

TEMPUR PEDIC INTERNATIONAL INC

Form 10-Q

October 26, 2009

---

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2009

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from

to

Commission file number 001-31922

TEMPUR-PEDIC INTERNATIONAL INC.  
(Exact name of registrant as specified in its charter)

|                                 |                  |
|---------------------------------|------------------|
| Delaware                        | 33-1022198       |
| (State or other jurisdiction of | (I.R.S. Employer |
| incorporation or                | Identification   |
| organization)                   | No.)             |

1713 Jaggie Fox Way  
Lexington, Kentucky 40511  
(Address, including zip code, of principal executive offices)

Registrant's telephone number, including area code: (800) 878-8889

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No

Edgar Filing: TEMPUR PEDIC INTERNATIONAL INC - Form 10-Q

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.905 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

(Do not check if a smaller reporting company) Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes " No ☒

The number of shares outstanding of the registrant's common stock as of October 23, 2009 was 74,977,377 shares.

---

---

---

TABLE OF CONTENTS

|                                                                                              | Page |
|----------------------------------------------------------------------------------------------|------|
| <u>Special Note Regarding Forward-Looking Statements</u>                                     | 3    |
| <br><u>PART I. FINANCIAL INFORMATION</u>                                                     |      |
| <u>ITEM 1.</u>                                                                               |      |
| <u>Financial Statements</u>                                                                  |      |
| <u>Condensed Consolidated Statements of Income</u>                                           | 4    |
| <u>Condensed Consolidated Balance Sheets</u>                                                 | 5    |
| <u>Condensed Consolidated Statements of Cash Flows</u>                                       | 6    |
| <u>Notes to Condensed Consolidated Financial Statements</u>                                  | 7    |
| <br><u>ITEM 2.</u>                                                                           |      |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 21   |
| <br><u>ITEM 3.</u>                                                                           |      |
| <u>Quantitative and Qualitative Disclosures About Market Risk</u>                            | 30   |
| <br><u>ITEM 4.</u>                                                                           |      |
| <u>Controls and Procedures</u>                                                               | 30   |
| <br><u>PART II. OTHER INFORMATION</u>                                                        |      |
| <br><u>ITEM 1.</u>                                                                           |      |
| <u>Legal Proceedings</u>                                                                     | 31   |
| <br><u>ITEM 1A.</u>                                                                          |      |
| <u>Risk Factors</u>                                                                          | 31   |
| <br><u>ITEM 2.</u>                                                                           |      |
| <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 32   |
| <br><u>ITEM 3.</u>                                                                           |      |
| <u>Defaults upon Senior Securities</u>                                                       | 32   |
| <br><u>ITEM 4.</u>                                                                           |      |
| <u>Submission of Matters to a Vote of Security Holders</u>                                   | 32   |
| <br><u>ITEM 5.</u>                                                                           |      |
| <u>Other Information</u>                                                                     | 32   |
| <br><u>ITEM 6.</u>                                                                           |      |
| <u>Exhibits</u>                                                                              | 32   |
| <br><u>Signatures</u>                                                                        | 33   |

Table of Contents

Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q, including the information incorporated by reference herein, contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which include information concerning our plans, objectives, goals, strategies, future events, future revenues or performance, the impact of the macroeconomic environment in both the U.S. and internationally on sales and our business segments, investments in operating infrastructure, our expected capital expenditures, the impact of consumer confidence, the antitrust class action lawsuit and similar issues, pending tax assessments, our financial flexibility and changes to our operating cash flow, the impact of initiatives to accelerate growth, expand market share and attract sales from the standard mattress market, the initiatives to expand business within established accounts, the initiatives to reduce costs and operating expenses and improve manufacturing productivity, the initiatives to improve retail account productivity, our expectations regarding our gross margins, the impact of internet leads, our ability to source raw materials effectively, the development, rollout and market acceptance of new products, changes in our inventory levels, our ability to further invest in the business and in brand awareness, our ability to meet financial obligations and continue to comply with the terms of our credit facility, the effects of our business model, the effects of changes in foreign exchange rates on our reported earnings, our expected sources of cash flow, the effect of foreign tax credits on U.S. income tax liability, our ability to effectively manage cash and our debt/leverage ratio, our ability to align costs with sales expectations and other information that is not historical information. Many of these statements appear, in particular, under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in ITEM 2 of Part I of this report. When used in this report, the words “estimates,” “expects,” “anticipates,” “projects,” “plans,” “intends,” “believes” and variations of such words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this report. Important factors that could cause our actual results to differ materially from those expressed as forward-looking statements are set forth in this report, including under the heading “Risk Factors” under ITEM 1A of Part II of this report and under the heading “Risk Factors” under ITEM 1A of Part 1 of our annual report on Form 10-K for the year ended December 31, 2008. There may be other factors that may cause our actual results to differ materially from the forward-looking statements.

All forward-looking statements attributable to us apply only as of the date of this report and are expressly qualified in their entirety by the cautionary statements included in this report. Except as may be required by law, we undertake no obligation to publicly update or revise any of the forward-looking statements, whether as a result of new information, future events, or otherwise.

When used in this report, except as specifically noted otherwise, the term “Tempur-Pedic International” refers to Tempur-Pedic International Inc. only, and the terms “Company,” “we,” “our,” “ours” and “us” refer to Tempur-Pedic International Inc. and its consolidated subsidiaries.

Table of Contents

## PART 1. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per common share amounts)

(Unaudited)

|                                                | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|------------------------------------------------|-------------------------------------|------------|------------------------------------|------------|
|                                                | 2009                                | 2008       | 2009                               | 2008       |
| Net sales                                      | \$ 224,082                          | \$ 252,814 | \$ 586,362                         | \$ 738,697 |
| Cost of sales                                  | 117,373                             | 147,323    | 311,461                            | 419,109    |
| Gross profit                                   | 106,709                             | 105,491    | 274,901                            | 319,588    |
| Selling and marketing expenses                 | 39,272                              | 39,956     | 108,335                            | 137,906    |
| General, administrative and other expenses     | 24,761                              | 22,644     | 68,847                             | 73,139     |
| Operating income                               | 42,676                              | 42,891     | 97,719                             | 108,543    |
| Other expense, net:                            |                                     |            |                                    |            |
| Interest expense, net                          | (4,311)                             | (6,294)    | (13,359)                           | (19,630)   |
| Other (expense) income, net                    | (214)                               | 96         | 404                                | (995)      |
| Total other expense                            | (4,525)                             | (6,198)    | (12,955)                           | (20,625)   |
| Income before income taxes                     | 38,151                              | 36,693     | 84,764                             | 87,918     |
| Income tax provision                           | 12,467                              | 12,622     | 28,885                             | 30,105     |
| Net income                                     | \$ 25,684                           | \$ 24,071  | \$ 55,879                          | \$ 57,813  |
| Earnings per common share:                     |                                     |            |                                    |            |
| Basic                                          | \$ 0.34                             | \$ 0.32    | \$ 0.75                            | \$ 0.77    |
| Diluted                                        | \$ 0.34                             | \$ 0.32    | \$ 0.74                            | \$ 0.77    |
| Cash dividend per common share                 | \$ —                                | \$ 0.08    | \$ —                               | 0.24       |
| Weighted average common shares<br>outstanding: |                                     |            |                                    |            |
| Basic                                          | 74,938                              | 74,815     | 74,902                             | 74,704     |
| Diluted                                        | 76,166                              | 74,992     | 75,396                             | 74,944     |

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

|                                                   | September 30,<br>2009<br>(Unaudited) | December 31,<br>2008 |
|---------------------------------------------------|--------------------------------------|----------------------|
| <b>ASSETS</b>                                     |                                      |                      |
| <b>Current Assets:</b>                            |                                      |                      |
| Cash and cash equivalents                         | \$ 20,003                            | \$ 15,385            |
| Accounts receivable, net                          | 105,397                              | 99,811               |
| Inventories                                       | 48,456                               | 60,497               |
| Prepaid expenses and other current assets         | 11,456                               | 9,233                |
| Deferred income taxes                             | 19,839                               | 11,888               |
| <b>Total Current Assets</b>                       | <b>205,151</b>                       | <b>196,814</b>       |
| Property, plant and equipment, net                | 175,817                              | 185,843              |
| Goodwill                                          | 193,456                              | 192,569              |
| Other intangible assets, net                      | 65,318                               | 66,823               |
| Other non-current assets                          | 2,919                                | 4,482                |
| <b>Total Assets</b>                               | <b>\$ 642,661</b>                    | <b>\$ 646,531</b>    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>       |                                      |                      |
| <b>Current Liabilities:</b>                       |                                      |                      |
| Accounts payable                                  | \$ 46,625                            | \$ 41,355            |
| Accrued expenses and other current liabilities    | 87,824                               | 65,316               |
| Income taxes payable                              | 14,533                               | 7,783                |
| <b>Total Current Liabilities</b>                  | <b>148,982</b>                       | <b>114,454</b>       |
| Long-term debt                                    | 315,000                              | 419,341              |
| Deferred income taxes                             | 29,142                               | 28,371               |
| Other non-current liabilities                     | 8,952                                | 11,922               |
| <b>Total Liabilities</b>                          | <b>502,076</b>                       | <b>574,088</b>       |
| <b>Commitments and contingencies—see Note 9</b>   |                                      |                      |
| <b>Total Stockholders' Equity</b>                 | <b>140,585</b>                       | <b>72,443</b>        |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>\$ 642,661</b>                    | <b>\$ 646,531</b>    |

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

|                                                                                   | Nine Months Ended<br>September 30, |                  |
|-----------------------------------------------------------------------------------|------------------------------------|------------------|
|                                                                                   | 2009                               | 2008             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                    |                  |
| Net income                                                                        | \$ 55,879                          | \$ 57,813        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |                  |
| Depreciation and amortization                                                     | 23,526                             | 24,847           |
| Amortization of stock-based compensation                                          | 6,448                              | 6,101            |
| Amortization of deferred financing costs                                          | 518                                | 888              |
| Bad debt expense                                                                  | 4,659                              | 5,859            |
| Deferred income taxes                                                             | (8,006)                            | (1,634)          |
| Foreign currency adjustments                                                      | 53                                 | 74               |
| (Gain) Loss on sale of equipment and other                                        | (19)                               | 679              |
| Changes in operating assets and liabilities:                                      | 37,345                             | 74,287           |
| Net cash provided by operating activities                                         | 120,403                            | 168,914          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                    |                  |
| Purchases of property, plant and equipment                                        | (8,961)                            | (7,844)          |
| Acquisition of businesses, net of cash acquired                                   | —                                  | (1,529)          |
| Other                                                                             | (87)                               | (428)            |
| Net cash used by investing activities                                             | (9,048)                            | (9,801)          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                    |                  |
| Proceeds from long-term revolving credit facility                                 | 85,797                             | 65,429           |
| Repayments of long-term revolving credit facility                                 | (189,036)                          | (89,691)         |
| Repayments of long-term debt                                                      | —                                  | (1,359)          |
| Repayments of Series A Industrial Revenue Bonds                                   | —                                  | (57,785)         |
| Proceeds from issuance of common stock                                            | 129                                | 695              |
| Excess tax benefit from stock based compensation                                  | —                                  | 301              |
| Dividend paid to stockholders                                                     | —                                  | (17,933)         |
| Other                                                                             | —                                  | (14)             |
| Net cash used by financing activities                                             | (103,110)                          | (100,357)        |
| <b>NET EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>                                | <b>(3,627)</b>                     | <b>(4,394)</b>   |
| <b>Increase in cash and cash equivalents</b>                                      | <b>4,618</b>                       | <b>54,362</b>    |
| <b>CASH AND CASH EQUIVALENTS, beginning of period</b>                             | <b>15,385</b>                      | <b>33,315</b>    |
| <b>CASH AND CASH EQUIVALENTS, end of period</b>                                   | <b>\$ 20,003</b>                   | <b>\$ 87,677</b> |
| <b>Supplemental cash flow information:</b>                                        |                                    |                  |

Cash paid during the period for:

|                              |    |        |    |        |
|------------------------------|----|--------|----|--------|
| Interest                     | \$ | 13,187 | \$ | 18,960 |
| Income taxes, net of refunds | \$ | 28,672 | \$ | 17,884 |

See accompanying Notes to Condensed Consolidated Financial Statements.



Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)  
(In thousands, except per common share amounts)

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation and Description of Business—Tempur-Pedic International Inc., a Delaware corporation, together with its subsidiaries is a U.S. based, multinational company. The term “Tempur-Pedic International” refers to Tempur-Pedic International Inc. only, and the term “Company” refers to Tempur-Pedic International Inc. and its consolidated subsidiaries. Tempur World, Inc. was formed on January 1, 2000 to combine the manufacturing facilities and the global distribution capabilities of all TEMPUR® products, and Tempur-Pedic International Inc. was formed in 2002 to acquire Tempur World, Inc. This acquisition (Tempur Acquisition) was effective as of November 1, 2002.

The Company manufactures, markets, and sells pillows, mattresses and other related products. The Company manufactures essentially all its pressure-relieving TEMPUR® products at three manufacturing facilities, with one located in Denmark and two in the U.S. The Company has sales distribution subsidiaries operating in the U.S., Europe and Asia Pacific and has third party distribution arrangements in certain other countries where it does not have subsidiaries. The Company sells its products through four sales channels: Retail, Direct, Healthcare and Third party.

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and include all of the information and disclosures required by generally accepted accounting principles in the United States (US GAAP) for interim financial reporting. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements of the Company and related footnotes for the year ended December 31, 2008, included in the Company’s annual report on Form 10-K.

The results of operations for the interim periods are not necessarily indicative of results of operations for a full year. It is the opinion of management that all necessary adjustments for a fair presentation of the results of operations for the interim periods have been made and are of a recurring nature unless otherwise disclosed herein.

(b) Accounting Standards Codification—In June 2009, the Financial Accounting Standards Board (FASB) confirmed that the FASB Accounting Standards Codification (FASB ASC) will become the single official source of authoritative US GAAP (other than guidance issued by the Securities and Exchange Commission (SEC)), superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. After the FASB ASC became effective (interim and annual periods ending on or after September 15, 2009), only one level of authoritative US GAAP exists. All other literature will be considered non-authoritative. FASB ASC does not change US GAAP; it introduces a new structure that is organized in an easily accessible online research system. The Company adopted FASB ASC beginning in the third quarter of fiscal 2009.

(c) Basis of Consolidation—The accompanying financial statements include the accounts of Tempur-Pedic International and its subsidiaries. All subsidiaries are wholly owned. Intercompany balances and transactions have been eliminated. The Company does not hold any interest in variable-interest entities.

(d) Use of Estimates—The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company’s results are affected by economic, political, legislative, regulatory and legal actions. Economic conditions, such as recessionary trends, inflation, interest and monetary exchange rates, government fiscal policies and changes in the prices of raw materials, can have a

significant effect on operations. While the Company maintains reserves for anticipated liabilities and carries various levels of insurance, the Company could be affected by civil, criminal, regulatory or administrative actions, claims or proceedings.

7

---

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)  
(In thousands, except per common share amounts)

(e) Inventories—Inventories are stated at the lower of cost or market, determined by the first-in, first-out method, and consist of the following:

|                            | September<br>30,<br>2009 | December<br>31,<br>2008 |
|----------------------------|--------------------------|-------------------------|
| Finished goods             | \$32,572                 | \$41,385                |
| Work-in-process            | 6,920                    | 5,706                   |
| Raw materials and supplies | 8,964                    | 13,406                  |
|                            | \$48,456                 | \$60,497                |

(f) Accrued Sales Returns—Estimated sales returns are provided at the time of sale based on historical sales channel return rates. The level of sales returns differs by channel with the Direct channel typically experiencing the highest rate of return. Estimated future obligations related to these products are provided by a reduction of sales in the period in which the revenue is recognized. The Company allows product returns up to 120 days following a sale through certain sales channels and on certain products. Accrued sales returns are included in Accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheets.

The Company had the following activity for sales returns from December 31, 2008 to September 30, 2009:

|                                  |           |
|----------------------------------|-----------|
| Balance as of December 31, 2008  | \$3,804   |
| Amounts accrued                  | 23,665    |
| Returns charged to accrual       | (23,132 ) |
| Balance as of September 30, 2009 | \$4,337   |

(g) Warranties—The Company provides a 20-year warranty for U.S. sales and a 15-year warranty for non-U.S. sales on mattresses, each prorated for the last 10 years. The Company also provides a two year to three year warranty on pillows. Estimated future obligations related to these products are charged to operations in the period in which the related sale is recognized. Estimates of warranty expenses are based primarily on historical claims experience and product testing. Warranties are included in Accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheets.

The Company had the following activity for warranties from December 31, 2008 to September 30, 2009:

|                                  |          |
|----------------------------------|----------|
| Balance as of December 31, 2008  | \$3,903  |
| Amounts accrued                  | 2,432    |
| Warranties charged to accrual    | (2,438 ) |
| Balance as of September 30, 2009 | \$3,897  |

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)  
(In thousands, except per common share amounts)

(h) Revenue Recognition—Sales of products are recognized when persuasive evidence of an arrangement exists, products are shipped and title passes to customers and the risks and rewards of ownership are transferred, the sale price is fixed or determinable and collectability is reasonably assured. The Company extends volume discounts to certain customers and reflects these amounts as a reduction of sales. The Company also reports sales net of tax assessed by qualifying governmental authorities. The Company extends credit based on the creditworthiness of its customers. No collateral is required on sales made in the normal course of business.

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company regularly reviews the adequacy of its allowance for doubtful accounts. The Company determines the allowance based on historical write-off experience and current economic conditions and also considers factors such as customer credit, past transaction history with the customer and changes in customer payment terms when determining whether the collection of a receivable is reasonably assured. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The allowance for doubtful accounts included in Accounts receivable, net in the accompanying Condensed Consolidated Balance Sheets was \$9,168 and \$6,726 as of September 30, 2009 and December 31, 2008, respectively.

(i) Advertising Costs—The Company expenses advertising costs as incurred except for production costs and advance payments, which are deferred and expensed when advertisements run for the first time. Direct response advance payments are deferred and are amortized over the life of the program.

(j) Research and Development Expenses—Research and development expenses for new products are expensed as they are incurred and are included in General, administrative and other expenses. Research and development costs charged to expense were \$1,481 and \$1,330 for the three months ended September, 2009 and 2008, respectively. For the nine months ended September 30, 2009 and 2008, research and development costs charged to expense were \$4,580 and \$4,621, respectively.

(k) Subsequent Events—During the third quarter of fiscal 2009, the Company has evaluated all events or transactions that occurred after September 30, 2009 up through October 26, 2009, the date these condensed consolidated financial statements were issued. During this period, there were no material recognizable or non-recognizable subsequent events.

## (2) Goodwill and Other intangible assets

The following summarizes changes to the Company's Goodwill, by reportable business segment:

|                                          | Domestic  | International | Total     |
|------------------------------------------|-----------|---------------|-----------|
| Balance as of December 31, 2008          | \$ 89,929 | \$ 102,640    | \$192,569 |
| Foreign currency translation adjustments | —         | 887           | 887       |
| Balance as of September 30, 2009         | \$ 89,929 | \$ 103,527    | \$193,456 |

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)  
(In thousands, except per common share amounts)

The following table summarizes information relating to the Company's Other intangible assets:

|                                                |                            | September 30, 2009          |                             |                           | December 31, 2008           |                             |                           |
|------------------------------------------------|----------------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
|                                                | Useful<br>Lives<br>(Years) | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
| Unamortized indefinite life intangible assets: |                            |                             |                             |                           |                             |                             |                           |
| Trademarks                                     |                            | \$55,000                    | \$ —                        | \$55,000                  | \$55,000                    | \$ —                        | \$55,000                  |
| Amortized intangible assets:                   |                            |                             |                             |                           |                             |                             |                           |
| Technology                                     | 10                         | \$16,000                    | \$ 11,067                   | \$4,933                   | \$16,000                    | \$ 9,866                    | \$6,134                   |
| Patents & other trademarks                     | 5-20                       | 11,874                      | 7,932                       | 3,942                     | 11,655                      | 7,767                       | 3,888                     |
| Customer database                              | 5                          | 4,870                       | 4,568                       | 302                       | 4,838                       | 4,455                       | 383                       |
| Foam formula                                   | 10                         | 3,700                       | 2,559                       | 1,141                     | 3,700                       | 2,282                       | 1,418                     |
|                                                |                            | \$91,444                    | \$ 26,126                   | \$65,318                  | \$91,193                    | \$ 24,370                   | \$66,823                  |

Amortization expense relating to intangible assets for the Company was \$600 and \$603 for the three months ended September 30, 2009 and 2008, respectively. For the nine months ended September 30, 2009 and September 30, 2008 amortization expense relating to intangible assets was \$1,810 and \$1,810, respectively.

## (3) Long-term Debt

(a) Long-term Debt—Long-term debt for the Company consists of the following:

|                                                                                                                                                                                                                                                 | September<br>30, 2009 | December<br>31, 2008 |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| 2005 Senior Credit Facility:                                                                                                                                                                                                                    |                       |                      |
| Domestic Long-Term Revolving Credit Facility payable to lenders, interest at Index Rate or LIBOR plus applicable margin (4.59% and 4.44% as of September 30, 2009 and December 31, 2008, respectively), commitment through and due June 8, 2012 | \$315,000             | \$403,500            |
| Foreign Long-Term Revolving Credit Facility payable to lenders, interest at Index Rate or LIBOR plus applicable margin (2.59% as of December 31, 2008), commitment through and due June 8, 2012                                                 | —                     | 15,841               |
|                                                                                                                                                                                                                                                 | \$315,000             | \$419,341            |

(b) Secured Credit Financing—On October 18, 2005, the Company entered into a credit agreement (2005 Senior Credit Facility) with a syndicate of banks. The 2005 Senior Credit Facility, as amended, consists of domestic and

foreign credit facilities (Revolvers) that provide for the incurrence of indebtedness up to an aggregate principal amount of \$640,000 and matures in 2012. The domestic credit facility is a five-year, \$615,000 revolving credit facility (Domestic Revolver). The foreign credit facility is a five-year \$25,000 revolving credit facility (Foreign Revolver). The Revolvers provide for the issuance of letters of credit which, when issued, constitute usage and reduce availability under the Revolvers. The aggregate amount of letters of credit outstanding under the Revolvers was \$3,748 at September 30, 2009. After giving effect to letters of credit and \$315,000 in borrowings under the Domestic Revolver, total availability under the Revolvers was \$321,252 as of September 30, 2009. Both credit facilities bear interest at a rate equal to the 2005 Senior Credit Facility's applicable margin, as determined in accordance with a performance pricing grid set forth in Amendment No. 3, plus one of the following indexes: London Inter-Bank Offering Rate (LIBOR) and for U.S. dollar-denominated loans only, a base rate. The base rate of U.S. dollar-denominated loans is defined as the higher of the Bank of America prime rate or the Federal Funds rate plus .50%. The Company also pays an annual facility fee on the total amount of the 2005 Senior Credit Facility. The facility fee is calculated based on the consolidated leverage ratio and ranges from .125% to .25%.

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)  
(In thousands, except per common share amounts)

The 2005 Senior Credit Facility is guaranteed by Tempur-Pedic International, as well as certain other subsidiaries of Tempur-Pedic International, and is secured by certain fixed and intangible assets of Dan-Foam ApS and substantially all the Company's U.S. assets. The 2005 Senior Credit Facility contains certain financial covenants and requirements affecting the Company, including a consolidated interest coverage ratio and a consolidated leverage ratio. The Company was in compliance with all covenants as of September 30, 2009.

In May 2008, the Company entered into a three year interest rate swap agreement to manage interest costs and changing interest rates associated with the 2005 Senior Credit Facility. Refer to Note 5, "Derivative Financial Instruments" for additional information regarding the Company's derivative instruments, including this interest rate swap.

## (4) Fair Value Measurements

Fair Value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset and liability in an orderly transaction between market participants at the measurement date. The Company estimates fair value of its financial instruments utilizing an established three-level hierarchy. The hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date as follows:

- Level 1 – Valuation is based upon unadjusted quoted prices for identical assets or liabilities in active markets.
- Level 2 – Valuation is based upon quoted prices for similar assets and liabilities in active markets, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instruments.
- Level 3 – Valuation is based upon other unobservable inputs that are significant to the fair value measurements.

