equation up against it, Peter, we're really excited about this opportunity and where we are right now. And we think it's a good thing and we're well positioned.

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*

Wanted to ask about the store openings later this year and growth in New York. If my math is right, you'll end the year with about 8% growth in your store base this year, which looks like in the fourth quarter, that alone could single-handedly get you to the high single-digit growth rate in 4Q. I guess, for one, is that a fair conclusion? And then, for two, more broadly, could you talk a little bit more about your strategy in New York and how if at all that market might be different than other store growth you've done?

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

Yes, the new store growth net of closings or repositions would be 5% for this period. And we expect to end about 585 for the number of stores. And then, if you look at, as we open each new store, so we do have 40 stores we're opening here in the back of compared to the 24 they are not all net new. And if you look at the new store weeks, the majority of that will impact 2019. Overall, for the full year, we expect about a 3% new store growth. Just what we experienced here in Q2.

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

Got you. That's helpful. And then, how if at all, Shelly, is the market different from some of the other ones? In terms of the returns you are looking for?

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

As far as New York goes -- Manhattan -- opening in Manhattan is -- and complete different strategy than our other stores or DMAs. I mean, just looking at Manhattan in itself, and it's far more localized and we are so excited. This is the right time for us to open in Manhattan now that we have all 360 smart beds, it makes perfect sense. We're really excited about our location and being able to activate there and have that overall brand awareness in that particular marketplace. And then, supported by many other great quality locations, we've been doing numerous relocations to improve real estate that has been there in the DMA. And then, adding some net new opportunities. So getting much better positioned and we're happy with the performance of some of our other stores in the boroughs as well.

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Overall, Brad, I'd add that we expect similar kind of economics from the new stores that we're opening this year, as we've seen in the past.

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

New York included.

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Yes.

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

Got you. And then just to ask a question that's every company is getting asked right now. As you look at your business, do you see any impact from tariffs coming down the pipeline here?

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

Yes, very little for us. I mean, I think there will be some impact in the industry as we are -- as I was just surfacing some comments with Peter about the commodity and the imports that are coming into the industry at the low-end. There'll be some impact between that, and antidumping will start to help normalize some of those issues at the low-end. But for us, it really won't impact us.

Operator

Then 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 around gross margin. You guys helped spell out some of the headwinds you experienced this quarter, but maybe, you could give us a little bit more color to which of those headwinds were bigger than your expectations?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Sure. Seth, I'd say that we had about 100 basis points additional pressure than what we really thought about it coming into the quarter. Largely from the inefficiencies from operating the 2 product lines, and closeout sales, which are, we expect those to wind down toward the end of the year.

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

Got it, okay. And when you think about the mix effects that you're experiencing, and part of this quarter was due to closeouts, but you're also very excited about the new lower-end c2 product. Would you expect continued mix-driven pressure going forward from a mattress standpoint?

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

Yes, a couple of things there. We've considered that, and how we have talked about the 50 basis points of improvement in gross margin in the back half that we did consider the mix that we expect from both attach as well as C series. And then, importantly, we -- we've got market share opportunity to go get. We have good, better, best pricing within premium. And for us to compete strongly in this C series area, we're really excited. And in the end, the key is to bring more customers to our brand, and that's what we intend to do with this value equation. So we see market share opportunity there. We also see it at the better price points in our line, and we see it at the high-end. So we do expect to grow both units and ARU.

And then on a separate note, one of the exciting things about this business model is that we have exclusive distribution direct-to-consumer with proprietary products. And that means that we have a selling process and a promotional process that can drive mix change, based on the dollars off we use for conversion. So if you look at the second quarter, for example, we did not drive up year-over-year promotional dollars, while achieving what we expected for the quarter. And you can drive mix shift based on different activities. So keep that in mind too, and you can make some of those adjustments pretty quickly. So we like where we are at, and really excited to have the full line in place at good, better, best pricing in premium.

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

All right. That makes perfect sense in terms of your goals to grow both units and ARU. If you look at on a comparable store basis, Shelly, what's your expectation for unit growth? Are you concerned that there is a cannibalization effect as you introduce the c2, as you might trade customers down from some of the higher-end products as well?

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

This goes back to, the key is bringing more customers to the brand. And we think about new customers similar to unit growth.

