

TEMPUR PEDIC INTERNATIONAL INC  
Form 10-Q  
November 07, 2006  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended September 30, 2006

.. **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

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**TEMPUR-PEDIC INTERNATIONAL INC.**

(Exact name of registrant as specified in its charter)

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Delaware

33-1022198

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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

1713 Jaggie Fox Way

Lexington, Kentucky 40511

(Address of registrant's principal executive offices) (Zip code)

(800) 878-8889

(Registrant's telephone number, including area code)

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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  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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 31, 2006 was 83,007,896 shares.

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**Table of Contents**

**TABLE OF CONTENTS**

	<b>Page</b>
<u>Special Note Regarding Forward-Looking Statements</u>	3
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
ITEM 1. <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
ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	28
ITEM 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	39
ITEM 4. <u>Controls and Procedures</u>	40
<b><u>PART II. OTHER INFORMATION</u></b>	
ITEM 1. <u>Legal Proceedings</u>	41
ITEM 1A. <u>Risk Factors</u>	41
ITEM 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	50
ITEM 3. <u>Defaults upon Senior Securities</u>	50
ITEM 4. <u>Submission of Matters to a Vote of Security Holders</u>	50
ITEM 5. <u>Other Information</u>	50
ITEM 6. <u>Exhibits</u>	50
<u>Signatures</u>	51

**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, capital expenditures, the impact of the adoption of recently issued accounting pronouncements, the putative securities class action lawsuits and related lawsuits, the Company's increased presence in U.S. and International retail stores, the rollout and market acceptance of new products, our investments to increase our global brand awareness, the Company's expectations regarding its gross margin for the full year of 2006, the Company's expectations regarding additional opportunities for growth, plans to increase sales and reduce costs, the impact of increases in raw materials costs, the construction of our new manufacturing facility in New Mexico, 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. 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****FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(In thousands, except per share amounts)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Net sales	\$ 240,917	\$ 206,095	\$ 688,465	\$ 621,089
Cost of sales	124,894	103,577	354,672	305,793
Gross profit	116,023	102,518	333,793	315,296
Selling and marketing expenses	41,579	41,590	126,674	124,708
General and administrative expenses	19,465	17,483	55,870	51,849
Research and development expenses	1,240	627	3,031	1,944
Operating income	53,739	42,818	148,218	136,795
Other income (expense), net:				
Interest expense, net	(6,728)	(5,079)	(17,402)	(15,306)
Loss on extinguishment of debt				(717)
Other income (expense), net	(201)	(160)	(349)	167
Total other expense	(6,929)	(5,239)	(17,751)	(15,856)
Income before income taxes	46,810	37,579	130,467	120,939
Income tax provision	17,947	20,211	48,599	51,971
Net income	\$ 28,863	\$ 17,368	\$ 81,868	\$ 68,968
Earnings per share:				
Basic	\$ 0.35	\$ 0.18	\$ 0.96	\$ 0.70
Diluted	\$ 0.34	\$ 0.17	\$ 0.92	\$ 0.67
Weighted average shares outstanding:				
Basic	82,946	99,090	85,533	98,770
Diluted	85,681	103,346	88,666	103,171

See accompanying Notes to Condensed Consolidated Financial Statements.

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except per share amounts)**

	September 30, 2006	December 31, 2005
	(Unaudited)	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 15,253	\$ 17,855
Accounts receivable, net	136,236	111,726
Inventories	63,754	81,064
Prepaid expenses and other current assets	10,478	11,072
Income taxes receivable		19
Deferred income taxes	8,288	6,532
Total Current Assets	234,009	228,268
Property, plant and equipment, net	206,541	193,224
Goodwill	199,258	199,962
Other intangible assets, net	71,598	73,908
Deferred financing and other non-current assets, net	6,462	6,949
Total Assets	\$ 717,868	\$ 702,311
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 38,439	\$ 33,639
Accrued expenses and other	65,747	56,570
Income taxes payable	23,090	
Current portion of long-term debt	19,051	30,770
Total Current Liabilities	146,327	120,979
Long-term debt	354,425	313,711
Deferred income taxes	39,532	40,386
Other non-current liabilities	415	906
Total Liabilities	540,699	475,982
Commitments and contingencies see Note 8		
Stockholders Equity:		
Common stock \$.01 par value; 300,000 shares authorized; 99,215 shares issued as of September 30, 2006 and December 31, 2005	992	992
Additional paid in capital	261,973	255,369
Deferred stock compensation net of amortization of \$12,312 as of December 31, 2005		(2,196)
Retained earnings	111,705	46,245
Accumulated other comprehensive income	1,908	1,137
Treasury stock, at cost; 16,214 and 6,767 shares as of September 30, 2006 and December 31, 2005, respectively	(199,409)	(75,218)

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Total Stockholders' Equity	<u>177,169</u>	<u>226,329</u>
Total Liabilities and Stockholders' Equity	<u>\$ 717,868</u>	<u>\$ 702,311</u>

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)

	Nine Months Ended September 30,	
	2006	2005
	(Unaudited)	(Unaudited)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 81,868	\$ 68,968
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	18,640	18,815
Amortization of deferred financing costs	1,479	1,804
Loss on extinguishment of debt		717
Amortization of stock-based compensation	2,672	2,312
Allowance for doubtful accounts	2,813	2,286
Deferred income taxes	(2,479)	(909)
Foreign currency adjustments	243	606
Loss on sale of equipment and other	359	574
Changes in operating assets and liabilities:		
Accounts receivable	(23,696)	(30,477)
Inventories	18,545	(23,917)
Prepaid expenses and other current assets	573	1,569
Accounts payable	2,572	6,275
Accrued expenses and other	6,765	2,078
Income taxes	22,737	28,375
<b>Net cash provided by operating activities</b>	<b>133,091</b>	<b>79,076</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Payments for trademarks and other intellectual property	(699)	(1,520)
Purchases of property, plant and equipment	(24,159)	(68,139)
Proceeds from sale of equipment	83	327
<b>Net cash used by investing activities</b>	<b>(24,775)</b>	<b>(69,332)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from long-term revolving credit facility	152,000	73,500
Repayments of long-term revolving credit facility	(55,000)	(22,000)
Repayments of long-term debt	(70,622)	(33,492)
Repayments of Series A Industrial Revenue Bonds	(3,840)	
Common stock issued, including reissuances of treasury stock	3,401	2,204
Excess tax benefit from stock based compensation	6,189	
Stock repurchases	(144,000)	
Payments for deferred financing costs	(698)	(250)
<b>Net cash (used) / provided by financing activities</b>	<b>(112,570)</b>	<b>19,962</b>
<b>NET EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>	<b>1,652</b>	<b>(5,673)</b>

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(Decrease) / increase in cash and cash equivalents	<b>(2,602)</b>	24,033
CASH AND CASH EQUIVALENTS, beginning of period	<b>17,855</b>	28,368
	<hr/>	<hr/>
CASH AND CASH EQUIVALENTS, end of period	<b>\$ 15,253</b>	<b>\$ 52,401</b>
	<hr/>	<hr/>
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	<b>\$ 23,560</b>	\$ 17,337
Income taxes, net of refunds	<b>\$ 22,663</b>	\$ 24,478

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 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. As used herein, the term Tempur-Pedic International refers to Tempur-Pedic International Inc. only, and the term Company refers to Tempur-Pedic International Inc. and its subsidiaries.

The Company manufactures, markets, and sells viscoelastic products including pillows, mattresses, and other related products. The Company manufactures essentially all its pressure-relieving TEMPUR<sup>®</sup> products at two manufacturing facilities, with one located in Denmark and one 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 in over 70 countries. The Company sells its products through four sales channels: Retail, Direct, Healthcare, and Third party, and extends credit based on the creditworthiness of its customers.

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 do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, 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, 2005, included in the Company's Annual Report on Form 10-K. The balance sheet as of December 31, 2005 has been derived from the audited consolidated financial statements as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

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) *Reclassifications* Certain prior period amounts have been reclassified to conform to the 2006 presentation.

(c) *Basis of Consolidation* The accompanying financial statements include the accounts of Tempur-Pedic International and its subsidiaries. All subsidiaries are wholly owned. All material intercompany balances and transactions have been eliminated.

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(d) *Use of Estimates* The preparation of financial statements in conformity with U.S. 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.

(e) *Foreign Currency Translation* Assets and liabilities of non-U.S. subsidiaries, whose functional currency is the local currency, are translated at period-end exchange rates. Income and expense items are translated at the weighted average rates of exchange prevailing during the period. The adjustment resulting from translating the financial statements of foreign subsidiaries is included in Accumulated other comprehensive income, a component of Stockholders' Equity. Foreign currency transaction gains and losses are reported in results of operations.

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

(f) *Financial Instruments and Hedging* Derivative financial instruments are used within the normal course of business principally to manage foreign currency exchange rate risk. These instruments are generally short term in nature and are subject to fluctuations in foreign exchange rates and credit risk. Credit risk is managed through the selection of sound financial institutions as counterparties. The changes in fair market value of foreign exchange derivatives are recognized currently through income. The changes in fair market value of derivative financial instruments used to manage interest rates are recognized through Accumulated other comprehensive income.

(g) *Cash and Cash Equivalents* Cash and cash equivalents consist of all investments with initial maturities of three months or less.

(h) *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 30, 2006	December 31, 2005
Finished goods	\$ 43,888	\$ 61,071
Work-in-process	6,854	7,427
Raw materials and supplies	13,012	12,566
	<b>\$ 63,754</b>	<b>\$ 81,064</b>

(i) *Long Lived Assets* In accordance with Statement of Financial Accounting Standards (SFAS) 144, Accounting for the Impairment or Disposal of Long-lived Assets, long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of long-lived assets is assessed by a comparison of the carrying amount of the asset to the estimated future net cash flows expected to be generated by the asset. If estimated future undiscounted net cash flows are less than the carrying amount of the asset or group of assets, the asset is considered impaired and an expense is recorded in an amount required to reduce the carrying amount of the asset to its then fair value.

(j) *Goodwill and Other Intangible Assets* The Company follows SFAS 142, Goodwill and Other Intangible Assets. SFAS 142 requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values and reviewed for impairment in accordance with SFAS 144. The Company performs an annual impairment test on all existing goodwill in the fourth quarter of each year. If facts and circumstances lead the Company's management to believe that one of the Company's other amortized intangible assets may be impaired, the Company will evaluate the extent to which the related cost is recoverable by comparing the future undiscounted cash flows estimated to be associated with that asset to the asset's carrying amount and write-down that carrying amount to fair value to the extent necessary.



**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

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

	Useful Lives (Years)	September 30, 2006			December 31, 2005		
		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Unamortized indefinite life intangible assets:							
Trademarks		\$ 55,000	\$	\$ 55,000	\$ 55,000	\$	\$ 55,000
Amortized intangible assets:							
Technology	10	\$ 16,000	\$ 6,267	\$ 9,733	\$ 16,000	\$ 5,067	\$ 10,933
Patents	5-20	6,125	4,079	2,046	5,968	3,234	2,734
Customer database	5	4,200	3,290	910	4,200	2,660	1,540
Foam formula	10	3,700	1,449	2,251	3,700	1,172	2,528
Trademarks and other	5	3,728	2,070	1,658	3,146	1,973	1,173
<b>Total</b>		<b>\$ 88,753</b>	<b>\$ 17,155</b>	<b>\$ 71,598</b>	<b>\$ 88,014</b>	<b>\$ 14,106</b>	<b>\$ 73,908</b>

Amortization expense relating to intangible assets for the Company was \$1,021 and \$996 for the three months ended September 30, 2006 and September 30, 2005, respectively. For the nine months ended September 30, 2006 and September 30, 2005 amortization expense relating to intangible assets was \$3,049 and \$2,956, respectively.

The changes in the carrying amount of Goodwill for the nine months ended September 30, 2006 are related to changes in amounts for foreign currency translation as follows:

Balance as of December 31, 2005	\$ 199,962
Foreign currency translation adjustments and other	(704)
<b>Balance as of September 30, 2006</b>	<b>\$ 199,258</b>

Goodwill as of September 30, 2006 and December 31, 2005 has been allocated to the Domestic and International segments as follows:

	September 30, 2006	December 31, 2005
Domestic	\$ 89,930	\$ 89,452
International	109,328	110,510
	<b>\$ 199,258</b>	<b>\$ 199,962</b>

(k) *Software* Preliminary project stage costs incurred are expensed and, thereafter, costs incurred in the developing or obtaining of internal use software are capitalized. Certain costs, such as maintenance and training, are expensed as incurred. Capitalized costs are amortized over a period of not more than five years and are subject to impairment evaluation in accordance with SFAS 144. Amounts capitalized for software are included in Property, plant and equipment, net.

(l) *Accrued Sales Returns* Estimated sales returns are provided at the time of sale based on historical sales channel return rates. The return rates are typically lower within the Retail channel as compared to the Direct

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

channel. The Company allows product returns up to 120 days following a sale through certain sales channels and on certain products. Estimated future obligations related to these products are provided by a reduction of sales in the period in which the revenue is recognized. Accrued sales returns are included in Accrued expenses and other in the accompanying Condensed Consolidated Balance Sheets.

The Company had the following activity for sales returns from December 31, 2005 to September 30, 2006:

Balance as of December 31, 2005	\$ 6,304
Amounts accrued	30,668
Returns charged to accrual	(31,021)
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Balance as of September 30, 2006	\$ 5,951
	<hr/>

(m) *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 2-year to 3-year warranty on pillows. Estimated future obligations related to these products are provided by charges to operations in the period in which the related revenue is recognized. Warranties are included in Accrued expenses and other in the Condensed Consolidated Balance Sheets.

The Company had the following activity for warranties from December 31, 2005 to September 30, 2006:

Balance as of December 31, 2005	\$ 3,107
Amounts accrued	2,341
Warranties charged to accrual	(2,562)
	<hr/>
Balance as of September 30, 2006	\$ 2,886
	<hr/>

(n) *Income Taxes* Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Company is regularly under audit by tax authorities around the world. The Company accrues for probable foreign and domestic tax obligations as required by facts and circumstances in the various regulatory environments.

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(o) *Revenue Recognition* Sales of products are recognized when the products are shipped to customers and the risks and rewards of ownership are transferred. 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 determines the allowance based on historical write-off experience. The Company reviews the adequacy of its allowance for doubtful accounts quarterly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Allowance for doubtful accounts was \$5,875 and \$5,436 as of September 30, 2006 and December 31, 2005, respectively. Deposits made by customers are recorded as a liability and recognized as a sale when product is shipped. The Company had \$304 and \$454 of deferred revenue related to such deposits included in Accrued expenses and other in the accompanying Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005, respectively.

The Company reflects all amounts billed to customers for shipping and handling in Net sales and the costs incurred from shipping and handling product in Cost of sales. The Company no longer bills customers in the

**Table of Contents**

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**

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

**(In thousands, except per share amounts)**

Domestic Retail channel for freight on large quantity orders. Amounts included in Net sales for shipping and handling were approximately \$2,437 and \$5,606 for the three months ended September 30, 2006 and September 30, 2005, respectively. For the nine months ended September 30, 2006 and September 30, 2005 amounts included in Net sales for shipping and handling were approximately \$8,093 and \$18,262, respectively. Amounts included in Cost of sales for shipping and handling were approximately \$18,977 and \$18,295 for the three months ended September 30, 2006 and September 30, 2005, respectively. Amounts included in Cost of sales for shipping and handling were approximately \$53,790 and \$57,578 for the nine months ended September 30, 2006 and September 30, 2005, respectively.