The classification of fair value measurements within the hierarchy is based upon the lowest level of input that is significant to the measurement. At September 30, 2009, the Company had an interest rate swap and foreign currency forward contracts recorded at fair value. The fair values of these instruments were measured using valuations based upon quoted prices for similar assets and liabilities in active markets (Level 2) and are valued by reference to similar financial instruments, adjusted for credit risk and restrictions and other terms specific to the contracts. As of September 30, 2009, the Company had no assets or liabilities measured at fair value on a nonrecurring basis. The following tables provide a summary by level of the fair value of assets and liabilities measured on a recurring basis:

|                                    |                    | Fair Value Measurements at September 30, 2009 using:           |                                               |                                           |
|------------------------------------|--------------------|----------------------------------------------------------------|-----------------------------------------------|-------------------------------------------|
|                                    |                    | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|                                    | September 30, 2009 |                                                                |                                               |                                           |
| <b>Liabilities:</b>                |                    |                                                                |                                               |                                           |
| Foreign currency forward contracts | \$3,688            | \$—                                                            | \$3,688                                       | \$—                                       |
| Interest rate swap                 | \$8,598            | \$—                                                            | \$8,598                                       | \$—                                       |

| Fair Value Measurements at December 31, 2008 using: |                      |                                                                                  |                                                           |                                                    |
|-----------------------------------------------------|----------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                                     |                      | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                                                     | December<br>31, 2008 |                                                                                  |                                                           |                                                    |
| <b>Assets:</b>                                      |                      |                                                                                  |                                                           |                                                    |
| Foreign currency forward contracts                  | \$96                 | \$—                                                                              | \$96                                                      | \$—                                                |
| <b>Liabilities:</b>                                 |                      |                                                                                  |                                                           |                                                    |
| Interest rate swap                                  | \$11,610             | \$—                                                                              | \$11,610                                                  | \$—                                                |

Borrowings under the 2005 Senior Credit Facility (as defined in Note 3(b)) are at variable interest rates and accordingly their carrying amounts approximate fair value.



Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)–(Continued)

(In thousands, except per common share amounts)

(5) Derivative Financial Instruments

In the normal course of business, the Company is exposed to certain risks related to fluctuations in interest rates and foreign currency exchange rates. The Company uses various derivative contracts, primarily interest rate swaps and foreign currency exchange forward contracts to manage risks from these market fluctuations. The financial instruments used by the Company are straight-forward, non-leveraged instruments. The counterparties to these financial instruments are financial institutions with strong credit ratings. The Company maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit ratings of these institutions.

The Company is required to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

Interest Rate Risk

The Company is exposed to changes in interest rates on its 2005 Senior Credit Facility. In order to manage this risk, in May 2008, the Company entered into a three year interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. The Company designated this interest rate swap as a cash flow hedge of floating rate borrowings and expects the hedge to be highly effective in offsetting fluctuations in the designated interest payments resulting from changes in the benchmark interest rate. The gains and losses on the designated swap agreement will offset losses and gains on the transactions being hedged. The Company formally documented the effectiveness of this qualifying hedge instrument (both at the inception of the swap and on an ongoing basis) in offsetting changes in cash flows of the hedged transaction. The fair value of the interest rate swap is calculated as described in Note 4, "Fair Value Measurements" taking into consideration current interest rates and the current creditworthiness of the counterparties or the Company, as applicable.

As a result of this swap, the Company pays at a fixed rate and receives payment at a variable rate. The swap effectively fixed the floating LIBOR-based interest rate to 3.755% on \$350,000 of the outstanding balance under the 2005 Senior Credit Facility, with the outstanding balance subject to the swap declining over time. The amount of the outstanding balance subject to the swap declines as follows: to \$300,000 on November 28, 2008 (through November, 2009); to \$200,000 on November 28, 2009 (through November, 2010); and to \$100,000 on November 28, 2010 (through November 28, 2011). The Company will select the LIBOR-based rate on the hedged portion of the 2005 Senior Credit Facility during the term of the swap. The effective portion of the change in value of the swap is reflected as a component of Accumulated other comprehensive loss (OCL) and recognized as Interest expense, net as payments are paid or accrued. The remaining gain or loss in excess of the cumulative change in the present value of the future cash flows of the hedged item, if any (i.e., the ineffectiveness portion) or hedge components excluded from the assessment of effectiveness are recognized as Interest expense, net during the current period.

As of September 30, 2009, the total notional amount of the Company's interest rate swap agreement is \$300,000. Over the next 12 months, the Company expects to reclassify \$6,889 of deferred losses on derivative instruments from Accumulated OCL to earnings due to the payment of variable interest associated with the 2005 Senior Credit Facility.

Foreign Currency Exposures

The Company is exposed to foreign currency risk related to intercompany debt and associated interest payments. To manage the risk associated with fluctuations in foreign currencies, the Company enters into foreign currency forward contracts. The Company does not designate any of these foreign currency forward contracts as hedging instruments, however, the Company considers the contracts as economic hedges. Accordingly, changes in the fair value of these instruments effect earnings during the current period. These foreign currency forward contracts protect against the reduction in value of forecasted foreign currency cash flows resulting from payments in foreign currencies. The fair value of foreign currency agreements are estimated as described in Note 4, "Fair Value Measurements" taking into consideration foreign currency rates and the current creditworthiness of the counterparties or the Company, as applicable.

12

---

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)  
(In thousands, except per common share amounts)

As of September 30, 2009, the Company had foreign currency forward contracts with expiration dates ranging from October 5, 2009 through October 26, 2010. The changes in fair value of these foreign currency hedges are included as a component of Other (expense) income, net. As of September 30, 2009 the Company had the following outstanding foreign currency forward contracts:

| Foreign<br>Currency     | Currency Denomination |         |
|-------------------------|-----------------------|---------|
| Great Britain<br>Pound  | £                     | 7,326   |
| Euros                   | €                     | 16,274  |
| Japanese<br>Yen         | ¥                     | 441,826 |
| Swiss<br>Franc          | fr.                   | 11,092  |
| Swedish<br>Krona        | kr.                   | 29,493  |
| Norwegian<br>Krona      | kr.                   | 4,275   |
| Australian<br>Dollar    | \$                    | 1,189   |
| New Zealand<br>Dollar   | \$                    | 2,067   |
| United States<br>Dollar | \$                    | 6,354   |

As of September 30, 2009 and December 31, 2008, the fair value carrying amount of the Company's derivative instruments were recorded as follows:

| Asset Derivatives                                       |                                              |            |                                              |            |
|---------------------------------------------------------|----------------------------------------------|------------|----------------------------------------------|------------|
| September 30, 2009                                      |                                              |            | December 31, 2008                            |            |
|                                                         | Balance Sheet<br>Location                    | Fair Value | Balance Sheet<br>Location                    | Fair Value |
|                                                         |                                              |            |                                              |            |
| Derivatives not<br>designated as hedging<br>instruments |                                              |            |                                              |            |
| Foreign exchange<br>forward contracts                   | Prepaid expenses and<br>other current assets | \$ —       | Prepaid expenses and<br>other current assets | \$ 96      |
|                                                         |                                              | \$ —       |                                              | \$ 96      |

| Liability Derivatives |            |                   |            |
|-----------------------|------------|-------------------|------------|
| September 30, 2009    |            | December 31, 2008 |            |
|                       | Fair Value |                   | Fair Value |

Edgar Filing: TEMPUR PEDIC INTERNATIONAL INC - Form 10-Q

|                                                         | Balance Sheet<br>Location                            |    |        | Balance Sheet<br>Location                            |    |        |
|---------------------------------------------------------|------------------------------------------------------|----|--------|------------------------------------------------------|----|--------|
| Derivatives designated<br>as hedging instruments        |                                                      |    |        |                                                      |    |        |
| Interest rate swap                                      | Other non-current<br>liabilities                     | \$ | 8,598  | Other non-current<br>liabilities                     | \$ | 11,610 |
|                                                         |                                                      | \$ | 8,598  |                                                      | \$ | 11,610 |
| Derivatives not<br>designated as hedging<br>instruments |                                                      |    |        |                                                      |    |        |
| Foreign exchange<br>forward contracts                   | Accrued expenses<br>and other current<br>liabilities | \$ | 3,688  | Accrued expenses<br>and other current<br>liabilities | \$ | —      |
|                                                         |                                                      | \$ | 12,286 |                                                      | \$ | 11,610 |

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)  
(In thousands, except per common share amounts)

The effect of derivative instruments on the Condensed Consolidated Statement of Income for the three months ended September 30, 2009 was as follows:

|                                                                 | Amount of<br>(Gain)/Loss<br>Recognized in<br>Other<br>Comprehensive Income | Location of Loss<br>Reclassified from<br>Accumulated OCL<br>into Income<br>(Effective Portion) | Amount of<br>Loss<br>Reclassified<br>from<br>Accumulated<br>OCL<br>into Income<br>(Effective<br>Portion) | Location of Loss<br>Recognized in<br>Income on<br>Derivative<br>(Ineffective<br>Portion and<br>Amount<br>Excluded from<br>Effectiveness<br>Testing) | Amount of<br>Loss<br>Recognized<br>in Income<br>on<br>Derivative<br>(Ineffective<br>Portion<br>and<br>Amount<br>Excluded<br>from<br>Effectiveness<br>Testing) |
|-----------------------------------------------------------------|----------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Derivatives Designated<br>as Cash Flow Hedging<br>Relationships | on<br>Derivative<br>(Effective Portion)                                    | into<br>Income<br>(Effective Portion)                                                          |                                                                                                          |                                                                                                                                                     |                                                                                                                                                               |
| Interest rate swap                                              | \$ (794)                                                                   | Interest expense, net                                                                          | \$ 2,445                                                                                                 | Interest expense, net                                                                                                                               | \$ —                                                                                                                                                          |
|                                                                 | \$ (794)                                                                   |                                                                                                | \$ 2,445                                                                                                 |                                                                                                                                                     | \$ —                                                                                                                                                          |

| Derivatives Not Designated as Hedging<br>Instruments | Location of (Loss)/Gain<br>Recognized in Income on<br>Derivative | Amount of (Loss)/Gain<br>Recognized in Income<br>on Derivative |
|------------------------------------------------------|------------------------------------------------------------------|----------------------------------------------------------------|
| Foreign exchange forward contracts                   | Other (expense) income, net                                      | \$ (222)                                                       |
|                                                      |                                                                  | \$ (222)                                                       |

For the nine months ended September 30, 2009:

|                                                                 | Amount of<br>(Gain)/Loss<br>Recognized in<br>Other<br>Comprehensive Income | Location of Loss<br>Reclassified from<br>Accumulated OCL<br>into Income<br>(Effective Portion) | Amount of<br>Loss<br>Reclassified<br>from<br>Accumulated<br>OCL<br>into Income<br>(Effective<br>Portion) | Location of Loss<br>Recognized in<br>Income on<br>Derivative<br>(Ineffective<br>Portion and<br>Amount<br>Excluded from<br>Effectiveness<br>Testing) | Amount of<br>Loss<br>Recognized<br>in Income<br>on<br>Derivative<br>(Ineffective<br>Portion<br>and<br>Amount<br>Excluded<br>from<br>Effectiveness<br>Testing) |
|-----------------------------------------------------------------|----------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Derivatives Designated<br>as Cash Flow Hedging<br>Relationships | on<br>Derivative<br>(Effective Portion)                                    | into<br>Income<br>(Effective Portion)                                                          |                                                                                                          |                                                                                                                                                     |                                                                                                                                                               |
| Interest rate swap                                              | \$ (3,012)                                                                 | Interest expense, net                                                                          | \$ 5,991                                                                                                 | Interest expense, net                                                                                                                               | \$ —                                                                                                                                                          |
|                                                                 | \$ (3,012)                                                                 |                                                                                                | \$ 5,991                                                                                                 |                                                                                                                                                     | \$ —                                                                                                                                                          |

| Derivatives Not Designated as Hedging<br>Instruments | Location of (Loss)/Gain<br>Recognized in Income on<br>Derivative | Amount of (Loss)/Gain<br>Recognized in Income<br>on Derivative |
|------------------------------------------------------|------------------------------------------------------------------|----------------------------------------------------------------|
| Foreign exchange forward contracts                   | Other (expense) income, net                                      | \$ (2,367)                                                     |
|                                                      |                                                                  | \$ (2,367)                                                     |

14

---

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

(In thousands, except per common share amounts)

## (6) Stockholders' Equity

(a) Capital Stock—Tempur-Pedic International's authorized shares of capital stock are 300,000 shares of common stock and 10,000 shares of preferred stock. Subject to preferences that may be applicable to any outstanding preferred stock, holders of the common stock are entitled to receive ratably such dividends as may be declared from time to time by the Board of Directors out of funds legally available for that purpose. In the event of liquidation, dissolution, or winding up, the holders of the common stock are entitled to share ratably in all assets remaining after payment of liabilities, subject to prior distribution rights of preferred stock, if any, then outstanding.

