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Mattress Firm Holding Corp. (MFRM)

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MANAGEMENT DISCUSSION SECTION

Scott W. McKinney

Vice President-Investor Relations

We're going to get started now. Thank you for joining us today, either in person here or via webcast. I'm Scott McKinney, Vice President of Investor Relations for Mattress Firm. We've got an exciting growth story. We're going to share more about with you today [ph] over the next couple of hours (00:16) with you.

Before we do get into the presentation I then must remind you that today's presentation will contain forward-looking statements and non-GAAP financial information. So please refer to the disclaimer on page two of your presentation. Our actual results may differ materially from these.

So with that said, I'll now turn it over to Steve Stagner. Steve?

Stephen R. Stagner

Chief Executive Officer & Director

Okay. Thank you, Scott, and welcome, everyone and thank you for first of all taking the time to come out and have lunch with us today. And those of you who have joined us via webcast, we thank you for joining us as well. We really appreciate that.

We also appreciate your continued [audio gap] (00:55) Mattress Firm family of brands. We are [audio gap] (01:09) mattress specially retailer in the United States. We believe that we are not only best-in-class, but today, we're going to share with you the strategies and the capabilities that differentiate us.

With over 2,300 locations across the United States, we have the largest footprint, but we also enjoy the fact that about 90% of our stores operate in markets where we believe that we have a number one market share position. Not only are we the largest but we've been able to grow our units, our sales and our adjusted EBITDA by over 30% annually since 2010. Growth in our industry has continued to shift to this mattress specialty retailers as you can see here clearly on the slide.

We have played a major role in that shift and the reason why is because consumers demand three things. They demand selection, service and convenience. Given these consumer preferences, we believe that the mattress specialty retail category is uniquely insulated from the typical big box or the typical threats on retail, including the big box retailers and the Internet. So first starting with big box retailers. Big box retailers lack the depth, the breadth and the selection to be effective in this category. And in fact, if you look over time, their share has shrunk inside the category. Secondly, the Internet, this product is high touch, it's tactile and consumers want to try out the product before they buy it. So as a result of that, the Internet is still primarily used as a research vehicle and this is still – this category remains a click-to-brick category.

Within the mattress specialty retail category, the industry is highly fragmented with the top eight retailers representing just shy of 35% of the marketplace. We are the largest in the industry and with nearly twice the market share lead over the next largest players. And if you go pro forma for the acquisitions that we accomplished in 2014, we believe that our share would be a couple of points higher. Now there are really five key reasons why you should invest or continue to invest in this story. First, the very compelling industry dynamics, that Rob will walk you through in a few moments. This is an industry where we sell a product that every single person needs, because everyone sleeps. And we believe that there're still significant pent-up demand.

Secondly, we are a best-in-class specialty retailer and Ken Murphy is going to walk you through some of the reasons why momentarily. Not only do we have the largest footprint but we combine that with our unique selling proposition and our very talented sales associates.

Third, we have a very proven track record of driving profitable growth. Our new stores generate a less than one-year store level payback. And we have demonstrated the ability to penetrate and develop markets both through organic acquisitions and through organic growth.

Fourth, our growth story is in the very middle innings. We have nearly doubled our store count size and our store base over the last two years and we have a plan to do that again. This should drive over 20% annual EPS growth before acquisitions.

And finally, the management team is aligned with the shareholder base and has a significant retail and industry experience. Speaking of the management team, today you're going to hear from the management team that is here with me today that will come up on stage. We have Ken Murphy, who is our President. He brings nearly two decades of experience both in the industry and with our company, and his focus is on the areas of the business that sell beds.

Rob Killgore, our Chief Operating Officer. He has nearly three decades of industry experience and we have the benefit of Rob joining us over just about a year ago and a few days as a result of the Sleep Train acquisition, and Rob's responsibility is the areas of the business that support those who sell beds. Alex Weiss joins us. He's our Chief Financial Officer, many of you know him. He will walk us through the financial highlights today.

So this is our team and this is our team that's leading the organization and responsible for delivering our growth plan. I must say, over the last few months as CEO, we've really done a lot of work on streamlining not only the reporting structure but the decision-making inside our organization and the speed of decision-making. As Chief Executive Officer, I'm extremely confident that this team and the structure that we have are poised and ready to maximize the growth and profit opportunities that we have in front of us.

Key accomplishments, I'd like to set the stage today by really going through some very significant key accomplishments [audio gap] (06:45) time that we are here June of 2014 when we had our Analyst Day in Houston. We've really had a very busy year and I think it's worth notating all of the things that we've accomplished and put them into perspective.

First, we've delivered significant store growth through the acquisition of 668 stores in 2014, as well as organically opening a couple hundred stores. This has expanded our store footprint into very key geographic areas.

We have also grown our sales by about $1 billion with over to 60% [6-0] increase in sales and adjusted EBITDA. We have generated significant organic growth and are opening the equivalent for perspective of what would be the fifth largest chain in the industry this year with our targeted new growth, but we've also done that while executing on eight consecutive quarters of positive same-store sales. We are integrating the acquisitions that we have acquired while also deleveraging. Last quarter, we paid down $55 million of debt and our free cash flow is also funding our new store growth and our store conversions.

So looking at the agenda for today, what we're going to do is Rob Killgore, our COO, is going to take us through the industry and the key trends. Then Ken is going to highlight what we believe makes us best-in-class and then I will lay out our [ph] (growth) (8:33) strategy. We'll [audio gap] (08:31) After that, we will have a Q&A [audio gap] (08:37-08:57)

Robert D. Killgore

Chief Operating Officer

Good afternoon. I'm really excited to be up here talking to you today about the industry that I have a lot of passion for. I've been a part of the bedding industry for nearly 30 years. So I've been through all the ups and downs and twists and turns and I have a lot of experience in the category. And I think it's a fantastic industry. I'm really excited to be a part of it and share a little bit about what makes it special. And currently [ph] there's a mute (09:21) somewhere around here.

Great. That's hopefully a little bit better. So I have about a dozen slides I'd like to walk all of you through, kind of take you through a high level about the industry, the mattress consumer and then hand it off to Ken Murphy, who will tell you how we take that information to really build what we believe to be the best-in-class retail in the bedding industry.

This first slide takes a little bit of set-up. It's a lot of information. This is historical wholesale mattress shipments by year and forecasts from 1980 through 2017. It's laid up against the economic cycles that have happened during this time period. And then at the bottom, we have dollar unit in AUP growth year-over-year. There are a couple of really big takeaways from this slide. First of all, the long-term growth rate for the industry is about 5%, compound annual growth rate. The second big takeaway is that the industry itself is a very recession resistant. And prior to the Great Recession, there's really only one year of negative dollar growth year-over-year and that was in the double-dip recession in 1982. What typically happens in the bedding industry during a recession is consumers will postpone – they'll kind of put off that purchase or the replacement of that old mattress and then in the two years following recession, we'll get a snapback usually with growth somewhere in the 20% range.

Now during the Great Recession, it affected the industry just like it did many other industries a little harder with a little bit more muted comeback of 11% over the first two years. But really, when you take a look at 2010 through 2017 in the forecast, the growth rate is around 6%. So it's just a little bit more protracted recovery. It's taking a little bit longer to come back in. The final point is ISPA, International Sleep Products Association, that produces a forecast twice a year, just released the results in October and reaffirmed somewhere between 6% and 7% dollar growth rate expectations for 2015 through 2017.

This next slide correlates really the main drivers of the bedding industry. Mattress retail business closely correlates with overall economic growth and with consumer sentiment or consumer confidence. The long-term economic growth is really around 3% and we'd like to see consumer sentiment, consumer confidence up around in index score of 100.

Really, what we've had since the Great Recession is an economy that's really growing closer to 2% and we've seen some fits and starts with the consumer sentiment has been choppy. And I think this really not only points to the fact that, the bedding industry correlates overall with economic growth, but it also shows the resilience of the industry. Because it is an economy that isn't really growing that great and it's got some choppiness to it, the mattress business is still doing very well and is growing either at or above long-term historical rates.

Now about 80% of mattress buyers are replacing a worn out mattress. It's a replacement driven business. As a result of that, we're fairly well insulated from the housing market. We don't have to rely on housing to drive demand for the category. The vast majority of that is just simply driven by people replacing worn-out beds.

And we'll take a little closer look at unit and AUP growth trends in the industry. So on the left hand side, we have unit sales by household. On the right hand side, we're taking a look at a little longer term on AUP growth.

Now from 1994 through to last year, the industry relied a little bit more strongly on AUP growth with a compound annual growth rate of about 4%. And you can see unit sales kind of peaked around 2005 and have bottomed out around 2009. And while they're recovering we're not back up where we were before and we think there's a couple of different reasons for that.

One is the overall economic environment that we're in and I think that's hit the lower end – the lower ticket mattress unit sales a little more aggressively than it has the premium category. And then, secondarily I think there is some demographic factors at play that I'll speak to you in a moment to kind of show what's been happening with the unit sales in the industry.

So demographics and population growth, obviously have a big impact on the mattress industry. So we have up in front of you, it's kind of the past, present and future of the generations that are affecting the mattress industry the most right now.

So people start getting or buying their new mattresses really more in their 20s. The peak spending years are in kind of mid to late 40s and then you continue to spend through your 60s. It's a 10-year replacement cycle. You buy a lot of different beds throughout your lifetime. So where we're at right now in the generational shift is the Gen Xers are right in the core mattress buying years. The baby boomers are just starting to transition out a little bit. And then, we have this, what I believe to be one of our best opportunities that really bodes well for future growth in the industry we have this millennial generation coming behind the Gen Xers, that's 25 million stronger in population. In a little later, Ken is going to talk about some of the shifts that we have in strategy to really evolve our strategy to embrace this opportunity. It's a great opportunity for the category in the future.

Another driver for the bedding industry is just the overall awareness of the importance it is to get a good night sleep. As a country, we have a bit of a sleep epidemic in our hands. Over 60 million people in the United States that have problems getting a good night's sleep. This chart that's up on the wall right now shows searches around sleep on Google terms. So people are becoming more aware of the importance of getting good night's sleep on your overall health. They know they have a problem and of course the mattress and having a comfortable supportive mattress has a lot to do with being part of the solution to the sleep issues that we have in the country right now and that overall awareness is helping to drive the category.

As evidence of the pent-up unit demand, the unit's not recovering as much, there is what I'd refer to as an outdated fleet of mattresses out in the customers' homes out there, as evidence of that, about 60% of the mattresses being replaced right now are over eight years old.

So given the slow unit growth in recent years, we have a really great opportunity with our advertising dollars to take a balanced approach between demand creation and promotional activity. So it's a great opportunity for us to run our Replace Every 8 campaign to educate consumers on how often they should replace their mattress and the importance of having a good mattress on their overall health and then balance that out with promotional activity to drive demand day to day.

Product innovation, when I look at the beds of the showroom floors and available in the mid-1980s compared to what's out there today, you wouldn't even really believe it. The category has come a long way. We are making more comfortable, higher quality sleep sets every year. Some of the most recent high-profile trends in the space have been around temperature management and around personalization or customization.

And really it's important to maintain a consistent body temperature when you're sleeping, so that you don't get disrupted in your sleep. And then from a personalization perspective, almost all the mattresses that are sold today articulate. And so one of the trends that's very popular is to place a mattress on an Ergo or an adjustable foundation which allows you to be able to adjust your head and feet a little bit, [ph] relieve the pressure (16:52), builds a bigger ticket but it creates a better sleep system experience for the consumer.

Aside from that, every year we continue to make beds that look better and feel better. And one of the strongest trends right now this year in the industry is in and around luxury and ultra-luxury hybrids.

We have a product on the floor, the Simmons Beautyrest Black Hybrid that's an exclusive for us and then Tempur-Pedic has come out with their Flex this year. And these beds combine the best of both worlds. And they blur the lines a little bit between what would typically be considered specialty sleep products and traditional innerspring sleep products and some of that now shows up in some of the ISPA numbers if you track that. But basically it takes the super comfortable materials, the gels and memory foams and Tempur material that you'd find in a specialty mattress and combines it with a traditional innerspring unit that you'd find in a sleep set. And it broadens the range of comfort and the consumers' options in the luxury and ultra luxury category. It's been a real strong driver for us of AUP this year.

Moving on to the mattress consumer. I jokingly and lovingly refer to it as a 50-50 consumer, the average age is pretty close to about 50 years old. And the average household income is about $50,000 a year. It's fairly well balanced. Purchase is typically made by couples with women tending to push a little bit more in the strong influence and the need for the replacement of the mattress. And the average ticket in the industry is about $720, and that's pretty consistent with some past surveys that we've done before.

The next slide walks you through spending by income and by age group. Now you remember a little bit earlier, I had a slide up about the generations as we're moving through the boomers, the Gen Xers and the millennials. The millennials will be closely represented by the red bar there, the 25 to 34, they're just starting to come into the category and spend money on mattresses. The Gen Xers are right in the core, overlapping a little bit with the baby boomers kind of moving towards the other side.

And it's important to point out too that about 75% of the dollars in the industry comes from households of $50,000 or higher income. So from an advertising perspective, how we use this information is really focusing on that 35 to 54 consumer, $50,000 to $100,000 a year. But it's important to point out that we are income- and age-agnostic. We have the ability to be able to flex up or down in terms of age or price band, to be competitive – everyone sleeps. And we'd like to be the preferred sleep solution for all income and price ranges.

This next slide walks you through dollars both in terms of price bands and units by price bands. Really, we want to cut it down the middle and let's call it about half the dollars come in below $1,000 and about half the dollars come in above $1,000, maybe a little bit higher 55%. But the key thing there is that even though only about 30% of the units sold are about $1,000, they represent over 55% of the dollars. It's a very important category to address with our best-in-class retail philosophy. And when you get into the lower-end units, again I believe that we've got a lot of old mattresses out there in that price band that hopefully will start to come back into the marketplace over the future.

So what are the attributes that drive retailer selections? Why do people shop where they shop? Steve mentioned a little bit earlier on in his presentation, it really comes down to selection, convenience and service. So the number one attribute up here is price. Now it doesn't just mean low price, what it means, is consumers expect to have a selection of price at any given price point. If I want to spend $1,000, I want to come at your store and I want to see a range of products around $1,000.

Further down in the slide you see the selection bar in blue that really to me speaks more to the brand assortments. So not only do I want to see that you have a lot of different products for me to choose from at whatever price range

I find value in. But I want to make sure that you have a range of selection of brands as well, all that's very important.