In connection with customer purchases financed under an extended financing program with certain third party financiers (Card Servicers), the Card Servicer pays the Company an amount equal to the total amount of such purchases, net of a non-refundable financing fee as well as an interest bearing holdback of 15% (to be released upon ultimate collection) of certain amounts financed with recourse under the program. Amounts associated with this limited program are not material to the financial statements for all periods presented.

(p) *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. Advertising costs charged to expense were approximately \$22,276 and \$23,630 for the three months ended September 30, 2006 and September 30, 2005, respectively. For the nine months ended September 30, 2006 and September 30, 2005, advertising costs charged to expense were approximately \$71,146 and \$69,913, respectively. Advertising costs deferred and included in Prepaid expenses and other current assets in the accompanying Condensed Consolidated Balance Sheets were approximately \$5,783 and \$6,064 as of September 30, 2006 and December 31, 2005, respectively.

(q) *Research and Development Expenses* Research and development expenses for new products are expensed as they are incurred.

(r) *Treasury Stock* As discussed in Note 5 below, in October 2005 Tempur-Pedic International's Board of Directors authorized a share repurchase program (Share Repurchase Program). Shares repurchased under Tempur-Pedic International's Share Repurchase Program are held in treasury for general corporate purposes, including issuances under various employee stock option plans. Treasury shares are accounted for under the cost method and reported as a reduction of Stockholders' equity. As of June 30, 2006 Tempur-Pedic International had completed its existing share repurchase authorization.

(s) *Stock Based Compensation* The Company adopted SFAS 123R, Share-Based Payment (SFAS 123R) on January 1, 2006 using the modified prospective method for the transition. SFAS 123R requires compensation expense relating to share-based payments be recognized in the financial statements. The cost is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the estimable life of the equity award. The effect of the adoption of SFAS 123R on the Company's results of operations and earnings per share was not material and is included in the Condensed Consolidated Statements of Income for the period ended September 30, 2006. Also, in accordance with SFAS 123R, Deferred stock compensation amounts in the Stockholders' Equity section of the Condensed Consolidated Balance Sheet are included in Additional paid in capital as of September 30, 2006.

Additionally, SFAS 123R requires that the benefit of tax deductions in excess of recognized compensation expense be reported as a financing cash flow activity in the consolidated statements of cash flows. The Company had excess tax benefits related to the exercise of stock-options of \$6,189 as of September 30, 2006. Financial results including cash flows from operating activities for 2005 have not been restated for the adoption of SFAS 123R.

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

Pro forma information in accordance with SFAS 123, Accounting for Stock Based Compensation (SFAS 123) for the Company for the three and nine months ended September 30, 2005 is as follows:

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
Net income as Reported	\$ 17,368	\$ 68,968
Add: Stock-based employee compensation expense included in reported net income, net of related tax benefit	621	2,188
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax benefit	(1,718)	(5,427)
<b>Pro forma Net income</b>	<b>\$ 16,271</b>	<b>\$ 65,729</b>
<b>Earnings per share:</b>		
Basic as reported	\$ 0.18	\$ 0.70
Diluted as reported	\$ 0.17	\$ 0.67
Basic Pro forma Net income	\$ 0.16	\$ 0.67
Diluted Pro forma Net income	\$ 0.16	\$ 0.64

In December 2005, Tempur-Pedic International accelerated the vesting of certain unvested incentive stock options which had exercise prices greater than the fair market value of the stock on the date of acceleration. Options to purchase approximately 467 shares of common stock, or approximately 18% of Tempur-Pedic International's outstanding unvested options, were subject to the acceleration. Options subject to the acceleration had exercise prices ranging from \$13.94 to \$24.40 per share and a weighted average remaining life of 9 years. The weighted average exercise price of the options subject to the acceleration was \$18.51. The purpose of the acceleration was to enable the Company to avoid recognizing compensation expense associated with these options in future periods in its financial statements, upon adoption of SFAS 123R. The acceleration resulted in an increase of \$2,842 in the pro forma employee stock option stock-based compensation expense for the fourth quarter and year ended December 31, 2005. See Note 6 for further discussion of the Company's adoption of SFAS 123R.

**(2) Recently Issued Accounting Pronouncements**

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In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154 is a replacement of Accounting Principles Board No. 20, Accounting Changes and FASB Statement No. 3 Reporting Accounting Changes in Interim Financial Statements. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections and is effective for accounting changes and corrections of errors made in fiscal years beginning after December 31, 2005. The Company adopted this pronouncement on January 1, 2006. The adoption had no effect on the Company's Condensed Consolidated Financial Statements.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which is an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting and disclosure requirements for uncertainty in tax positions, as defined. The Company is currently evaluating the provisions of FIN 48, which is effective for fiscal years beginning after December 15, 2006.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in U.S. GAAP, and expands disclosure about fair value measurements. The Company is evaluating the potential impact of adopting SFAS 157, which is effective for fiscal years beginning after November 15, 2007.

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)****(3) Property, Plant and Equipment**

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

	September 30, 2006	December 31, 2005
Land and buildings	\$ 70,614	\$ 67,193
Machinery and equipment	105,864	96,298
Construction in progress	100,600	82,775
	<u>277,078</u>	<u>246,266</u>
Total accumulated depreciation	(70,537)	(53,042)
	<u>\$ 206,541</u>	<u>\$ 193,224</u>

Construction in progress is primarily comprised of the costs for the construction of the Company's New Mexico facility and includes capitalized interest costs of \$6,326 and \$2,567 as of September 30, 2006 and December 31, 2005, respectively, in connection with the construction of assets. Additionally, Construction in progress includes \$1,370 and \$843 that is also included in Accounts payable as of September 30, 2006 and December 31, 2005, respectively. These amounts have been excluded from Cash flows from investing activities in the Consolidated Statements of Cash Flows in their respective periods.

**(4) Long-term Debt**(a) *Long-term Debt* Long-term debt for the Company consisted of the following:

	September 30, 2006	December 31, 2005
<b>2005 Senior Credit Facility:</b>		
Foreign Term Loan (EUR Denominated) payable to lenders, interest at Index Rate or LIBOR plus margin (4.78% and 3.46% as of September 30, 2006 and December 31, 2005, respectively),	\$ 44,485	\$ 108,565

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principal payments due quarterly through September 30, 2010 with a final payment on October 18, 2010

Domestic Long-Term Revolving Credit Facility payable to lenders, interest at Index Rate or LIBOR plus applicable margin (6.83% and 5.28% as of September 30, 2006 and December 31, 2005, respectively), commitment through and due October 18, 2010	<b>180,000</b>	83,000
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**2005 Industrial Revenue Bonds:**

Variable Rate Industrial Revenue Bonds Series 2005A, interest rate determined by remarketing agent not to exceed the lesser of (a) the highest rate under state law or (b) 12% per annum (5.31% and 4.35% as of September 30, 2006 and December 31, 2005, respectively), interest due monthly and principal due quarterly through September 1, 2030	<b>50,085</b>	53,925
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**Senior Subordinated Notes:**

U.S. Senior Subordinated Notes payable to institutional investors, interest at 10.25%, due August 15, 2010	<b>97,500</b>	97,500
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**Other:**

Mortgages payable to a bank, secured by certain property, plant and equipment and other assets, bearing fixed interest at 4.0% to 5.1%	<b>1,406</b>	1,491
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	<b>373,476</b>	344,481
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Less: Current portion	<b>(19,051)</b>	(30,770)
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Long-term debt	<b>\$ 354,425</b>	\$ 313,711
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**Table of Contents**

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**

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

**(In thousands, except per share amounts)**

(b) *Secured Credit Financing* On October 18, 2005, Tempur-Pedic International entered into a credit agreement (the 2005 Senior Credit Facility) with Tempur-Pedic, Inc., Tempur Production USA, Inc., Dan-Foam ApS, certain other subsidiaries of Tempur-Pedic International, and Bank of America, N.A., Fifth Third Bank, Nordea Bank Danmark, A/S and Suntrust Bank. The Company used proceeds from the 2005 Senior Credit Facility to pay off amounts outstanding under its prior senior credit facility and an unsecured revolving credit facility, among other things. The prior senior credit facility was terminated upon repayment. On February 8, 2006, the Company entered into an amendment to its 2005 Senior Credit Facility, which increased availability and adjusted one of the financial covenants.

The 2005 Senior Credit Facility, as amended, consists of domestic and foreign credit facilities that provide for the incurrence of indebtedness up to an aggregate principal amount of \$390,000. The domestic credit facility is a five-year, \$260,000 revolving credit facility (Domestic Revolver). Availability under the Domestic Revolver is reduced by \$3,000 each quarter, beginning with the second quarter of 2006. The foreign credit facilities consist of a \$20,000 revolving credit facility (Foreign Revolver) and \$110,000 term loan (Foreign Term Loan). The various 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 the 2005 Senior Credit Facility, plus one of the following indexes: (i) LIBOR and (ii) for U.S. dollar-denominated loans only, a base rate (defined as the higher of (a) the Bank of America prime rate and (b) 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 .175% to .35%.

The 2005 Senior Credit Facility is guaranteed by Tempur-Pedic International, Tempur World, LLC and Tempur World Holdings, LLC, 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 maturity date of the 2005 Senior Credit Facility is October 18, 2010. The 2005 Senior Credit Facility contains certain financial covenants and requirements affecting the Company, among the most significant of which are a fixed charge coverage ratio requirement and a consolidated leverage ratio requirement. The Company was in compliance with all covenants as of September 30, 2006.

At September 30, 2006, the Company had a total of \$274,000 of long-term revolving credit facilities under the 2005 Senior Credit Facility, which was comprised of the \$254,000 Domestic Revolver and the \$20,000 Foreign Revolver (collectively, the Revolvers). 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 \$52,952 at September 30, 2006. After giving effect to letters of credit and \$180,000 in borrowings under the Domestic Revolver, total availability under the Revolvers was \$41,048 at September 30, 2006. There were no borrowings under the Foreign Revolver as of September 30, 2006.

(c) *Industrial Revenue Bonds* On October 27, 2005, Tempur Production USA, Inc. (Tempur Production), a subsidiary of Tempur-Pedic International, completed an industrial revenue bond financing for the construction and equipping of Tempur Production's new manufacturing facility (the Project) located in Bernalillo County, New Mexico (Bernalillo County). Under the terms of the financing, Bernalillo County will issue up to \$75,000 of Series 2005A Taxable Variable Rate Industrial Revenue Bonds (the Series A Bonds). The Series A Bonds are marketed to third parties by a remarketing agent and secured by a letter of credit issued under the Company's Domestic Revolver and purchased by qualified investors. The Series A Bonds have a final maturity date of September 1, 2030. The interest rate on the Series A Bonds is a weekly rate set by the remarketing agent, in its sole discretion, though the interest rate may not exceed the lesser of (i) the highest rate allowed under New Mexico

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law or (ii) 12% per annum. On October 27, 2005, Tempur Production made an initial draw of \$53,925 on the Series A Bonds. The Company used proceeds from the Bonds to pay down the prior domestic revolving credit facility, among other things.

**Table of Contents**

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**

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

**(In thousands, except per share amounts)**

Bernalillo County will also issue up to \$25,000 of Series 2005B Taxable Fixed Rate Industrial Revenue Bonds (the Series B Bonds, and collectively with the Series A Bonds, the Bonds). The Series B Bonds will be sold to Tempur World LLC, will not be secured by the letter of credit described above, and will be held by Tempur World, LLC, representing the Company's equity in the Project. The Series B Bonds have a final maturity date of September 1, 2035. The interest rate on the Series B Bonds is fixed at 7.75%. On October 27, 2005, Tempur Production made an initial draw of \$17,975 under the Series B Bonds, which was transferred to and used by Tempur World LLC to purchase Series B Bonds.

On October 27, 2005, Tempur Production transferred its interest in the Project to Bernalillo County, and Bernalillo County leased the Project back to Tempur Production on a long-term basis with the right to purchase the Project for one dollar when the Bonds are retired. Pursuant to the lease agreement, Tempur Production will pay rent to Bernalillo County in an amount sufficient to pay debt service on the Bonds and certain fees and expenses. The Bonds are not general obligations of Bernalillo County, but are special, limited obligations payable solely from bond proceeds, rent paid by Tempur Production under the lease agreement, and other revenues. The substance of the transaction is that Bernalillo County issued the Bonds on behalf of Tempur Production. Therefore, the Company recorded the obligation as long-term debt of \$53,925 in its consolidated balance sheet on the date of the transaction.

(d) Senior Subordinated Notes In 2003, Tempur-Pedic, Inc. and Tempur Production (Issuers) issued \$150,000 aggregate principal amount of 10.25% Senior Subordinated Notes due 2010 (Senior Subordinated Notes). The Senior Subordinated Notes are unsecured senior subordinated indebtedness of the Issuers and are fully and unconditionally, and jointly and severally, guaranteed on an unsecured senior subordinated basis by the Issuers' ultimate parent, Tempur-Pedic International and certain other subsidiaries of Tempur-Pedic International. Except as noted below, the Senior Subordinated Notes have no mandatory redemption or sinking fund requirements. However, the indenture governing the Senior Subordinated Notes permits the partial redemption at the Issuer's option under certain circumstances prior to August 15, 2006, and full redemption at the Issuer's option prior to August 15, 2007 at a redemption price of 100% of the principal amount plus a make whole premium based on the discounted value of the redemption price payable at August 15, 2007 plus remaining interest payments to such date or after August 15, 2007 at a redemption price of 105.125% of the principal amount.

If Tempur-Pedic, Inc., Tempur Production USA, Inc., Tempur-Pedic International or any of Tempur-Pedic International's other restricted subsidiaries sell certain assets or experience specific kinds of changes of control, Tempur-Pedic, Inc. and Tempur Production USA, Inc. must offer to repurchase the Senior Subordinated Notes at the prices, plus accrued and unpaid interest, and additional interest, if any, to the date of redemption specified in the indenture.

The Senior Subordinated Notes contain certain nonfinancial and financial covenants which include restrictions on: the declaration or payment of dividends and distributions; the payment, purchase, redemption, defeasance, acquisition or retirement of subordinated indebtedness; the granting of liens; the making of loans and the transfer of properties and assets; mergers; consolidations or sale of assets; the acquisition or creation of additional subsidiaries; and the sale and leaseback of assets. The Company was in compliance with all covenants as of September 30, 2006.

**(5) Stockholders' Equity**

(a) *Capital Stock* Tempur-Pedic International 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

**Table of Contents**

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**

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

**(In thousands, except per share amounts)**

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 Program* On October 18, 2005, the Board of Directors authorized the repurchase of up to \$80,000 of Tempur-Pedic International's common stock. Share repurchases under this program were made through open market transactions, negotiated purchases or otherwise, at times and in such amounts as management deemed appropriate. During 2005, Tempur-Pedic International repurchased 6,840 shares, at a total cost of \$76,000. Tempur-Pedic International funded these share repurchases from borrowings under the 2005 Senior Credit Facility and funds from operations.