(b) Share Repurchase Programs—On October 16, 2007, the Board of Directors authorized a repurchase authorization of up to \$300,000 of the Company's common stock. Under the existing share repurchase authorization, the Company has \$280,100 available for repurchase as of September 30, 2009. No shares were repurchased during the three or nine months ended September 30, 2009. Share repurchases under this authorization may be made through open market transactions, negotiated purchase or otherwise, at times and in such amounts as the Company and a committee of the Board of Directors deem appropriate. This share repurchase authorization may be suspended, limited or terminated at any time without notice.

## (7) Other Balance Sheet Items

## (a) Property, Plant and Equipment—

Property, plant and equipment, net consists of the following:

|                                                            | September<br>30, 2009 | December<br>31, 2008 |
|------------------------------------------------------------|-----------------------|----------------------|
| Land and buildings                                         | \$ 124,829            | \$ 122,256           |
| Machinery and equipment, furniture and fixtures, and other | 203,257               | 192,029              |
| Construction in progress                                   | 6,359                 | 5,321                |
|                                                            | 334,445               | 319,606              |
| Accumulated depreciation                                   | (158,628)             | (133,763)            |
|                                                            | \$ 175,817            | \$ 185,843           |

## (b) Accrued expenses and other current liabilities—

Accrued expenses and other current liabilities consisted of the following:

|                                     | September 30,<br>2009 | December 31,<br>2008 |
|-------------------------------------|-----------------------|----------------------|
| Salary and related expenses         | \$ 15,489             | \$ 11,226            |
| Accrued sales and value added taxes | 14,546                | 10,768               |
| Accrued unrecognized tax benefits   | 13,589                | 11,012               |
| Sales returns                       | 4,337                 | 3,804                |
| Warranty accrual                    | 3,897                 | 3,903                |
| Other                               | 35,966                | 24,603               |
|                                     | \$ 87,824             | \$ 65,316            |

(c) Accumulated other comprehensive loss—

Accumulated OCL consisted of the following:

|                                                                                                    | September 30,<br>2009 | December 31,<br>2008 |
|----------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| Derivative instruments accounted for as hedges,<br>net of tax of \$3,353 and \$4,528, respectively | \$ (5,245)            | \$ (7,082)           |
| Foreign currency translation                                                                       | (2,355)               | (5,508)              |
| Accumulated other comprehensive loss                                                               | \$ (7,600)            | \$ (12,590)          |



Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

(In thousands, except per common share amounts)

## (d) Comprehensive income

The components of comprehensive income consisted of the following:

|                                                                                                                   | Three Months Ended<br>September 30,<br>2009 |           | Nine Months Ended<br>September 30,<br>2009 |          |
|-------------------------------------------------------------------------------------------------------------------|---------------------------------------------|-----------|--------------------------------------------|----------|
|                                                                                                                   | 2009                                        | 2008      | 2009                                       | 2008     |
| Net income                                                                                                        | \$25,684                                    | \$24,071  | \$55,879                                   | \$57,813 |
| Derivative instruments accounted for as hedges, net of taxes of \$(310), \$385, \$(1,175) and \$832, respectively | 484                                         | (602 )    | 1,837                                      | (1,301 ) |
| Cumulative translation adjustment                                                                                 | 2,423                                       | (21,249 ) | 3,152                                      | (9,807 ) |
| Comprehensive income                                                                                              | \$28,591                                    | \$2,220   | \$60,868                                   | \$46,705 |

## (8) Stock-Based Compensation

The Company currently has three stock-based compensation plans: the 2002 Option Plan (2002 Plan), the Amended and Restated 2003 Equity Incentive Plan (2003 Plan) and the 2003 Employee Stock Purchase Plan (ESPP), which are described under the caption “Stock-based Compensation” in the notes to the Consolidated Financial Statements of the Company’s Annual Report on Form 10-K for the year ended December 31, 2008.

The Company granted new options to purchase 36 and 1,730 shares of common stock during the three and nine months ended September 30, 2009, respectively. The Company recognized compensation expense of \$559 and \$1,036 associated with the 2009 grants during the three and nine months ended September 30, 2009, respectively. The Company granted new options to purchase 9 and 2,132 shares of common stock during the three and nine months ended September 30, 2008. The Company recognized compensation expense of \$677 and \$1,100 associated with the 2008 grants during the three and nine months ended September 30, 2008, respectively. As of September 30, 2009, there was \$3,894 of unrecognized compensation expense associated with the options granted in 2009, which is expected to be recorded over the weighted average remaining vesting period of 3.1 years. The options granted in the three months ended September 30, 2009 had a weighted average grant-date fair value of \$7.00 per option, as determined by the Black-Scholes option pricing model using the following assumptions:

|                                    |                |
|------------------------------------|----------------|
| Expected volatility of stock       | 62.6 %<br>68.1 |
| Expected life of options, in years | 5.0            |
| Risk-free interest rate            | 2.4 – 2.5%     |
| Expected dividend yield on stock   | 2.2%           |

The Company granted 18 new restricted stock units (RSUs) during the three months ended September 30, 2009. There were no RSUs granted in the six months ended June 30, 2009 or the twelve months ended December 31, 2008. The Company recognized compensation expense of \$77 with the 2009 RSUs during the three months ended September 30, 2009. As of September 30, 2009, there was \$181 of unrecognized compensation expense associated with the RSUs granted in 2009, which is expected to be recorded over the weighted average remaining vesting period of 1.3 years.

The Company recorded \$2,355 and \$2,060 of total stock-based compensation expense for the three months ended September 30, 2009 and September 30, 2008, respectively. The Company recorded \$6,448 and \$6,101 of total stock-based compensation expense for the nine months ended September 30, 2009 and 2008, respectively.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

(In thousands, except per common share amounts)

(9) Commitments and Contingencies

(a) Purchase Commitments—The Company will, from time to time, enter into limited purchase commitments for the purchase of certain raw materials. Amounts committed under these programs are not significant as of September 30, 2009.

(b) Antitrust Action—On January 5, 2007, a purported class action was filed against the Company in the United States District Court for the Northern District of Georgia, Rome Division (Jacobs v. Tempur-Pedic International, Inc. and Tempur-Pedic North America, Inc., or the Antitrust Action). The Antitrust Action alleges violations of federal antitrust law arising from the pricing of Tempur-Pedic mattress products by Tempur-Pedic North America and certain distributors. The action alleges a class of all purchasers of Tempur-Pedic mattresses in the United States since January 5, 2003, and seeks damages and injunctive relief. Count Two of the complaint was dismissed by the court on June 25, 2007, based on a motion filed by the Company. Following a decision issued by the United States Supreme Court in *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.* on June 28, 2007, the Company filed a motion to dismiss the remaining two counts of the Antitrust Action on July 10, 2007. On December 11, 2007, that motion was granted and, as a result, judgment was entered in favor of the Company and the plaintiffs' complaint was dismissed with prejudice. On December 21, 2007, the plaintiffs filed a "Motion to Alter or Amend Judgment," which has been fully briefed. On May 1, 2008, that motion was denied. The Jacobs appealed the dismissal of their claims, and the parties argued the appeal before the United States Circuit Court for the Eleventh Circuit on December 11, 2008. The matter has been taken under advisement by the court. The Company continues to strongly believe that the Antitrust Action lacks merit, and intends to defend against the claims vigorously. However, due to the inherent uncertainties of litigation, we cannot predict the outcome of the Antitrust Action at this time, and can give no assurance that these claims will not have a material adverse affect on the Company's financial position or results of operation. Accordingly, the Company cannot make an estimate of the possible ranges of loss.

(c) New York Attorney General—In December 2008, the Office of the Attorney General of the State of New York, Antitrust Bureau (OAG) requested that the Company consider discontinuing its unilateral retail price policy (UPPL) in the State of New York, and informed them that it may bring an enforcement action against the Company under New York law if they chose not to do so. The Office of the Attorney General has made information and document requests of the Company and the Company is cooperating with these requests. The Company believes that its UPPL complies with state and federal law and, should the OAG challenge the UPPL, intends to vigorously defend it. However, due to the inherent uncertainties of this matter, the Company cannot at this time predict the outcome of any such enforcement action, if brought, and can give no assurance that these claims will not have a material adverse affect on its financial position or results of operation.

The Company is involved in various other legal proceedings incidental to the operations of its business. The Company believes that the outcome of all such pending legal proceedings in the aggregate will not have a materially adverse affect on its business, financial condition, liquidity, or operating results.

(10) Income Taxes

The Company's effective tax rate for the nine months ended September 30, 2009 was 34.1%, with reconciling items between the effective tax rate and the federal statutory income tax rate of 35.0% including certain foreign tax rate differentials, state and local income taxes, foreign income currently taxable in the U.S., the production activities deduction, and certain other permanent differences. For the same period in 2008, the effective tax rate was 34.2% with reconciling items between the effective tax rate and the federal statutory income tax rate of 35.0% including

certain foreign tax rate differentials, state and local income taxes, valuation allowances on certain net operating losses, foreign income currently taxable in the U.S., the production activities deduction and certain other permanent differences.

The Company completed the repatriation of certain foreign earnings in the first quarter of 2009. This repatriation was initiated in the fourth quarter of 2008 and the associated income tax expense was recognized at that time. The Company has not provided for U.S. federal and/or state income and foreign withholding taxes on the remaining \$112.6 million of undistributed earnings from non-U.S. operations as of September 30, 2009 because the Company intends to reinvest such earnings indefinitely outside of the U. S. If these earnings were to be distributed, foreign tax credits may become available under current law to reduce the resulting U.S. income tax liability.

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)–(Continued)  
(In thousands, except per common share amounts)

On October 24, 2007, the Company received an income tax assessment from the Danish Tax Authority with respect to the 2001, 2002 and 2003 tax years. The tax assessment relates to the royalty paid by one of Tempur-Pedic International's U.S. subsidiaries to a Danish subsidiary and the position taken by the Danish Tax Authority could apply to subsequent years. The total tax assessment is approximately \$39.3 million including interest and underpayment premium. On January 23, 2008 the Company filed timely complaints with the Danish National Tax Tribunal denying the tax assessments. The National Tax Tribunal formally agreed to place the Danish tax litigation on hold pending the outcome of a Bilateral Advance Pricing Agreement (Bilateral APA) between the United States and the Danish Tax Authority. A Bilateral APA involves an agreement between the Internal Revenue Service (IRS) and the taxpayer, as well as a negotiated agreement with one or more foreign competent authorities under applicable income tax treaties. On August 8, 2008 the Company filed the Bilateral APA with the IRS and the Danish Tax Authority. The IRS began analyzing the Bilateral APA in the first quarter of 2009 and expects to finalize its position by the first or second quarter of 2010. The Company believes it has meritorious defenses to the proposed adjustment and will oppose the assessment in the Danish courts, as necessary. It is reasonably possible that the amount of the total unrecognized tax benefits may change in the next twelve months. An estimate of the amount of such change cannot be made at this time.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and income tax returns in various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to tax examinations by tax authorities in the U.S. for periods prior to 2006, U.S. state and local municipalities for periods prior to 2004, and in non-U.S. jurisdictions for periods prior to 2001. Additionally, the Company is currently under examination by various tax authorities around the world. The Company anticipates it is reasonably possible an increase or decrease in the amount of unrecognized tax benefits could be made in the next twelve months as a result of the statute of limitations expiring and/or the examinations being concluded on these returns. However, the Company does not presently anticipate that any increase or decrease in unrecognized tax benefits will be material to the consolidated financial statements. During the three and nine months ended September 30, 2009, there were no significant changes to the liability for unrecognized tax benefits.