Beyond that, I want to have a store, that's in my neighborhood, that's convenient to me to get to, that I know where it's at. I want to be aware of your brand, and I want to be able to quickly check online to make sure that you're a good company to do business with. There's that loyalty, that referral, I'm going to have a high degree of confidence in your company. All those attributes really add up to drive mattress specialty retailer sales.

And last but not the least, ticket average. This is an example across the major competitive bands in the industry and what the average sale is. Now I think it really speaks to the quality of the category that specialty mattresses run higher than any of the other retail channels but beyond that I think it speaks to the quality and the expertise of our sales professionals. Over 5,000 sales professionals we have in our stores, that we deliver on a great experience for our guests. We educate them. We walk them through the process. We make it easy and they end up with a higher quality sleep solution for their needs.

So that gives you a little bit of an overview of the industry and the consumer. What I'd like to do now is to hand it off to Ken Murphy and he will talk to you a little bit about how we take that information to build the best-in-class retail sleep shop. Thanks, again.

Kenneth E. Murphy
President

Thanks, Rob.

Robert D. Killgore
Chief Operating Officer

Thanks, Ken.

Kenneth E. Murphy
President

All right. Good afternoon, everyone.

Steve asked that we bring the thunder today and it literally is happening here, if you hear the noise around us today. But I just want to reiterate the comment that Steve made at the outset which is that we really very much appreciate you all taking time out of your day to be here today and we certainly appreciate your continued support in this company.

There are a host of exciting attributes that we believe comprise to make Mattress Firm the preferred choice for better sleep in this industry. And my goal over the next 25 minutes or so is to shed a little bit of color on some of the most prominent pillars that we think are vital to understanding our go-to-market model. This will include a little bit of a discussion on our data driven approach to real estate. I want to talk a little bit about the marketing model that not only drives awareness and consideration, but ultimately we believe will lead to brand advocacy. We're going to talk about our merchandizing strategy that is essentially a curation of selection for folks who are looking for not only choice and comfort and in style but also construction and price.

We'll talk about Mattress Firm's in-store experience that is not only customer centric, but I would say is predicated upon ensuring that guests have the opportunity to get the best night's sleep that's available to them. We have a thriving and robust national distribution network that accords us the opportunity to deliver high touch, first class service opportunities in the space that are very rare. And finally, we have an emerging omni-channel platform that uniquely positions Mattress Firm to be at the intersection of changing consumer demands, whatever they want, whenever they want and wherever they want. We believe we're equipped to make sure that this brand can be relevant for them.

And for us, this really starts in real estate. It is often times in this category, the first exposure, consumers have with our brand. In many senses, our real estate strategy is one that we want to be where consumers are shopping before they may even know they're in the mattress market as it were.

If you know the Mattress Firm real estate, you'll know that it's high profile, attractive, crisp representative of a national retailer. Our commitments to not only being proximal, as Rob talked about – we know proximity is important. We also want to be prominent. And it's the reason, you will see 80% of our stores are either in end caps or out pads. We do have some in line stores but our objective is to be at the corner of Main and Main as frequently as possible.

Today the MFRM family of brands operates multiple, physical retail banners. We operate obviously Mattress Firm, the name you perhaps know the best. Approximately 1,900 stores in the fleet operate under the Mattress Firm name. With the acquisition that we brought on board last year, you'll recall the Sleep Train business was operating under actually three different brands. Sleep Train, Mattress Discounters and Sleep Country. This time a month from now, we'll be materially done in converting all of those behind the Sleep Train name and that conversion process has gone really well. Steve will talk about that a little bit more.

We operate today up in Dallas approximately 50 Sleep Experts stores. This is a brand we don't have any intentions today to advance but it's been a meaningful part of our success in the Metroplex and we feel really good about the results. And the name that you may not recognize as much as this idea of Mattress Firm Final Markdown. We shared with you at Q2 earnings the decision we had made to walk away from our Mattress Pro concept. We're converting the majority of those stores either to a standalone Mattress Firm, if it isn't super close proximity, but for the close proximity stores, we're converting it to a concept called Mattress Firm Final Markdown. It accords us the opportunity [ph] to draft (25:53) from an advertising perspective by Mattress Firm being the core name. It will have the best sellers from the core line. It will also have factory directs, overstocks, certified pre-owned and some bulk buys as well.

And then finally what I would tell you it's important to know about our strategy in real estate. It's indicative of how we go to market quite frankly in many domains and that is that we have a very data driven approach to our operation. In real estate committee at Mattress Firm, we have a deep management team with a lot of years of experience that have intuition to some degree about where to place sites but we don't rest on that. We use data to help inform where emerging trade areas are. We have a system that is proprietary which allows us to ascertain where propensities to shop may be, what the estimated effect of cannibalization might be as new stores come on. It has been a really big part of us being able to grow so prolifically from an organic perspective as well, not just from an acquisition perspective.

So if proximity is a big part of bringing them in, certainly promotion is as well. And the reality is this is a very high consideration category, as Rob alluded to. Our approach from a marketing mix perspective focuses primarily on awareness and creating demand. We do this with a campaign that implores the customers to replace their mattress, so that they can enjoy the benefits of better sleep health and a better night sleep. We also though feel pretty bullish about our ability to help accelerate conversion through a more targeted approach of digital advertising. We have begun expanding our mix in the online space, direct mail, video, social, mobile to ultimately help facilitate conversions. And then ultimately we want there to be a brand advocacy associated with this product and that's a seemingly daunting task given how infrequently folks purchase a mattress but we believe there is a way for that to happen.

From a go-to-market messaging perspective, really we try to accomplish three things. First and foremost we want to answer the question why buy? And that goes back to our demand creation approach. We also though think it's highly important that we connect the dots to why Mattress Firm. And a lot of our marketing efforts will help complement our story, will tell about some of the unique selling propositions that we have given our size and scale and the advantages we can convey in the marketplace. And then ultimately we want to convey urgency. This is a product that takes a while to get into market but once you're there people generally want to get it done and start enjoying the benefits of that. And so we use a variety of promotional handles to help accelerate urgency for us as well.

And we also think as an extension of our marketing approach that it's important to connect with the community. This is really reflective of what we believe is a responsibility we have as an organization to support the communities we operate in. But there is a supplemental benefit to just feel good. It is the reality or the opportunity to improve lives in a very meaningful way and we've been able to do that nationally by helping to aid pancreatic cancer research and we've been able to do it in the West Coast very prolifically in improving the lives of foster care youth and it's something that we're excited to continue investing in our communities. And this is really something that speaks to our heritage as a company over the last 30 years. We recognized the important – and then quite frankly, it is part of the opportunity for brand advocates to show that this is a company that more than just convenience and selection and price and distribution. This is a company that cares and we've gotten really good feedback on that.

So then after proximity and promotion are sort of the first two ingredients in the invitation. We know that it's important for our experience to continue distinguishing itself in the store and there are a lot of attributes associated with that. The one that I would call your attention to here is our in-store approach to merchandising. The reality is in this category, the proposition of shopping for mattress isn't a lot of fun. For many folks, it can be confusing. And we believe in doing it differently. We've done it differently since 1986. This particular manifestation of our uniqueness is one that has we believe accorded us not only great results but a lot of favor with consumers.

And that is essentially when walking into a Mattress Firm store, instead of a sea of potentially confusing mattresses, we have a color-coded comfort designation system that empowers our guests. It helps them be a part of the process, ultimately control their own destiny and what our professional sales associates are more considered to be trusted advisors, well educated trusted advisors that can help them along the process.

We have had tremendous feedback and this has been a big part of our success over the last several years. We also think it's important as America's largest and fastest growing and preferred retailer to make sure we have a product offering that's representative of the very best brands, the very best prices, the very best product considerations. And so, when you walk into a physical Mattress Firm store, you're going to see the brands that you know, you're going to have an opportunity to guide your own destiny from a price perspective, and you're going to have a chance to know that you are getting the best possible bed at that price.

From an online perspective, although this is more of emerging space for us, we have a virtual catalog of products that we've begun building, we think ultimately will be quite an asset to us in the long-term so that ultimately, we can begin extending the experience beyond just the physical stores.

What I would tell you most prolifically you need to know about our approach to merchandising, is it resonates with consumers because it offers choice. That is one of the long heralded demands of consumers in any category but certainly here is this opportunity to have selection and choice, and we feel really good about that.

From a long-term growth perspective, one of the opportunities internally we're quite excited about is the chance to continue growing in a much more meaningful way, our private label strategy. Today, private label is a modest 12% or 13% of our business. This number doesn't look too dissimilar from what you saw two years ago. That's more reflective of some of the acquisition growth and so that base more or less saying staying same. I would tell you long term, we think this is an opportunity to double, if not triple. The reality is, it's important for us in the context not only quite frankly of margin expansion but also in traffic generation. We believe that there is a compelling opportunity to create a unique and inviting invitations by intersecting better sleep and better sleep health and technology. We think that we can do that in an array of fashions but certainly in the private label space as well.

And the reality friends is that we know with our size and scale there is no shortage of manufacturers lining up to help us in this path. And so we're excited to have a willing partnership base to help us in our private label endeavors. So we have – if you look at what we've talked about so far in the sort of pillars of Mattress Firm, there are lot of things we would submit to you that comprise the results that we get. Starts with real estate, extends to advertising, certainly merchandising are all part of what you see behind me, which is an outperformance in the luxury category.

But I would tell you that as someone who started myself as a store manager for this company in 1998, there is perhaps no greater driver or influence behind our strong results than those folks that are on our sales force. We have an amazingly talented and committed organization as Rob alluded to and that is one of the things that folks looking for an opportunity to shop today, that they crave is the experience, they crave education, they crave an opportunity to be – to extend trust and we're there to be able to fulfill that for folks.

So for a little context about this, I must tell you that the prospect of hiring and training and retaining enough sales associates to go through the sort of frenetic growth that we have gone through over the last 10 years is daunting at best. And I would tell you it could not have been accomplished up to this point and cannot be accomplished in the future without a very strategic approach to the sort of talent management lifecycle, attraction, development and retention.

For us, it starts with the folks that we bring into the company and those jobs who are specifically focused on that are an amazing team in this company. They are brand ambassadors; the face of this company. 90% of our talent acquisition team came from the field and we think that's really important to be able to walk the talk.

We have an average tenure of over six years in our talent acquisition team which is atypical for a front level talent acquisition folks. And this is a group that is very much focused on results and tied to data to support that. A number of years ago, we introduced into our ecosystem a talent profile system that allowed us to, much like our real estate system, fine-tune and pinpoint the attributes of individuals that we thought would be most successful, and the results have been very much successful.

We know that when our profiling system recommends a candidate for hire, when they come in, they sell on average 11% more than associates who are not recommended. Since we launched this program, our associate turnover has declined just north of 60% which, as you can imagine, is incredibly expensive cost in the business turnover. And we also know that recommended hires from our profiling system are 80% less likely to terminate than those who aren't recommended.

And the final thing I would point your attention to on this slide is our mix of where we go about sourcing talent. We have by virtue of investing over the last two decades established some meaningful and compelling relationships on college campuses all across this country. We have an opportunity when you come to work at Mattress Firm for it to be about more than just selling beds, but an opportunity for career growth and development. But I would tell you, probably what we're most proud of is the fact that nearly four out of 10 folks come into this company because they were referred by someone they knew. That's an absolute testament to a positive culture and it probably in our view is as reflective of the opportunity as anything you'll see on this slide.

So after acquiring great talent, the onus then becomes on the organization, what do you do with it, and this is a fundamental part of running any business to be sure it can be very challenging in retail. We like to think we do it in a unique way and it's a big part of our results.

To say that we have a developmentally rich culture at MFRM is probably an understatement. Learning in this organization is a aspirational cultural value and we do it from the day you come in to the day you leave, by investing in opportunities and development. We'll put in for all of our first year sales folks over 260 hours of first year training and it's not done after that. On an ongoing basis, our associates will have access to over 85 hours of annual training and this will happen in a variety of different ways. It will happen in technology facilitated, self-guided learning. It will happen in classroom workshop learning opportunities where we have a big focus on skills practice. And we also have a cultural focus on one-on-one coaching, developing and mentoring and you'll see that in the field structure that you have before us.

When you come to work at this company, you'll make a lot of money and quite frankly, have a very long and prosperous career on the sales force. But for those who aspire to learn about running a business and learn about developing and mentoring, we have a very well structured career path that continues to sort of self-fulfill this model of development.

And I present it here for this reason. Ours is a category as you may know that has a relatively low barrier of entry to get into this category. That's true. Little carpet, some paint, a few beds, let the vendors foot the bill for you, you're up and running. But what this category has that most don't appreciate is a very high barrier for scale. You want to be a national retailer, or retailer of any size and presence, you have to have the wherewithal and the discipline and quite frankly the courage to make investment in infrastructure like this. And there is no one else in this space doing it, and it's a big part of not only the fact that we have a lead, but a lead that is growing, is because this is important to us.

The reality, folks, is that at Mattress Firm and the MFRM family of brands, culture counts. It's a big deal and we know that when someone comes into our stores, willing to trust someone they just met off the street to help guide them with an experience they don't make but once a decade, and maybe spend $1,000, $2,000 $3,000 $4,000, that's a daunting proposition or it can be. And we think our model is a big part of the reason, we're able to get the results that we can.

Retail is, and is always associated with high turnover, it's some of the reality. We believe we have industry leading turnover. We know that in – for our sales force, our total turnover is about 35%. And even further, still for folks who – that includes the folks we invite to start a new career of their own, for performance management reasons. Those who leave of their own volition as it were, is just under 25% which we think is a really big part of our success.

Our turnover at the leadership ranks is even less than that, at less than 5% and that provides continuity. It's important for a company at any point in their lifecycle but certainly when you're going through the kind of change, and growth that we are, as I said before mentoring, coaching and sort of leadership is a really big intangible in being a successful high-growth company.

Many of you may be familiar with the company Glassdoor.com. They are one of the fastest-growing jobs and recruiting sites in the U.S. They have a database of over 8 million company reviews. And as you can see from this slide, we're in some pretty heady company with some retailers out there when it comes to being recommended as a place to come work into our overall rating, and we're certainly very proud of that.