On January 25, 2006, Tempur-Pedic International's Board of Directors amended the share repurchase program described above to increase the total authorization by an additional \$100,000. On May 22, 2006, Tempur-Pedic International's Board of Directors further amended the share repurchase program to increase the total authorization under the share repurchase program by an additional \$40,000 for a total authorization to purchase up to \$220,000 of Tempur-Pedic International's common stock. During the six months ended June 30, 2006, Tempur-Pedic International repurchased 11,275 shares at a total cost of \$144,000. The share repurchases were funded from borrowings under the 2005 Senior Credit Facility and funds from operations. As of June 30, 2006, Tempur-Pedic International had completed its existing share repurchase authorization.

**(6) Stock-Based Compensation**

Tempur-Pedic International has two stock-based compensation plans which provide for grants of non-qualified and incentive stock options, stock appreciation rights, restricted stock and stock unit awards, performance shares, stock grants and performance based awards to employees, non-employee directors, consultants and Company advisors. The plans under which equity awards are granted are the 2002 Option Plan and the 2003 Equity Incentive Plan (the 2003 Plan). Tempur-Pedic International also has a stock-based compensation plan which permits eligible employees to purchase its shares at a discounted price, subject to certain guidelines set forth by its 2003 Employee Stock Purchase Plan (ESPP). The Company believes that awards and purchases made under these plans better align the interests of the plan participants with those of its stockholders.

The 2002 Option Plan was adopted on November 1, 2002 and provides for grants of options to purchase shares of common stock to employees and directors of the Company. Options granted under the 2002 Option Plan that qualify as incentive stock options, as defined by the Internal Revenue Code of 1986, as amended (the Code), must have an exercise price of not less than the fair market value of Tempur-Pedic International's common stock at the date of grant. The determination of the exercise price was made by the Board of Directors. Options granted under the 2002 Option Plan provided for vesting terms as determined by the Board of Directors at the time of grant, which are generally based on 4 years of continuous service. Options can be exercised up to 10 years from the grant date and up to 5 years from the grant date for any stockholders who own 10% or more of the total combined voting power of all shares of stock of Tempur-Pedic International. The total number

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of shares of common stock subject to issuance under the 2002 Option Plan did not exceed 6,534 shares, which was subject to certain adjustment provisions. The Company currently anticipates there will be no additional options issued under this plan.

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

The 2003 Plan is administered by the Compensation Committee of the Board of Directors, which, together with the Board of Directors, has the exclusive authority to administer the 2003 Plan, including the power to determine eligibility to receive awards, the types and number of shares of stock subject to the awards, the price and timing of awards and the acceleration or waiver of any vesting and performance of forfeiture restrictions, in each case subject to the terms of the 2003 Plan. Any of the Company's employees, non-employee directors, consultants and Company advisors, as determined by the Compensation Committee, may be selected to participate in the 2003 Plan. The 2003 Plan provides for awards of stock options, stock appreciation rights, restricted stock and stock unit awards, performance shares, stock grants and performance based awards. The awards generally vest based on 4 years of continuous service and have 10-year contractual terms. Tempur-Pedic International may issue a maximum of 8,000 shares of its common stock under the 2003 Plan.

The ESPP permits eligible employees to purchase up to certain limits as defined in the 2003 ESPP of Tempur-Pedic International's common stock annually over the course of two semi-annual offering periods at a price of no less than 85% of the price per share of Tempur-Pedic International's common stock either at the beginning or the end of each six-month offering period, whichever is less. The Compensation Committee of the Board of Directors administers the 2003 ESPP. The Board of Directors may amend or terminate the 2003 ESPP. The 2003 ESPP is intended to comply with the requirements of Section 423 of the Code. Tempur-Pedic International may issue a maximum of 500 shares of its common stock under the 2003 ESPP.

Effective January 1, 2006, the Company adopted the provisions of SFAS 123R. The Company uses the Black-Scholes option pricing model to calculate the fair value of options granted which are subject to SFAS 123R. The Company also used this pricing model for all periods prior to the adoption of SFAS 123R to disclose the pro forma information regarding net income and earnings per share as required by SFAS 123, which also required that the information be determined as if the Company had accounted for its stock options granted subsequent to December 31, 2002 under the fair value method of SFAS 123.

The assumptions used in the Black-Scholes pricing model for the three and nine months ended September 30, 2006 and September 30, 2005 are set forth in the following table. Expected volatility is based on the historical volatility of Tempur-Pedic International's common stock. The expected life of the options represents the period of time that the Company expects the options granted to be outstanding. The risk-free rate is based on the expected yield of the option over the period during its contractual life. The assumptions used in the Black-Scholes pricing model for the three and nine months ended September 30, 2006 and September 30, 2005 are as follows:

	Nine Months Ended September 30,	
	2006	2005
Expected volatility range of stock	43 46%	46%
Expected life of option, range in years	5 6.1	5
Risk-free interest rate	3%	3%
Expected dividend yield on stock	0%	0%

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of subjective assumptions, including the expected stock price volatility. Tempur-Pedic International's options have had characteristics significantly different from those of similar traded options, and changes in the subjective input can materially affect the fair value estimate.

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

A summary of stock options activity under the 2002 Option Plan and 2003 Plan for the nine months ended September 30, 2006 is presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options outstanding at December 31, 2005	5,979	\$ 5.13		\$
Granted	1,470	13.51		
Exercised	(1,804)	1.64		
Forfeited or expired	(174)	5.37		
Options outstanding at September 30, 2006	5,471	\$ 8.49	\$ 7.95	\$ 47,501
Options exercisable at September 30, 2006	2,391	\$ 6.14		\$ 26,373

The total intrinsic value of options exercised during the three months ended September 30, 2006 and September 30, 2005 was \$2,003 and \$3,622, respectively. For the nine months ended September 30, 2006 and September 30, 2005 the total intrinsic value of options exercised was \$22,997 and \$17,723, respectively. During the three months ended September 30, 2006 and September 30, 2005, there were 110 and 75 options granted, respectively. During the nine months ended September 30, 2006 and September 30, 2005, there were 1,470 and 150 options granted, respectively.

A summary of Tempur-Pedic International's unvested shares as of September 30, 2006, and changes during the nine months ended September 30, 2006, is presented below:

	Shares	Weighted Average Grant Date Fair Value
Options unvested at December 31, 2005	3,344	\$ 4.75
Granted	1,470	13.51
Vested	(1,502)	1.83
Forfeited	(174)	5.37

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Options unvested at September 30, 2006	3,138	\$ 10.24
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The Black-Scholes pricing model amortizes compensation expense on a straight-line basis, and the expense is expected to be recognized over a weighted-average period of 3.8 years. The total fair value of shares vested during the three months ended September 30, 2006 and September 30, 2005 was \$7,092 and \$11,157, respectively. The total fair value of shares vested during the nine months ended September 30, 2006 and September 30, 2005 was \$21,755 and \$30,807, respectively. For the three and nine months ended September 30, 2006, the Company recognized \$818 and \$1,416 of stock-based compensation expense in General and administrative expenses and Selling and marketing expenses related to stock options granted under the 2003 Plan which were subject to SFAS 123R. As of September 30, 2006, there was \$12,462 of unearned stock-based compensation expense related to these options. The future amortization of these unearned stock-based compensation costs will be \$803 for the remainder of 2006; \$3,212 in 2007; \$3,212 in 2008; \$3,177 in 2009 and \$2,058 in 2010.

The Company recorded \$239 and \$927 of stock-based compensation expense for the three and nine months ended September 30, 2006, respectively, related to options granted under the 2002 Option Plan prior to the initial

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

public offering in 2003 that have exercise prices that are less than the deemed market value of the underlying common stock at the date of grant. As of September 30, 2006, there was \$392 of unearned stock-based compensation expense. The resulting unearned stock-based compensation is amortized to compensation expense over the respective vesting term, based on the graded vesting methodology. The future amortization of these unearned stock-based compensation costs will be \$178 for the remainder of 2006 and \$214 in 2007.

For the three and nine months ended September 30, 2006, the Company recognized \$109 and \$329, respectively, of stock-based compensation expense related to restricted stock units (RSUs) granted in December 2004. As of September 30, 2006, there was \$548 of unearned stock-based compensation expense related to the RSUs. The resulting unearned stock-based compensation is amortized to compensation expense over the respective vesting term on a straight-line basis. The future amortization of these unearned stock-based compensation costs will be \$110 for the remainder of 2006 and \$438 in 2007.

Cash received from options exercised under all stock-based compensation plans, including cash received from options issued from treasury shares, for the three months ended September 30, 2006 and September 30, 2005 was \$310 and \$507, respectively. Cash received from options exercised under all stock-based compensation plans, including cash received from options issued from treasury shares, for the nine months ended September 30, 2006 and September 30, 2005 was \$3,161 and \$2,204, respectively.

**(7) Accumulated Other Comprehensive Income**

The components of Accumulated other comprehensive income are as follows:

	September 30, 2006	December 31, 2005
Financial instruments accounted for as hedges	\$ (495)	\$ (478)
Foreign currency translation	2,403	1,615
Accumulated other comprehensive income	<u>\$ 1,908</u>	<u>\$ 1,137</u>

**(8) Commitments and Contingencies**

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(a) *Purchase Commitments* As of September 30, 2006, the Company had outstanding commitments of approximately \$3,796 of capital expenditures, primarily related to the construction of the production facility in Albuquerque, New Mexico. 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, 2006.

(b) *Securities Litigation* Between October 7, 2005 and November 21, 2005, five complaints were filed against Tempur-Pedic International and certain of its directors and officers in the United States District Court for the Eastern District of Kentucky (Lexington Division) purportedly on behalf of a class of shareholders who purchased Tempur-Pedic International's stock between April 22, 2005 and September 19, 2005. On December 29, 2005, the court consolidated these five actions (the Securities Law Action). Lead plaintiffs filed a consolidated complaint on February 27, 2006. In their consolidated complaint, lead plaintiffs assert claims arising under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Lead plaintiffs allege that certain of Tempur-Pedic International's public disclosures regarding its financial performance between April 22, 2005 and September 19, 2005 were false and/or misleading. The principal allegation set forth in the Securities Law Action is that Tempur-Pedic International did not disclose the impact of competition on its prospects. The

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**Table of Contents**

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**

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

**(In thousands, except per share amounts)**

plaintiffs seek compensatory damages, costs, fees and other relief within the Court's discretion. On June 14, 2006, the Company filed a motion to dismiss all claims in the Securities Law Action. That motion is currently pending before the Court. The Company strongly believes that the Securities Law Action lacks merit, and the Company intends to defend against the claims vigorously. However, due to the inherent uncertainties of litigation, the Company cannot predict the outcome of the Securities Law Action at this time, and the Company can give no assurance that these claims will not have a material adverse effect on the Company's financial position or results of operations.

On November 10, 2005 and December 15, 2005, complaints were filed in the state courts of Delaware and Kentucky, respectively, against certain officers and directors of Tempur-Pedic International purportedly derivatively on behalf of Tempur-Pedic International (the Derivative Complaints). The Derivative Complaints assert that the named officers and directors breached their fiduciary duties when they allegedly sold Tempur-Pedic International's securities on the basis of material non-public information in 2005. The Delaware Derivative Complaint also asserts a claim for breach of fiduciary duty with respect to the disclosures that also are the subject of the Securities Law Action described above. On December 14, 2005 and January 26, 2006, respectively, the Delaware court and Kentucky court stayed these derivative actions pending the outcome of the motion to dismiss that defendants have filed in the Securities Law Action. Tempur-Pedic International is also named as a nominal defendant in the Derivative Complaints, although the actions are derivative in nature and purportedly asserted on behalf of Tempur-Pedic International. Tempur-Pedic International is in the process of evaluating these claims.

The Company is also party to various other legal proceedings generally incidental to its business. Although the ultimate disposition of these proceedings is not presently determinable, management believes that the outcome of all of such pending legal proceedings in the aggregate will not have a materially adverse effect on our business, financial condition, liquidity, or operating results.

**(9) Income Taxes**

The Company's effective tax rate for the nine months ended September 30, 2006 was 37.3%. For the same period in 2005, the effective tax rate was 43.0%. The decrease in effective tax rate is primarily attributable to the one-time tax charge taken in the third quarter of 2005 related to the foreign repatriation under the provisions of the American Jobs Creation Act of 2004. Excluding the impact of the foreign repatriation in the third quarter of 2005, the Company's effective tax rate would have been 37.6% for the nine months ended September 30, 2005. In addition, the Company received a favorable state tax ruling in the fourth quarter of 2005 that reduced its state tax expense.

Reconciling items between the federal statutory income tax rate of 35.0% and the effective tax rate include 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., compensation expense associated with certain options granted prior to the initial public offering, the production activities deduction, and certain other permanent differences.

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At September 30, 2006, Tempur-Pedic International had remaining undistributed earnings of \$8,199 from its foreign subsidiaries determined under U.S. tax principles as of November 1, 2002 related to the period prior to the acquisition of Tempur World Inc. by Tempur-Pedic International translated into U.S. dollars at the applicable exchange rate on September 30, 2006. All pre-acquisition earnings of \$60,810 related to Dan Foam ApS were distributed as part of the \$155,650 repatriation plan under the Jobs Creation Act in 2005. The remaining balance of \$8,199 relates to other foreign subsidiaries. No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining \$8,199 of undistributed earnings, as these earnings are considered indefinitely reinvested.

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

In addition, Tempur-Pedic International had remaining undistributed earnings from its foreign subsidiaries determined under U.S. generally accepted accounting principles for the period from November 1, 2002 through September 30, 2006 of \$107,764. No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining \$107,764 of undistributed earnings, as these earnings are considered indefinitely reinvested.

**(10) Major Customers**

Five customers accounted for approximately 16% and 13% of the Company's Net sales for the three months ended September 30, 2006 and September 30, 2005, respectively. The top five customers in each period also accounted for approximately 18% and 21% of Accounts receivable, net as of both September 30, 2006 and September 30, 2005, respectively. Five customers accounted for approximately 14% and 11% of the Company's Net sales for the nine months ended September 30, 2006 and September 30, 2005, respectively. The top five customers in each period also accounted for approximately 18% and 19% of Accounts receivable, net as of September 30, 2006 and September 30, 2005. The loss of one or more of these customers could negatively impact the Company. The composition of our top five customers varies between the periods ended September 30, 2006 and September 30, 2005.

**(11) Earnings Per Share**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Numerator:</b>				
Net income	\$ 28,863	\$ 17,368	\$ 81,868	\$ 68,968
<b>Denominator:</b>				
Denominator for basic earnings per share- weighted average shares	82,946	99,090	85,533	98,770
Effect of dilutive securities:				
Employee stock options	2,735	4,256	3,133	4,401
Denominator for basic earnings per share- adjusted weighted average shares	85,681	103,346	88,666	103,171
<b>Basic earnings per share</b>	<b>\$ 0.35</b>	<b>\$ 0.18</b>	<b>\$ 0.96</b>	<b>\$ 0.70</b>
<b>Diluted earnings per share</b>	<b>\$ 0.34</b>	<b>\$ 0.17</b>	<b>\$ 0.92</b>	<b>\$ 0.67</b>

The Company excluded 475 and 425 shares issuable upon exercise of outstanding stock options for the three months ended September 30, 2006 and 2005, respectively, from the Diluted earnings per share computation since their exercise price was greater than the average market price of our common stock or if they were otherwise anti-dilutive. The Company excluded 625 and 50 shares issuable upon exercise of outstanding stock options for the nine months ended September 30, 2006 and 2005, respectively.