## (11) Earnings Per Common Share

|                                                                                  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|----------------------------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                                                                                  | 2009                                | 2008      | 2009                               | 2008      |
| <b>Numerator:</b>                                                                |                                     |           |                                    |           |
| Net income                                                                       | \$25,684                            | \$ 24,071 | \$ 55,879                          | \$ 57,813 |
| <b>Denominator:</b>                                                              |                                     |           |                                    |           |
| Denominator for basic earnings per common share-weighted average shares          | 74,938                              | 74,815    | 74,902                             | 74,704    |
| <b>Effect of dilutive securities:</b>                                            |                                     |           |                                    |           |
| Employee stock options                                                           | 1,228                               | 178       | 494                                | 240       |
| Denominator for basic earnings per common share-adjusted weighted average shares | 76,166                              | 74,992    | 75,396                             | 74,944    |
| Basic earnings per common share                                                  | \$0.34                              | \$ 0.32   | \$ 0.75                            | \$ 0.77   |

Edgar Filing: TEMPUR PEDIC INTERNATIONAL INC - Form 10-Q

|                                   |        |         |         |         |
|-----------------------------------|--------|---------|---------|---------|
| Diluted earnings per common share | \$0.34 | \$ 0.32 | \$ 0.74 | \$ 0.77 |
|-----------------------------------|--------|---------|---------|---------|

The Company excluded 2,039 and 4,932 shares issuable upon exercise of outstanding stock options for the three months ended September 30, 2009 and 2008, respectively, and 4,372 and 3,606 shares issuable upon exercise of outstanding stock options for the nine month periods ended September 30, 2009 and 2008, respectively, from the Diluted earnings per common share computation because their exercise price was greater than the average market price of Tempur-Pedic International's common stock or they were otherwise anti-dilutive.

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

(In thousands, except per common share amounts)

## (12) Business Segment Information

The Company operates in two business segments: Domestic and International. These reportable segments are strategic business units that are managed separately based on the fundamental differences in their operations. The Domestic segment consists of the two U.S. manufacturing facilities, whose customers include the U.S. distribution subsidiary and certain third party distributors in the Americas. The International segment consists of the manufacturing facility in Denmark, whose customers include all of the distribution subsidiaries and third party distributors outside the Domestic segment. The Company evaluates segment performance based on Net sales and Operating income.

The following table summarizes Total assets by segment:

|                            | September<br>30, 2009 | December<br>31, 2008 |
|----------------------------|-----------------------|----------------------|
| Domestic                   | \$475,746             | \$474,824            |
| International              | 282,702               | 282,884              |
| Inter-segment eliminations | (115,787 )            | (111,177 )           |
|                            | \$642,661             | \$646,531            |

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)  
(In thousands, except per common share amounts)

The following table summarizes other segment information:

|                                                                                     | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|-------------------------------------------------------------------------------------|-------------------------------------|------------|------------------------------------|------------|
|                                                                                     | 2009                                | 2008       | 2009                               | 2008       |
| Net sales from external customers:                                                  |                                     |            |                                    |            |
| Domestic                                                                            |                                     |            |                                    |            |
| Mattresses                                                                          | \$ 103,122                          | \$ 121,356 | \$ 265,133                         | \$ 336,598 |
| Pillows                                                                             | 13,216                              | 14,476     | 34,090                             | 40,181     |
| Other                                                                               | 29,939                              | 30,056     | 74,232                             | 85,529     |
|                                                                                     | \$ 146,277                          | \$ 165,888 | \$ 373,455                         | \$ 462,308 |
| International                                                                       |                                     |            |                                    |            |
| Mattresses                                                                          | \$ 46,688                           | \$ 53,513  | \$ 128,149                         | \$ 169,955 |
| Pillows                                                                             | 15,170                              | 16,938     | 41,363                             | 51,728     |
| Other                                                                               | 15,947                              | 16,475     | 43,395                             | 54,706     |
|                                                                                     | \$ 77,805                           | \$ 86,926  | \$ 212,907                         | \$ 276,389 |
|                                                                                     | \$ 224,082                          | \$ 252,814 | \$ 586,362                         | \$ 738,697 |
| Inter-segment sales:                                                                |                                     |            |                                    |            |
| Domestic                                                                            | \$—                                 | \$—        | \$—                                | \$—        |
| International                                                                       | 686                                 | 1,237      | 1,255                              | 2,347      |
| Inter-segment eliminations                                                          | (686 )                              | (1,237 )   | (1,255 )                           | (2,347 )   |
|                                                                                     | \$—                                 | \$—        | \$—                                | \$—        |
| Operating income:                                                                   |                                     |            |                                    |            |
| Domestic                                                                            | \$ 21,710                           | \$ 21,607  | \$ 43,737                          | \$ 43,613  |
| International                                                                       | 20,966                              | 21,284     | 53,982                             | 64,930     |
|                                                                                     | \$ 42,676                           | \$ 42,891  | \$ 97,719                          | \$ 108,543 |
| Depreciation and amortization<br>(including stock-based compensation amortization): |                                     |            |                                    |            |
| Domestic                                                                            | \$ 7,979                            | \$ 6,954   | \$ 22,855                          | \$ 22,785  |
| International                                                                       | 2,388                               | 2,782      | 7,119                              | 8,163      |
|                                                                                     | \$ 10,367                           | \$ 9,736   | \$ 29,974                          | \$ 30,948  |
| Capital expenditures:                                                               |                                     |            |                                    |            |
| Domestic                                                                            | \$ 2,548                            | \$ 1,068   | \$ 4,636                           | \$ 5,003   |
| International                                                                       | 1,685                               | 448        | 4,325                              | 2,841      |
|                                                                                     | \$ 4,233                            | \$ 1,516   | \$ 8,961                           | \$ 7,844   |



## Table of Contents

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with the Condensed Consolidated Financial Statements and accompanying notes included in this Form 10-Q. Unless otherwise noted, all of the financial information in this report is condensed consolidated information for Tempur-Pedic International Inc. or its predecessor. The forward-looking statements in this discussion regarding the mattress and pillow industries, our expectations regarding our future performance, liquidity and capital resources and other non-historical statements in this discussion include numerous risks and uncertainties, as described under "Special Note Regarding Forward-Looking Statements" and "Risk Factors" elsewhere in this quarterly report on Form 10-Q and in our annual report on Form 10-K for the year ended December 31, 2008. Our actual results may differ materially from those contained in any forward-looking statements. Except as may be required by law, we undertake no obligation to publicly update or revise any of the forward-looking statements contained herein.

#### Executive Overview

**General**—We are the leading manufacturer, marketer and distributor of premium mattresses and pillows which we sell in approximately 80 countries under the TEMPUR® and Tempur-Pedic® brands. We believe our premium mattresses and pillows are more comfortable than standard bedding products because our proprietary pressure-relieving TEMPUR® material is temperature sensitive, has a high density and therapeutically conforms to the body.

**Business Segment Information**—We have two reportable business segments: Domestic and International. These reportable segments are strategic business units that are managed separately based on the fundamental differences in their operations. The Domestic operating segment consists of our U.S. manufacturing facilities, whose customers include our U.S. distribution subsidiary and certain third party distributors in the Americas. The International segment consists of our manufacturing facility in Denmark, whose customers include all of our distribution subsidiaries and third party distributors outside the Domestic operating segment. We evaluate segment performance based on Net sales and Operating income.

#### Strategy and Outlook

We believe we are the industry leader in terms of profitability. Our long-term goal is also to become the world's largest bedding company in terms of revenue. To achieve our long-term goals while managing through the current economic environment, we expect to continue to pursue certain key strategies:

- Maintain our focus on premium mattresses and pillows and to regularly introduce new products.
- Invest in increasing our global brand awareness through advertising campaigns that further associate our brand name with better overall sleep and premium quality products.
- Extend our presence and improve our account productivity in both the Domestic and International Retail segments.
- Invest in our operating infrastructure to meet the requirements of our business, including investments in our research and development capabilities.
- Take actions to further improve our financial flexibility and strengthen the business.

#### Results of Operations

A summary of our results for the three and nine months ended September 30, 2009 includes the following:

- Earnings per common share (EPS) was \$0.34 per diluted common share for the three months ended September 30, 2009 as compared to \$0.32 per diluted common share for the three months ended September 30, 2008.
- Gross profit margin was 47.6% for the three months ended September 30, 2009 compared to 41.7% for the three months ended September 30, 2008.
- We reduced total debt by \$104.3 million to \$315.0 million as of September 30, 2009 from \$419.3 million at December 31, 2008.

Table of Contents(In thousands,  
except per common  
share amounts)

|                                                   | Three Months Ended<br>September 30, |         |            |         | Nine Months Ended<br>September 30, |         |            |         |
|---------------------------------------------------|-------------------------------------|---------|------------|---------|------------------------------------|---------|------------|---------|
|                                                   | 2009                                |         | 2008       |         | 2009                               |         | 2008       |         |
| Net sales                                         | \$ 224,082                          | 100.0 % | \$ 252,814 | 100.0 % | \$ 586,362                         | 100.0 % | \$ 738,697 | 100.0 % |
| Cost of sales                                     | 117,373                             | 52.4    | 147,323    | 58.3    | 311,461                            | 53.1    | 419,109    | 56.7    |
| Gross profit                                      | 106,709                             | 47.6    | 105,491    | 41.7    | 274,901                            | 46.9    | 319,588    | 43.3    |
| Selling and<br>marketing expenses                 | 39,272                              | 17.5    | 39,956     | 15.8    | 108,335                            | 18.5    | 137,906    | 18.7    |
| General,<br>administrative and<br>other expenses  | 24,761                              | 11.0    | 22,644     | 9.0     | 68,847                             | 11.7    | 73,139     | 9.9     |
| Operating income                                  | 42,676                              | 19.1    | 42,891     | 17.0    | 97,719                             | 16.7    | 108,543    | 14.7    |
| Interest expense, net                             | (4,311 )                            | (1.9 )  | (6,294 )   | (2.5 )  | (13,359 )                          | (2.3 )  | (19,630 )  | (2.7 )  |
| Other (expense)<br>income, net                    | (214 )                              | (0.1 )  | 96         | —       | 404                                | 0.1     | (995 )     | (0.1 )  |
| Income before<br>income taxes                     | 38,151                              | 17.1    | 36,693     | 14.5    | 84,764                             | 14.5    | 87,918     | 11.9    |
| Income tax<br>provision                           | 12,467                              | 5.6     | 12,622     | 5.0     | 28,885                             | 4.9     | 30,105     | 4.1     |
| Net income                                        | \$ 25,684                           | 11.5 %  | \$ 24,071  | 9.5 %   | \$ 55,879                          | 9.6 %   | \$ 57,813  | 7.8 %   |
| Earnings per<br>common share:                     |                                     |         |            |         |                                    |         |            |         |
| Basic                                             | \$ 0.34                             |         | \$ 0.32    |         | \$ 0.75                            |         | \$ 0.77    |         |
| Diluted                                           | \$ 0.34                             |         | \$ 0.32    |         | \$ 0.74                            |         | \$ 0.77    |         |
| Cash dividend per<br>common share:                | \$ —                                |         | \$ 0.08    |         | \$ —                               |         | \$ 0.24    |         |
| Weighted average<br>common shares<br>outstanding: |                                     |         |            |         |                                    |         |            |         |
| Basic                                             | 74,938                              |         | 74,815     |         | 74,902                             |         | 74,704     |         |
| Diluted                                           | 76,166                              |         | 74,992     |         | 75,396                             |         | 74,944     |         |

## Three Months Ended September 30, 2009 Compared with Three Months Ended September 30, 2008

We sell our premium mattresses and pillows through four distribution channels: Retail, Direct, Healthcare, and Third party. The Retail channel sells to furniture and bedding, specialty and department stores. The Direct channel sells directly to consumers. The Healthcare channel sells to hospitals, nursing homes, healthcare professionals and medical retailers. The Third party channel sells to distributors in countries where we do not operate our own wholly-owned subsidiaries. A summary of Net sales by channel is below:

CONSOLIDATED  
Three Months Ended  
September 30,

DOMESTIC  
Three Months Ended  
September 30,

INTERNATIONAL  
Three Months Ended  
September 30,

Edgar Filing: TEMPUR PEDIC INTERNATIONAL INC - Form 10-Q

| (In thousands) | 2009       | 2008       | 2009       | 2008       | 2009      | 2008      |
|----------------|------------|------------|------------|------------|-----------|-----------|
| Retail         | \$ 191,012 | \$ 216,226 | \$ 129,883 | \$ 147,992 | \$ 61,129 | \$ 68,234 |
| Direct         | 12,245     | 11,230     | 10,600     | 9,169      | 1,645     | 2,061     |
| Healthcare     | 8,942      | 11,636     | 2,804      | 3,727      | 6,138     | 7,909     |
| Third party    | 11,883     | 13,722     | 2,990      | 5,000      | 8,893     | 8,722     |
|                | \$ 224,082 | \$ 252,814 | \$ 146,277 | \$ 165,888 | \$ 77,805 | \$ 86,926 |

Table of Contents

A summary of Net sales by product is below:

| (In thousands) | CONSOLIDATED<br>Three Months Ended<br>September 30, |            | DOMESTIC<br>Three Months Ended<br>September 30, |            | INTERNATIONAL<br>Three Months Ended<br>September 30, |           |
|----------------|-----------------------------------------------------|------------|-------------------------------------------------|------------|------------------------------------------------------|-----------|
|                | 2009                                                | 2008       | 2009                                            | 2008       | 2009                                                 | 2008      |
| Mattresses     | \$ 149,810                                          | \$ 174,869 | \$ 103,122                                      | \$ 121,356 | \$ 46,688                                            | \$ 53,513 |
| Pillows        | 28,386                                              | 31,414     | 13,216                                          | 14,476     | 15,170                                               | 16,938    |
| Other          | 45,886                                              | 46,531     | 29,939                                          | 30,056     | 15,947                                               | 16,475    |
|                | \$ 224,082                                          | \$ 252,814 | \$ 146,277                                      | \$ 165,888 | \$ 77,805                                            | \$ 86,926 |

Net sales—Net sales for the three months ended September 30, 2009 decreased to \$224.1 million from \$252.8 million for the same period in 2008, a decrease of \$28.7 million, or 11.4%, primarily a result of our industry continuing to be affected by the macroeconomic environment, resulting in lower consumer traffic and decreased consumer demand. Consolidated Mattress sales decreased \$25.1 million, or 14.3% compared to the third quarter of 2008. For the three months ended September 30, 2009, our Retail channel Net sales decreased to \$191.0 million from \$216.2 million for the same period in 2008, a decrease of \$25.2 million, or 11.7%. Consolidated pillow sales decreased approximately \$3.0 million, or 9.6%, from the third quarter of 2008. Consolidated Other, which includes adjustable bed bases, foundations and other related products, decreased \$0.6 million, or 1.4%.

Domestic—Domestic Net sales for the three months ended September 30, 2009 decreased to \$146.3 million from \$165.9 million for the same period in 2008, a decrease of \$19.6 million, or 11.8%. Our Domestic Retail channel contributed \$129.9 million in Net sales for the three months ended September 30, 2009 for a decrease of \$18.1 million, or 12.2%, for the same period in 2008. We believe that the macroeconomic environment and slower consumer traffic impacted our Domestic Retail channel during the third quarter. As a result, Domestic mattress sales in the third quarter of 2009 decreased \$18.2 million, or 15.0%, over the same period in 2008. Pillow sales decreased \$1.3 million, or 8.7%. Many of our pillow products are sold with mattress purchases. Therefore, when mattress sales decline, pillow sales are also impacted. Net sales in the Direct channel increased by \$1.4 million, or 15.6%. We believe our focus on generating internet leads has helped improve our Direct channel. Our Healthcare channel Net sales decreased by \$0.9 million, or 24.8%, which we believe is primarily related to the decreased availability of spending in the healthcare industry. Net sales in the Third party channel decreased \$2.0 million, or 40.2%, due to macroeconomic conditions in our Third party regions.

International—International Net sales for the three months ended September 30, 2009 decreased to \$77.8 million from \$86.9 million for the same period in 2008, a decrease of \$9.1 million, or 10.5%. On a constant currency basis, our International Net sales declined approximately 7.2%. Our International segment was primarily impacted by the global economic slowdown, which continues to impact our International segment. The International Retail channel decreased \$7.1 million, or 10.4%, for the three months ended September 30, 2009. Our Direct channel decreased 20.2% and Third party channel increased 2.0%. Healthcare channel Net sales decreased \$1.8 million or 22.4%. International mattress sales in the third quarter of 2009 decreased \$6.8 million, or 12.8%, over the third quarter of 2008. Pillow sales for the third quarter of 2009 decreased \$1.8 million, or 10.4%, as compared to the third quarter of 2008.

Gross profit—Gross profit for the three months ended September 30, 2009 increased to \$106.7 million from \$105.5 million for the same period in 2008, an increase of \$1.2 million, or 1.2%. The Gross profit margin for the three months ended September 30, 2009 was 47.6% as compared to 41.7% for the same period in 2008. The factors that impacted Gross profit margin during the quarter are identified and discussed below in the respective segment discussions. During 2009 we have been implementing projects to expand our margins, including improving utilization rates, a redesign of our transportation network and maximizing vendor sourcing opportunities.

Domestic—Domestic Gross profit for the three months ended September 30, 2009 increased to \$63.8 million from \$58.8 million for the same period in 2008, an increase of \$5.0 million, or 8.6%. The Gross profit margin in our Domestic segment was 43.6% and 35.4% for the three months ended September 30, 2009 and September 30, 2008, respectively. Improvements in our Domestic Gross profit margin were primarily driven by our focus on improving manufacturing efficiencies, lower commodity pricing including raw material and transportation costs and pricing actions taken earlier in 2009. These factors were partially offset by fixed cost de-leverage as production volumes were down during the three months ended September 30, 2009 as compared to the same period in 2008. Domestic Cost of sales for the three months ended September 30, 2009 decreased to \$82.5 million from \$107.1 million for the same period in 2008, a decrease of \$24.6 million, or 23.0%.

## Table of Contents

**International—International Gross profit** for the three months ended September 30, 2009 decreased to \$42.9 million from \$46.7 million for the same period in 2008, a decrease of \$3.8 million, or 8.1%. The Gross profit margin in our International segment was 55.2% and 53.8% for the three months ended September 30, 2009 and September 30, 2008, respectively. Improvements in our International Gross profit margin were primarily driven by our focus on improving manufacturing efficiencies, lower commodity pricing including raw materials and pricing actions taken earlier in 2009. These factors were partially offset by fixed cost de-leverage as production volumes were down during the three months ended September 30, 2009 as compared to the same period in 2008. Our International Cost of sales for the three months ended September 30, 2009 decreased to \$34.9 million from \$40.2 million for the same period in 2008, a decrease of \$5.3 million, or 13.2%.

**Selling and marketing expenses—Selling and marketing expenses** include advertising and media production, other marketing materials such as catalogs, brochures, videos, product samples, direct customer mailings and point of purchase materials and sales force compensation. We also include in Selling and marketing expenses certain new product development costs, including market research and testing for new products. In the third quarter of 2009, Selling and marketing expenses decreased to \$39.3 million for the three months ended September 30, 2009 as compared to \$40.0 million for the three months ended September 30, 2008. Selling and marketing expenses as a percentage of Net sales were 17.5% and 15.8% for the three months ended September 30, 2009 and September 30, 2008, respectively. Our objective is to align advertising costs to reflect our sales expectations. During the last three quarters of 2008 and the first half of 2009, we took actions to better align our advertising spend with our sales expectations and implemented initiatives to reduce costs in other selling activities. In the third quarter of 2009 we made investments in advertising to support future growth. Our new marketing and advertising campaign which began in the third quarter of 2009 will continue to roll out in the fourth quarter of 2009.

**General, administrative and other expenses—General, administrative and other expenses** include management salaries, information technology, professional fees, depreciation of furniture and fixtures, leasehold improvements and computer equipment, expenses for administrative functions and research and development costs. General, administrative and other expenses increased to \$24.8 million for the three months ended September 30, 2009 as compared to \$22.6 million for the three months ended September 30, 2008, an increase of \$2.1 million, or 9.3%. General, administrative and other expenses as a percentage of Net sales was 11.0% and 9.0% for the three months ended September 30, 2009 and September 30, 2008, respectively. The increase in general, administrative and other expenses as a percentage of Net sales in the third quarter of 2009 as compared to the third quarter of 2008 is primarily attributable to increasing the bonus pool related to our results through the third quarter of 2009 and our expectations for the remainder of the year. Additionally, we incurred incremental legal expenses during the third quarter of 2009.

**Interest expense, net—Interest expense, net**, includes the interest costs associated with our borrowings and the amortization of deferred financing costs related to those borrowings. Interest expense, net, decreased to \$4.3 million for the three months ended September 30, 2009, as compared to \$6.3 million for the three months ended September 30, 2008, a decrease of \$2.0 million, or 31.5%. The decrease in interest expense is primarily attributable to the decrease in our total Long-term debt levels and a lower interest rate on our variable rate debt compared to the third quarter of 2008.

**Income tax provision—Income tax provision** includes income taxes associated with taxes currently payable and deferred taxes, and it includes the impact of net operating losses for certain of our foreign operations.

Our effective tax rate for the three months ended September 30, 2009 was 32.7%. For the same period in 2008, the effective tax rate was 34.4%. The decrease in the effective tax rate is due to the tax charge of an unrecognized tax benefit included in the effective tax rate for the three months ended September 30, 2008, with no charge occurring during the same period in 2009.

Our effective income tax rates for the three months ended September 30, 2009 and 2008 differed from the federal statutory rate of 35.0% principally because of certain foreign tax rate differentials, state and local income taxes, foreign income currently taxable in the U.S., the production activities deduction and certain other permanent differences.

On October 24, 2007, we received an income tax assessment from the Danish Tax Authority with respect to the 2001, 2002 and 2003 tax years. The tax assessment relates to the royalty paid by one of Tempur-Pedic International's U.S. subsidiaries to a Danish subsidiary and the position taken by the Danish Tax Authority could apply to subsequent years. The total tax assessment is approximately \$39.3 million including interest and penalties. On January 23, 2008 we filed timely complaints with the Danish National Tax Tribunal denying the tax assessments. The National Tax Tribunal formally agreed to place the Danish tax litigation on hold pending the outcome of a Bilateral Advance Pricing Agreement (Bilateral APA) between the United States and the Danish Tax Authority. A Bilateral APA involves an agreement between the IRS and the taxpayer, as well as a negotiated agreement with one or more foreign competent authorities under applicable income tax treaties. On August 8, 2008 we filed the Bilateral APA with the IRS and the Danish Tax Authority. The IRS began analyzing the Bilateral APA in the first quarter of 2009 and expects to finalize its position by the first or second quarter of 2010. We believe we have meritorious defenses to the proposed adjustment and will oppose the assessment in the Danish courts, as necessary. It is reasonably possible that the amount of the total unrecognized tax benefits may change in the next twelve months. An estimate of the amount of such change cannot be made at this time.



Table of Contents

Nine Months Ended September 30, 2009 Compared with Nine Months Ended September 30, 2008

A summary of Net sales by channel is below:

|                | CONSOLIDATED<br>Nine Months Ended<br>September 30, |            | DOMESTIC<br>Nine Months Ended<br>September 30, |            | INTERNATIONAL<br>Nine Months Ended<br>September 30, |            |
|----------------|----------------------------------------------------|------------|------------------------------------------------|------------|-----------------------------------------------------|------------|
| (In thousands) | 2009                                               | 2008       | 2009                                           | 2008       | 2009                                                | 2008       |
| Retail         | \$ 497,109                                         | \$ 623,453 | \$ 328,870                                     | \$ 407,181 | \$ 168,239                                          | \$ 216,272 |
| Direct         | 32,759                                             | 37,499     | 28,506                                         | 31,171     | 4,253                                               | 6,328      |
| Healthcare     | 26,105                                             | 36,449     | 8,184                                          | 12,050     | 17,921                                              | 24,399     |
| Third party    | 30,389                                             | 41,296     | 7,895                                          | 11,906     | 22,494                                              | 29,390     |
|                | \$ 586,362                                         | \$ 738,697 | \$ 373,455                                     | \$ 462,308 | \$ 212,907                                          | \$ 276,389 |

A summary of Net sales by product is below:

|                | CONSOLIDATED<br>Nine Months Ended<br>September 30, |            | DOMESTIC<br>Nine Months Ended<br>September 30, |            | INTERNATIONAL<br>Nine Months Ended<br>September 30, |            |
|----------------|----------------------------------------------------|------------|------------------------------------------------|------------|-----------------------------------------------------|------------|
| (In thousands) | 2009                                               | 2008       | 2009                                           | 2008       | 2009                                                | 2008       |
| Mattresses     | \$ 393,282                                         | \$ 506,553 | \$ 265,133                                     | \$ 336,598 | \$ 128,149                                          | \$ 169,955 |
| Pillows        | 75,453                                             | 91,909     | 34,090                                         | 40,181     | 41,363                                              | 51,728     |
| Other          | 117,627                                            | 140,235    | 74,232                                         | 85,529     | 43,395                                              | 54,706     |
|                | \$ 586,362                                         | \$ 738,697 | \$ 373,455                                     | \$ 462,308 | \$ 212,907                                          | \$ 276,389 |

Net sales—Net sales for the nine months ended September 30, 2009 decreased to \$586.4 million from \$738.7 million for the same period in 2008, a decrease of \$152.3 million, or 20.6%, primarily a result of our industry continuing to be affected by the macroeconomic environment, resulting in lower consumer traffic and decreased consumer demand. For the nine months ended September 30, 2009, our Retail channel Net sales decreased to \$497.1 million from \$623.5 million for the same period in 2008, a decrease of \$126.3 million, or 20.3%. The factors that impacted Net sales for each segment are discussed below, in the respective segment discussion.