And as exciting as that is, I would tell you that one of the most exciting things, one of the things that we are incredibly excited about, is what we have going on in our logistics and delivery ecosystem right now. The reality is in this category, it has forever been challenging to get products delivered with high service, to get it done efficiently, to get it done consistently and to get it done at scale. It is one of the great barriers, as I talked about just a moment ago, to scale. And we are doing it in a way that very few have the capability of. And it's one of the emerging, exciting realities of this company, thanks to the hard work and committed approach of over 1,000 folks in our operations group that either work for us or with us. We're able today to do things like provide delivery in a three-hour window. We've amassed sort of under the radar to the – most notable part of our growth has been around new stores and new markets. What I would tell you, I'm just as excited about as the fact that we now have a national distribution network of over 72 distribution centers.

This year, we'll have close to 80% of our transactions delivered and we know that that's an important manifestation of the brand. And the reality is we can deliver easily over a third of those on the same day, and that is a true value add for customers. That same-day delivery capacity expands up during key promotional areas. We have as recently as Labor Day weekend gone through where 50% of our sales in major markets have been delivered in the same day. And you're just not going to see that sort of opportunity in this industry.

The reality is most retailers don't have the logistical prowess and capabilities that we do. It takes cost. It takes investment to be able to offer that. And the fact of the matter is we think it will continue to sustain our competitive advantage. You can today, for all intents and purposes, get a mattress delivered same day or next day just about anywhere in the United States. When we were with you a year-and-a-half ago, we talked about this as an aspirational goal; we're very close today. We'll continue trying to accelerate our same-day capacity. In markets in the country like here in the Northeast, where we don't have a company-owned distribution center, we have access to third-party distribution centers. And so, we really are excited about what this means for us.

And quite frankly, it dovetails in to the final pillar of our go-to-market model, which is as cliché a term as there ever was in the world of retail, which is omni-channel, I bear it to you knowing that everybody talks about it, whether it's omni-channel or all channel, online, offline, all line, integrated retail. Look, here's the reality. There is a lot of discussion about, what does the future of online mean for this business in particular, is this category going to go the way of so many others?

Here's what I would tell you. That's not the headline. The headline in retail is not about offline. It's not about online. It's about the convergence in the middle. It's about the worlds of digital and physical intersecting. It's no coincidence that the online darlings like Warby Parker, Bonobos, Blue Nile, these are all examples of organizations looking for physical presence to open up stores. Amazon themselves here in this part of the country a year ago, they now have the store Purdue, rumored at one point to be trying to buy the post office to get to distribution.

Here is the thing. Regardless of generational proclivities, convenience is king. And it doesn't matter how old you are, where you come from, what your preferred engagement method is for starting the shopping experience. In the end, convenience is what wins. And we think we are positioned better than anyone in this category to capitalize on that.

With over 2,300 convenient locations, where folks can try before they buy, you can also have the opportunity to buy online and pick up on store. I mentioned 80% of our beds are delivered. That provides a good opportunity for others that aren't. In the store network, we barely scratch the surface of soft goods. I'll talk about that in just a moment, but this is another opportunity. The reality is, for us, probably the part of the omni-channel platform that we're most excited about is that it's been coming together more or less under the radar.

Certainly, there's been a lot of attention about what we've been doing to build a offline platform with growing our network. We've quietly been focusing pretty aggressively on trying to build our online network as well, not necessarily for the sake of selling a ton of beds online, although we do a nice business online, but more because of connecting for folks what their needs are.

We know, for us an example, that year-to-date, Web traffic being up almost 75%, it's one of the most exciting attributes of our story. And it isn't because it's helping drive sales. It's because it's helping people come into the store, and it's helping facilitate this quest for knowledge and information. And I'll speak about that for a just second.

The role that online plays in this category, as Steve said at the offset, is still very much associated with research. We know that close to 80% of consumers in this category are going to begin their purchase journey online. We know that that's important. We know that there may be a quest or a thirst to be able to have online and offline touch points. For us, we think it's an important focus area, and it's part of the reason we've been investing in it.

The reality is, though, in terms of actual online purchases, it is a very small and albeit growing, growing slower than our own channel of distribution. Furniture today recently put out their updated study that showed over the last five years online, as a subset of consumer direct, grew 100 basis points in the last five years from 5% to 6%, whereas specialty has grown 400 basis points from 43% to 47%.

Forrester in 2014 put out some research similarly that supported this notion. It said that effectively, in the home furnishings category, online retail is typically understood to be about half of what it is for more broad U.S. retail. That's for all of home furnishings. It's typically understood to be even maybe half of that again here in the bedding category. And reason that is – and there are some very prominent reasons – it is a tactile purchase to be sure. There is a strong consumer preference for choice, and a lot of the online opportunities out there really struggle to be able to offer that.

And the reality is there are high-touch service constraints or attributes associated with this model, and those are the things that what the data would suggest, comprised to further perpetuate, not only this category, but our company as the preferred choice for better sleep and certainly the fastest growing.

Now, I say all of that not to say that online isn't important or the digital isn't. In fact, if anything, it's probably one of the things we're most excited about in terms of our growth. But it's for the reasons we talked about previously and it's for some other opportunities as well. There is no question that digital enhances physical. We're beginning to see that today.

I will tell you over the last few years, we've made some pretty strategic investments in this space. We've overhauled our website. We've stood up a standalone digital department. We made our first acquisition back in 2013 of a non-brick-and-mortar company, so that we could begin getting our hands around virtual inventory. We've recently announced a digitally-focused new brand. We'll talk about that in just a few moments.

But now, we're starting to get into the fun space and that is seeing where digital really can't enhance our per store productivity. I have three examples of this. Only one is in any sort of scale today. But earlier this quarter, here in Q3, we introduced a store reviews program to enhance our store locators where we recognize that if you have any hopes of brand advocacy, you're going to have to go to the well around crowdsourced wisdom. Reviews are as important a marketing medium as any there is. And you can't buy it, you got to go out and earn them. And I'm pleased to tell you we're doing that. 94% of the reviews that we've received at this point, literally over the last two months, have been four stars or above. We think this creates a meaningful experience at the store level. And really, it's an opportunity to engage in a more meaningful way.

The two other programs we're excited about, we're piloting one now in pretty small fashion, but that is getting into the idea of endless aisles. Understanding in our category, we have historically not really leaned into soft goods and accessory sales because of inventory carrying costs, because quite frankly, we've been growing so fast, we've focused on other things. But there is an opportunity for us to extend the sale. We know it's starting online. It ultimately is going to commensurate in the stores, but it can continue online as well.

And so, in a sort of small batch of stores, we're starting to see some nice results in terms of being able to offer consumers access to a catalog of products we wouldn't carry in the stores. Ultimately, we think there's probably 200,000 SKUs that could live in this place, and more on that in the quarters to come. But the early results from a technology perspective and from a customer feedback perspective have been very positive.

And then in 2016, one of the things you're going to see for Mattress Firm is the introduction across the enterprise of a tool that the folks at Sleep Train had been having a lot of success with, and it's the concept of what's being called a wish list, an integrated wish list. And the idea would be when you come into the store, we try to qualify, we try to diagnose, we hopefully can help earn your business that very moment. But for folks who need to think about it, want to talk to a spouse, whatever the case may be, what the wish list does is an opportunity to take that ticket, get it entered into the system and then from the comfort of your own home or phone or whatever the case might be, simply with the click of a button, you can actualize your purchase. And we know that that's been received positively as well. Those are three examples of things inside of our digital toolkit that we're excited about.

Ultimately though, I think the thing that probably bears most mention about why we're excited about the digital space is because what digital represents is an opportunity for more frequent and more meaningful connections with customers. The reality, when you're buying a bed but once a decade, as I said before, it's tough to form a relationship with folks. But if we can accelerate the touch points and we can communicate in a medium that this emerging consumer wants to communicate with, we think that's really important.

And to that end, we introduced to the world three weeks ago, today actually, we launched a new brand that's going to be focused primarily digitally at least out of the gate, and that is a brand called The Dream Bed. We recognize, as we've already talked about, it's a pretty small percentage of consumers who are looking to buy a mattress without trying it before. But for us, we think the infatuation with online, roll pack, bed-in-a-box that I know is a big conversation of the day, where we think the excitement there is an opportunity to engage with consumers who are now thinking about buying a mattress for the first time.

When Steve and I grew up in this industry, and Rob as well, first-time mattress buyers were spending on average $550 for their first purchase. If there's an opportunity for emerging consumers to step up to the plate and spend $700, $800, $900 for their first time, imagine what happens when they grow up and want to really begin investing in quality sleep. So, we're really excited about the opportunity.

For us, this is a chance to connect with our heritage of giving back. The focus on Dream Bed is it's a very comfortable mattress. It's delivered in a way that is remarkably convenient. It offers choice which you're not going to find in some of the other options. But ultimately, it connects with a cause and we think that's incredibly important. The Dream Bed is a product that for every bed sold, this company donates a new mattress to a child or family in need. We have the opportunity for millennials, consumers to do more with their dollars. We know that that is important, and we think this is a great vehicle for that.

We're three weeks since we've introduced this brand to the line. I would tell you, we feel pretty excited about the results that we've seen. Is it earth shattering? No, but the affirmation has been very positive and we've sold a few as well, more than just a few. So, we feel good about that. In fact, in November, we're going to be introducing The Dream Bed to a major market inside our stores as an opportunity potentially to provide even greater options for folks stepping up, and we'll report back to you on what happens there.

But in summary, the pillars that we talked about, high-profile real estate and marketing model that brings folks through the funnel and in-store merchandising that's predicated on choice and selection, talented associates that can make sure this is a positive experience, a robust delivery network in an emerging omni-channel platform. Those are all things that are exciting. They've been a part of our growth largely in the past. They're perhaps more prolifically a part of our growth today moving forward.

But to talk a little bit more about growth, where we're heading into perhaps, it's a topic – for those of you who don't know Steve, this will be his first time talking about relative market share, but we think it's important he has that opportunity nonetheless. So, I'm going to call back to the stage Mr. Stagner. Sir. Steve, thanks again.

Stephen R. Stagner
Chief Executive Officer & Director

I didn't bring my RMS T-shirts which are coming soon. Well, thanks Ken and Rob. There's a lot to be said about this industry. Certainly, this is such a great industry to be in, and the dynamics are fantastic. But I got to tell you, when I was here back in 2011 in this building, I was so excited about the growth that we had to double the size of the company. We did that, and we're going to be doing that again. I just got to tell you, there's so much excitement in front of – what's in front of us. And I want to kind of talk a little bit about that.

And starting with really what is the core of our strategy, it's a very disciplined strategy, as Ken was alluding to, about our basic belief on relative market share. Well, market share is very important, certainly to every company. But what we look at is not just market share but our relative market share, which is more or less the distance that we have over our next competitor. We can have the same market share in a variety of markets. But the difference is the profitability that we have within those markets. And the reason for that isn't our market share. It's the distance we have over our competition. And I'm going to demonstrate that to you as we walk through these slides.

As a footnote, when we talk about RMS, relative market share, externally we use the concept of market level penetration. Why? Because that's phone book numbers. It's public information that we can substantiate. The true definition, as I have up here, is our company share divided by our competitor's share. However, none of our competitors are – primarily, maybe one of our competitors is public, so it's hard to get information that we can substantiate. But I can assure you that there is a very strong proxy between relative market share and market level penetration.

But why is this so important? Well it's important because there's also a very distinct and direct relationship between relative market share and market level profitability. And I know that there's people out there that question the strategy or whatever. But since we were first introduced to the study back over a decade ago and we look at the charts of relative market share, certainly, they look the same today. It's been consistent, it's always been consistent, and I project it will continue to be consistent. And it's kind of a simple concept because it's all about leveraging scale.

So if we were to take a market – this is a case study of a market. And you can look at this market and really, this is a way – the first layer of the onion – to look at how when we think about RMS, how it really operates at the market level. Starting kind of at noon on the page, it does start with market level penetration. Here, you can see where we took a market and we added – we really more than doubled the store count. We added 16 stores into the marketplace. And we like to equilibrate our markets based on the population relationship between the number of stores that we have and the population. So, in this case, we went from one store per 112,000 down to a relatively strong penetration level of one store per 51,000. For perspective, some of our best markets are right around that one store per 50,000. And the majority of our chain, if you take the base of our chain, it's around about one store per 85,000 to one store per 90,000.

So, this was a market that was kind of slightly underpenetrated and we took to another level of penetration. What that enabled us to do at 3 o'clock on the dial there was it enabled us to increase our advertising dollars, and you can see that we increased by $1.6 million or we went from $0.38 a head, also equilibrated to the population up to $1.51 ahead. This is a very important point because we started to increase our dollars in the advertising with doubling the store count. And what that drove at 5 o'clock on the dial is it drove a 32% increase in sales per store. We went from $900,000 a store to $1.2 million a store.

And by the way, that's with doubling our store count. That's the counterintuitive part of RMS. Some people have the perception that, well, to do that, your store averages are going to go down. But that's not always the case, and the reason why is because we're redeploying dollars in advertising and driving up sales per store.

The punch line, as you can see, is that we distanced ourselves from the competition and we drove up the profitability, not only $4.8 million, but 350 basis points. So, you can say okay, Steve, that's great as a market, what about your chain? Well, this represents pretty much the majority of the chain that's been open for a year. We continue to give this chart. And what you clearly can see is if you were to take the penetration levels starting on the left, all the way to the right, going from developmental to fortress, what you can see is that we go from spending in advertising in the blue bars from about $0.50 ahead in advertising. We can triple the advertising dollars, the impressions that we have outside into the marketplace, triple it to about $1.50 ahead. But what's most important is the leverage that we get over that going from 11.3% down to 8.3%, just by leveraging the scale.

Concurrently, we drive up in the red, the sales per store, from about $900,000 to $1.2 million. And also, as we move through developmental, we start spending more, becoming the first place to shot, driving up the sales per store. We drive down that occupancy by getting more sales per store. And the occupancy, as you can see, drops 640 basis points in this example. Again, the most important part of this slide is when we enter a market, we enter the market sub-10%. As we develop through a market, you can see the collection of our markets are averaging right around 17%. So, that's another way to look at RMS.

Yet another way to look at RMS is the balance between driving RMS through both organic growth and acquisitions. Here's a great example of a market that we entered into. It's a very large market in the United States. And we entered into the market, and we were losing some money as we started. We had about 28 stores as you can see, doing about $700,000 a store, still making money on a four-wall basis at the store level. But because of the advertising dollars to support that market, we were having a drag effect on the market, and we were losing $1.7 million and we were still – even though we were losing because of having it advertise across the market, we weren't really reaching enough people. We're only spending $0.23 a head in advertising because we got one store per 232,000. Bottom line is we were not penetrated enough.