**(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 U.S. manufacturing facility, whose customers include the U.S. distribution

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)**

subsidiary and certain North American third party distributors. 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:

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
Total assets:		
Corporate	\$ 594,313	\$ 372,341
Domestic	684,144	493,871
International	296,160	301,465
Intercompany eliminations	(856,749)	(465,366)
	<b>\$ 717,868</b>	<b>\$ 702,311</b>

The following tables summarize other segment information:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net sales from external customers:				
Corporate	\$	\$	\$	\$
Domestic	164,446	132,323	458,627	404,307
International	76,471	73,772	229,838	216,782
	<b>\$ 240,917</b>	<b>\$ 206,095</b>	<b>\$ 688,465</b>	<b>\$ 621,089</b>
Inter-segment sales:				
Corporate	\$	\$	\$	\$
Domestic	4		4	
International	1,407	14,323	2,821	38,237

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Intercompany eliminations	(1,411)	(14,323)	(2,825)	(38,237)
	\$	\$	\$	\$
Operating income/(loss):				
Corporate	\$ (4,669)	\$ (3,761)	\$ (12,176)	\$ (11,463)
Domestic	37,117	23,223	96,804	83,849
International	21,291	23,356	63,590	64,409
	\$ 53,739	\$ 42,818	\$ 148,218	\$ 136,795
Depreciation and amortization (excluding stock-based compensation amortization):				
Corporate	\$ 131	\$ 116	\$ 385	\$ 329
Domestic	3,219	3,031	9,607	8,783
International	2,917	3,078	8,648	9,703
	\$ 6,267	\$ 6,225	\$ 18,640	\$ 18,815

Table of Contents

## TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

The following table sets forth Net sales by significant product group:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Mattresses	\$ 169,334	\$ 139,162	\$ 479,119	\$ 424,042
Pillows	29,934	30,950	87,463	92,860
All other	41,649	35,983	121,883	104,187
	\$ 240,917	\$ 206,095	\$ 688,465	\$ 621,089

During the course of normal operations, the Domestic segment may purchase inventory from the Danish manufacturing facility from time to time. These purchases are included in the International segment as Intercompany sales. The Intercompany profits on these sales are eliminated from the International segment when the manufacturing profit in ending finished goods inventory is eliminated during the consolidation of the Company's results. These manufacturing profits were \$476 and \$1,524 for the three months ended September 30, 2006 and September 30, 2005, respectively, and \$765 and \$4,963 for the nine months ended September 30, 2006 and September 30, 2005, respectively.

**(13) Condensed Consolidating Interim Financial Information**

On August 15, 2003, the Issuers issued \$150,000 aggregate principal amount of Senior Subordinated Notes. Approximately \$97,500 aggregate principal amount of Senior Subordinated Notes remain outstanding. The Senior Subordinated Notes are unsecured senior subordinated indebtedness of the Issuers and are fully and unconditionally, and jointly and severally, guaranteed on an unsecured senior subordinated basis by the Issuers' ultimate parent, Tempur-Pedic International, and two intermediate parent corporations (referred to as the Combined Guarantor Parents) and all of Tempur-Pedic International's current and future domestic subsidiaries (referred to collectively as the Combined Guarantor Subsidiaries), other than the Issuers. The Issuers and subsidiary guarantors are indirectly 100% owned subsidiaries of the Combined Guarantor Parents and the subsidiary guarantors are 100% owned subsidiaries of the Issuers. The foreign subsidiaries (referred to as Combined Non-Guarantor Subsidiaries) represent the foreign operations of the Company and will not guarantee this debt. The following financial information presents Condensed Consolidating Balance Sheets, Statements of Income, and Statements of Cash Flows for the Combined Guarantor Parents, Issuers and their Subsidiary Guarantors and Combined Non-Guarantor Subsidiaries.

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)**

(In thousands, except per share amounts)

**Condensed Consolidating Statements of Income****For the Three Months Ended September 30, 2006****(Unaudited)**

	Ultimate	Combined	Combined	Combined	Combined	Consolidating	Consolidated
	Parent	Issuer	Guarantor	Guarantor	Non-Guarantor	Adjustments	
		Subsidiaries	Parents	Subsidiaries	Subsidiaries		
Net sales	\$	\$ 716	\$	\$ 163,734	\$ 77,878	\$ (1,411)	\$ 240,917
Cost of goods sold		10	(368)	93,075	33,588	(1,411)	124,894
Gross profit		706	368	70,659	44,290		116,023
Operating expenses	1,625	5,399	3,413	28,848	22,999		62,284
Operating income (loss)	(1,625)	(4,693)	(3,045)	41,811	21,291		53,739
Interest income (expense), net	(2,634)	(2,992)	(5)	1	(1,098)		(6,728)
Other income (loss)	5	26,276	(15)	(26,337)	(130)		(201)
Loss on extinguishment of debt							
Income taxes		11,173	(256)	374	6,656		17,947
Net income (loss)	\$ (4,254)	\$ 7,418	\$ (2,809)	\$ 15,101	\$ 13,407	\$	\$ 28,863

**Condensed Consolidating Statements of Income****For the Three Months Ended September 30, 2005****(Unaudited)**

Ultimate	Combined	Combined	Combined	Combined	Consolidating	Consolidated
Parent	Issuer	Guarantor	Guarantor	Non-Guarantor	Adjustments	
	Subsidiaries	Parents	Subsidiaries	Subsidiaries		

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Net sales	\$	\$ 2,576	\$	\$ 129,746	\$ 88,096	\$ (14,323)	\$ 206,095	
Cost of goods sold		37	1,300	(290)	74,979	41,874	(14,323)	103,577
Gross profit		(37)	1,276	290	54,767	46,222	102,518	
Operating expenses		1,166	4,807	2,848	28,013	22,866	59,700	
Operating income (loss)		(1,203)	(3,531)	(2,558)	26,754	23,356	42,818	
Interest income (expense), net		(5)	(4,133)	(1,114)	15	158	(5,079)	
Other income (loss)		1	25,955	12	(25,954)	(174)	(160)	
Income taxes			6,537	6,852	63	6,759	20,211	
Net income (loss)	\$	\$ (1,207)	\$ 11,754	\$ (10,512)	\$ 752	\$ 16,581	\$ 17,368	

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)**

(In thousands, except per share amounts)

**Condensed Consolidating Statements of Income****For the Nine Months Ended September 30, 2006****(Unaudited)**

	Ultimate	Combined	Combined	Combined	Combined	Consolidating	Consolidated
	Parent	Issuer	Guarantor	Guarantor	Non-Guarantor	Adjustments	
		Subsidiaries	Parents	Subsidiaries	Subsidiaries		
Net sales	\$	\$ 2,314	\$	\$ 456,317	\$ 232,659	\$ (2,825)	\$ 688,465
Cost of goods sold		640	(1,022)	257,132	100,747	(2,825)	354,672
Gross profit		1,674	1,022	199,185	131,912		333,793
Operating expenses	3,938	15,258	9,261	88,795	68,323		185,575
Operating income (loss)	(3,938)	(13,584)	(8,239)	110,390	63,589		148,218
Interest income							
(expense), net	(4,069)	(10,852)	589	29	(3,099)		(17,402)
Other income (loss)	(10)	78,694	(122)	(78,888)	(23)		(349)
Loss on extinguishment of debt							
Income taxes		29,024	(1,145)	1,372	19,348		48,599
Net income (loss)	\$ (8,017)	\$ 25,234	\$ (6,627)	\$ 30,159	\$ 41,119	\$	\$ 81,868

**Condensed Consolidating Statements of Income****For the Nine Months Ended September 30, 2005****(Unaudited)**

Ultimate	Combined	Combined	Combined	Combined	Consolidating	Consolidated
Parent	Issuer	Guarantor	Guarantor	Non-Guarantor	Adjustments	
	Subsidiaries	Parents	Subsidiaries	Subsidiaries		

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Net sales	\$	\$ 7,059	\$	\$ 397,247	\$ 255,020	\$ (38,237)	\$ 621,089	
Cost of goods sold		37	3,463	(883)	218,489	122,924	(38,237)	305,793
Gross profit		(37)	3,596	883	178,758	132,096	315,296	
Operating expenses		3,909	13,877	8,400	84,628	67,687	178,501	
Operating income (loss)		(3,946)	(10,281)	(7,517)	94,130	64,409	136,795	
Interest income (expense), net		(5)	(11,873)	(3,170)	26	(284)	(15,306)	
Other income (loss)		16	75,390	359	(75,815)	217	167	
Loss on extinguishment of debt						(717)	(717)	
Income taxes			23,109	5,418	3,449	19,995	51,971	
Net income (loss)	\$	(3,935)	\$ 30,127	\$ (15,746)	\$ 14,892	\$ 43,630	\$ 68,968	

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)**

(In thousands, except per share amounts)

**Condensed Consolidating Balance Sheets**

As of September 30, 2006

(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Current assets	\$ 1,049	\$ 233,058	\$ 4,846	\$ 76,938	\$ 107,908	\$ (189,790)	\$ 234,009
Property, plant and equipment, net		144,044	242	6,872	55,383		206,541
Other noncurrent assets	237,205	307,042	350,972		132,869	(750,770)	277,318
<b>Total assets</b>	<b>\$ 238,254</b>	<b>\$ 684,144</b>	<b>\$ 356,060</b>	<b>\$ 83,810</b>	<b>\$ 296,160</b>	<b>\$ (940,560)</b>	<b>\$ 717,868</b>
Current liabilities	\$ 156,023	\$ (980)	\$ 14,004	\$ 97,782	\$ 69,288	\$ (189,790)	\$ 146,327
Noncurrent liabilities	62	592,560	86,147		183,526	(467,923)	394,372
Equity (deficit)	82,169	92,564	255,909	(13,972)	43,346	(282,847)	177,169
<b>Total liabilities and equity (deficit)</b>	<b>\$ 238,254</b>	<b>\$ 684,144</b>	<b>\$ 356,060</b>	<b>\$ 83,810</b>	<b>\$ 296,160</b>	<b>\$ (940,560)</b>	<b>\$ 717,868</b>

**Condensed Consolidating Balance Sheets**

As of December 31, 2005

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Current assets	\$ 647	\$ 76,888	\$ 19,917	\$ 56,428	\$ 107,156	\$ (32,768)	\$ 228,268
Property, plant and equipment, net		130,608	472	5,543	56,601		193,224
Other noncurrent assets	132,997	286,374	218,308	1,967	137,707	(496,534)	280,819
<b>Total assets</b>	<b>\$ 133,644</b>	<b>\$ 493,870</b>	<b>\$ 238,697</b>	<b>\$ 63,938</b>	<b>\$ 301,464</b>	<b>\$ (529,302)</b>	<b>\$ 702,311</b>
Current liabilities	\$ 15,866	\$ (25,446)	\$ 19,297	\$ 80,072	\$ 63,957	\$ (32,767)	\$ 120,979

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Noncurrent liabilities		482,170	89,327	50	236,060	(452,604)	355,003
Equity (deficit)	117,778	37,146	130,073	(16,184)	1,447	(43,931)	226,329
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total liabilities and equity (deficit)	\$ 133,644	\$ 493,870	\$ 238,697	\$ 63,938	\$ 301,464	\$ (529,302)	\$ 702,311
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

**Table of Contents****TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)****(In thousands, except per share amounts)****Condensed Consolidating Statements of Cash Flows****For the Nine Months Ended September 30, 2006****(Unaudited)**

	<u>Ultimate Parent</u>	<u>Combined Issuer Subsidiaries</u>	<u>Combined Guarantor Parents</u>	<u>Combined Guarantor Subsidiaries</u>	<u>Combined Non-Guarantor Subsidiaries</u>	<u>Consolidating Adjustments</u>	<u>Consolidated</u>
Net cash (used in) / provided by operating activities	134,495	(65,698)	1,515	547	62,232		133,091
Net cash used for investing activities		(21,351)	(806)	(547)	(2,071)		(24,775)
Net cash provided by / (used in) financing activities	(134,423)	90,462	(1,058)		(67,551)		(112,570)
Effect on exchange rate changes on cash					1,652		1,652
Net (decrease) increase in cash and cash equivalents	72	3,413	(349)		(5,738)		(2,602)
Cash and cash equivalents at beginning of period	451	2,044	502		14,858		17,855
Cash and cash equivalents at end of period	\$ 523	\$ 5,457	\$ 153	\$	\$ 9,120	\$	\$ 15,253

**Condensed Consolidating Statements of Cash Flows****For the Nine Months Ended September 30, 2005****(Unaudited)**

	<u>Ultimate Parent</u>	<u>Combined Issuer Subsidiaries</u>	<u>Combined Guarantor Parents</u>	<u>Combined Guarantor Subsidiaries</u>	<u>Combined Non-Guarantor Subsidiaries</u>	<u>Consolidating Adjustments</u>	<u>Consolidated</u>
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Net cash (used in) / provided by operating activities	(3,118)	15,005	531	1,568	65,090	79,076
Net cash used for investing activities		(61,808)	(1,585)	(1,655)	(4,284)	(69,332)
Net cash provided by / (used in) financing activities	2,221	48,551	475		(31,285)	19,962
Effect on exchange rate changes on cash					(5,673)	(5,673)
Net (decrease) increase in cash and cash equivalents	(897)	1,748	(579)	(87)	23,848	24,033
Cash and cash equivalents at beginning of period	970	551	607	219	26,021	28,368
Cash and cash equivalents at end of period	\$ 73	\$ 2,299	\$ 28	\$ 132	\$ 49,869	\$ 52,401

## **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 thereto included herein. 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. 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 worldwide, which we sell in over 70 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 conforms to the body to therapeutically align the neck and spine, thus reducing neck and lower back pain, two of the most common complaints about other sleep surfaces.

*Business Segment Information* We have two operating business segments: Domestic and International. These reportable segments are strategic business units that are managed separately. The Domestic operating segment consists of our U.S. manufacturing facility whose customers include our U.S. distribution subsidiary and certain North, Central, and South American third party distributors. The International operating segment consists of our manufacturing facility in Denmark, whose customers include all of our distribution subsidiaries and third party distributors outside the Domestic segment. We evaluate segment performance based on Net sales and Operating income. For the purpose of this Management's Discussion and Analysis of Financial Condition and Results of Operations, our corporate office operating expenses and certain amounts relating to Goodwill and other assets that are carried at the holding company level are included in the Domestic operating segment.

#### **Strategy and Outlook**

Our goal is to be the global leader in the bedding industry. In order to achieve this goal, we expect to continue to pursue certain key strategies in 2006:

Maintain our focus primarily on premium mattresses and pillows and to regularly introduce new products.

Continue to invest in increasing our global brand awareness through targeted marketing and advertising campaigns that further associate our brand name with better overall sleep and premium quality products.

Continue to extend our presence on a targeted basis in retail stores in both the U.S. and International segments.

Continue to invest in our operating infrastructure to meet the requirements of our growing business, including increases in our research and development capacity.