Domestic—Domestic Net sales for the nine months ended September 30, 2009 decreased to \$373.5 million from \$462.3 million for the same period in 2008, a decrease of \$88.9 million, or 19.2%. Our Domestic Retail channel contributed \$328.9 million in Net sales for the nine months ended September 30, 2009. This is a decrease of \$78.3 million, or 19.2%, over the prior year same period in the prior year. This decrease is due primarily to the ongoing challenging U.S. macroeconomic environment during 2009, which resulted in lower consumer traffic. The Healthcare channel Net sales decreased \$3.9 million, or 32.1%. Our Third party channel Net sales decreased \$4.0 million, or 33.7%, as the second quarter increase in our Third party channel was offset by decreases in the first and third quarters of 2009. Our Direct channel Net sales decreased 8.5%, which is also directly correlated to the changes in the U.S. macroeconomic environment. Domestic mattress sales decreased \$71.5 million, or 21.2%, over the same period in 2008, driven by the decrease in our Retail channel. Pillow sales decreased \$6.1 million, or 15.2%. Many of our pillow products are sold with mattress purchases. Therefore, when mattress sales decline, pillow sales are also impacted.

International—International Net sales for the nine months ended September 30, 2009 decreased to \$212.9 million from \$276.4 million for the same period in 2008, a decrease of \$63.5 million, or 23.0%. On a constant currency basis, our International sales declined by approximately 14.7%. Our International segment was primarily impacted by macroeconomic factors, as the global economic slowdown continues to impact our International segment. The International Retail channel decreased \$48.0 million, or 22.2%, for the nine months ended September 30, 2009. Our Direct channel Net sales decreased 32.8%. Our Third party sales decreased 23.5%. Additionally, our Healthcare

channel Net sales decreased \$6.5 million, or 26.6%. International mattress sales decreased \$41.8 million, or 24.6%, as compared to 2008. Pillow sales for the nine months ended September 30, 2009 decreased \$10.4 million, or 20.0%, as compared to the same period in 2008. Many of our pillow products are sold with mattress purchases. Therefore, when mattress sales decline, pillow sales are also impacted.

## Table of Contents

**Gross profit**—Gross profit for the nine months ended September 30, 2009 decreased to \$274.9 million from \$319.6 million for the same period in 2008, a decrease of \$44.7 million, or 14.0%. The Gross profit margin for the nine months ended September 30, 2009 was 46.9% as compared to 43.3% for the same period in 2008. Several factors impacted our Gross profit margin during the period. These factors are identified and discussed below in the respective segment discussions. During 2009 we have been implementing projects to expand our margins, including improving utilization rates, a redesign of our transportation network and maximizing vendor sourcing opportunities.

**Domestic**—Domestic Gross profit for the nine months ended September 30, 2009 decreased to \$157.0 million from \$170.0 million for the same period in 2008, a decrease of \$12.9 million, or 7.6%. The Gross profit margin in our Domestic segment was 42.0% and 36.8% for the nine months ended September 30, 2009 and September 30, 2008, respectively. The increase in our Gross profit margin for the Domestic segment was driven by improved manufacturing efficiencies, lower commodity prices including raw material and transportation costs and pricing actions taken early in 2009, partially offset by fixed cost de-leverage related to lower production volumes. Our Domestic segment Cost of sales decreased to \$216.4 million for the nine months ended September 30, 2009 as compared to \$292.3 million for the nine months ended September 30, 2008, a decrease of \$75.9 million, or 26.0%.

**International**—International Gross profit for the nine months ended September 30, 2009 decreased to \$117.9 million from \$149.6 million for the same period in 2008, a decrease of \$31.8 million, or 21.2%. The Gross profit margin in our International segment was 55.4% and 54.1% for the nine months ended September 30, 2009 and September 30, 2008, respectively. For the nine months ended September 30, 2009, the improvement in our Gross Profit margin for the International segment was driven by our focus on improving manufacturing efficiencies, lower commodity prices, and pricing actions taken early in 2009, partially offset by fixed cost de-leverage related to lower production volumes. Our International segment Cost of sales for the nine months ended September 30, 2009 decreased to \$95.0 million from \$126.8 million for the same period in 2008, a decrease of \$31.7 million, or 25.0%.

**Selling and marketing expenses**—Selling and marketing expenses decreased to \$108.3 million for the nine months ended September 30, 2009 as compared to \$137.9 million for the nine months ended September 30, 2008. Selling and marketing expenses as a percentage of Net sales decreased to 18.5% for the nine months ended September 30, 2009 from 18.7% for the same period for 2008. Our objective is to align advertising costs to reflect our sales expectations. In the third quarter of 2009 we made investments in advertising to support future growth, including our new marketing and advertising campaign which began in the third quarter of 2009 and will continue to roll out in the fourth quarter of 2009.

**General, administrative and other expenses**—General, administrative and other expenses decreased to \$68.8 million for the nine months ended September 30, 2009 as compared to \$73.1 million for the nine months ended September 30, 2008, a decrease of \$4.3 million. General, administrative and other expenses as a percentage of Net sales was 11.7% and 9.9% for the nine months ended September 30, 2009 and September 30, 2008, respectively. The increase in General, administrative and other expenses as a percentage of Net sales for the nine months ended September 30, 2009 compared to the same period in 2008 is primarily attributable to increasing the bonus pool related to our results through the third quarter of 2009 and our expectations for the remainder of the year. Additionally, we incurred incremental legal expenses during the third quarter of 2009.

**Interest expense, net**—Interest expense, net, decreased to \$13.4 million for the nine months ended September 30, 2009, as compared to \$19.6 million for the nine months ended September 30, 2008, a decrease of \$6.3 million, or 31.9%. The decrease in our interest expense is related to lower levels of long-term debt and a decrease in the interest rate on our variable rate debt through September 30, 2009, as compared to the same time period in 2008.

**Income tax provision**—Our effective tax rate for the nine months ended September 30, 2009 was 34.1%. For the same period in 2008, the effective tax rate was 34.2%.

Our effective income tax rates for the nine months ended September 30, 2009 and 2008 differed from the federal statutory rate of 35.0% principally because of certain foreign tax rate differentials, state and local income taxes, foreign income currently taxable in the U.S., the production activities deduction and certain other permanent differences.

## Liquidity and Capital Resources

### Liquidity

Our principal sources of funds are cash flows from operations. Our principal uses of funds consist of payments of principal and interest on our debt facilities, capital expenditures, payments of dividends and share repurchases from time to time pursuant to a share repurchase program. At September 30, 2009, we had working capital of \$56.2 million including Cash and cash equivalents of \$20.0 million as compared to working capital of \$82.4 million including \$15.4 million in Cash and cash equivalents as of December 31, 2008. The increase in Cash and cash equivalents was primarily related to the timing of certain payments to third-party vendors and our continued focus to improve operating cash flow. During the twelve month period ended December 31, 2008 and nine month period ended September 30, 2009, there were no repurchases of our common stock.

26

---

## Table of Contents

Our cash flow from operations decreased to \$120.4 million for the nine months ended September 30, 2009 as compared to \$168.9 million for the nine months ended September 30, 2008. During the remainder of 2009, we plan to maintain our focus on driving working capital improvements to maximize operating cash flow and increase our financial flexibility. The decrease in operating cash flow for the nine month period ending September 30, 2009 compared to the nine month period ending September 30, 2008 was primarily the result of the changes in operating assets and liabilities and deferred income taxes. During the third quarter of 2009, we continued to effectively manage our working capital levels by reducing inventory levels, taking advantage of vendor payment terms, and the timing of tax payments. In order to support retailers and respond to consumer demand we expect our inventory levels to increase by approximately \$10.0 million by the end of 2009.

Net cash used in investing activities decreased to \$9.0 million for the nine months ended September 30, 2009 as compared to \$9.8 million for the nine months ended September 30, 2008, a decrease of \$0.8 million. The decrease is primarily related to the purchase of our former third party distributor in New Zealand during 2008, whereas no purchases have occurred in 2009, this was partially offset by increased capital expenditures during the nine months ended September 30, 2009.

Cash flow used by financing activities was \$103.1 million for the nine months ended September 30, 2009 as compared to \$100.4 million for the nine months ended September 30, 2008, representing an increase in cash flow used of \$2.8 million. Cash used in financing activities is primarily related to our continued focus to reduce our level of outstanding debt. For the nine months ended September 30, 2009, we reduced our debt by \$104.3 million. In the first quarter of 2009, we completed our repatriation of foreign earnings which was initiated during the fourth quarter of 2008 and used a portion of the proceeds to reduce our level of outstanding debt. Additionally, in the fourth quarter of 2008, we suspended our quarterly dividend payment in order to redirect the use of these funds to pay down outstanding debt.

### Capital Expenditures

Capital expenditures totaled \$9.0 million for the nine months ended September 30, 2009 and \$7.8 million for the nine months ended September 30, 2008. We currently expect our 2009 capital expenditures to be approximately \$15.0 million.

### Debt Service

Our long-term debt decreased to \$315.0 million as of September 30, 2009 from \$419.3 million as of December 31, 2008. After giving effect to \$315.0 million in borrowings under the 2005 Senior Credit Facility and letters of credit outstanding, total availability under the Revolvers was \$321.3 million as of September 30, 2009.

The interest rate and certain fees that we pay in connection with the 2005 Senior Credit Facility are subject to periodic adjustment based on changes in our consolidated leverage ratio. In May 2008, we entered into an interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. Under this swap, we pay at a fixed rate and receive payments at a variable rate. The swap effectively fixes the floating LIBOR-based interest rate to 3.755% on \$300.0 million of the outstanding balance as of September 30, 2009 under the 2005 Senior Credit Facility, with the outstanding balance subject to the swap declining over time. The amount of the outstanding balance subject to the swap declines as follows: to \$300.0 million on November 28, 2008 (through November, 2009); to \$200.0 million on November 28, 2009 (through November, 2010) and to \$100.0 million on November 28, 2010 (through November 28, 2011).

### Stockholders' Equity

Share Repurchase Program—On October 16, 2007, our Board of Directors authorized a share repurchase authorization of up to \$300.0 million of our common stock. Under the existing share repurchase authorization, we have \$280.1 million available for repurchase as of September 30, 2009. No shares were repurchased during the year ended December 31, 2008 and nine months ended September 30, 2009. Share repurchases under this authorization may be made through open market transactions, negotiated purchase or otherwise, at times and in such amounts as we deem appropriate. This share repurchase authorization may be suspended, limited or terminated at any time without notice.

27

---

## Table of Contents

**Dividend Program**—Our Board of Directors declared dividends in the first three quarters of 2008 of \$0.08 per common share. On October 16, 2008, we announced that we would suspend the payment of the quarterly cash dividend and redirect the use of those funds to reduce debt. The decision to pay a dividend is reviewed quarterly and requires declaration by our Board of Directors.