Fast forward to 2014, we added a lot more stores, got to 98 stores. The sales per store went from $700,000, up about 57% to $1.1 million. You can see that the advertising jumped from $0.23 to $1.32 a head. But the most beautiful thing on this slide is we went from losing $1.7 million to making $13.6 million. But there's room to grow. We're still not at the 17% range as a percentage. So in knowing this market, you can see that stores per capita are still at one store per 67,000. Obviously, we're going to continue driving that down to around to one store per 50,000 range.

There's no better picture from 50,000 feet of the proof of relative market share than this slide. This is all the markets – basically market level EBITDA on one axis with market level penetration across the other axis. And what you can clearly see is that basically, all the markets as we penetrate more, there is a direct relationship between market level profitability. Where you see positive and negative deviance, well, that really goes back to the true definition of relative market share which is understanding what's going on in that market, up against the competitor.

A positive deviant, like you see the circle over there, is mostly likely a market where there's very light competition. We have a big lead. Even though we're not fully penetrated yet, we still have a big lead over everyone. So we're kind of their first shot. Where you see a negative deviant, it's because we're probably in a little more of a battle and we have some more competitors. But the punch line is you can clearly see that the math works consistently over time. I can tell you, going back over a decade or so, looking at these charts, they look the same and I anticipate they'll continue to look the same.

So now moving into – that's kind of the strategy. That relative market share is the discipline. It's the strategy. It's a lot about what we're doing to go with our march to go border-to-border and coast-to-coast. But we also want to talk about specifically what we're going to do and where we're going to do it.

So the main thing for us is there's kind of two major drivers. There's obviously the organic store growth which is going to be broken into two sub-buckets, which is existing markets and new markets, and then there's the acquisitions. The acquisitions certainly, we don't model acquisitions. We can't predict when the acquisitions are going to come. But as I'll describe in a few moments, we have a very long and successful track record of acquisitions, and we'll really considered the rollup player in this industry.

And then secondarily, we also have some alternative channels, certainly e-commerce. I think Ken Murphy just did a great job of outlining all the opportunities that exist with us, but we also have a little over 100 franchise locations that pretty much create an opportunity for parallel growth as we've bought back a lot of the franchises and potentially can buy some back in the future. It's a great way to parallel our growth.

So when we were in this building in 2011, this map looked a lot different. There was a lot of wide space. We certainly have been putting our footprint and our mark across a lot of the country. Today, we serve about 75% of the U.S. population with some kind of stores within some level of proximity.

As Ken talked about with the opportunity of omni-channel, we are now poised with the 72 distribution centers to really be leveraging that delivery service that he was talking about, that convenience that he was talking about for the consumer really border-to-border and coast-to-coast, and that's one of the visions that we have that we're able to really effectuate where 95% of the population can get a bed from Mattress Firm within the same the day. But when you look at this slide, it's a little misleading because we color in the states when we put a store in there. But there is – it doesn't represent how much true opportunity there really is.

This is a more relative way to look at the opportunity or the relative growth opportunity that we have. When you take the concept that we've been talking about with RMS and penetration, only eight states are at the fortress level of penetration at this point which really speaks to the tremendous amount of opportunity that we have in the 75% of the population that we serve to continue growing inside those existing markets. But on top of that, obviously, there's another quarter of the country, population, that ultimately over time we will be focused on as well.

Although we have a very strong proven track record of growth, I think it's important to highlight a couple of things. One is one of the big assets of our growth is our ability to not only acquire companies but to integrate them. This demonstrates not all of the acquisitions that we've made. Many of the acquisitions that we've made, I think we're well north of 25 or 26 since 2005 since I got to Mattress Firm corporate. But it also demonstrates just how fragmented this industry is.

As the slide I showed you guys earlier, where the top eight make up less than 35% of the industry, there's a lot of players out there. Outside of the big larger ones, there's still a lot of little tuck-in opportunities that are very, very productive operators out there and very productive businesses for us as we bring those together. And we have a very proven track record of doing that.

But it's not just about acquisitions. We've also been able to grow organically at a very significant rate. If you caught what I said earlier in the very beginning, just our organic growth rate alone this year would represent the fifth largest chain in this industry, just what we're adding this year incrementally, and that's organically. And we've had a very balanced growth rate. You can see that our annual growth rate between organic stores and acquired stores is roughly 16% to 17% for both of those – at those rates which just demonstrates that we're not just a one-trick pony so to speak.

Speaking of acquisitions, look, we understand – we took a lot on our plate in 2014, we understand that. As I've said many times, we sometimes cannot time these things. We're on our march to go border-to-border and coast-to-coast, and I think given our growth rate, 60% increase in sales and adjusted EBITDA, we're doing a really good job of getting that done.

We've also been doing a very good job of integrating multiple acquisitions. I can't think of another company that's purchased nine companies in one year, but there's maybe some out there. But we've done that and we've been showing and proving that we can convert those, get those brought in and we're doing a very good job of doing that.

In Chicago, it's very highly noted that we have a little bit of a rough start right out of the gate, primarily because of signs and really trying to get those signs permitted. Once we got that done, as you can clearly see that line of demarcation, we started to really ramp up as that advertising set in, going back to that slide I showed you earlier. Once you convert those over and get that advertising going, with the 26.5% growth rate from Q1 to Q2, we showed a reduction in the drag by approximately $2 million. And so, we're now approaching a breakeven level, and so we're pretty excited about the progress that we made in Chicago.

Sleep Train, obviously one of the largest – actually, not one of, but the largest strategic acquisition to-date that we have made, very strong business. That business has been growing all year basically at low-double digit comp rates which is not in our comp base. We hear a lot of discussions around, should you be comping equal to ISPA? Keep in mind, we have about 400 stores to 500 stores that are not inside our comp base that are comping at double-digit rates and that are driving the ISPA numbers up. So just for perspective, that's something that I think is really important to notate.

But we've also – as we were talking earlier, we've taken these stores and what we've done is we've rebranded the Mattress Discounters stores. As Ken talked about in the brand slide of the different brand formats that we have between Sleep Train and Mattress Discounters, we've been converting those Mattress Discounters to the Sleep Train name. Why would we do that? Because of RMS, because RMS means that we can leverage more advertising dollars by getting more penetration and driving a lot more profitability. And you can see it's working. As soon as we rebranded those in the middle of the summer, we've also been growing those at 26%. And by the way, these are highly performing stores from a top line point of view. So from our perspective, I think that's a lot of evidence about the power of how RMS works.

Now, as far as organic growth goes, what's in front of us, what do we have to look forward to? As I said, in my opening remarks, we're in the middle innings. We have a tremendous opportunity in front of us with a little over 2,200 locations. If you kind of just fast forward over the next few years, basically the balance of this year and then between new stores and closures, we'll open about 700 more stores when we get through 2018. So, that will take us to about 3,000 stores which leaves the other 1,500 stores for the future. That 1,500 stores basically when we get to 4,500 stores would take us, if you impute that up against the U.S. population at that time as projected, we'll be right at about one store per 70,000 across the whole United States, keeping in mind that our top markets are operating at about one store per 50,000. We don't believe we can get to one store per 50,000 in every single market, but we do believe in a lot of the top markets that are highly dense where there's not a problem at all in getting to those numbers and we've proven that.

So, that's a lot about our growth plan. I think from here, what we'd like to do is I'd like to introduce our CFO, Alex Weiss, to go over our financial and our growth targets. Thank you.

Alexander S. Weiss
Chief Financial Officer

Thank you, Steve. I'm going to go through the financial portion of the presentation. As you can see, we've grown our sales and our adjusted EBITDA at both very strong rates historically, with our sales growing at a 41% CAGR since 2010 and our adjusted EBITDA growing at a 36% CAGR. This has come from both new store growth, same-store sales growth and acquisitions.

We have been very pleased with the consistency we have seen in same-store sales recently, showing five years of positive comparable store sales growth and eight consecutive quarters of positive comparable store sales growth. We've received a lot of questions historically around the reports that ISPA puts out where ISPA, as many of you know, tracks the wholesale growth of the industry on a month-to-month basis.

One thing to keep in mind is that ISPA is a total industry growth rate, not a comp store growth rate. So we've made an attempt at normalizing what ISPA would look like if you pulled out our organic growth and if you pulled out the new store growth of the other top 10 mattress players.

And in order to do this, what we did is – and you can trace a lot of this back if you look at our public filings. But we pulled out new stores. We've pulled out same-store growth from Mattress Firm. We've pulled out our growth in the Sleep Train business on a comparable store basis in the second quarter and subtracted out closed store growth. What this came to be was about 2.3% of industry growth.

Then when we pulled out the new store growth from the other leading players, we found that to be about 1.3%. And you subtract that out and you get to about a 3.4% normalized Q2 growth rate for ISPA which was slightly higher than Mattress Firm's comparable store growth rate during the second quarter. And the big reason for that was a little bit of underperformance in the oil market as we mentioned. However, it's nowhere close to the delta that it looks like on the surface, plus when you factor in, the fact that we have been opening a lot of acquisition markets and other stores, we've well outperformed on the top line.

Going into our third party financing business, it's important to note- and Steve and Ken mentioned it earlier – that third party financing has been a nice incremental driver for Mattress Firm. We've seen third party financing increase both ticket and conversion. And what we've really been able to drive over the last few years, you'll notice that our primary financing has stayed fairly consistent around 32%, but we've worked with our secondary and tertiary providers to increase our financing up to about 38% total at the end of 2014. And the biggest way that we've been able to do that is as we've grown our scale, we've been able to make a program that's really helpful and beneficial to both Progressive and Genesis in order to roll out across the country. And so, when they have the scale that we have, they can generate a better return and build programs for us.

We've been investing a lot of capital expenditures in order to support both the maintenance of our business, the conversions of the acquisitions and to self-fund all of our organic growth, and still generate additional free cash flow to pay down debt. One area that we invested in in 2015 was about $25 million to convert all of the acquisition stores we completed during 2014. As a result, that's $25 million of extra CapEx that is not going to repeat in 2016.

In addition, we've been making investments in standard maintenance-related items in IT, in new warehouses to support our growth. And then that comes out to be about 25% for a standard maintenance CapEx. Then we've been funding all of our new store growth, as I mentioned. When you add it all up, that comes to about $110 million which we expect to decline in 2016.

We have a very strong cash on cash payback model at the store level before additional market level cost or cannibalization. This payback model allows us to get all of our money back from opening a new store in less than a one year period. We're able to do this because we control our build-out costs. We don't have to add a lot of new inventory when we open up a new store, and we get money from our landlords and vendors. Our cost to open a new store comes out to a little over $200,000 per store, and we achieve about $950,000 in sales over the first year and mid-20% store level EBITDA margins.

We also have a negative working capital model which is very helpful in funding our free cash flow growth. Typically, we're able to receive cash when we sell a mattress about two weeks before we actually have to pay our vendors.

As you can see, we have a very strong history of generating free cash flow that we've proved out this year generating about $55 million during the second quarter and generating what we expect to be $77 million over the full year. This has been done by limiting capital expenditures as appropriate but also through ways that we have purchased companies in a proper manner to achieve potential tax deductions of what will be $11 million a year for the next 14 years, in addition to finding other ways that we can generate cash within the business.

Typically, you see cash flow decline during periods of acquisitions. You saw this in 2012 when we purchased Mattress Giant and, in addition, in 2014 when we purchased the nine acquisitions. As a result, you've also seen a bounce back in 2013 and in 2015.

We're really happy that when you look back to the time of the Sleep Train acquisition, we raised a bunch of debt. We levered up to about 3.5 times. And since then, we're expected to lever down to about 2.6 times on a net debt to EBITDA basis by the end of 2015 or a deleverage of about 90 basis points, both from free cash flow and additional EBITDA expansion.

Now, I will turn to our long-term targets. Before I get into the specific numbers, we have a very clear path to achieve the targets that I'm going to lay out for you. This path will be determined through both continued store growth, which will be proven out through infilling existing markets and achieving relative market share, which

Steve discussed, by continuing our march towards national scale, through driving average store volume, which is some of the items that Ken discussed, by sharing best practices between Mattress Firm and Sleep Train and improving our accessories business, and then lastly, by expanding operating margins back closer to where they were historically. And this will really come through proprietary and exclusive products, as Ken described, through efficiencies with third party financing once we start our new financing contract in April with our new provider and also through overhead leverage now that we've streamlined the organization as a result of our recent organizational changes.

Starting off with store growth, you can see from 2003 to 2013, we grew our store growth at an 18% CAGR. Going forward, Steve laid out its store target of 2,900 stores to 3,000 stores by 2018 which is significantly higher than the store target we put out at our last Analyst Day. This allows us to achieve about 7% to 9% compounded annual growth rate per year through 2018 or about 200 net stores a year.

From a net sales growth perspective, we expect to take the 7% to 9% store growth CAGR that I just mentioned and grow our same-store sales at about a 2% to 3% rate, so similar to what we've guided to for the last couple of years. This takes us to a sales target of about $3.4 billion to $3.5 billion in sales, which is a slower growth rate than what we've able to achieve from 2003 to 2013, or 19%. So, we think it's very credible. In addition, this is much higher than the prior target we gave at our last Analyst Day.

Lastly, we expect to grow EBITDA at a 13% to 15% CAGR over the projection period, taking into account the sales growth which we just mentioned and about 100 basis points of margin expansion. This will take us to $375 million to $395 million of EBITDA by 2018 or significantly higher than the target we laid out at our last Analyst Day.

In order to achieve this 100 basis points of margin growth and take us back closer to our historical EBITDA margin targets, we believe that this will come from a number of reasons including having more time on the track with the recent acquisitions that we completed in 2014. The biggest area, as I mentioned earlier, will be gross margin expansion which, in addition to increasing private label usage and exclusive products, there'll be some sell – tweaking of selling behavior with some of our associates where we can increase some margin expansion as we focus on the business.

The next area of efficiency will be sales and marketing expense leverage, both the financing expense leverage that I've mentioned, once our new contract starts in April, in addition to the fact that as we're able to increase our relative market share and penetration, we should be able to leverage our advertising to some degree.

Lastly, we think there's considerable expansion in corporate overhead over time. Now that we've built an infrastructure for a high-growth company, we've shown you that we've started to leverage sales this year. With the organization streamlining, we expect to leverage sales further this year into driving down our corporate overhead. And then going forward, we expect to grow our overhead at a slower rate than sales growth. These positive factors will be offset by occupancy deleverage which we built into our model.