**Results of Operations**

Key financial highlights for the three months ended September 30, 2006 include the following:

Earnings per share (EPS) doubled to \$0.34 per diluted share in the third quarter of 2006 from \$0.17 per diluted share in the third quarter of 2005. Net income in the third quarter of 2006 increased 66% to \$28.9 million from \$17.4 million in the third quarter of 2005.

**Table of Contents**

Net sales rose 17% to \$240.9 million in the third quarter of 2006 from \$206.1 million in the third quarter of 2005. Retail channel Net sales increased 25% worldwide. Domestic Retail channel Net sales increased 31%, and International Retail channel Net sales increased 12%.

Worldwide, mattress unit growth increased 14%. Domestic mattress unit growth was particularly strong, increasing 26%.

(\$ in millions, except earnings per share)	Three Months Ended				Nine Months Ended			
	September 30,				September 30,			
	2006		2005		2006		2005	
Net sales	\$ 240.9	100%	\$ 206.1	100%	\$ 688.5	100%	\$ 621.1	100%
Cost of sales	124.9	52	103.6	50	354.7	52	305.8	49
Gross profit	116.0	48	102.5	50	333.8	48	315.3	51
Selling and marketing expenses	41.6	17	41.6	20	126.7	18	124.7	20
General and administrative expenses	19.5	9	17.5	9	55.9	8	51.9	9
Research and development expenses	1.2		0.6		3.0		1.9	
Operating income	53.7	22	42.8	21	148.2	22	136.8	22
Interest expense, net	(6.7)	(3)	(5.1)	(3)	(17.4)	(3)	(15.3)	(3)
Loss on extinguishment of debt							(0.7)	
Other income (expense), net	(0.2)		(0.1)		(0.3)		0.1	
Income before income taxes	46.8	19	37.6	18	130.5	19	120.9	19
Income tax provision	17.9	7	20.2	10	48.6	7	51.9	8
Net income	\$ 28.9	12%	\$ 17.4	8%	\$ 81.9	12%	\$ 69.0	11%
Earnings per share:								
Basic	\$ 0.35		\$ 0.18		\$ 0.96		\$ 0.70	
Diluted	\$ 0.34		\$ 0.17		\$ 0.92		\$ 0.67	
Weighted average shares outstanding, in thousands:								
Basic	82,946		99,090		85,533		98,770	
Diluted	85,681		103,346		88,666		103,171	

**Three Months Ended September 30, 2006 Compared with Three Months Ended September 30, 2005**

We generate sales through four distribution channels: Retail, Direct, Healthcare and Third party. The Retail channel sells to furniture, 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 distribution subsidiaries. The following table sets forth Net sales information, by channel, for the periods indicated:

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	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Three Months Ended		Three Months Ended		Three Months Ended	
	September 30,		September 30,		September 30,	
	2006	2005	2006	2005	2006	2005
<i>(\$ in millions)</i>						
Retail	\$ 198.7	\$ 159.4	\$ 139.9	\$ 106.9	\$ 58.8	\$ 52.5
Direct	20.6	23.7	18.2	20.1	2.4	3.6
Healthcare	10.5	10.7	3.1	2.7	7.4	8.0
Third Party	11.1	12.3	3.2	2.6	7.9	9.7
	<b>\$ 240.9</b>	\$ 206.1	<b>\$ 164.4</b>	\$ 132.3	<b>\$ 76.5</b>	\$ 73.8
Domestic	<b>\$ 164.4</b>	\$ 132.3				
International	<b>76.5</b>	73.8				
Total	<b>\$ 240.9</b>	\$ 206.1				

**Table of Contents**

A summary of Net sales by product is below:

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Three Months Ended September 30,		Three Months Ended September 30,		Three Months Ended September 30,	
	2006	2005	2006	2005	2006	2005
<i>(\$ in millions)</i>						
<i>Net sales:</i>						
Mattresses	\$ 169.4	\$ 139.3	\$ 122.0	\$ 96.5	\$ 47.4	\$ 42.8
Pillows	30.0	30.8	14.9	12.9	15.1	17.9
Other	41.5	36.0	27.5	22.9	14.0	13.1
	<b>\$ 240.9</b>	<b>\$ 206.1</b>	<b>\$ 164.4</b>	<b>\$ 132.3</b>	<b>\$ 76.5</b>	<b>\$ 73.8</b>
<i>Units sold <sup>(1)</sup>:</i>						
Mattresses	196,213	171,939	120,669	95,725	75,544	76,214
Pillows	576,194	650,934	295,022	277,262	281,172	373,672

<sup>(1)</sup> Units sold represent Net sales after consideration of returned mattresses and pillows and excludes units shipped to fulfill warranty claims and promotion activities.

**Net sales.** Net sales for the three months ended September 30, 2006 increased to \$240.9 million from \$206.1 million for the same period in 2005, an increase of \$34.8 million, or 17%. This increase was primarily attributable to an increase in mattress sales in our Retail channel. Consolidated mattress sales increased \$30.1 million or 22% from the third quarter in 2005, and consolidated pillow sales decreased approximately \$0.8 million or 3% from the third quarter of 2005. For the three months ended September 30, 2006, our Retail channel Net sales increased to \$198.7 million from \$159.4 million for the same period in 2005, an increase of \$39.3 million, or 25%. As our Retail channel has expanded, Net sales have also been positively impacted by a reduction in our sales returns as a percentage of our Net Sales. The Retail channel typically experiences a lower sales return rate than our Direct channel.

Our Third party channel Net sales decreased by 10%, which was due primarily to our decision to end relationships with certain third party distributors in our International segment. Our Direct and Healthcare channel Net sales declined 13% and 2%, respectively. The Direct channel decline is due primarily to the growth in our Retail channel in the Domestic and International segments, which is consistent with our strategy to expand distribution of our products through targeted retail stores.

**Domestic.** Domestic Net sales for the three months ended September 30, 2006 increased to \$164.4 million from \$132.3 million for the same period in 2005, an increase of \$32.1 million, or 24%. Our Domestic Retail channel continues to be our largest channel, with \$139.9 million in Net sales for the three months ended September 30, 2006. This is an increase of \$33.0 million, or 31% over the prior year quarter. The increase represents progress on several of the key initiatives we put in place to accelerate growth. We have improved account productivity by increasing sales and average slots per store in our Retail channel in both established and new accounts, expanded our Retail sales force by approximately 33% since December 2005, introduced new products, and continued to add new high quality accounts. Our Third party channel Net sales increased 23% due to our continued market share growth in Canada and in certain Central and South American countries. Our Direct channel Net sales decreased 9%. Direct channel Net sales are adversely affected by our continued growth in our Retail channel. Domestic mattress sales in the third quarter of 2006 increased \$25.5 million, or 26%, over the same period in 2005. In addition, pillow sales increased \$2.0 million, or 16%, over the same period in 2005.

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*International.* International Net sales for the three months ended September 30, 2006 increased to \$76.5 million from \$73.8 million for the same period in 2005, an increase of \$2.7 million, or 4%. The largest channel in our International segment continues to be our Retail channel, which increased \$6.3 million, or 12%, for the three months ended September 30, 2006. However, our Third party sales decreased 19%, resulting primarily from our decision to terminate our relationship with certain third party distributors for continued violations of their

## **Table of Contents**

distribution agreements regarding parallel exporting. This decision resulted in a period of time during which we experienced a temporary gap of representation in certain markets. We now have representation in those markets. Our Direct channel Net sales decreased 33%, which is primarily attributable to the growth in our Retail channel. In addition, our Healthcare channel Net sales decreased \$0.6 million, or 8%. International mattress sales in the third quarter of 2006 increased \$4.6 million, or 11%, over the third quarter of 2005. Pillow sales for the third quarter of 2006 decreased \$2.8 million, or 16%, as compared to the third quarter of 2005, resulting from our decision to cease selling to certain third party distributors.

**Gross profit.** Gross profit for the three months ended September 30, 2006 increased to \$116.0 million from \$102.5 million for the same period in 2005, an increase of \$13.5 million, or 13%. Gross margin for the quarter was 48%, as compared to a gross margin of 50% for the third quarter of 2005. Our margins were negatively impacted by several factors during the third quarter of 2006. First, they were impacted by the growth in our Retail channel. Sales in our Retail channel are generally at wholesale prices. Second, our overall product mix has shifted to mattresses and other products. Our mattresses generally carry lower margins than our pillows and are sold with lower margin products such as foundations and bed frames. Third, our gross margin was negatively impacted by the rollout of new and refreshed mattress products in the U.S. and the discounting of floor models to certain new Retail customers. Finally, we incurred one-time surcharges to expedite certain raw materials in order to meet the demand for our new products.

While there have been margin declines due to product and channel mix and other factors, we have made improvements in several areas of our operations which have helped to offset these declines. Yields have increased substantially at our manufacturing facilities, and we have achieved cost savings through our sourcing and distribution initiatives. After taking into account all of our operations initiatives, we expect our gross margin for the full year 2006 to be approximately 2% lower than the full year 2005.

**Domestic.** Domestic Gross profit for the three months ended September 30, 2006 increased to \$71.7 million from \$56.3 million for the same period in 2005, an increase of \$15.4 million, or 27%. The Gross profit margin in our Domestic segment was 44% and 43% for the three months ended September 30, 2006 and September 30, 2005, respectively. For the three months ended September 30, 2006, the Gross profit margin for our Domestic segment has improved primarily due to our ongoing productivity and global sourcing initiatives offset by the product and channel shift and discounted floor models. Our Domestic cost of sales increased to \$92.7 million for the three months ended September 30, 2006 as compared to \$76.0 million for the three months ended September 30, 2005, an increase of \$16.7 million, or 22%.

**International.** International Gross profit for the three months ended September 30, 2006 decreased to \$44.3 million from \$46.2 million for the same period in 2005, a decrease of \$1.9 million, or 4%. The Gross profit margin in our International segment was 58% and 63% for the three months ended September 30, 2006 and September 30, 2005, respectively. For the three months ended September 30, 2006, the Gross profit margin for our International segment was impacted by the continued Retail channel growth. Product and geographic mix have adversely impacted our gross margins in this segment as pillow sales in Japan and pillow sales to certain third party distributors have declined due to our decision to terminate our relationship with certain third party distributors for continued violations of their distribution agreements regarding parallel exporting. Our International Cost of sales for the three months ended September 30, 2006 increased to \$32.2 million from \$27.6 million for the same period in 2005, an increase of \$4.6 million, or 17%.

**Selling and marketing expenses.** Selling and marketing expenses include advertising and media production associated with our Direct channel; other marketing materials such as catalogs, brochures, videos, product samples, direct customer mailings and point of purchase materials; and sales force compensation and customer service. We also include in Selling and marketing expenses certain new product development costs, including market research and testing for new products. Selling and marketing expenses remained constant at \$41.6 million for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005. Selling and marketing expenses as a percentage of Net sales decreased to 17% during the three months ended



## **Table of Contents**

September 30, 2006 from 20% for the three months ended September 30, 2005. Both total Selling and marketing expenses and advertising spending decreased as a percentage of Net sales. Our objective is to increase our advertising spending at the same rate as our revenue growth. However, in the third quarter of 2006, our advertising spending decreased. This decrease is primarily attributable to the record campaign spending for the upcoming mid-term elections and its impact on available TV advertising space.

**General and administrative and other expenses.** General and administrative and other expenses include management salaries, information technology, professional fees, depreciation of furniture and fixtures, leasehold improvements and computer equipment, expenses for finance, accounting, human resources and other administrative functions, and research and development costs associated with our new product developments. General and administrative and other expenses increased to \$20.7 million for the three months ended September 30, 2006 as compared to \$18.1 million for the three months ended September 30, 2005, an increase of \$2.6 million. The increase was primarily attributable to increased investment in our information technology infrastructure, professional services, share based compensation expense related to the adoption of SFAS 123R, and research and development. General and administrative and other expenses as a percentage of Net sales were 9% for the three months ended September 30, 2006 and September 30, 2005.

**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, increased to \$6.7 million for the three months ended September 30, 2006, as compared to \$5.1 million for the three months ended September 30, 2005, an increase of \$1.6 million, or 31%. This increase in interest expense for the three months ended September 30, 2006 is primarily attributable to higher Long-term debt levels, which are directly related to our share repurchase program. In the third quarter of 2006, we also capitalized interest costs of \$1.3 million related to the construction of our new manufacturing facility which offset our increased interest expenses.

**Income tax provision.** Our Income tax provision includes income taxes associated with taxes currently payable and deferred taxes and includes the impact of net operating losses for certain of our foreign operations. Our effective income tax rates for the nine months ended September 30, 2006 and for the nine months ended September 30, 2005 differed from the federal statutory rate principally because of 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., compensation expense associated with certain options granted prior to the initial public offering, the production activities deduction, and certain other permanent differences.

Our effective tax rate for the three months ended September 30, 2006 was 38.3%. For the same period in 2005, the effective tax rate was 53.8%. In the third quarter of 2005, our Income tax provision included a one-time charge of \$6.5 million related to the repatriation of foreign earnings under the provisions of the American Jobs Creation Act of 2004 (Jobs Creation Act). Excluding the impact of the one-time charge, the effective tax rate for the third quarter of 2005 would have been 36.5% compared to 38.3% for the third quarter of 2006. The increase in the third quarter of 2006, excluding the one-time charge in 2005, is due primarily to the generation of net operating losses without benefit in certain foreign subsidiary jurisdictions.

**Table of Contents****Nine Months Ended September 30, 2006 Compared with Nine Months Ended September 30, 2005**

The following table sets forth Net sales information, by channel, for the periods indicated:

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Nine Months Ended		Nine Months Ended		Nine Months Ended	
	September 30,		September 30,		September 30,	
	2006	2005	2006	2005	2006	2005
<i>(\$ in millions)</i>						
Retail	\$ 555.5	\$ 472.4	\$ 382.8	\$ 321.2	\$ 172.7	\$ 151.2
Direct	63.0	78.4	55.8	67.7	7.2	10.7
Healthcare	31.8	34.1	9.1	8.3	22.7	25.8
Third Party	38.2	36.2	10.9	7.1	27.3	29.1
	<b>\$ 688.5</b>	<b>\$ 621.1</b>	<b>\$ 458.6</b>	<b>\$ 404.3</b>	<b>\$ 229.9</b>	<b>\$ 216.8</b>
Domestic	\$ 458.6	\$ 404.3				
International	229.9	216.8				
Total	<b>\$ 688.5</b>	<b>\$ 621.1</b>				

A summary of Net sales by product is below:

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Nine Months Ended		Nine Months Ended		Nine Months Ended	
	September 30,		September 30,		September 30,	
	2006	2005	2006	2005	2006	2005
<i>(\$ in millions)</i>						
<i>Net sales:</i>						
Mattresses	\$ 479.2	\$ 424.0	\$ 339.9	\$ 298.5	\$ 139.3	\$ 125.5
Pillows	87.5	92.9	40.7	38.8	46.8	54.1
Other	121.8	104.2	78.0	67.0	43.8	37.2
	<b>\$ 688.5</b>	<b>\$ 621.1</b>	<b>\$ 458.6</b>	<b>\$ 404.3</b>	<b>\$ 229.9</b>	<b>\$ 216.8</b>
<i>Units sold<sup>(1)</sup>:</i>						
Mattresses	570,133	509,095	339,733	293,974	230,400	215,121
Pillows	1,709,141	1,866,452	800,253	787,721	908,888	1,078,731

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<sup>(1)</sup> Units sold represent Net sales after consideration of returned mattresses and pillows and excludes units shipped to fulfill warranty claims and promotion activities.

