

TEMPUR PEDIC INTERNATIONAL INC
Form 10-Q
October 28, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2010

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

For the transition period from

to

Commission file number 001-31922

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

Delaware
(State or other
jurisdiction of
incorporation or
organization)

33-1022198
(I.R.S. Employer
Identification No.)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

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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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

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

The number of shares outstanding of the registrant's common stock as of October 26, 2010 was 68,165,595 shares.

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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 includes information concerning our plans; objectives; goals; strategies; future events; future revenues or performance; the impact of the macroeconomic environment in both the U.S. and internationally on sales and our business segments; investments in operating infrastructure; changes in capital expenditures; the impact of consumer confidence; litigation and similar issues; pending tax assessments; financial flexibility; the impact of initiatives to accelerate growth, expand market share and attract sales from the standard mattress market; the improvements in our Net sales; efforts to expand business within established accounts, improve account productivity, reduce costs and operating expenses and improve manufacturing productivity; initiatives to improve gross margin; the vertical integration of our business; the development, rollout and market acceptance of new products, including the success of the TEMPUR-Cloud™ collection; our ability to further invest in the business and in brand awareness; our ability to meet financial obligations and continue to comply with the terms of our credit facility, including its financial ratio covenants; effects of changes in foreign exchange rates on our reported earnings; our expected sources of cash flow; our ability to effectively manage cash; our ability to align costs with sales expectations and other information that is not historical information. Many of these statements appear, in particular, under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in ITEM 2 of Part I of this report. When used in this report, the words “estimates,” “expects,” “anticipates,” “projects,” “plans,” “intends,” “believes” and variations of such words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this report. Important factors that could cause our actual results to differ materially from those expressed as forward-looking statements are set forth in this report, including under the heading “Risk Factors” under ITEM 1A of Part II of this report and under the heading “Risk Factors” under ITEM 1A of Part 1 of our annual report on Form 10-K for the year ended December 31, 2009. 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.

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PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per common share amounts)

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| Net sales | \$ 295,785 | \$ 224,082 | \$ 812,718 | \$ 586,362 |
| Cost of sales | 145,031 | 117,373 | 409,114 | 311,461 |
| Gross profit | 150,754 | 106,709 | 403,604 | 274,901 |
| Selling and marketing expenses | 53,215 | 39,272 | 146,273 | 108,335 |
| General, administrative and other expenses | 29,385 | 24,761 | 83,037 | 68,847 |
| Operating income | 68,154 | 42,676 | 174,294 | 97,719 |
| Other expense, net: | | | | |
| Interest expense, net | (4,068) | (4,311) | (11,043) | (13,359) |
| Other (expense) income, net | (624) | (214) | (525) | 404 |
| Total other expense | (4,692) | (4,525) | (11,568) | (12,955) |
| Income before income taxes | 63,462 | 38,151 | 162,726 | 84,764 |
| Income tax provision | 19,324 | 12,467 | 51,830 | 28,885 |
| Net income | \$ 44,138 | \$ 25,684 | \$ 110,896 | \$ 55,879 |
| Net loss (income) attributable to the noncontrolling interest | 60 | — | (44) | — |
| Net income attributable to common stockholders | \$ 44,198 | \$ 25,684 | \$ 110,852 | \$ 55,879 |
| Earnings per common share: | | | | |
| Basic | \$ 0.64 | \$ 0.34 | \$ 1.56 | \$ 0.75 |
| Diluted | \$ 0.62 | \$ 0.34 | \$ 1.51 | \$ 0.74 |
| Weighted average common shares outstanding: | | | | |
| Basic | 69,199 | 74,938 | 71,065 | 74,902 |
| Diluted | 71,433 | 76,166 | 73,450 | 75,396 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

| | September 30, 2010 (Unaudited) | December 31, 2009 |
|--|--------------------------------------|----------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 38,048 | \$ 14,042 |
| Accounts receivable, net | 127,453 | 105,576 |
| Inventories | 68,175 | 57,686 |
| Prepaid expenses and other current assets | 15,027 | 11,268 |
| Deferred income taxes | 19,155 | 20,411 |
| Total Current Assets | 267,858 | 208,983 |
| Property, plant and equipment, net | 162,910 | 172,497 |
| Goodwill | 211,723 | 193,391 |
| Other intangible assets, net | 69,179 | 64,717 |
| Other non-current assets | 4,280 | 3,791 |
| Total Assets | \$ 715,950 | \$ 643,379 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 62,798 | \$ 47,761 |
| Accrued expenses and other current liabilities | 94,461 | 81,452 |
| Income taxes payable | 19,846 | 7,312 |
| Total Current Liabilities | 177,105 | 136,525 |
| Long-term debt | 436,000 | 297,470 |
| Deferred income taxes | 30,732 | 29,865 |
| Other non-current liabilities | 4,254 | 7,226 |
| Total Liabilities | 648,091 | 471,086 |
| Commitments and contingencies—see Note 9 | | |
| Equity attributable to common stockholders | 66,590 | 172,293 |
| Equity attributable to the noncontrolling interest | 1,269 | — |
| Total Stockholders' Equity | 67,859 | 172,293 |
| Total Liabilities and Stockholders' Equity | \$ 715,950 | \$ 643,379 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