When you sum up all of these financial targets, this gets you to approximately 20%-plus EPS growth through the 2018 timeframe. Please keep in mind that this is before acquisitions, and it's just our organic plan.

Now, we will open up the floor to Q&A. I'm going to have Rob, Scott, Ken and Steve come back up. And before you actually announce your Q&A, if you could mention your name and your institution, that would be very helpful. Thank you.

QUESTION AND ANSWER SECTION

A

All right. We're going to start right over here.

Michael Louis Lasser
UBS Investment Bank

Q

Hi. Good afternoon, it's Michael Lasser from UBS. So, you've just outlined a compelling plan. Can you talk a little bit more about the profitability goals? It's still where you expect to be in 2018, it's still going to be below where you've been in the past. So, what's changed about the business, such that the profitability is going to be lower despite the fact that you're going to be much bigger business? And also, what was not mentioned in some of the profitability drivers was accretion from all the acquisitions that you've consumed in the last couple of years. Is there something that you found about those acquisitions that are making them not as profitable as you anticipated?

Alexander S. Weiss
Chief Financial Officer

A

Yeah. So, those are two both very good questions. So, the first point is where we sit today, we've grown our sales and EBITDA considerably since the timeframe when we were coming from our last Analyst Day. However, our EBITDA margin percentage, we now sit at a reference point that's 100 basis points to 150 basis points lower. And that's from a few different factors, the largest factors being both occupancy deleverage, as rents have increased over the timeframe, additional financing use, which has raised our financing percentage. And one item is we've bought in some of our franchisees which were EBITDA margin percent beneficial, but we've generated more EBITDA dollars from them. But now, they're in our base, and so you don't have that sort of natural lift to the same degree from the franchisees.

So, we're sitting here at a lower reference point. We're still expecting 100 basis points EBITDA margin growth, which we think is very credible and deliverable, given that we're at a current reference point. We're coming off the acquisitions. We've got a management team in place that's been streamlined with the new organization and is able to take action quickly and effectively. And so I think we feel very good about the long-term in our plan for that.

Michael Louis Lasser
UBS Investment Bank

Q

And the accretion.

Alexander S. Weiss
Chief Financial Officer

A

And the accretion from the acquisitions, so as Steve showed you on the slide, we started out the year while the acquisitions were going through their ramp-up phase. During the second quarter, we started to ramp up those acquisitions significantly and have seen kind of a nice benefit from a large portion of those acquisitions with Chicago obviously still being a slight drag during the second quarter and really kind of the Phoenix and Tucson market being a little bit slower. But overall, we've started to see a nice ramp up. And we think that there will be a nice ramp-up going forward.

As you remember with Mattress Giant, it took a couple years to get fully ramped up. So, we continued to climb over a two-year period. And so, we think there's a nice benefit going forward over the next couple of years while we go through the 2018 projection period.

Steven Mark Wilson
Lapides Asset Management LLC Q

Steve Wilson, Lapides Asset Management. When you look out over that three-year growth plan, the most obvious void in your network is in the Northeast. In this case, it's the reverse to what you talked about. You're going to be facing an incumbent who has a fortress set up vis-à-vis where you're obviously starting from scratch, more expensive real estate, more expensive media. Where do you have to get in the Northeast to hit the 2018 goals? And how do you factor in going in that market with an entrenched specialty player vis-à-vis what you've been able to do in the rest of the country? How different do you think that plays out? How aggressive do you have to be, or how much time do you have to sort of make that work?

Stephen R. Stagner
Chief Executive Officer & Director A

Yeah, Steve. We can primarily reach our 2018 goals with the existing markets that we're in for the most part. Speaking of the way to enter the Northeast, there's obviously a lot of ways which we've proven over time. You can go organically and certainly, that's riddled with some of the challenges that you bring up – and we're very aware of that – or you can do it through acquisition, either one singular acquisition or a multitude of acquisitions. There are some other players in the marketplace, and then there's obviously the large players.

So, we don't predict or project what could happen in any of those different scenarios because we don't control how those acquisitions may or may not come about. But right now, we're focused on our existing markets. And if there's an opportunity that comes up in the Northeast, certainly, we're going to have our eyes towards that for our long-term goals. If you look, there was 1,500 locations kind of pushed 2018 and beyond. That's approximately the amount of stores that operate from about Washington, D.C. to Boston just as an example. So I think that we've left ourselves sometime to contemplate that and figure that out.

Curtis S. Nagle
Bank of America Merrill Lynch Q

Great. Thanks very much. Curt Nagle with Bank of America. I guess just quickly going back to or hinging off of Mike's question, in terms of the long-term comp rates, it looks like that was taken down just a little bit, part of the past Analyst Day. I guess if you could just comment on what's driving that. And just a quick follow-up, Texas, particularly given what [ph] Brinker (01:28:45) said and just kind of how that lies right now.

Alexander S. Weiss
Chief Financial Officer A

Yeah, absolutely. So from a comp perspective, we guided to 2% to 5% at our last Analyst Day. Now, we've guided to a 2% to 3% range. That's consistent with the guidance we've given at the beginning of the year for the last two years. I think that if we were able to achieve some of the pent-up demand that we believe is in the industry with units being down compared to historical levels, I think it would get back up to kind of the guidance we gave at the last Analyst Day from a same-store sales perspective. We don't want to estimate that that's going to occur in our guidance. And while same-store sales is a driver, given our relative market share model, we don't need same-store sales to function. It's a nice tailwind, but that's not the main driver of our story.

Laurance C. Leeds
Buckingham Capital Management, Inc.
Q

How much of the nation – the business is still inhabited by [indiscernible] (01:29:56) one-, two- or three-store operations around the country. And if that is still a lot, do you have an absorption plan where if it's two stores or three stores at a market that you could pick up that really dovetail with which you're doing, not all big – are there a series of very small accretive acquisitions, one, two Zs and three Zs?

Kenneth E. Murphy
President
A

They're definitely still are out there. Over the last 10 years, as Steve talked about, we've gone through 26. It's Sleep Train and Mattress Giant that get a lot of attention. We've had some of the small ones and twos. It would be – for us, the cost to open a store is so – those new store economics are so positive that we wouldn't typically really actively seek those. But if it helps expand a new market for us, it can get the scale, or it's a nice pickup for us, we'll sort of evaluate it through the lens of what would it cost to open a new store. So, there are none at that one store or two store that are actively on our list. But we have precedent for doing them, and I think we would consider that in the future as well.

Alexander S. Weiss
Chief Financial Officer
A

Yeah. What would be more likely, there are a bunch of 20 store chains which fly under the radar of the top 10 that you see in Furniture today. But particularly out on the West Coast, where Sleep Train did a phenomenal job of rolling up the West Coast, but they did not have the same capital base that Mattress Firm has. And so, there are still a couple of those, 20 store chains or 30 store chains, out there particularly on the West Coast.

Keith Hughes
SunTrust Robinson Humphrey, Inc.
Q

So, building on the first question, Alex, your answer on margins with the – the target is below what you've talked about in the past. You had talked about using more financing and things. Are you talking in the future or kind of where you are today? I was just confused.

Alexander S. Weiss
Chief Financial Officer
A

Yeah. So, I think from a financing perspective, we've obviously implemented our waterfall application which has increased our overall financing percent. So, what that will do is – and you saw a part of that in the second quarter where that raised our overall financing percentage as a cost of sales.

We've implemented some items during the current year in terms of changing where the limits are, when someone can use X years of financing to purchase a bed and other small tweaks to bring that back in line during the current year. And then going forward, starting in April, we have a new financing provider for the entire chain for our primary provider, and we've got a better contract than our current contract. And so, just once we roll on to that new contract, we're going to see some benefit.

Keith Hughes
SunTrust Robinson Humphrey, Inc.
Q

So looking at the next three years, the margin goal is lower. What's the drivers for the lower number versus what you talked about before?

Alexander S. Weiss
Chief Financial Officer

A

Can you say that one more time?

Stephen R. Stagner
Chief Executive Officer & Director

A

What he's asking is what's the driver before the lower guidance, kind of like Michael's question.

Alexander S. Weiss
Chief Financial Officer

A

Yeah, compared to the last Analyst Day. So, the driver as a percentage is really just we're starting at a lower reference point. And so, we think we're going to gain 100 basis points of leverage over the next three years. We're not going to stop there. That's not our goal. But we want to be realistic knowing that we're at this lower reference point. We're going to build it up over time, but it doesn't all come back overnight.

Stephen R. Stagner
Chief Executive Officer & Director

A

Yeah. Let me try to answer that a little. I think this will help everyone. You remember the slide I was talking about the Case Market B that showed the market that was losing $1.7 million. And then over – all the way from 2011 to 2014, it got up to about 10%. We brought in a $1 billion worth of business that was sub-10% in the past 20 months. So, what's happening is we're you're taking store averages that are in some cases like Chicago, $700,000. Even though we're getting this 26% lift, it doesn't happen just overnight.

So, as we bring these businesses in, 668 stores last year, acquired, as we bring these in over time, it's going to take us a couple of years. That's one of the main drivers, Keith, why we don't want to guide too aggressively towards saying that we're going to be back to where we were and then plus to 13% immediately because we've got to take into account realistically that we've got to bring these in, get the RMS wheel going, get the store penetrations right, and in some cases, get out of some poor lease decisions that were done with the legacy operators, get into new repositions and then grow.

The good news is, to Michael's question earlier, we're seeing all the accretion in the synergies that we thought we would get, that we guided to you. It's just as you can see on the case slide B, it just takes a couple of years to get there. We're one year in. And so, we need to make sure we're appropriately realistic with you guys on how we're going to get there.

Keith Hughes
SunTrust Robinson Humphrey, Inc.

Q

So the last – final question. The last year, the stores you brought in via acquisition and greenfield to what I think you're referring to, have they come in at lower margins that you would have anticipated a year, a year-and-a-half ago?

Stephen R. Stagner
Chief Executive Officer & Director

A

The new stores, you mean organically?

Keith Hughes
SunTrust Robinson Humphrey, Inc.
Q

Yeah. You said you started up – is it taking...

Stephen R. Stagner
Chief Executive Officer & Director
A

I'm talking about the acquired stores. The 668 stores that we acquired, even the Sleep Train business was making less than 6% as a total business. Until we get the RMS, we're 80% done on taking the Mattress Discounters stores over to Sleep Train. Until we get all those stores rationalized, that's when their profitability starts to flow, and all these stuff takes some time. But the actual EBITDA dollars are obviously you're seeing those really grow. But from a percentage point of view, it's going to take a couple of years to get there. And that's what we're really trying to give you guys the best realistic picture for this. But the new stores, to your answer, organically, there's no real change on those. Those stores are coming in just relatively similar to what we've historically seen.

Hale Holden
Barclays Capital, Inc.
Q

Hale Holden, Barclays. I have two for you. Alex, you delever really quickly, if you hit the midpoint of your guidance particularly with lower CapEx next year, so maybe you could talk about what use of free cash flow is and where you want balance sheet leverage?

And the second question was on real estate. We talked to some other folks that have had trouble finding real estate. There's a little bit of SG&A deleverage and occupancy in your guidance. I was wondering how easy it was for you to find the main and main locations that you're looking for and whether they still exist for that 200 stores a year or whatever?

Stephen R. Stagner
Chief Executive Officer & Director
A

I'll answer that first and then [indiscernible] (01:36:39). We can find the real estate. We've been able to find the real estate. The challenge today is it's just more expensive. We do a lot of developer-based ground-up development, partnering with different other retailers that are very strong. Our real estate department has proven to be very prolific and successful. So I'm not that concerned. I don't lose an ounce of sleep at night about our ability to find real estate. It's just the concern that I think Ken and Alex and Rob and I share is that the absolute rate of real estate in the country has really gone up quite a bit. And so, I think it's been a little more selective over the coming years to make sure that we're getting the appropriate leverage over there.

Alex, why don't you talk about the leverage and the free...

Alexander S. Weiss
Chief Financial Officer
A

Yeah. And so from a leverage perspective, this is something we're really proud about as a company that this business is set up to generate free cash flow when we're not in a heavy acquisition year. And so, even spending $25 million to convert all the stores that we acquired in 2014, we still generated $77 million of cash flow. When you combine that with, as Steve mentioned, taking EBITDA which included a lot of what we call pro forma EBITDA from the acquisitions we had done at a certain level and then taking those up to a much more normal level and once we get through the third quarter, we'll be through the majority of what we'd call that pro forma EBITDA. We do generate a lot of cash. It's our goal to pay down debt.

As you know historically, we've done acquisitions, levered up a little bit then paid down. And so every extra dollar we get, it's our goal to put it in the bank, pay down debt so that whenever future acquisitions come up, we're in a good place to do them at a reasonable leverage level and then continue to pay down debt.

John Baugh
Stifel, Nicolaus & Co., Inc.
Q

Thank you. John Baugh with Stifel, Nicolaus. And I like the [ph] socks (01:38:45) Ken, really.

Kenneth E. Murphy
President
A

John, I appreciate that. He wants us to get a comment on that so that's good.

John Baugh
Stifel, Nicolaus & Co., Inc.
Q

Private labels, somebody mentioned it's going to double or triple in the next few years. I'm just curious what the plan of attack is there. Are we going to see advertising or is this more lip service to your other vendors to, hey, wake up, we need more help?

Kenneth E. Murphy
President
A

Yeah. I don't know that it's lip service. I mean I think, just to contextualize the comment I made earlier, I think long term, we believe it could double if not triple where the slides that we think is 25%, 30% of the business, that would be sort of in the long view. As I mentioned earlier, if our existing partners want to help, be a part of that, we welcome it obviously; more than welcome it, we're asking for it. And there are real value accorded to the supply communities well, given our size and scale. It's more efficient if you want to do a proprietary product for somebody that has 2,500 doors across the country than it is original player.

We have a reason to believe that there's going to be an increased appetite for that. Simmons already has responded with a proprietary product in the hybrid space. It's been very well received. It's been received by consumers and by our associates quite well. They're the first one, at this point, that has stepped up to that. Our viewpoint, the path to getting there is it can happen from a couple different ways and we'd love nothing morethan for that to happen with our existing partners who want to follow Simmons suite to the degree that it doesn't.

There are opportunities for us to do true private label with other partners. We have a close relationship with the Sherwood Group, who builds a lot of our Hampton & Rhodes promotional product. And so, that already is a part of the opportunity today. And then certainly as Alex alluded, as we look to proliferate accessories, there's a good opportunity in that space as well. So we're looking existing partners. We're sort of scanning the universe as it were for opportunities. I think it'll probably happen in the categories of mattress, accessories and then maybe furniture as well.