**Net sales.** Net sales for the nine months ended September 30, 2006 increased to \$688.5 million from \$621.1 million for the same period in 2005, an increase of \$67.4 million, or 11%. This increase was primarily attributable to an increase in mattress sales in our Retail channel. Consolidated mattress sales increased \$55.2 million or 13% from the same period in 2005, and consolidated pillow sales decreased approximately \$5.4 million from the same period of 2005. For the nine months ended September 30, 2006, our Retail channel Net sales increased to \$555.5 million from \$472.4 million for the same period in 2005, an increase of \$83.1 million, or 18%. As our Retail channel has expanded, Net sales have also been positively impacted by a reduction in our sales returns as a percentage of our Net Sales. The Retail channel typically experiences a lower sales return rate than our Direct channel.

Our Third party channel Net sales increased by 6%, which was primarily due to growth in our Canadian and other third party distributors in our Domestic segment. Our Direct and Healthcare channels sales declined 20% and 7%, respectively. The Direct channel decline is due primarily to the growth in our Retail channel in the Domestic and International segments which is consistent with our strategy to expand distribution of our products through targeted retail stores. The decrease in the Healthcare channel was primarily related to changing healthcare reimbursement practices in certain international markets.

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**Table of Contents**

*Domestic.* Domestic Net sales for the nine months ended September 30, 2006 increased to \$458.6 million from \$404.3 million for the same period in 2005, an increase of \$54.3 million, or 13%. Our Domestic Retail channel continues to be our largest channel, with \$382.8 million in Net sales for the nine months ended September 30, 2006. This is an increase of \$61.6 million, or 19% over the same period in 2005. The increase represents progress on several of the key initiatives we put in place to accelerate growth. We have improved account productivity by increasing sales and average slots per store in our Retail channel in both established and new accounts, expanded our Retail sales force by approximately 33% since December 2005, introduced new products, and continued to add new high quality accounts. Our Third party channel Net sales increased 54% due to our continued market share growth in Canada and in certain Central and South American countries. Our Direct channel Net sales decreased 18%. Direct channel Net sales are adversely affected by our continued growth in our Retail channel. Domestic mattress sales in the third quarter of 2006 increased \$41.4 million, or 14%, over the same period in 2005. In addition, pillow sales had a slight increase of \$1.9 million.

*International.* International Net sales for the nine months ended September 30, 2006 increased to \$229.9 million from \$216.8 million for the same period in 2005, an increase of \$13.1 million, or 6%. The largest channel in our International segment continues to be our Retail channel, which increased \$21.5 million, or 14%, for the nine months ended September 30, 2006. However, our Third party sales decreased 6%, resulting from our decision to terminate our relationship with certain third party distributors for continued violations of their distribution agreements regarding parallel exporting. This decision resulted in a period of time during which we experienced a temporary gap in representation in certain markets. We now have representation in those markets. Our Direct channel Net sales decreased 33%, which is primarily attributable to the growth in our Retail channel. In addition, our Healthcare channel Net sales decreased \$3.1 million, or 12%, which was primarily related to changing healthcare reimbursement practices in certain international markets. International mattress sales for the nine months ended September 30, 2006 increased \$13.8 million, or 11%, over the same period in 2005. Pillow sales for the nine months ended September 30, 2006 decreased \$7.3 million, or 13%, as compared to the same period in 2005, resulting from our decision to cease selling to certain third party distributors.

*Gross profit.* Gross profit for the nine months ended September 30, 2006 increased to \$333.8 million from \$315.3 million for the same period in 2005, an increase of \$18.5 million, or 6%. Gross margin for the nine months ended September 30, 2006 was 48%, as compared to 51% in the same period of 2005. Our margins were negatively impacted by several factors during the nine months ended September 30, 2006. First, they were impacted by the growth in our Retail channel. Sales in our Retail channel are generally at wholesale prices. Second, our overall product mix has shifted to mattresses and other products. Our mattresses generally carry lower margins than our pillows and are sold with lower margin products such as foundations and bed frames. Finally, our gross margin was negatively impacted by the rollout of new and refreshed mattress products in the U.S. and the discounting of floor models to certain new Retail customers.

While there have been margin declines due to product and channel mix and other factors, we have made improvements in several areas of our operations which have helped to offset these declines. Yields have increased substantially at our manufacturing facilities, and we have achieved cost savings through our sourcing and distribution initiatives.

*Domestic.* Domestic Gross profit for the nine months ended September 30, 2006 increased to \$201.9 million from \$183.2 million for the same period in 2005, an increase of \$18.7 million, or 10%. The Gross profit margin in our Domestic segment was 44% and 45% for the nine months ended September 30, 2006 and September 30, 2005, respectively. For the nine months ended September 30, 2006, the Gross profit margin for our Domestic segment was impacted by the growth in our Retail channel, new mattress offerings, and new account openings. These factors were offset by our ongoing productivity and global sourcing initiatives. Our Domestic cost of sales increased to \$256.7 million for the nine months ended September 30, 2006 as compared to \$221.1 million for the nine months ended September 30, 2005, an increase of \$35.6 million, or 16%.

*International.* International Gross profit for the nine months ended September 30, 2006 decreased to \$131.9 million from \$132.1 million for the same period in 2005, a decrease of \$0.2 million. The Gross profit margin in



## **Table of Contents**

our International segment was 57% and 61% for the nine months ended September 30, 2006 and September 30, 2005, respectively. For the nine months ended September 30, 2006, the Gross profit margin for our International segment was impacted by the continued Retail channel growth. Product and geographic mix have adversely impacted our gross margins in this segment as pillow sales in Japan and to certain third party distributors have declined. Our International Cost of sales for the nine months ended September 30, 2006 increased to \$98.0 million from \$84.7 million for the same period in 2005, an increase of \$13.3 million, or 16%.

***Selling and marketing expenses.*** Selling and marketing expenses increased to \$126.7 million for the nine months ended September 30, 2006 as compared to \$124.7 million for the nine months ended September 30, 2005. Selling and marketing expenses as a percentage of Net sales decreased to 18% for the nine months ended September 30, 2006 from 20% for the same period for 2005. Both total Selling and marketing expenses and advertising spending decreased as a percentage of Net sales. Our objective is to increase our advertising spending at the same rate as our revenue growth. However, in the third quarter of 2006, our advertising spending decreased. This decrease is attributable to the record campaign spending for the upcoming mid-term election and its impact on available TV advertising space.

***General and administrative and other expenses.*** General and administrative and other expenses increased to \$58.9 million for the nine months ended September 30, 2006 as compared to \$53.8 million for the nine months ended September 30, 2005, an increase of \$5.1 million. The increase was primarily attributable to increased investment in our information technology infrastructure, professional services, share based compensation expense related to the adoption of SFAS 123R, and research and development. General and administrative and other expenses as a percentage of Net sales remained relatively flat for the nine months ended September 30, 2006 compared to the same period in 2005.

***Interest expense, net.*** Interest expense, net, increased to \$17.4 million for the nine months ended September 30, 2006, as compared to \$15.3 million for the nine months ended September 30, 2005, an increase of \$2.1 million, or 14%. This increase in interest expense for the nine months ended September 30, 2006 is primarily attributable to higher Long-term debt levels that are directly related to our share repurchase program. During the nine months ended September 30, 2006, we also capitalized interest costs of \$3.8 million related to the construction of our new manufacturing facility which offset our increased interest expenses.

***Income tax provision.*** Our effective income tax rates for the nine months ended September 30, 2006 and 2005 differed from the federal statutory rate principally because of 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., compensation expense associated with certain options granted prior to the initial public offering, the production activities deduction, and certain other permanent differences.

Our effective tax rate for the nine months ended September 30, 2006 was 37.3%. For the same period in 2005, the effective tax rate was 43.0%. For the nine months ended September 30, 2005, our Income tax provision included a one-time charge of \$6.5 million related to the repatriation of foreign earnings under the provisions of the Jobs Creation Act. Excluding the impact of the one-time charge, the effective tax rate for the nine months ended September 30, 2005 would have been 37.6% compared to 37.3% for the nine months ended September 30, 2006.

## **Liquidity and Capital Resources**

### *Liquidity*

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Our principal sources of funds are cash flows from operations and borrowings. Our principal uses of funds consist of capital expenditures, payments of principal and interest on our debt facilities, and share repurchases made under a share repurchase program. At September 30, 2006, we had working capital of \$87.7 million including Cash and cash equivalents of \$15.3 million as compared to working capital of \$107.3 million including \$17.9 million in Cash and cash equivalents as of December 31, 2005. This decrease in working capital of 18% primarily results from lower inventory and cash levels from December 31, 2005 to September 30, 2006.

## **Table of Contents**

Our cash flow from operations increased to \$133.1 million for the nine months ended September 30, 2006 as compared to \$79.1 million for the nine months ended September 30, 2005. The increase in operating cash flow was primarily related to our efforts to improve our cash cycle. Decreases in our inventory levels provided operating cash flows of \$42.4 million for the nine months ended September 30, 2006 as compared to the same period in 2005. Net income increased \$12.9 million for the nine months ended September 30, 2006 as compared to the same period in 2005.

During the fourth quarter of 2006, we plan to increase inventory levels in order to meet the demand for our products. We believe that the addition of the manufacturing facility in New Mexico will meet this need beyond 2006. In addition, we will be making an estimated tax payment of approximately \$17.0 million for 2006 in our International segment.

Net cash used in investing activities decreased to \$24.8 million for the nine months ended September 30, 2006 as compared to \$69.3 million for the nine months ended September 30, 2005, an increase of \$44.5 million. Investing activities in the nine months ended September 30, 2006 consisted primarily of \$15.3 million related to the construction of our new manufacturing facility in New Mexico, as compared to \$60.3 million in construction costs for the nine months ended September 30, 2005.

Cash flow used by financing activities was \$112.6 million for the nine months ended September 30, 2006 as compared to cash flow provided by financing activities of \$19.9 million for the nine months ended September 30, 2005, representing an increase in cash flow used of \$132.5 million. This increase is due primarily to our share repurchases of \$144.0 million, which were partially offset by an increase of \$97.0 million in net associated borrowings on our 2005 Senior Credit facilities.

### *Capital Expenditures*

Capital expenditures totaled \$24.2 million for the nine months ended September 30, 2006 including \$3.8 million in capitalized interest costs related to the construction of our new manufacturing facility in New Mexico. Capital expenditures totaled \$68.1 million for the nine months ended September 30, 2005. We currently expect our 2006 capital expenditures to be approximately \$38.0 million, including approximately \$19.5 million for the completion of the new manufacturing facility. Additionally, we had commitments of \$3.4 million associated with the construction of our new plant as of September 30, 2006.

In order to meet anticipated future demands for our products, we commenced construction of our third manufacturing facility in September 2004, located in Albuquerque, New Mexico. The new facility is expected to begin testing production at the end of 2006. Our expected capital expenditures related to this facility are approximately \$90.0 million plus capitalized interest. This facility will allow us to meet the demands for our products primarily in the western U.S. as well as certain third party distributors.

### *Debt Service*

Our total long-term debt increased to \$354.4 million as of September 30, 2006 from \$313.7 million as of December 31, 2005. In the third quarter of 2006, we made a voluntary prepayment of \$14.0 million on our Foreign Term Loan, in excess of the scheduled principal payment of \$3.7 million, for a total principal reduction of \$17.7 million. For the nine months ended September 30, 2006, we have made voluntary prepayments totaling \$55.9 million, which coupled with scheduled principal payments has lowered our European term loan by approximately \$70.2 million. These prepayments were funded entirely from the operating cash flows in our International segment. Additionally, during the nine months ended

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September 30, 2006, we increased borrowings on our domestic revolving credit facility by \$97.0 million in order to fund our share repurchase program, through which we purchased 11.3 million shares at a total cost of \$144.0 million.

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.

## **Table of Contents**

See Note 4 in the Notes to Condensed Consolidated Financial Statements in ITEM 1 for a discussion of our long-term debt.

### *Stockholders Equity*

On October 18, 2005, our Board of Directors authorized the repurchase of up to \$80.0 million of common stock. Share repurchases under this program may be made through open market transactions, negotiated purchases or otherwise, at times and in such amounts as we deemed appropriate. During 2005, we repurchased 6.8 million shares, at a total cost of \$76.0 million. We funded these share repurchases from borrowings under the 2005 Senior Credit Facility and funds from operations.

On January 25, 2006, our Board of Directors amended the share repurchase program described above to increase the total authorization by an additional \$100.0 million. On May 22, 2006, our Board of Directors further amended the share repurchase program to increase the total authorization under the share repurchase program by an additional \$40.0 million for a total authorization to purchase up to \$220.0 million of Tempur-Pedic International's common stock. During the six months ended June 30, 2006, we repurchased 11.3 million shares at a total cost of \$144.0 million. As of June 30, 2006, the Company had completed its existing share repurchase authorization. The share repurchases were funded from borrowings under the 2005 Senior Credit Facility and funds from operations.

### **Factors That May Affect Future Performance**

*Managing Growth* We have grown rapidly, with our Net sales increasing from \$221.5 million in 2001 to \$836.7 million for 2005 and \$688.5 million for the nine months ended September 30, 2006. Our growth has placed, and will continue to place, a strain on our management, production, product distribution network, information systems and other resources. In response to these challenges, management has continued to invest in increased production capacity, enhanced operating and financial infrastructure and systems and continued expansion of the human resources in our operations. Our expenditures for advertising and other marketing-related activities are made as advertising rates are favorable to us and as the continued growth in the business allows us the ability to invest in building our brand.

*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 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 are susceptible to competition from lower priced product offerings. 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.

*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 expanding our brand awareness and offering superior sleep surfaces, we

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believe consumers will continue to adopt our products at an increasing rate, which should expand our market share. We believe that the premium and specialty bedding categories that we target will continue to grow at a faster rate than the overall mattress industry and we believe we will continue to experience the benefits of this consumer adoption.

## **Table of Contents**

In addition, by expanding distribution within our existing accounts, we believe we have the opportunity to grow our business by expanding our sales force and extending our product line. We have expanded our sales force by approximately 33% this year. This expansion has given our salespeople fewer stores to call on, resulting in more time spent with each customer so they can work with them on merchandising, training, and educating retail associates about the benefits of our products. Additionally, by extending our product line, 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.

Expanding distribution into new stores is also a source of growth opportunities. Our products are currently sold in approximately 5,910 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 of approximately 10,000 stores, our plan is to increase our total penetration to a total of 7,000 to 8,000 stores over time. Our products are also sold in approximately 4,390 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. For the three months ended September 30, 2006, we added a net of approximately 150 stores in the U.S. and approximately 50 stores internationally to our Retail channel. For the nine months ended September 30, 2006 we added a net of approximately 600 stores in the U.S. and approximately 340 stores internationally to our Retail channel. In addition, we have a significant installed pillow base in our Asia market that we believe creates an opportunity to develop a successful mattress market. We are continuing to develop products that are responsive to consumer demand in our markets.