| | Nine Months Ended September 30, | |
|---|------------------------------------|------------------|
| | 2010 | 2009 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 110,896 | \$ 55,879 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 23,870 | 23,526 |
| Amortization of stock-based compensation | 7,953 | 6,448 |
| Amortization of deferred financing costs | 517 | 518 |
| Bad debt expense | 2,072 | 4,659 |
| Deferred income taxes | (1,509) | (8,006) |
| Foreign currency adjustments | (1,504) | 34 |
| Loss on disposal of equipment | 1,081 | — |
| Changes in operating assets and liabilities, net of effects of acquired business | (3,662) | 37,345 |
| Net cash provided by operating activities | 139,714 | 120,403 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Acquisition of business, net of cash acquired | (18,692) | — |
| Purchases of property, plant and equipment | (12,330) | (8,961) |
| Payments for other | (152) | (87) |
| Net cash used by investing activities | (31,174) | (9,048) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long-term revolving credit facility | 289,336 | 85,797 |
| Repayments of long-term revolving credit facility | (149,313) | (189,036) |
| Proceeds from issuance of common stock | 22,015 | 129 |
| Excess tax benefit from stock-based compensation | 3,282 | — |
| Treasury shares repurchased | (250,000) | — |
| Net cash used by financing activities | (84,680) | (103,110) |
| NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS | 146 | (3,627) |
| Increase in cash and cash equivalents | 24,006 | 4,618 |
| CASH AND CASH EQUIVALENTS, beginning of period | 14,042 | 15,385 |
| CASH AND CASH EQUIVALENTS, end of period | \$ 38,048 | \$ 20,003 |
| Supplemental cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | \$ 10,008 | \$ 13,187 |
| Income taxes, net of refunds | \$ 38,967 | \$ 28,672 |

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See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation and Description of Business—Tempur-Pedic International Inc., a Delaware corporation, together with its subsidiaries is a U.S. based, multinational company. The term “Tempur-Pedic International” refers to Tempur-Pedic International Inc. only, and the term “Company” refers to Tempur-Pedic International Inc. and its consolidated subsidiaries.

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

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for interim financial reporting. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements of the Company and related footnotes for the year ended December 31, 2009, included in the Company’s annual report on Form 10-K.

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

(b) Basis of Consolidation—The accompanying Condensed Consolidated Financial Statements include the accounts of Tempur-Pedic International, its wholly-owned subsidiaries and its majority-owned subsidiaries in which a controlling interest is held. Intercompany balances and transactions have been eliminated. The noncontrolling interest represents the portion of equity interests of consolidated affiliates not owned by the Company. On January 29, 2010, the Company established a 51% interest in Tempur Shanghai Holding Ltd (a Hong Kong company).

(c) 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. The Company’s results are affected by economic, political, legislative, regulatory and legal actions. Economic conditions, such as recessionary trends, inflation, interest and monetary exchange rates, government fiscal policies and changes in the prices of raw materials, can have a significant effect on operations. While the Company maintains reserves for anticipated liabilities and carries various levels of insurance, the Company could be affected by civil, criminal, regulatory or administrative actions, claims or proceedings.

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

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| | September 30, 2010 | December 31, 2009 |
|----------------------------|-----------------------|----------------------|
| Finished goods | \$ 51,588 | \$ 41,805 |
| Work-in-process | 6,136 | 6,654 |
| Raw materials and supplies | 10,451 | 9,227 |
| Inventories | \$ 68,175 | \$ 57,686 |

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

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

The Company had the following activity for sales returns from December 31, 2009 to September 30, 2010:

| | |
|----------------------------------|-----------|
| Balance as of December 31, 2009 | \$4,233 |
| Amounts accrued | 34,034 |
| Returns charged to accrual | (32,996) |
| Balance as of September 30, 2010 | \$5,271 |

(f) **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 charged to operations in the period in which the related revenue is recognized. Estimates of warranty expenses are based primarily on historical claim experience and product testing. Warranties are included in Accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheets.

The Company had the following activity for warranties from December 31, 2009 to September 30, 2010:

| | |
|----------------------------------|----------|
| Balance as of December 31, 2009 | \$4,052 |
| Amounts accrued | 3,186 |
| Warranties charged to accrual | (3,138) |
| Balance as of September 30, 2010 | \$4,100 |

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

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company regularly reviews the adequacy of its allowance for doubtful accounts. The Company determines the allowance based on historical write-off experience and current economic conditions and also considers factors such as customer credit, past transaction history with the customer and changes in customer payment terms when determining whether the collection of a receivable is reasonably assured. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The allowance for doubtful accounts included in Accounts receivable, net in the accompanying Condensed Consolidated Balance Sheets was \$9,464 and \$9,030 as of September 30, 2010 and December 31, 2009, respectively.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(h) 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.