So the more customers we're bringing into the brand, and converting that C series, means the more customers that won't be purchasing something else. In addition to the many customers who continue to -- who are able to afford and want to benefit from all the value at the higher end of our line. I mean, there are great reasons to trade up and there is also for the c2 smart bed against any commodity product, and there is a really great reason, pretty compelling to buy it. And at the same time, when you move up our line, there is exciting features and benefits along the way, and we're confident in our frontline, in our selling process, to be able to convert sales across our line. It's what we do well. This is our core competency.

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

Makes sense. Just lastly, to reframe thinking about the back of guidance here. And what is your expectation for a comparable store unit growth, do you expect to grow units or not?

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

Yes, we always talk about our total unit growth and we do expect full year unit and ARU growth.

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 if we just -- for the $25 million, shift from the second quarter or third quarter last year, it implies that comps were flattish or so this quarter. And that's with growth from closeout models and c2 bed. So implicitly, some of the higher-end beds, adjusted for this sales shifts were down. Why was that the case? Are you seeing folks trade down or are you just bringing folks in and having a harder time trading up to them?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

No, Michael. The sales performance in the second quarter was as planned, and we used the advantages of our complete model, as we rolled out the remaining models of our 360 smart bed. We took advantage of some of those closeout opportunities as well, and those were as planned in the quarter. And we're expecting now with the full 360 smart bed lineup in the stores as well as the support from media that highlights the advantages of that line, we're pretty excited about the by step-up going into back half.

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

So your sales were about at as planned, but you're moderating your sales guidance from mid- to high -- from previously, mid- to high single digits to mid-single digits. So what has changed?

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

Yes, the step-up in Q2 was as we expected. I mentioned that we had slightly better expectations in the second quarter. And for the back half, we expect mid-single-digit growth. And we are on track with our full year guidance of $1.70 to $2.

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

Yes, it's mid- to high single-digit growth in the back half. And on an adjusted basis, it's high single digits in the back half, adjusting out that $25 million. And we expect in Q3, to have mid- to high single-digit growth and a step-up in Q4 of high single-digit growth. But our guidance of $1.70 to $2 and EPS has been consistent, and we are committed to delivering pretty significant acceleration in our profitability in the back half.

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

And Shelly, you spoke about rising customer acquisition costs, and it seems like it was more intense this quarter. Could you give a quantification? For example, was it rising single digits, and now the cost to acquire customers is rising double digits? Is that the right order of magnitude?

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

Well, let me clarify and correct the point here. I did not talk about rising acquisition costs, I did speak to increasing search cost, which is different than rising acquisition cost.

So yes, we have increasing search costs and we're so happy that we've brought our digital buying in-home -- in-house so that we can be very responsive to that. We leveraged our major effectiveness in the second quarter, we've held our media dollars fairly flat so far, this year, until we rolled out our full 360 smart bed line, and now we will be investing in media here as we move into the back half. Also, we continuously highlight the importance and the competitive advantage we have with our lifelong relationship with our customers, which results in numerous advantages. But one important one is referral and repeat sales. And our referral and repeat sales have continued to be strong, and it is a very efficient source of customer acquisition for us.

Operator

(Operator Instructions) Next question comes from Curtis Nagle with Bank of America Merrill Lynch.

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

So I just wanted to -- just a quick question on liquidity cushion. It looks like, if I'm not mistaken, you're moving the range from I think what was a $100 million to $150 million to $100 million. I'm just curious why? Is it based on being a little more aggressive on the buybacks or did you just think that this is perhaps a more appropriate level, going forward?

David R. Callen - *Sleep Number Corporation - CFO & SVP*

Curtis, we've said $100 million to $150 million. We think the $100 million is more reflective of how we think about the business going forward. It still gives us a very significant liquidity cushion and we -- we've talked about this on an ongoing basis that we review our capital structure with our board on a regular basis and in those conversations, keep an eye on the upside and downside scenarios to evaluate what makes sense in terms of liquidity cushion, and that $100 million is the appropriate level.

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

I think the other add too, Curtis, where we are right now, we have our full line of 360 smart beds now deployed and it's that progression in the strategy that is also helpful.

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

Okay, understood. And then, just a quick question to Shelly, I think you alluded to potential anti-dumping action. Is this something that you think is really probable or might be in the works or just reference to chatter that's been in the industry?

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

Yes, I think we've all read similar reports, then it continuously comes up as potential action that will be taken.

Operator

Thank you. At this time, I would like to turn the call back over to your host 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 third quarter 2018 performance with you in October. Sleep well and dream big.

Operator

This concludes the Sleep Number's Q2 earnings conference call. Thank you for your participation. You may disconnect at this time.