In addition to these growth opportunities, we have only a small percentage market share in the nursing home and hospital markets. Clinical evidence indicates that our products are both effective and cost efficient for the prevention and treatment of pressure ulcers, or bed sores, a major problem for elderly and bed-ridden patients. We have recently begun partnering with healthcare vendors in an indirect sales method whereby the vendor integrates our product into their products, in order to improve patient comfort and wellness.

We are also focused on the hospitality industry and have recently devoted increased resources to this important area. We believe there are growth opportunities for our products through this channel as well as the opportunity to increase consumer trial and brand awareness. We are now in the process of retaining approximately 20 independent sales representatives. These representatives are already in the industry, calling on the hotels and building a rapport. These independent representatives will be trained in the fourth quarter of 2006 to position our product, and they will attend hospitality trade shows. In addition, we have started an advertising campaign focused on this market segment.

*Financial Leverage* As of September 30, 2006, we had \$354.4 million of Long-term debt outstanding, and our Stockholders' Equity was \$177.2 million. Higher financial leverage makes us more vulnerable to general adverse, competitive, economic and industry conditions. We believe that operating margins combined with the inherent operating leverage in the business will enable us to de-leverage the business in a manner consistent with historical experience. There can be no assurance, however, that our business will generate sufficient cash flow from operations or that future borrowing will be available under our 2005 Senior Credit Facility or otherwise, to enable us to de-leverage the business.

*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. We use foreign exchange forward contracts to manage a portion of the exposure to the risk of the eventual net cash inflows and outflows resulting from foreign currency denominated transactions between Tempur-Pedic subsidiaries and their customers and suppliers, as well as between the Tempur-Pedic subsidiaries themselves. These hedging transactions may not succeed in managing our foreign currency exchange rate risk. See ITEM 3. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exposures under Part I of this report.

Foreign currency exchange rate movements also 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.



## **Table of Contents**

Consequently, our reported earnings and financial position could fluctuate materially as a result of foreign exchange gains or losses. Our outlook assumes no significant changes in currency values from current rates. Should currency rates change sharply, our results could be negatively impacted. 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 Form 10-K for the year ended December 31, 2005. There have been no material changes to our critical accounting policies and estimates in 2006, except as follows:

*Stock-Based Compensation* In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123R, Share-Based Payment (SFAS 123R), which is a revision of SFAS 123, Accounting for Stock Based Compensation (SFAS 123). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure is no longer an alternative to financial statement recognition. SFAS 123R became effective for annual periods beginning after June 15, 2005.

SFAS 123R permits public companies to adopt its requirements using one of two methods. The first adoption method is a modified prospective approach in which compensation cost is recognized beginning with the effective date (i) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS 123 for all share-based payments granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date. The second adoption method is a modified retrospective approach, which includes the requirements of the modified prospective method described above, but also permits entities to restate, based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures, either (i) all prior periods presented or (ii) prior interim periods in the year of adoption.

We adopted SFAS 123R on January 1, 2006 using the modified prospective method for the transition and expect to recognize approximately \$2.2 million, pre-tax, in additional expense in 2006 based on option grants outstanding as of December 31, 2005. The impact of the adoption of SFAS 123R on future grants cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. Additionally, we have continued to use the Black-Scholes option pricing model to calculate the fair value of share based payments under SFAS 123R. Compensation amounts so determined will be expensed over the applicable estimated life. See Note 6 in the Notes to Condensed Consolidated Financial Statements in ITEM 1 for further discussion of our adoption of SFAS 123R.

### **Impact of Recently Issued Accounting Pronouncements**

See Note 2 in the Notes to Condensed Consolidated Financial Statements in ITEM 1 for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on results of operations and financial condition, which is incorporated herein by reference.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Foreign Currency Exposures**

Our earnings, as a result of our global operating and financing activities, are exposed to changes in foreign currency exchange rates, which may adversely affect our results of operations and financial position. Our current outlook assumes no significant changes in currency values from current rates. Should currency rates change sharply, our results could be negatively impacted.

## **Table of Contents**

We protect a portion of our currency exchange exposure with foreign currency forward contracts. A sensitivity analysis indicates the potential loss in fair value on foreign currency forward contracts outstanding at September 30, 2006, resulting from a hypothetical 10% adverse change in all foreign currency exchange rates against the U.S. Dollar, is approximately \$0.4 million. 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 remeasured through earnings.

## **Interest Rate Risk**

We are exposed to changes in interest rates. Our 2005 Senior Credit Facility and the Series A bonds issued in connection with our New Mexico facility are variable-rate debt. While the applicable margins specified by the 2005 Senior Credit Facility are contractually adjusted based on consolidated leverage, the debt shall remain variable-rate until its expiration. We currently do not expect to seek an amendment to the 2005 Senior Credit Facility that would have the effect of fixing the interest rate of any variable-rate debt. Therefore, the interest rate risk on this debt is not expected to change materially over the remaining life of the 2005 Senior Credit Facility.

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, 2006, we had variable-rate debt of approximately \$274.6 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 \$2.7 million.

In January 2003, the Company paid premiums to purchase two three-year interest rate caps for the purpose of protecting cash flows associated with interest payments on \$60.0 million of the existing variable-rate debt outstanding, at any given time, against LIBOR rates rising above 5%. The interest rate caps expired on March 31, 2006 and were not renewed.

## **ITEM 4. CONTROLS AND PROCEDURES**

An evaluation was performed under the supervision and with the participation of our management, including our principal executive officer and 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 principal executive officer and principal financial officer, concluded that our disclosure controls and procedures were effective as of September 30, 2006 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 principal executive and financial officers, 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.



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**Table of Contents**

**PART II**

**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

Between October 7, 2005 and November 21, 2005, five complaints were filed against Tempur-Pedic International and certain of its directors and officers in the United States District Court for the Eastern District of Kentucky (Lexington Division) purportedly on behalf of a class of shareholders who purchased the Company's stock between April 22, 2005 and September 19, 2005. On December 29, 2005, the court consolidated these five actions (the Securities Law Action). Lead plaintiffs filed a consolidated complaint on February 27, 2006. In their consolidated complaint, lead plaintiffs assert claims arising under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Lead plaintiffs allege that certain of Tempur-Pedic International's public disclosures regarding its financial performance between April 22, 2005 and September 19, 2005 were false and/or misleading. The principal allegation set forth in the Securities Law Action is that Tempur-Pedic International did not disclose the impact of competition on its prospects. The plaintiffs seek compensatory damages, costs, fees and other relief within the Court's discretion. On June 14, 2006, the Tempur-Pedic International filed a motion to dismiss all claims in the Securities Law Action. That motion is currently pending before the Court. We strongly believe that the Securities Law Action lacks merit, and we intend to defend against the claims vigorously. However, due to the inherent uncertainties of litigation, we cannot predict the outcome of the Securities Law Action at this time, and we can give no assurance that these claims will not have a material adverse affect on our financial position or results of operations.

On November 10, 2005 and December 15, 2005, complaints were filed in the state courts of Delaware and Kentucky, respectively, against certain officers and directors of Tempur-Pedic International, purportedly derivatively on behalf of the Company (the Derivative Complaints). The Derivative Complaints assert that the named officers and directors breached their fiduciary duties when they allegedly sold Tempur-Pedic International's securities on the basis of material non-public information in 2005. The Delaware Derivative Complaint also asserts a claim for breach of fiduciary duty with respect to the disclosures that also are the subject of the Securities Law Action described above. On December 14, 2005 and January 26, 2006, respectively, the Delaware court and Kentucky court stayed these derivative actions pending the outcome of the motion to dismiss that defendants have filed in the Securities Law Action. Tempur-Pedic International is also named as a nominal defendant in the Derivative Complaints, although the actions are derivative in nature and purportedly asserted on behalf of Tempur-Pedic International. Tempur-Pedic International is in the process of evaluating these claims.

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

**ITEM 1A. RISK FACTORS**

*The following risk factors and other information included in this report should be carefully considered. Please also see Special Note Regarding Forward-Looking Statements on page 3.*

*We operate in the highly competitive mattress and pillow industries, and if we are unable to compete successfully, we may lose customers and our sales may decline.*

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

## **Table of Contents**

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 now offer mattress products claimed to be similar to our viscoelastic mattresses and pillows. These competitors or other mattress manufacturers may aggressively pursue the viscoelastic mattress market. Any such competition by established manufacturers or new entrants into the market could have a material, adverse effect on our business, financial condition and operating results by causing our products to lose market share. In addition, should any of our competitors reduce prices on premium mattress products, we may be required to implement price reductions in order to remain competitive, which could significantly impair our liquidity and profitability. The pillow industry is characterized by a large number of competitors, none of which is dominant, but many of which have greater resources than us and greater brand recognition than our brand.

*We may be unable to sustain our profitability, which could impair our ability to service our indebtedness and make investments in our business.*

Our ability to service our indebtedness depends on our ability to maintain our profitability. Our sales growth slowed in 2005, with Net sales growing at a 22% rate from 2004, as compared to a sales growth rate of 43% for 2004 compared to 2003. Net sales for the first nine months of 2006 grew at an 11% rate compared to the first nine months of 2005. We may not be able to maintain our profitability on a quarterly or annual basis in future periods. Further, our profitability will depend upon a number of factors, including without limitation:

the level of competition in the mattress and pillow industry;

our ability to continue to successfully execute our strategic initiatives;

our ability to effectively sell our products through our distribution channels in volumes sufficient to drive growth and leverage our cost structure and advertising spending;

our ability to continuously improve our products to offer new and enhanced consumer benefits, better quality and reduced costs;

our ability to maintain efficient, timely and cost-effective production and utilization of our manufacturing capacity;

the efficiency and effectiveness of our advertising campaigns and other marketing programs in building product and brand awareness, driving traffic to our distribution channels and increasing sales;

our ability to successfully identify and respond to emerging trends in the mattress and pillow industry;

our ability to maintain public association of our brand with premium products, including overcoming any impact on our brand caused by some of our customers seeking to sell our products at a discount to our recommended price;

the level of consumer acceptance of our products; and

general economic conditions and consumer confidence.

*Our operating results are increasingly subject to fluctuations, which could adversely affect the market price of our common stock.*

A significant portion of our growth in Net sales is attributable to growth in sales in our Domestic retail channel, particularly sales to furniture stores. We believe that our sales of mattresses and pillows to furniture stores are subject to seasonality inherent in the bedding industry with sales expected to be generally lower in the second and fourth quarters and higher in the first and third quarters. Accordingly, our Net sales may be affected by this seasonality as our domestic retail sales channel continues to grow as a percentage of our overall Net sales.

## **Table of Contents**

In addition, to seasonal fluctuations, the demand for our premium products can fluctuate significantly based on a number of other factors including general economic conditions and consumer confidence, and the timing of price increases announced by us or our competitors. We believe that as our consumer base continues to expand the average demographics of our consumer base change, with a greater percentage of middle income consumers. This change in our consumer base makes our business more susceptible to general economic factors that impact disposable income or consumer confidence.

***Our advertising expenditures may not result in increased sales or generate the levels of product and brand name awareness we desire and we may not be able to manage our advertising expenditures on a cost-effective basis.***

A significant component of our marketing strategy involves the use of direct marketing to generate sales. Future growth and profitability will depend in part on the effectiveness and efficiency of our advertising expenditures, including our ability to:

create greater awareness of our products and brand name;

Determine the appropriate creative message and media mix for future advertising expenditures;

effectively manage advertising costs, including creative and media, to maintain acceptable costs per inquiry, costs per order and operating margins; and

convert inquiries into actual orders.

***We are subject to fluctuations in the cost of raw materials, and increases in these costs would reduce our liquidity and profitability.***

The major raw materials that we purchase for production are chemicals and proprietary additives. The price and availability of these raw materials are subject to market conditions affecting supply and demand, and prices have risen substantially on certain materials since August 2005. Our financial condition and results of operations may be materially and adversely affected by increases in raw material costs to the extent we are unable to pass those higher costs to our customers. For additional discussion, see also Part I, ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

***Loss of suppliers and disruptions in the supply of our raw materials could increase our costs of production and reduce our ability to compete effectively.***

We currently obtain the raw materials used to produce our pressure-relieving TEMPUR® material from outside sources. We currently acquire chemicals and proprietary additives from a number of suppliers with manufacturing locations around the world. If we were unable to obtain chemicals and proprietary additives from these suppliers, we would have to find replacement suppliers. Any substitute arrangements for chemicals and proprietary additives might not be on terms as favorable to us. We maintain relatively small supplies of our raw materials on-site, and any disruption in the on-going shipment of supplies to us could interrupt production of our products, which could result in a decrease of our sales, or could cause an increase in our cost of sales, and either of these results could decrease our liquidity and profitability. In addition, we continue to outsource the procurement of certain goods and services from suppliers in foreign countries. If we were no longer able to outsource

these suppliers, we could source it elsewhere at a higher cost. To the extent we are unable to pass those higher costs to our customers, these costs could reduce our gross profit margin, which could result in a decrease in our liquidity and profitability.

## **Table of Contents**

***We may face exposure to product liability, which could reduce our liquidity and profitability and reduce consumer confidence in our products.***

We face an inherent business risk of exposure to product liability claims if the use of any of our products results in personal injury or property damage. In the event that any of our products prove to be defective, we may be required to recall or redesign those products. We maintain insurance against product liability claims, but such coverage may not continue to be available on terms acceptable to us or be adequate for liabilities actually incurred. A successful claim brought against us in excess of available insurance coverage could impair our liquidity and profitability, and any claim or product recall that results in significant adverse publicity against us, could result in consumers purchasing fewer of our products, which would also impair our liquidity and profitability.

***We may be adversely affected by fluctuations in exchange rates, which could affect our results of operations, the costs of our products and our ability to sell our products in foreign markets.***

Approximately 32% and 33% of our Net sales were denominated in foreign currency for the three and nine months ended September 30, 2006, respectively. 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. We use foreign exchange forward contracts to manage a portion of the exposure to the risk of the eventual net cash inflows and outflows resulting from foreign currency denominated transactions between Tempur-Pedic subsidiaries and their customers and suppliers, as well as between Tempur-Pedic subsidiaries themselves from time to time. The hedging transactions may not succeed in managing our foreign currency exchange rate risk. See ITEM 3. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exposures under Part I of this report.

Foreign currency exchange rate movements also 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 gains or losses. Our outlook assumes no significant changes in currency values from current rates. Should currency rates change sharply, our results could be negatively impacted. See ITEM 3 Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exposures under Part I of this report.

***Regulatory requirements may require costly expenditures and expose us to liability.***

Our products and our marketing and advertising programs are and will continue to be subject to regulation in the U.S. by various federal, state and local regulatory authorities, including the Federal Trade Commission and the U.S. Food and Drug Administration. In addition, other governments and agencies in other jurisdictions regulate the sale and distribution of our products. Compliance with these regulations may have an adverse effect on our business. For example, compliance with changes in fire resistance laws may be costly and could have an adverse impact on the performance of our products. In February 2006, the U.S. Consumer Product Safety Commission issued new rules relating to fire retardancy standards for the mattress and pillow industry. The State of California adopted new fire retardancy standards beginning in 2005. We have developed product modifications that allow us to meet these new standards. Required product modifications have added cost to our products. Many foreign jurisdictions also regulate fire retardancy standards, and changes to these standards and changes in our products that require compliance with additional standards would raise similar risks.