## Factors That May Affect Future Performance

**General Business and Economic Conditions**—Our business has been affected by general business and economic conditions, and these conditions could have an impact on future demand for our products. The U.S. macroeconomic environment remains challenging and was the primary factor in a slowdown in the mattress industry. In addition, our International segment experienced further weakening as a result of certain consumer trends in several European and Asian markets. We expect the economic environment in the U.S., Europe and Asia to continue to be challenging.

Maintaining financial flexibility is our primary short-term focus. In light of the macroeconomic environment, we took steps to further align our cost structure with our anticipated level of Net sales. During the third quarter of 2009 we have continued to increase our financial flexibility by reducing our inventory, improving collections, lowering expenses and paying down debt. During the remainder of 2009, we expect to continue to pursue certain key strategies including: maintaining focus on premium mattresses and pillows and regularly introducing new products; investing in increasing our global brand awareness; extending our presence and improving our Retail account productivity; investing in our operating infrastructure to meet the requirements of our business; maintain a reasonable cushion for the covenants in our credit facility; improve cost structures and taking actions to further improve our financial flexibility and strengthen our business.

**Managing Growth**—Over the last eight years, we have had to manage our business both through periods of rapid growth and the current challenging economic environment. Our Net sales increased from \$221.5 million in 2001 to \$1,106.7 million in 2007 and our Net sales were \$927.8 million for the year ended December 31, 2008. For the nine months ended September 30, 2009, our Net sales were \$586.4 million. In the past, our growth has placed, and may continue to place, a strain on our management, production, product distribution network, information systems and other resources. In response to these types of challenges, management has continued to enhance operating and financial infrastructure, as appropriate. In addition, since 2007, we have had to manage a decline in sales as a result of the macroeconomic environment. During this period, we had to manage our cost structure to contain costs. Going forward, we expect our expenditures to enhance our operating and financial infrastructure, as well as expenditures for advertising and other marketing-related activities, will continue to be made as the continued growth in the business allows us the ability to invest. However, these expenditures may be limited by lower than planned sales or an inflationary cost environment.

**Gross Margins**—Our gross margin is primarily impacted by the cost of raw materials, operational efficiency, product and channel mix and volume incentives offered to certain retail accounts. Future increases in raw material prices could have a negative impact on our gross margin if we do not raise prices to cover increased cost. Our gross margin can also be impacted by our operational efficiencies, including the particular levels of utilization at our three manufacturing facilities. Our margins are also impacted by the growth in our Retail channel as sales in our Retail channel are at wholesale prices whereas sales in our Direct channel are at retail prices. Additionally, our overall product mix has shifted to mattresses and other products over the last several years, which has impacted our gross margins because mattresses generally carry lower margins than pillows and are sold with lower margin products such as foundations and bed frames. We expect that gross margins in the fourth quarter of 2009 will remain consistent with or slightly improve compared to the gross margins in the third quarter of 2009. We expect that productivity and fixed cost leverage will have a positive impact on our margins in the fourth quarter. However, we expect that the effects of these improvements will be offset by commodity pricing and discounts offered to retailers.

Competition—Participants in the mattress and pillow industries compete primarily on price, quality, brand name recognition, product availability and product performance. We compete with a number of different types of mattress alternatives, including standard innerspring mattresses, other foam mattresses, waterbeds, futons, air beds and other air-supported mattresses. These alternative products are sold through a variety of channels, including furniture and bedding stores, specialty bedding stores, department stores, mass merchants, wholesale clubs, telemarketing programs, television infomercials and catalogs.

Our largest competitors have significant financial, marketing and manufacturing resources and strong brand name recognition, and sell their products through broad and well established distribution channels. Additionally, we believe that a number of our significant competitors offer mattress products claimed to be similar to our TEMPUR® mattresses and pillows. We provide strong channel profits to our retailers and distributors which management believes will continue to provide an attractive business model for our retailers and discourage them from carrying competing lower-priced products.

28

---



## Table of Contents

**Significant Growth Opportunities**—We believe there are significant opportunities to take market share from the innerspring mattress industry as well as other sleep surfaces. Our market share of the overall mattress industry is relatively small in terms of both dollars and units, which we believe provides us with a significant opportunity for growth. By broadening our brand awareness and offering superior sleep surfaces, we believe consumers will over time adopt our products at an increasing rate, which should expand our market share. However, our business may be affected by general business and economic conditions that could have an impact on demand for our products. In addition, by expanding distribution within our existing accounts, we believe we have the opportunity to grow our business. By extending our product line and our new segmentation of products, we should be able to continue to expand the number of Tempur-Pedic models offered at the retail store level, which should lead to increased sales. Based on this strategy we believe a focus on expanding distribution within our existing accounts provides for continued growth opportunities and market share gains. However, our business may continue to be affected by general business and economic conditions that could have an impact on demand for our products, which could limit our market share and decrease sales. Our products are currently sold in approximately 6,400 furniture and bedding retail stores in the U.S., out of a total of approximately 10,000 stores we have identified as appropriate targets. Within this addressable market, our plan is to increase our total penetration to a total of 7,000 to 8,000 over time. Our products are also sold in approximately 4,900 furniture retail and department stores outside the U.S., out of a total of approximately 7,000 stores that we have identified as appropriate targets. We are continuing to develop products that are responsive to consumer demand in our markets internationally.

**Financial Leverage**—As of September 30, 2009, we had \$315.0 million of total Long-term debt outstanding, and our Stockholders' Equity was \$140.6 million. Higher financial leverage makes us more vulnerable to general adverse competitive, economic and industry conditions. Our recent repatriation of foreign earnings, suspending our quarterly cash dividend, and modest debt rebalancing between our Domestic and International segments, together with productivity improvements and cost containment initiatives has enabled us to decrease our financial leverage and increase our financial flexibility during the first nine months of 2009. There can be no assurance, however, that our business will generate sufficient cash flow from operations or that future borrowings will be available under our 2005 Senior Credit Facility.

**Exchange Rates**—As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. Foreign currency exchange rate movements create a degree of risk by affecting the U.S. dollar value of sales made and costs incurred in foreign currencies. We do not enter into hedging transactions to hedge this risk. Consequently, our reported earnings and financial position could fluctuate materially as a result of foreign exchange movements. Should currency rates change sharply, our results could be negatively impacted.

We use foreign exchange forward contracts to manage a portion of the exposure to the risk related to intercompany debt and interest payments. These hedging transactions may not succeed in effectively managing our foreign currency exchange rate risk related to these transactions. See "ITEM 3. Quantitative and Qualitative Disclosures About Market Risk—Foreign Currency Exposures" under Part I of this report.

## Critical Accounting Policies and Estimates

For a discussion of our critical accounting policies and estimates, see "ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in our annual report on Form 10-K for the year ended December 31, 2008. There have been no material changes to our critical accounting policies and estimates in 2009.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exposures

As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. Foreign currency exchange rate movements create a degree of risk by affecting the U.S. dollar value of sales made and costs incurred in foreign currencies. We do not enter into hedging transactions to hedge this risk. Consequently, our reported earnings and financial position could fluctuate materially as a result of foreign exchange movements. Should currency rates change sharply, our results could be negatively impacted.

We use foreign exchange forward contracts to manage a portion of the exposure to the risk related to intercompany debt and interest payments. These hedging transactions may not succeed in effectively managing our foreign currency exchange rate risk related to these transactions. A sensitivity analysis indicates the potential loss in fair value on foreign currency forward contracts outstanding as of September 30, 2009, would be approximately \$2.3 million if an adverse 10% change in foreign currencies subject to these contracts occurred. Such losses would be largely offset by gains from the revaluation or settlement of the underlying assets and liabilities that are being protected by the foreign currency forward contracts.

We do not apply hedge accounting to the foreign currency forward contracts used to offset currency-related changes in the fair value of foreign currency denominated assets and liabilities. These contracts are marked-to-market through earnings at the same time that the exposed assets and liabilities are re-measured through earnings.

Interest Rate Risk

We are exposed to changes in interest rates. Our 2005 Senior Credit Facility has a variable rate. In May 2008, we entered into a three year interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. Under this swap, we pay at a fixed rate and receive payments at a variable rate. The swap effectively fixes the floating LIBOR-based interest rate to 3.755% on \$350.0 million of the outstanding balance under the 2005 Senior Credit Facility, with the outstanding balance subject to the swap declining over time. The amount of the outstanding balance subject to the swap declines as follows: to \$300.0 million on November 28, 2008 (through November, 2009); to \$200.0 million on November 28, 2009 (through November, 2010) and to \$100.0 million on November 28, 2010 (through November 28, 2011).

Interest rate changes generally do not affect the market value of such debt, but do impact the amount of our interest payments and therefore, our future earnings and cash flows, assuming other factors are held constant. On September 30, 2009, we had variable-rate debt of approximately \$15.0 million. Holding other variables constant, including levels of indebtedness, a one hundred basis point increase in interest rates on our variable-rate debt would cause an estimated reduction in income before income taxes for the next year of approximately \$0.2 million.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), of the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act) as of the end of the period covered by this report. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of September 30, 2009 and designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such

information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

During our last fiscal quarter, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 9 to the Notes to the Condensed Consolidated Financial Statements in ITEM 1 under Part I of this report for a full description of our legal proceedings.

We are involved in various other legal proceedings incidental to the operations of our business. We believe that the outcome of all such pending legal proceedings in the aggregate will not have a materially adverse affect on our business, financial condition, liquidity, or operating results.

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this quarterly report, you should carefully consider the factors discussed under the heading, “Risk Factors” in Item 1A of Part I of our annual report on Form 10-K for the year ended December 31, 2008, some of which are updated below. These risks are not the only ones facing the Company. Please also see “Special Note Regarding Forward-Looking Statements” on page 3.

We are subject to a pending tax proceeding in Denmark, and an adverse decision would reduce our liquidity and profitability.

On October 24, 2007, we received an income tax assessment from the Danish Tax Authority with respect to the 2001, 2002 and 2003 tax years. The tax assessment relates to the royalty paid by one of Tempur-Pedic International’s U.S. subsidiaries to a Danish subsidiary and the position taken by the Danish Tax Authority could apply to subsequent years. The total tax assessment is approximately \$39.3 million including interest and penalties. On January 23, 2008 we filed timely complaints with the Danish National Tax Tribunal denying the tax assessments. The National Tax Tribunal formally agreed to place the Danish tax litigation on hold pending the outcome of the Bilateral APA between the United States and the Danish Tax Authority. A Bilateral APA involves an agreement between the IRS and the taxpayer, as well as a negotiated agreement with one or more foreign competent authorities under applicable income tax treaties. On August 8, 2008 we filed the Bilateral APA with the IRS and the Danish Tax Authority. The IRS began analyzing the Bilateral APA in the first quarter of 2009 and expects to finalize its position by the first or second quarter of 2010. We believe we have meritorious defenses to the proposed adjustment and will oppose the assessment in the Danish courts, as necessary. It is reasonably possible that the amount of the total unrecognized tax benefits may change in the next twelve months. An estimate of the amount of such change cannot be made at this time.

Our current executive officers, directors and their affiliates own a large percentage of our common stock and could limit you from influencing corporate decisions.

As of October 23, 2009, our executive officers, directors, and their respective affiliates own, in the aggregate, approximately 12% of our outstanding common stock on a fully diluted basis, after giving effect to the vesting of all unvested options. These stockholders, as a group, are able to influence all matters requiring approval by our stockholders, including mergers, sales of assets, the election of all directors, and approval of other significant corporate transactions, in a manner with which you may not agree or that may not be in your best interest. In addition, we have several stockholders who presently own more than 5% of our outstanding common stock, and as a result, may be able to influence all matters requiring the approval of other significant corporate transactions.

Table of Contents

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) Not applicable.

(b) Not applicable.

(c) Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

(a) Not applicable.

(b) Not applicable.

ITEM 6. EXHIBITS

The following is an index of the exhibits included in this report:

|              |                                                                                                                                                                                           |
|--------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <u>31.1</u>  | <u>Certification of Chief Executive Officer, pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>31.2</u>  | <u>Certification of Chief Financial Officer, pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.1*</u> | <u>Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>     |

- \* This exhibit shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78r), or otherwise subject to the liabilities of that Section, nor shall it be deemed incorporated by reference in any filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.



Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TEMPUR-PEDIC INTERNATIONAL INC.  
(Registrant)

Date: October 26,  
2009

By:

/s/ DALE E. WILLIAMS

Dale E. Williams  
Executive Vice President, Chief Financial  
Officer,  
and Secretary