John Baugh
Stifel, Nicolaus & Co., Inc.
Q

[Inaudible] (01:40:44) Will you start advertising Hampton & Rhodes? Number one. And are you considering the Simmons exclusive an example of private label?

Kenneth E. Murphy
President
A

Yeah, we need to. Today, if you were to evaluate the units sold under the Hampton & Rhodes label, it would be enough to position that brand as the sixth largest mattress manufacturer today and [indiscernible] (01:41:07) to have a website for it, let-alone market it. So, that is part of the plan. It is to make sure that we – one of the benefits afforded you was size and scale. You have obviously a larger advertising budget. We can, if we need to, go it alone. We can invest more into that to the degree that it comes from our existing partners, that's even more efficient and it's a win for them too.

Simmons feels really good about the success of the Black Hybrid program because it's helping their books as well. And so, we really do try to create win-win opportunities provided the product is meaningful in the marketplace and it can hold value.

Daniel H. Hofkin
William Blair & Co. LLC

Q

Dan Hofkin, William Blair. I just wanted to come back to this chart on page 61 for a minute where you kind of bridged the gap between the ISPA industry growth and your comps. Is cannibalization captured somewhere in here like in that second – that negative 2.3% or is there's some – I'm just trying to understand how simply you're adding stores organically at the pace that you have would lead to that much extra total industry spending. I can understand creating an outsized contribution for you, and maybe there's some cannibalization in there. But how does that lead to that much extra total consumer spending in the industry?

Alexander S. Weiss
Chief Financial Officer

A

Yeah, I'll give you the exact numbers because you can basically pull almost 100% of this from public filings. So what it is, if you go to our Q2 release and you look at – you basically take the new store dollars from Mattress Firm, the comps for Mattress Firm, and then you subtract out the closed store dollars from Mattress Firm. And that's what we post kind of in our breakout. And then you add and Scott – I think the exact number is it's about $11 million from comparable store sales growth for Sleep Train. That gets you to what we would call organic sales growth for Mattress Firm.

And then basically, we take that and divide it, call it, by in half to get to an approximate wholesale-ish number. Then if you take that number, divide it by the total industry sales in Q2 at the wholesale level from ISPA in their report from the – during our fiscal second quarter, you'll come up with the 2.3% number. So we can talk about it offline, but it's all either stuff we've reported or you can pull directly from our filings.

Daniel H. Hofkin
William Blair & Co. LLC

Q

Okay. And then your expectation going forward, 2% to 3% comps, what's baked into that in terms of units versus AUR, and why might you not expect that to be a little closer to the type of industry growth, not necessarily all the way there but somewhat closer.

Alexander S. Weiss
Chief Financial Officer

A

Yes, so I think we except that to return to more kind of a normalized balance between units and AUR going forward. As you know, for the last year, we've been driving our growth a little bit more with AUR really as the Tempur-Pedic customer. And the mid- to higher-end customer has been feeling pretty good. The low-end customers, as you know, like kind of across retail has been a little soft this year. And so, going forward, we expect it to be much more of a blend.

Stephen R. Stagner
Chief Executive Officer & Director
A

And if I may add something to that, Dan, we're talking to you about adding about 700 stores in existing markets. I spent a couple of minutes talking about relative market share. One of the big drivers of our growth story is driving profitability. And we understand that comps are really important with five years of consecutive positive comps, eight consecutive quarters of positive comps.

But at the same time, part of our focus is getting a distinct lead over our competition, A, and then, B, driving out market level profitability. Not at the complete expense of comps but comps is not the primary wake-up-in-the-morning driver. I know it's a great optic for The Street to look at and all that, and it's really important. And we take it very seriously which is why you've seen us react in quarters where we've had negative comps to try to drive units or to try to drive AUP. So, it is a very [ph] tough thing (01:45:34).

But we would rather guide, if we're going to be adding 700 stores in primarily existing markets, we'd rather just be as realistic as we can. There might be a little bit – usually, we see 10% to 12% cannibalization in existing stores when we put stores in somewhat close proximity. So, it may mute our comps a little bit, but at the same time it drives up profitability.

Kenneth E. Murphy
President
A

Yeah. I think that point for Dan, but I know it's out there, just sort of in the ether is we see exhibits where RMS drives up total store productivity and that's true. What you may not get, where they maybe a disconnect is the fact that this is perpetual adding of stores, 200 stores, 300 stores a year. If we were done with the store growth business, then yes, our expectations for comparable performance would be proximal or probably perhaps even above ISPA. But it's the byproduct of adding 300 stores, 200 stores, whatever the number of stores is. So, it is muted a little bit. And it could be confusing when you see while on these exhibits. I saw your store average ultimately moved up but you don't perhaps get the full picture of it. It takes some time to get there. We will see this 10%, 12%, 13% for close proximity stores on average degradation, the base than resets the next year and it starts growing. It's not static...

Stephen R. Stagner
Chief Executive Officer & Director
A

And part of that – yeah. Just to add a part of that is you might have a $3 million store that's just really overachieving in a trade zone. And we may add two more $1 million stores and that $3 million stores may go down to $2 million. And comp, really ugly negative, still make a lot of money. But now, we're doing $5 million in the trade zone.

And so, we look at trade zone, that real estate slide that Ken was showing you, we look at propensity to buy inside trade zones, and we try to maximize up to a 40 share to 50 share inside that specific trade zone which might be a 7-minute to 10-minute drive time. And so, yes, it's important to comp, but just because we open up the store and we're doing $4 million or $5 million or $3 million of a specific store, I don't think that I'm going to sit there as a team here. We're not going to sit there and say, well, let's focus exclusive and driving that to $3.2 million. I'd rather open two more stores, cover the north to south, the east and the west and do $5 million or $6 million or $7 million in that trade zone. And leverage the advertising, leverage the warehouse, leverage the training, and leverage all that. And that's where it gets confusing with those charts, is because yeah, the sales per store go up because you're adding all these stores. But you got a lot moving. But again, it all goes back to RMS.

Bobby K. Griffin
Raymond James & Associates, Inc.
Q

Bobby Griffin from Raymond James. Alex, can you maybe just talk about what the pathway to 2018 assumes for the oil affected market? Are you – yeah. And do you expect them to get back to prior peak in order to reach 2018 goals?

Alexander S. Weiss
Chief Financial Officer
A

Yeah. So, for the oil affected markets, we kind of expect them to stay at a similar sales level that they're at. So, basically we expect – we don't expect further drops in oil. We expect some stabilization, but we also don't expect oil to come rocketing back in those markets to come rocketing back.

Daniel P. Cannon
Benjamin & Jerold, LLC
Q

Hi. Dan Cannon, Benjamin & Jerold. As part of your growth strategy, have you considered moving into Canada, Mexico or the Caribbean?

Stephen R. Stagner
Chief Executive Officer & Director
A

Dan, our focus right now is primarily the United States.

Alexander S. Weiss
Chief Financial Officer
A

Yeah, longer term, I think we would consider other places but as Steve said, the U.S. first.

Seth M. Basham
Wedbush Securities, Inc.
Q

Hi. Seth Basham with Wedbush. Can we talk a little bit more about RMS? I'm still a little bit confused. As you think about the next three years, do you expect to have comparable store sales growth to make the RMS strategy work?

Stephen R. Stagner
Chief Executive Officer & Director
A

Yeah. I think we're guiding to comp store growth that this is what we're communicating, 2% to 3%.

Seth M. Basham
Wedbush Securities, Inc.
Q

Okay. So by definition comps matter and you need comps in order to leverage the fixed cost and grow profitability?

Stephen R. Stagner
Chief Executive Officer & Director
A

Yeah, very clearly, As I said, comps matter. Just from an RMS perspective, keep in mind because of the scale that you get, Seth, over the marketplace, if you've got a trade zone where you're doing $2 million in a store and you can open up another store and do $1 million, even if you comp down 10% by adding that $1 million in a trade zone, you can drive more profitability because you get leverage over advertising. As we kind of outlined in the slides where you could see that the advertising as a percentage in the market levels went down from 11.3% down to 8.3%. So that drives up the profitability that you saw go up from 6% to about 17%, and that's a primary driver.

Then as Ken mentioned, when we get the country filled out and we become more steady state, then comps become more of a primary driver. So we're not saying that comps are not important at all. We're saying it is a very important part of our strategy, but it's balanced by the fact that we got to drive a fortress position and market level profitability.

Seth M. Basham
Wedbush Securities, Inc. Q

Okay. And then just as a follow-up from a cannibalization rate standpoint, do you expect that to change between now and your 2018 timeframe?

Kenneth E. Murphy
President A

I would say, Seth, we don't. And the reason that we say that is, that's been fairly steady state for us over the last really five years. We, from time-to-time, will update our cannibalization analysis studies. We will pick new markets. We'll pick new places. Recently, we just completed that, some very similar results to what we saw back in 2012. So if history is a proxy for the future. We feel that that's the appropriate way to sort of think about that.

Seth M. Basham
Wedbush Securities, Inc. Q

Thank you.

Michael Joseph Russell
TimesSquare Capital Management LLC Q

Hi. Mike Russell from TimesSquare Capital Management. I have three questions, and they're all pretty short. I guess one for Rob. The 60% that you mentioned that people are turning over their beds within the eight years, that's better than it was last year. I think it's 65%. Can you talk about maybe what got you to change that number? Is that something you guys are doing, some success that's occurring?

Robert D. Killgore
Chief Operating Officer A

Yeah. The section what we're talking about...

Michael Joseph Russell
TimesSquare Capital Management LLC Q

[Inaudible] (01:51:38)

Stephen R. Stagner
Chief Executive Officer & Director A

Yeah. Slide 18.

Robert D. Killgore
Chief Operating Officer A

Yeah. Yeah, I think it's the value of the Replace Every 8 campaign. And I think as the economy improves, we continue to make market share through RMS. We're generating more demand. We're getting more distributors back in the marketplace to replace those guys.

Michael Joseph Russell
TimesSquare Capital Management LLC

Q

Okay.

Kenneth E. Murphy
President

A

Yeah. Michael, just real quick to add on to Rob's point. We've recently introduced some research that suggest that close to 90% recall on that Replace Every 8 campaign. Anecdotally, we're at cocktail parties or just sort of out in the neighborhood, you hear people talking about that empirically that that concept seems to be resonating in the markets that we're in. So we absolutely do think we're part of that solution.

Michael Joseph Russell
TimesSquare Capital Management LLC

Q

Great. And then on page 55, the nine acquisition markets, there are three going the wrong way in terms of margins. I know that you're not labeling which is which. You've mentioned Chicago, Tucson and Phoenix. But if you could just make sure that we understand what's collectively going on outside of Chicago, just maybe within Phoenix and Tucson, to give us the acquisition. I guess 5, 6 and 7 are all kind of...

Kenneth E. Murphy
President

A

Yeah. So, you can use your own deductive reasoning just to figure out perhaps what those markets are. Alex talked about Arizona. We remain long-term very bullish still on the State of Arizona. It has historically been a good state for us. I would tell you, you walk in to Arizona over the last 12 months, there's a lot of stuff going on. We not only acquired two different companies within a relatively condensed span, we also introduced the Mattress Pro concept. This has been a market internally that really and truly has been in pretty high degree of flux.

We don't look at anything from a macro perspective that gives us pause about the State of Arizona or the Southwest. It's our belief this is a byproduct of uber intensive digestion. The example that Steve showed, the Exhibit B, where he showed the market progression, that was another market where we had multiple acquisitions that happened in a relatively condensed period of time. It got ugly before it got better. But ultimately, it got better and we expect that to be the case here as well.

Michael Joseph Russell
TimesSquare Capital Management LLC

Q

Okay, great. And last one for you, Steve. On slide 46 when you go through the different leadership fortress and developmental, it seems like you're doing better in fortress and developmental. And I know that this is kind of apples, oranges and pears. And that last year's leadership might not be the same stores as this year's leadership, but leadership seems to be the place where that category – where the margins are lighter than they were before. And I'm just wondering is there any – is there a story in there? Is there something about occupancy in the leadership category, or is it just a different set of stores than it was last year?

Stephen R. Stagner
Chief Executive Officer & Director

A

Slightly different set of stores and I think that typically, we're in that bucket. It's just a little more competitive set. I mean when you're developing, you're just entering kind of new. And then you're kind of fighting for position. And then as we get into position, it takes us up.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Yes. Brad Thomas for KeyBanc. I wanted to ask about accessories as a revenue driver for you. You're well below a number of competitors in terms of accessories as a percentage of sales. Can you just talk a little bit more about how quickly you could drive that higher and how you'll do that?

Kenneth E. Murphy
President

A

We think, Brad, it's a great observation and we would be the first to make it ourselves. Candidly, it has not been an area of focus for this organization and we've been a square footage growth story, highly acquisitive and all that sort of things. So there are, at the end of the day, only so many things that you could focus on. But we think the upside is considerable. Certainly, there are competitors in our direct channel distribution that do a really nice job of it. Even within our own ecosystem, the Sleep Train organization, that's one of the best practices that we're porting over to the larger enterprise. It's a – some of the fundamental tenets of having a healthy accessory program.

We're being fairly conservative in terms of our expectations for what that might become. But ultimately, I think there's pretty good examples out there of the kind of legs it could be. So how are we doing it? We're testing a couple of different applications. Right now, in Houston, Texas as an example, we have more physical inventory in the stores positioned in a way. I think we may have had a slide, maybe on the slide around private label that I spoke to you.

You can see an example of that display unit. And results have been very positive there. I also mentioned a few slides later that we're piloting endless aisle program where it might be opening up the idea of a digital virtual catalog and today we're doing it literally with, I think, two SKUs. It's almost what we're selling is not so much important as does it work, is it easy for associates and guests. And we're advancing the pilot. We're going to roll that out to three or four more markets here late Q4. So probably it will happen in two ways.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Great. And just one follow-up if I could, your two biggest suppliers are undergoing some leadership changes, could you talk about how if at all you think that might affect Mattress Firm?