Our marketing and advertising practices could also become the subject of proceedings before regulatory authorities or the subject of claims by other parties. In addition, we are subject to federal, state and local laws and regulations relating to pollution, environmental protection and occupational health and safety. We may not be in complete compliance with all such requirements at all times. We have made and will continue

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to make capital and other expenditures to comply with environmental and health and safety requirements. If a release of hazardous substances occurs on or from our properties or any associated offsite disposal location, or if contamination from prior activities is discovered at any of our properties, we may be held liable and the amount of such liability could be material.

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**Table of Contents**

*An increase in our product return rates or an inadequacy in our warranty reserves could reduce our liquidity and profitability.*

Part of our Domestic marketing and advertising strategy in certain Domestic channels focuses on providing up to a 120-day money back guarantee under which customers may return their mattress and obtain a refund of the purchase price. For the three and nine months ended September 30, 2006, in the U.S. we had approximately \$8.7 million and \$26.2 million in returns, respectively for a return rate of approximately 5% and 6% of our Net sales in the U.S. for the two periods. As we expand our sales, our return rates may not remain within our historical levels. An increase in return rates could significantly impair our liquidity and profitability. We also currently provide our customers with a limited, pro-rata 20-year warranty on mattresses sold in the U.S. and a limited 15-year warranty on mattresses sold outside of the U.S. However, as we have only been selling mattresses in significant quantities since 1992, and have released new products in recent years, many are fairly early in their product life cycles. We also provide 2-year to 3-year warranties on pillows.

Because our products have not been in use by our customers for the full warranty period, we rely on the combination of historical experience and product testing for the development of our estimate for warranty claims. However, our actual level of warranty claims could prove to be greater than the level of warranty claims we estimated based on our products' performance during product testing. If our warranty reserves are not adequate to cover future warranty claims, their inadequacy could have a material adverse effect on our liquidity and profitability.

*We are subject to risks from our international operations, such as increased costs and the potential absence of intellectual property protection, which could impair our ability to compete and our profitability.*

We currently conduct international operations in 14 countries directly and in approximately 60 additional countries through distributors, and we may pursue additional international opportunities. We generated approximately 32% and 33% of our Net sales from non-U.S. operations during the three and nine months ended September 30, 2006, and international suppliers provided a significant portion of our manufacturing material during this period. Our international operations are subject to the customary risks of operating in an international environment, including complying with foreign laws and regulations and the potential imposition of trade or foreign exchange restrictions, tariff and other tax increases, fluctuations in exchange rates, inflation and unstable political situations, the potential unavailability of intellectual property protection and labor issues.

*If we are not able to protect our trade secrets or maintain our trademarks, patents and other intellectual property, we may not be able to prevent competitors from developing similar products or from marketing in a manner that capitalizes on our trademarks, and this loss of a competitive advantage could decrease our profitability and liquidity.*

We rely on trade secrets to protect the design, technology and function of our TEMPUR® material and our products. To date, we have not sought U.S. or international patent protection for our principal product formula and manufacturing processes. Accordingly, we may not be able to prevent others from developing viscoelastic material and products that are similar to or competitive with our products. Our ability to compete effectively with other companies also depends, to a significant extent, on our ability to maintain the proprietary nature of our owned and licensed intellectual property. We own several patents on aspects of our products and have patent applications pending on aspects of our manufacturing processes. However, the principal product formula and manufacturing processes for our TEMPUR® material and our products are not patented and we must maintain these as trade secrets in order to protect this intellectual property. We own 14 U.S. patents, and we have 15 U.S. patent applications pending. Further, we own 46 foreign patents, and we have 35 foreign patent applications pending. In addition, we hold approximately 297 trademark registrations worldwide. We own U.S. and foreign registered trade names and service marks and have applications for the registration of trade names and service marks pending domestically and abroad. We also license certain intellectual property rights from third parties.



## **Table of Contents**

Although our trademarks are currently registered in the U.S. and registered or pending in 58 foreign countries, they could be circumvented, or violate the proprietary rights of others, or we could be prevented from using them if challenged. A challenge to our use of our trademarks could result in a negative ruling regarding our use of our trademarks, their validity or their enforceability, or could prove expensive and time consuming in terms of legal costs and time spent defending against it. Any loss of trademark protection could result in a decrease in sales or cause us to spend additional amounts on marketing, either of which could decrease our liquidity and profitability. In addition, if we incur significant costs defending our trademarks that could also decrease our liquidity and profitability. In addition, we may not have the financial resources necessary to enforce or defend our trademarks. Furthermore, our patents may not provide meaningful protection and patents may never be issued for our pending patent applications. It is also possible that others could bring claims of infringement against us, as our principal product formula and manufacturing processes are not patented, and that any licenses protecting our intellectual property could be terminated. If we were unable to maintain the proprietary nature of our intellectual property and our significant current or proposed products, this loss of a competitive advantage could result in decreased sales or increased operating costs, either of which would decrease our liquidity and profitability.

In addition, the laws of certain foreign countries may not protect our intellectual property rights and confidential information to the same extent as the laws of the U.S. or the European Union. Third parties, including competitors, may assert intellectual property infringement or invalidity claims against us that could be upheld. Intellectual property litigation, which could result in substantial cost to and diversion of effort by us, may be necessary to protect our trade secrets or proprietary technology or for us to defend against claimed infringement of the rights of others and to determine the scope and validity of others' proprietary rights. We may not prevail in any such litigation, and if we are unsuccessful, we may not be able to obtain any necessary licenses on reasonable terms or at all.

***Because we depend on our significant customers, a decrease or interruption in their business with us would reduce our sales and profitability.***

Our top five customers, collectively, accounted for 16% and 14% of our Net sales for the three and nine months ended September 30, 2006, respectively. Many of our customer arrangements are by purchase order or are terminable at will at the option of either party. A substantial decrease or interruption in business from our significant customers could result in write-offs or in the loss of future business and could reduce our liquidity and profitability.

In the future, retailers may consolidate, undergo restructurings or reorganizations, or realign their affiliations, any of which could decrease the number of stores that carry our products or increase the ownership concentration in the retail industry. Some of these retailers may decide to carry only a limited number of brands of mattress products, which could affect our ability to sell our products to them on favorable terms, if at all. Our loss of significant customers would impair our sales and profitability and have a material adverse effect on our business, financial condition and results of operations.

***We produce all of our products in two manufacturing facilities and have commenced construction on a third manufacturing facility, and unexpected equipment failures, delays in deliveries, catastrophic loss or construction delays may lead to production curtailments or shutdowns.***

We manufacture all of our products at our two facilities in Aarup, Denmark and Duffield, Virginia and are in the process of constructing a third facility in Albuquerque, New Mexico. An interruption in production capabilities at these plants as a result of equipment failure could result in our inability to produce our products, which would reduce our sales and earnings for the affected period. In addition, we generally deliver our products only after receiving the order from the customer or the retailer and thus do not hold large inventories. In the event of a stoppage in production at either of our manufacturing facilities, even if only temporary, or if we experience delays as a result of events that are beyond our control, delivery times could be severely affected. For example,



## **Table of Contents**

our third party carrier could potentially be unable to deliver our products within acceptable time periods due to a labor strike or other disturbance in its business. Any significant delay in deliveries to our customers could lead to increased returns or cancellations and cause us to lose future sales. Any increase in freight charges could increase our costs of doing business and harm our profitability. We have introduced new distribution programs to increase our ability to deliver products on a timely basis, but if we fail to deliver products on a timely basis, we may lose sales which could decrease our liquidity and profitability. Our manufacturing facilities are also subject to the risk of catastrophic loss due to unanticipated events such as fires, explosions or violent weather conditions. We may in the future experience material plant shutdowns or periods of reduced production as a result of equipment failure, delays in deliveries or catastrophic loss.

*A deterioration in labor relations could disrupt our business operations and increase our costs, which could decrease our liquidity and profitability.*

As of September 30, 2006, we had approximately 1,300 full-time employees, with approximately 600 in the U.S., 300 in Denmark and 400 in the rest of the world. The employees in Denmark are under a government labor union contract, but those in the U.S. are not. Any significant increase in our labor costs could decrease our liquidity and profitability and any deterioration of employee relations, slowdowns or work stoppages at any of our locations, whether due to union activities, employee turnover or otherwise, could result in a decrease in our Net sales or an increase in our costs, either of which could decrease our liquidity and profitability.

*The loss of the services of any members of our senior management team could impair our ability to execute our business strategy and as a result, reduce our sales and profitability.*

We depend on the continued services of our senior management team. The loss of key personnel could have a material adverse effect on our ability to execute our business strategy and on our financial condition and results of operations. We do not maintain key-person insurance for members of our senior management team.

*Our leverage limits our flexibility and increases our risk of default.*

As of September 30, 2006, we had \$354.4 million in total Long-term debt outstanding. In addition, as of June 30, 2006, our Stockholders' Equity was \$177.2 million. Between October 2005 and June 30, 2006 we have repurchased a total of \$220.0 million in common stock pursuant to a stock repurchase program authorized by our Board of Directors in the total amount of \$220.0 million. We funded the repurchase in part through borrowings under our 2005 Senior Credit Facility, which has substantially increased our leverage. Our Board of Directors may authorize additional share repurchases in the future and we may fund these repurchases with debt. Our degree of leverage could have important consequences to our investors, such as:

limiting our ability to obtain in the future additional financing we may need to fund future working capital, capital expenditures, product development, acquisitions or other corporate requirements; and

requiring the dedication of a substantial portion of our cash flow from operations to the payment of principal and interest on our debt, which will reduce the availability of cash flow to fund working capital, capital expenditures, product development, acquisitions and other corporate requirements.

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In addition, the instruments governing our debt contain financial and other restrictive covenants, which limit our operating flexibility and could prevent us from taking advantage of business opportunities. In addition, our failure to comply with these covenants may result in an event of default. If such event of default is not cured or waived, we may suffer adverse effects on our operations, business or financial condition, including acceleration of our debt.

## **Table of Contents**

*We are vulnerable to interest rate risk with respect to our debt, which could lead to an increase in interest expense.*

We are subject to interest rate risk in connection with our issuance of variable rate debt under our new global senior credit facility. Interest rate changes could increase the amount of our interest payments and thus, negatively impact our future earnings and cash flows. We estimate that our annual interest expense on our floating rate indebtedness would increase by \$2.7 million for each 1% increase in interest rates. See ITEM 3. Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk under Part I of this report.

*Allegations of the possibility of price fixing in the mattress industry could increase our costs or otherwise adversely affect our operations.*

Our retail pricing policies are subject to antitrust regulations in the U.S. and abroad. If antitrust regulators in any jurisdiction in which we do business initiate investigations into or challenge our pricing or advertising policies, our efforts to respond could force us to divert management resources and we could incur significant unanticipated costs. If such an investigation were to result in a charge that our practices or policies were in violation of applicable antitrust laws or regulations, we could be subject to significant additional costs of defending such charges in a variety of venues and, ultimately, if there were a finding that we were in violation of antitrust laws or regulations, there could be an imposition of fines, damages for persons injured, as well as injunctive or other relief. Any requirement that we pay fines or damages could decrease our liquidity and profitability, and any investigation that requires significant management attention or causes us to change our business practices could disrupt our operations, also resulting in a decrease in our liquidity and profitability.

*Our stock price is likely to continue to be volatile, your investment could decline in value, and we may incur significant costs from class action litigation.*

The trading price of our common stock is likely to continue to be volatile and subject to wide price fluctuations. The trading price of our common stock may fluctuate significantly in response to various factors, including:

actual or anticipated variations in our quarterly operating results, including those resulting from seasonal variations in our business;

introductions or announcements of technological innovations or new products by us or our competitors;

disputes or other developments relating to proprietary rights, including patents, litigation matters, and our ability to patent our products and technologies;

changes in estimates by securities analysts of our financial performance;

conditions or trends in the specialty bedding industry, or the mattress industry generally;

additions or departures of key personnel;

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announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;

announcements by our competitors of their quarterly operating results or announcements by our competitors of their views on trends in the bedding industry;

regulatory developments in the U.S. and abroad;

economic and political factors; and

public announcements or filings with the SEC indicating that significant stockholders, directors or officers are selling shares of common stock.

In addition, the stock market in general has experienced significant price and volume fluctuations that have often been unrelated or disproportionate to operating performance. These broad market factors may seriously harm the market price of our common stock, regardless of our operating performance.

## **Table of Contents**

In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted. A securities class action suit against us could result in potential liabilities, substantial costs, and the diversion of our management's attention and resources, regardless of the outcome. See Part II, ITEM 1, Legal Proceedings.

### ***Future sales of our common stock may depress our stock price.***

The market price of our common stock could decline as a result of sales of substantial amounts of our common stock in the public market, or the perception that these sales could occur. In addition, these factors could make it more difficult for us to raise funds through future offerings of common stock. As of October 31, 2006, there were 83.0 million shares of our common stock outstanding. All of our shares of our common stock are freely transferable without restriction or further registration under the Securities Act of 1933, except for certain shares of our common stock which were purchased by our executive officers, directors, principal stockholders, and some related parties. In September 2006, one of our largest stockholders, a private equity fund that invested in the Company in 2002 in connection with the acquisition of our predecessor, made a distribution to its investors of 5.0 million shares. This stockholder continues to hold 10.6 million shares of our common stock and may choose to make additional distributions or sales of our common stock in the future.

In addition, on December 24, 2003, we registered up to 14,982,532 shares of our common stock reserved for issuance upon the exercise of options granted or reserved for grant under our 2002 Stock Option Plan, our 2003 Equity Incentive Plan and our 2003 Employee Stock Purchase Plan. Stockholders can sell these shares in the public market upon issuance, subject to restrictions under the securities laws and any applicable lock-up agreements.

### ***Our current principal stockholder owns a large percentage of our common stock and could limit you from influencing corporate decisions.***

As of October 31, 2006, our executive officers, directors, and our largest stockholder, and their respective affiliates, owned in the aggregate, approximately 20% 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.

### ***Provisions of Delaware law and our charter documents could delay or prevent an acquisition of us, even if the acquisition would be beneficial to you.***

Provisions of Delaware law and our certificate of incorporation and by-laws could hamper a third party's acquisition of us, or discourage a third party from attempting to acquire control of us. You may not have the opportunity to participate in these transactions. These provisions could also limit the price that investors might be willing to pay in the future for shares of our common stock.

These provisions include:

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our ability to issue preferred stock with rights senior to those of the common stock without any further vote or action by the holders of our common stock;

the requirements that our stockholders provide advance notice when nominating our directors; and

the inability of our stockholders to convene a stockholders meeting without the chairperson of the board, the president, or a majority of the board of directors first calling the meeting.

**Table of Contents**

*We do not anticipate paying dividends on our capital stock in the foreseeable future.*

We do not anticipate paying any dividends in the foreseeable future, although as discussed elsewhere in this report we have adopted a share repurchase program. In addition, the terms of the instruments governing our existing debt and any future debt or credit facility may preclude us from paying any dividends.

**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:

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- 10.1 Employment Agreement dated as of July 18, 2006 between Tempur-Pedic International Inc. and Richard Anderson.
- 31.1 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.
- 31.2 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.
- 32.1\* 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.

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\* This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 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 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