Steven Mark Wilson
Lapides Asset Management LLC

A

Well, the two suppliers are obviously Tempur Sealy, and Simmons and Serta are going through leadership changes. I think in both cases, the leaders that are kind of running the business we have very deep relationships with. We have contracts that are tied up over time. So there is no short-term concerns or effects of that. We spent a little bit of time talking to the new Tempur-Pedic CEO Scott, and he's mentioned that he's going to be very supportive of Mattress Firm and supportive of national advertising which is kind of near and dear to our hearts. And so we gained some confidence from that conversation. And then moving forward to Simmons and Serta, we have a very deep relationship obviously with Tony and with Michael and Gary has been a great supporter of

Mattress Firm forever. So that relationship is just improving by the hour. So Brad, I don't really see any reason of concern.

I think the real big opportunity is what we've been talking about is how are they going to strategically partner with us as we become larger and in terms of private label opportunities with them. And I think that's our number one thing and we said it publicly and we're saying it publically right now here again and I think it's pretty loud and clear message.

Keith Hughes
SunTrust Robinson Humphrey, Inc.

Q

Keith Hughes, SunTrust. Two questions. First on the Atmos, how is that going? And are you considering a wider rollout soon on that product. And number two, just on Mattress Pro, if you look back on Mattress Pro, what went wrong, why did that concept not work?

Stephen R. Stagner
Chief Executive Officer & Director

A

I'll start, Keith, with Mattress Pro. I think Mattress Pro is a fantastic concept in the sense of it has a huge opportunity, the problem is supporting it from an advertising point of view. It required us to support it with incremental advertising. So therefore we couldn't really make market level profitability until we get to scale.

And so if we potentially weren't trying to go quarter-to-quarter and hit all these numbers, we might [indiscernible] (01:58:56) and do that over time. I think there's an opportunity for a second chain. The stores and the people were doing a great job inside those stores. But the market level profitability wasn't there. The store-level profitability was but when you put into the overhead and then market level advertising that it required, it ultimately dragged us. We were very public about the drag effect.

And so the question is, do we have the tolerance for waiting another two years to get it to scale, inside those existing markets when concurrently we have all these other things going on. So we said to ourselves, look we don't want to on one hand say we're not really doing as well as we could be, but on the other hand, we'd rather be wise about it, cut our losses now and start focusing on bigger fish, and start really getting the business going and that's what happened, so.

Kenneth E. Murphy
President

A

To your first question Keith on Atmos. Atmos today is in three different markets for us, it's been received, I would say, generally pretty well by consumers and by associates alike. We are not planning at this point on an accelerated rollout and really for just out of a – I think wanting to be cautionary to make sure that it's completely right. As you know, we've had some fits and starts with the concept, today the results are generally, fairly positive. We're looking for a bed that ultimately and this is included in the Atmos program today. It not only can customize the microclimate but also can customize firmness and the articulation of your sleep position. We think for us to go national all three of those things have to be working and working in a pretty compelling way.

We remain super convicted in the belief that microclimate customization is a great frontier. We know that some of the national suppliers are – I should say we believe that they're interested in that as well. So who knows down the road, where the intersection for opportunity might be. I think it's a big space and we'll continue to monitor results before rolling out.

Keith Hughes
SunTrust Robinson Humphrey, Inc.
Q

Final product question on adjustable bases. We've seen tremendous growth in the industry on adjustable bases and Tempur said at their Analyst Day early this year, the Tempur brand was 50% or greater in terms of attachment rate. I would suspect Select Comfort's even higher than that. If you will, what kind of attachment rate have you seen, and is there any signs that this is penetrating into lower price mattresses or any signs that this just tapping out in general?

Kenneth E. Murphy
President
A

I don't know that we think it's tapping out. I don't believe we discuss publicly our attachment rate. I will tell you it's better than Tempur's average nationally. I can tell you that with pretty good conviction. So we think it's a great opportunity to enhance the quality of sleep. Our associates are really excited about it. Still today it's predominantly at the north end of the product opportunity. But we do think to your question that there is opportunity for that to help raise ticket in the lower price product.

As an example, the Dream Bed we introduce at the State Fair of Texas recently just to see how it would sort of interact and people would feel about it, had a very high attachment rate of Dream Bed sales with adjustable bases. So yes, we think definitively that could be a big part of AUP growth over the long term.

Peter Jacob Keith
Piper Jaffray & Co (Broker)
Q

Hi, there. Peter Keith, Piper Jaffray. I want to talk about interest free financing. It looks like we're in a really nice sweet spot right now. You've got four or five I've even seen some of your competitor do six years of interest free financing. Just looking out to 2018, if maybe we do see a rise in interest rates, could the industry and you guys maintain that level of promotion? And if so, how does the cost mechanism work with your financing providers?

Kenneth E. Murphy
President
A

It's a great question. So I think if you look historically at this company, interest free finance or consumer finance has been a part of our go-to-market offense for a long period of time and in variety of financial climates. So to your first question, if interest rates were to change, I think to think – it's important to keep in mind that would change for everyone. And so given our size and scale, we're well positioned we believe to have the most favorable rates out there. We remain committed to it.

For us, it's a good opportunity to help conceptualize the best possible sleep set but given the fact that we don't carry the paper, we don't carry the risk, we think it is – will continue to be a nice part of our offense. We'll look to do it efficiently. We want to make sure that we're wise and thoughtful about that. Part of that comes by negotiating better rates and part of it comes through being disciplined in when and where and how we offer it. But our viewpoint is not that it's going to change all that materially in terms of how it fits into our offense.

Peter Jacob Keith
Piper Jaffray & Co (Broker)
Q

And then there is the change to your prime financing provider in 2016, what was the decision behind that? And then what are the benefits with going with a new provider?

Alexander S. Weiss
Chief Financial Officer

A

Yes. So it was a couple of things. And Wells has been a very good partner to us over the last five years. Synchrony has been a financing provider to the Sleep Train business over the last few years and they've done a really good job with the Sleep Train business. They've been very hands on, high touch and try to think through creative ways to expand the overall business.

So as we focused on our waterfall application in ways we can drive additional financing business in a cost effective manner, we think they're going to be a great partner. They do primarily the financing for the majority of the people within the industry. So as we continue to roll up companies over time and expand across the country, there will be some real benefits there where we can roll people on to the Synchrony platform – would already be on the Synchrony platform but on to our version really quickly and in a more cost effective manner. Plus with the Sleep Train business, they have a long-term contract with Synchrony. And so by switching to Synchrony at this point in April, when our current contract is up with Wells Fargo, we're able to allow achievement and a lot more benefits a lot quicker with that portion of the business and roll on to just one combined system across the country.

Peter Jacob Keith
Piper Jaffray & Co (Broker)

Q

Okay. Thanks. And then I do have one other question on a separate topic with regard to the store growth. So you did about 150 stores two years ago, you're doing 300 stores this year – that's just a lot of stores. But just nitpicking a little bit, looks like your store economic model, year one sales came down by about 5% from last year's deck. Can you just help us get confidence that the 300 stores you're doing this year are getting the economics that you need in order to keep your returns where they've been and how do you guys monitor and measure that?

Alexander S. Weiss
Chief Financial Officer

A

Yeah. So we monitor every store that comes out of the gate and we look at it every board meeting. And as you mentioned Peter, it has come down a little bit from last year and prior years. It's still very healthy returns still, one year cash-on-cash return at the store level before market level cost and cannibalization of other stores. So it's still generating positive cash flow, positive dollars for us, even if it's slightly less beneficial than it was before. When we look going forward, we've given guidance for about 200 net stores per year. So kind of a very slight moderation but we have these new markets both out on the West Coast and in particular, you look at area on the West Coast like L.A., where we don't even have stores. We have stores in the Inland Empire, but no stores in L.A. Chicago, we need more penetration. There's still a lot of markets that are at that developmental and leadership level for us and so we definitely have room to grow and it's a model that pays back quickly.

Kenneth E. Murphy
President

A

I think one other thing that's important to understand is there's been a downside to all the frenetic growth and acquisitions. We've inherited a lot of good real estate but we've also inherited some stuff that when leases expire, we'll probably let it go. We obviously have very good line of sight into that.

One of the points of flexibility about this model is that we lease our stores, we don't own them. And typically they're relatively short term. So we to the degree as we see if the math doesn't support renewing certain stores, we're going to have an opportunity to do some targeted pruning. And I think knowing that and knowing where we're going, it emboldens us to make sure that we can get position for the right store. So as we look out over next two years or three years, we have a pretty good sense where we need to do a little targeted pruning. And again the beauty of the model is that we can do that and ultimately run a more healthy ship long term.

Michael Louis Lasser
UBS Investment Bank

Q

Michael Lasser again from UBS. Steve, the company has had inconsistent track record of meeting some of the financial targets that was set forth. So how should we get confident that these goals are more achievable? What can you point you to, to suggest that, we should walk out of here and believe that, that the targets are going to be obtainable? Then I have the follow-up after that.

Stephen R. Stagner
Chief Executive Officer & Director

A

Michael, you chastised us for margins too low and now it's the other [indiscernible] (02:08:24) You want us to keep...

Michael Louis Lasser
UBS Investment Bank

Q

I figured [indiscernible] (02:08:27)

Stephen R. Stagner
Chief Executive Officer & Director

A

You guys want us to go back to the13%, but then you want us to – yeah. Stop paying attention to everyone and focus on what we can do. That's rule number one. The truth is we've always try to set very realistic targets. We expected a lot of things to go right this year. We took on a lot and we own that. There were some decisions that we made, certainly some advertising decisions that we made in the middle of the summer that kind of tripped us up.

We're a management team that responds very quickly to things. We responded and got things righted very quickly. And so, we feel like we've rightsized things. I think over time, we're going to have to prove that to you, Michael, and so we know that. The conversation that we were just having around 2% to 3% comps versus 3% to 5% or 2% to 5%, again it goes to the whole conversation around what is the realistic targets. And I think what we're trying to communicate is this is still a great growth story. We're adding a lot of growth. But we also want to be very realistic about things as we've always try to be. But putting a higher degree of certainty around the numbers is what we've really been trying to do, so.

Kenneth E. Murphy
President

A

Alex talked about this in his comments earlier but we obviously have made a lot of investment over the last year, in infrastructure. And this has been a messy story with new markets and acquisitions. And ostensibly, you get to scale, you should see that flow through, kind of like the comp example of adding new stores. There have been things that have diluted that. I think I would tell you the reaction over the last few months to our first half results is not lost in this team. We get it. We understand that we have not set expectations appropriately. And quite frankly, I would tell you there's a level of discipline in our go-forward model. We're pretty resolved to make sure that we can control those things from an expense perspective and that we try to talk about growth and I won't say conservative but in moderate ways.

Michael Louis Lasser
UBS Investment Bank

Q

And Steve, you mentioned that there were some responses earlier in the year that didn't go as you planned. It wasn't too long ago that the company was less than 500 stores and now it's close to 2,300 stores. Do you have to take a different mindset to running an organization? Does the whole management team have to take a different mindset and a different approach to running a company this size versus one that was much smaller maybe less reactionary and spontaneous, because it's hard to effectuate change across the store base that you have today than it was back in the day?

Stephen R. Stagner
Chief Executive Officer & Director

A

I think overall – certainly, Michael, there's a ton more complexity as you triple the store count from when we went public, we had less than 780 stores. And so today – last year we opened more stores than we had when we went public between acquisitions and new stores. So just for perspective, there is some complexity.

But all in all, the business fundamentals are the same. We have the ability to operate this business and be not only flexible but also very responsive. I think that some of the noise that we had over the past year was we not only had nine acquisitions, but we had an integration which is very unique to us. We had an integration at the management team level. And so we probably underestimated a little bit of the noise that would happen through the integration of having new and different leaders with different mindsets. The blessing in all that is the lessons that we've learned from all that going forward. That's been a little bit unique versus prior years. That is behind us. Moving forward, we've learned a lot of things. And that's very typical. You always learn something new. We've very introspective leaders. We have – our saying is a positive sense of discontent. We don't believe that we know it all. We don't believe that we're the smartest people in the world. We just work really, really hard.

And so what we've done in the last year is we tried to figure out what are the things that we did right and what can we do differently. And to Ken's point, once we got through the management changes, we've been very aggressive about making the right decisions. And candidly I think, we're moving faster than we moved even back in 2011. I think the movement that I feel in this organization between September, say, the 10th and today is at lightning speed. And so I think anyone I can see [ph] Sunni back there (02:13:11) shaking her head. She's in the organization. And we're moving pretty quick. So I think we have the ability to do that. I don't think it's necessary a deterrent.

Kenneth E. Murphy
President

A

Yeah, quick but not haphazard. I think the reality is one of our greatest advantages is the ability to be agile and to make insight-inspired decisions and so in that respect, we're going to continue to do that. But to the point of the consequences of things that might be construed as whimsical but we have a great opportunity to test stuff. I mean the reality is we have conviction in a program or concept. We can go test it in 500 stores which is incredibly meaningful and yet not put the entire organization at risk. I think what you'll see from this management team is a balance of tests in that way but also decisive action when we think it needs to be taken.

Stephen R. Stagner
Chief Executive Officer & Director

A

And we weren't trying to not be fast last year. But we didn't know what we did know. And so when you take on a whole new business that has $2 million store averages and a slightly different way of going to market, there's a lot to learn from that. And so you don't want to be so fast that you throw the baby out with the bathwater, so to speak. So you really want to try to figure out, wait a minute, what's going on here? And that's going to slow you up just naturally. But I think we're in a really great place going forward to truly take advantage. Do you want to add something or I thought you were...

Robert D. Killgore
Chief Operating Officer
A

No. I feel the same way. The organization is moving very quickly now. We're streamlined. We're focused. The way that we have things aligned [indiscernible] (02:14:41) I have a great working relationship with Ken and Steve and Alex. Under the new organization structure, really having Ken focus on all the items that really drive selling and delivering beds, having me focus on the support functions, really cleans up the line of thought. We move quickly. We've gone through this process over the last year of sharing best practices between the Sleep Train organization, the Mattress Firm organization. The teams are highly aligned. We're excited about the path ahead of us.

Joseph Isaac Feldman
Telsey Advisory Group LLC
Q

Hi. Joe Feldman, Telsey Advisory Group. I wanted to ask a broader industry kind of question. On slide 15, you guys put up kind of unit sales for the industry and also the average price per unit. And the unit sales, I understand why it would come down during the recession but it hasn't quite snapped back and it wouldn't be a more normal steady state and I'm curious why you think that hasn't returned to a more normalized level and if it ever will, clearly the industry is growing. But it seems mainly from pricing as opposed to actual units and you would think with more people and the population and turnover and it's just a replacement cycle. It should grow at a higher rate. And I'm curious why that isn't? And also, if you could compare it to your own numbers – maybe like your own organic unit growth rate, not with acquisition? Thanks.

Stephen R. Stagner
Chief Executive Officer & Director
A

So, I think there is a pretty clean explanation. It has to do with this slide right here. I'm 46. So I'm right in the middle of what's also the top of the bell curve of peak spending. And so my generation if you go back 10 years ago, when we were at that peak, we had TIME magazine would have – Bill Clinton is a baby boomer, they are doing all this stuff. The reality is they were still in the spending curve, but it was 30 million more people. So my generation is 30 million less and no matter what we do to spend, we could spend like crazy. We're not going to make up what the generation in front of us spent. The generation behind us is also, as you can see, 30 million higher.

So I think that part of what is happening during that slide right back there is that the bounce back is just generational – just pure quantum. That's my view. And I think there is also – we went through a double recession. We went through a housing and a financial crisis. And with 60% of the beds over 10 years old, people have delayed the purchase cycle and that low-end consumer has not come back completely. The economy is showing some dribs and drabs of improvement over time but it hasn't fully come back. So you add all that up and you're going to be off on units, I believe. I don't know if Alex you want to add to that but...

Alexander S. Weiss
Chief Financial Officer
A

Yeah. No, I think that's definitely the primary reason that millennial customers are still coming through and then the low end customers struggling a little bit. So we view it as kind of an upside opportunity. If the economy does get into a full gear and I know that people you see kind of the economic data getting a little bit better but consumer confidence will go up, then it will go down. You see unemployment come down as a percent but underemployment needs to come fully back. GDP is kind of in that slightly below historical growth rates, which Rob mentioned.

And so if you can do that and you can help that 35,000 or less consumer who buys a lot of the units, you would see some of that come back. But like we said earlier, we don't model towards that, that would be all upside and we need to the economy to get back into full gear to get there.

Kenneth E. Murphy
President

A

Your question though about what it has done in our business, certainly the past, or the most recent history, our comp has been really supported by AUP growth. But if you go back a little bit further over the last few years, I think you'll see it's been fairly balanced. Over the last 20 years as a management team, we've had the fairly successful track record of being able to navigate whatever the climate might be. And so there have been times when comp has come for us on the back of aggressive unit capture. There've been others more recently when it's been enjoying some of the benefits the AUP growth. And that's really probably what informs our forward-looking viewpoints that you're going to see comp behave at the firm in probably a little bit more measured way, coming from both units and AUP long term.

Laurance C. Leeds
Buckingham Capital Management, Inc.

Q

I'm almost embarrassed to ask this question, I'm a former Houston retailer. And I know the most overrated thing in Wall Street by far is comp store sales. I mean that's more important than profits or as you've said, comps are everything, which is nonsense. Now, will it be possible do you think that when you announce comps, you can estimate to some degree the effect of cannibalization on those comps. In other words, if you wanted to say, without cannibalization it would have been x, or close to x, something like that.

Alexander S. Weiss
Chief Financial Officer

A

And so we track that internally. Typically we see about low double-digit cannibalization percent. If we're going to open up a store that's really close to another store, so call it, within a quarter mile or somewhere very close. What we then do, as Steve was kind of explaining earlier, we would take the extra advertising dollars that we have, we put that into primarily demand-driving advertising.

So that's kind of the reason that you haven't seen our advertising as a percentage of sales decline over the last few years even though we've levered up a little bit, because we've been plowing every last dollar back into that advertising, shortening the replacement cycle, getting people to trade up to a higher ticket and that's why we've been able to have positive comparable store sales for the last five years. So we do see kind of that low double-digit...

Laurance C. Leeds
Buckingham Capital Management, Inc.

Q

I'm only saying when you announce your comp if you can put that factor in there, I think you'll do yourself a lot of good in terms of straight reaction.

Alexander S. Weiss
Chief Financial Officer

A

Yeah, it's a good point.

Kenneth E. Murphy
President

A

It's a fair piece of feedback. And one other attribute that sort of clouds the comp story is that, because we have been on such an acquisitive run the last few years, one thing to keep in mind is that when we see improvement that happens out of the gate in acquired stores, that comp doesn't come into our base obviously for another 14 months.

And so, Chicago while we – there hasn't been a great story from an earnings perspective on a pro forma basis, if that comp were in the base you would have seen a much higher number. And that seems like onesies and twosies probably wouldn't be that big a deal but when you're acquiring as many businesses as we have – the Sleep Train business has performed remarkably well this year. They're not in the comp base today. And so on a pro forma basis, businesses we've actually owned, the comp would be much higher than that which we report. So your point is fair. I don't know long-term whether or not that's something we could include or not but it's a fair point.

Q

Steve, have you ever tested in markets where you have one store per 50,000, 60,000, 70,000 and relative market share of 2x or 3x? What the impact is cutting ad dollars on an absolute basis to sales in that market?

Stephen R. Stagner
Chief Executive Officer & Director

A

Well, I can't speak to specifically testing, just pulling back on those ad dollars. What we have seen is the percentage of advertising has really gone down, so, no, there's not any specific test I can point to candidly that we have done that. But what we try to do is we try to figure out where that inflection is, where we get that return on the incremental invested dollar. So if we're not getting the same return that we're used to expecting, we kind of keep it in check. But pulling back is not necessarily an isolation or test. We do have periods of time where we pull back but for different reasons.

Kenneth E. Murphy
President

A

Yeah. The recession would be the proxy for that where we pull back broadly. I think one of the other points that's important to keep top of mind, this category, there are so few people as I mentioned earlier that are in the market, there is a certain baseline from just awareness and demand creation that we think has to be there. When we see pullbacks because of we're sort of watching advertising, or if it's a finite pullback for a period of time, the water levels will fall. And so I think we want to be conscientious of not turning that [ph] faucet off, we feel that we'll be (02:23:43).

Stephen R. Stagner
Chief Executive Officer & Director

A

[ph] Bobby (02:23:49), did you have question?

Bobby K. Griffin
Raymond James & Associates, Inc.

Q

[ph] I'll go ahead and ask you. (02:23:50) The slide 16 obviously shows that the population between the three generation is huge. Can you maybe talk in depth a little bit more how you go about attracting that millennium population as they move into their key purchasing type timeframe?

Kenneth E. Murphy
President

A

Yeah. I think this is a great question and it's a great opportunity. We really obviously for all intents and purposes have been focused on running the business the way that we have for the last few years, the target Mattress Firm customer of today or of yesterday is the 55-year-old couple sleeping on a Tempur-Pedic adjustable base. And we recognize obviously the sheer magnitude of opportunity.

So our approach to connecting with this emerging consumer, there isn't one single answer. We recognize it's important that we connect emotionally in the communities that we serve. We recognize it's important that we have an expanded mix of digital marketing to be able to reach this customer and new places. I go back to the commentary earlier this morning about making sure we can exist at the most convenient intersection, be it in the online space or in the offline. The Dream Bed is a product introduction that in and of itself is not a solution to engage 70 million new customers. But it's an opportunity to extend the conversation. And that's something we think ultimately is – we've got to open the funnel and open the arc to find more meaningful opportunities for communication.

So you're going to see this company run the offense that has worked well in the past. But as an adjunct to that, I think you'll start to see more involvement in the social space. You'll see a product offering that perhaps is reflective of that. And we'll try to make sure that we're ready to meet this new customer wherever they want to be met.

Seth M. Basham
Wedbush Securities, Inc.

Q

Can we return to the slide on third party financing. I think you mentioned this year Alex that year-to-date penetration was up. Where do you expect it to fall out this year and over the next three years, what kind of penetration do you expect?

Alexander S. Weiss
Chief Financial Officer

A

Yeah. So it's definitely up at the Mattress Firm business. We haven't given out the exact number but what we've kind of been telling people is that, it's not up to the 50% level but it's somewhere in between the 38% and 50% level at MFI.

At the Sleep Train business, financing is at a lower total percentage. So when you look at the 2015 number, it's tough to give you an exact number because it's going to be a blended rate between the lower Sleep Train number and the higher Mattress Firm number. So it probably comes up a little bit but that probably understates the true growth in financing business that we've seen.

I think over time, we expect it to stay fairly constant and we do things to drive additional financing but I think it's at a pretty healthy rate once you get into the kind of 40% of sales, obviously, a lower rate as a percentage of units. But it is kind of a nice additive driver. And as Ken mentioned, we do kind of move within a band where if you're in a recessionary period, it goes a little bit lower, so call it 25% to 30%. And then when you move into a normalized period, you're in the low 30s% with your primary provider.

And so you have that kind of band, the primary and secondary there's probably some movement as well but Progressive in particular has shown a really good job of going into that kind of tertiary space and finding a consumer who is willing to pay money to get something that they can't afford to get credit for. And so it's been really additive and we like it and it will moderate up and down but we think there's still an opportunity to move forward and to increase that rate going forward if we need to.

Seth M. Basham
Wedbush Securities, Inc.

Q

So in 2014, 6% of your sales were with the second and tertiary finance providers. What do you think that did to your comps? Do you think those were all incremental sales? Or how do you think about that equation?

Alexander S. Weiss
Chief Financial Officer

A

Yes. So what we think is that those definitely weren't 100% incremental. Those people would have purchased anyway. The difference is that we were able to raise people's tickets, right. And it comes at a cost. We spend real money. And one thing I failed to mentioned earlier, I think is that all of our finance sales are non-recourse to us.

So we'll pay money upfront to either Wells or Synchrony to Genesis, Tidewater, Progressive, we'll give them a check day one and they will give us a check for the price of the full bed, but if that customer doesn't pay in three months, no, there is no recourse to Mattress Firm. So what we've been using that as is basically people will spend more, raise up our comps to some degree. So that 6% of sales might have been 4% of sales, right, if not. And so, we're capturing incremental gross margin dollars enough to offset the financing dollars we use but it's not a pure flow-through. And so, it's been incremental. It's been additive but it hasn't changed the world for us.

Kenneth E. Murphy
President

A

And Progressive in particular, they've been partners of ours for a few years. So I think where there's been news in the finance space, it's been that we were able to finally implement the customer waterfall application process. The idea of having non-primary providers in place, that's a little bit older story.

Seth M. Basham
Wedbush Securities, Inc.

Q

Got it. So just going forward looking at the secondary and tertiary providers, are they the biggest driver of your financing penetration growth?

Alexander S. Weiss
Chief Financial Officer

A

What we've seen with the – from 2011 to 2014, they basically drove all of the growth in our financing business as a percentage. Our primary continue to grow with the overall business and they continue to help increase tickets but, yeah, it was primarily that 6% of secondary and tertiary. Going forward, as we've implemented the waterfall app, we've seen both our primary and our secondary and tertiary grow, which it might be a little harder to explain because most people say, you've been implemented this waterfall or you're going to lose your people throughout the process. That should benefit your secondary and tertiary but why would that benefit your primary.

Well, the reason for that is our associates now that they know you're not going to have to reject somebody, they're much more likely to pitch that financing project at the beginning of the sale. And so, they've used it much more [ph] in their pitch (02:30:30). They're a lot more confident.

Before you might have said, oh, you look like a Wells customer. Okay, we'll pitch it out to you. But you kind of look like a Progressive customer. I'm not sure if we want to pitch it, sorry, [ph] Dan (02:30:44). Just kidding.

Q

What did I do?

Alexander S. Weiss
Chief Financial Officer

A

So basically it's people [ph] who've a lot more confidence (02:30:50).

Stephen R. Stagner
Chief Executive Officer & Director

A

[ph] I don't know if it's stereotyping (02:30:52). Just to be clear, I think it may have been more – [ph] there's some (02:30:55) apprehension around folks not getting approved or whatever because it can be a difficult conversation for the customer, so.

Mr. Thomas?

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Yes, just a follow-up on the long-term guidance, so probably Alex. The prior EBITDA growth guidance, I think had been high double digit. Now, it's 13% to 15%. You're keeping the 20% EPS growth target. Can you just help to bridge that difference?

Alexander S. Weiss
Chief Financial Officer

A

Yeah, so the real benefit there comes from deleveraging and when you kind of break that down. We're expected to generate $77 million of free cash flow in 2015. That's after $25 million of one-time CapEx required to convert all the acquisitions. So if you remove that and you add some growth, we're expecting to generate over $100 million a year in free cash flow going forward – obviously barring any sort of major recession or a change in business model. But that's our plan going forward and that allows us to pay down debt.

The Sleep Train acquisition, it's allowed us to generate more cash flow than you would just expect from its pure EBITDA, partially because of the cash flow benefit we talked about earlier where we have about an $11 million a year benefit that doesn't run through our income statement but it does run through our cash flow statement just in a way that we were able to structure the transaction.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Great. And if I could add one more question just about Texas in general, a topic on everybody's minds. There seem to be maybe two issues that have affected you, the strength of the energy markets and perhaps more competition in some of your more mature cities. Could you just talk about these two factors and your latest thoughts on this?

Stephen R. Stagner
Chief Executive Officer & Director

A

Sure. So certainly we saw in the oil markets, in particular in Texas, oil prices went down from $60 down to $40 pretty precipitously. There's been a lot of jobs loss in the state of Texas that we see it definitely in Houston. So there is some nervousness around that market.

Competitively speaking, certainly we've seen some competitive entrants into that market, add a lot of stores inside that marketplace, and that's affected us a little bit and we've certainly talked a little bit about that. Let's keep in mind, we're still a very highly profitable business there in Houston. It's just not as super highly profitable as it was before. But I think over time, there is one challenge to open up into a market, it's altogether another challenge to open it up profitably and highly profitably. And I think over time, you'll see us make sure we express our competitive side to ourselves in that marketplace. And we'll see if there is enough bandwidth for our competition to continue to grow inside that marketplace the way they have been. So we'll see how that plays out.

Stephen R. Stagner

Chief Executive Officer & Director

Okay. We'll wrap it up there. So I think first of all, I really appreciate you guys taking the time today to come here and spend some time with us and go over what we've accomplished. I think we've really accomplished a lot in the past year. And I think more importantly, we're very poised to do what we've always talked about which is doubling the size of the company and we're poised to do that yet again.

So thank you for hearing the story and I appreciate your continued support. We had a long history with a lot of you in this room. And there's some new faces in the room and we look forward to having, certainly a great history with you going forward. So hopefully you enjoy the lunch as well. I thought it was very good. And you all have a great rest of the week. And we look forward to seeing you soon. Thank you very much.

Alexander S. Weiss

Chief Financial Officer

And the presentation is online, if you wanted to take a copy back home.