(i) Research and Development Expenses—Research and development expenses for new products are expensed as they are incurred and included in General, administrative and other expenses in the accompanying Condensed Consolidated Statements of Income. Research and development costs charged to expense were approximately \$1,714 and \$1,481 for the three months ended September 30, 2010 and 2009, respectively. For the nine months ended September 30, 2010 and 2009, research and development costs charged to expense were \$5,263 and \$4,580, respectively.

(j) Subsequent Events—On October 15, 2010 the Company's Board of Directors approved the purchase of an additional \$50,000 of its common stock under the previously approved July 2010 authorization. The total amount of the Company's common stock available for repurchase under this authorization is \$100,000. Share repurchases under this authorization may be made through open market transactions, negotiated purchases or otherwise, at times and in such amounts as management and a committee of the Board deem appropriate; these repurchases may be funded by operating cash flows and/or borrowings under the Company's credit facility. This share repurchase program may be limited, suspended or terminated at any time without notice.

(2) Goodwill and Other intangible assets

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

| | North America | International | Total |
|--|---------------|---------------|------------|
| Balance as of December 31, 2009 | \$ 89,929 | \$ 103,462 | \$ 193,391 |
| Goodwill from acquisition | 18,581 | — | 18,581 |
| Foreign currency translation adjustments and other | (228) | (21) | (249) |
| Balance as of September 30, 2010 | \$ 108,282 | \$ 103,441 | \$ 211,723 |

On April 1, 2010, the Company acquired its third party distributor in Canada. The total amount of cash paid for the acquisition was \$18,692. Additional payments may be made to the former owners if certain financial targets are met; the present value of these payments as of the acquisition date was \$6,241. Accordingly, the acquisition date fair value of the consideration transferred was \$24,933. The Company estimated the fair value of the contingent consideration using a probability-weighted discounted cash flow model, which represents Level 3 fair value measure under U.S. GAAP.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date. The Company is in the process of finalizing its purchase price allocation and accordingly, fair value estimates may change as valuations and assessments are completed.

| | |
|-------------------------------|----------|
| Net working capital | \$456 |
| Deferred tax liability | (1,955) |
| Property, plant and equipment | 322 |
| Intangible assets | 7,529 |

| | |
|----------------------|----------|
| Goodwill | 18,581 |
| Total purchase price | \$24,933 |

Intangible assets are comprised of \$5,639 related to reacquired rights with a useful life of 3 years and \$1,890 related to customer relationships with a useful life of 5 years. The goodwill was assigned to the North American segment. None of the goodwill is expected to be deductible for income tax purposes.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

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

| | Useful Lives (Years) | September 30, 2010 | | | December 31, 2009 | | |
|--|----------------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
| | | 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 | \$ 12,667 | \$ 3,333 | \$ 16,000 | \$ 11,467 | \$ 4,533 |
| Patents & other trademarks | 5-20 | 12,033 | 8,436 | 3,597 | 11,876 | 8,002 | 3,874 |
| Customer database | 5 | 4,824 | 4,668 | 156 | 4,855 | 4,593 | 262 |
| Foam formula | 10 | 3,700 | 2,929 | 771 | 3,700 | 2,652 | 1,048 |
| Reacquired rights | 3 | 5,570 | 927 | 4,643 | — | — | — |
| Customer relationships | 5 | 1,866 | 187 | 1,679 | — | — | — |
| Other intangible assets, net | | \$ 98,993 | \$ 29,814 | \$ 69,179 | \$ 91,431 | \$ 26,714 | \$ 64,717 |

Amortization expense relating to intangible assets for the Company was \$1,219 and \$600 for the three months ended September 30, 2010 and 2009, respectively. For the nine months ended September 30, 2010 and 2009 amortization expense relating to intangible assets was \$3,123 and \$1,810 respectively. No impairments of goodwill or other intangible assets have adjusted the gross carrying amount of these assets in any historical period.

(3) Long-term Debt

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

| | September 30, 2010 | December 31, 2009 |
|---|-----------------------|----------------------|
| 2005 Senior Credit Facility: | | |
| Domestic Long-Term Revolving Credit Facility payable to lenders, interest at Index Rate or LIBOR plus applicable margin (3.00% and 3.72% as of September 30, 2010 and December 31, 2009, respectively), commitment through and due June 8, 2012 | \$ 436,000 | \$ 294,000 |
| Foreign Long-Term Revolving Credit Facility payable to lenders, interest at Index Rate or LIBOR plus applicable margin (2.06% as of December 31, 2009), commitment through and due June 8, 2012 | — | 3,470 |

| | | | | |
|----------------|----|---------|----|---------|
| Long-term debt | \$ | 436,000 | \$ | 297,470 |
|----------------|----|---------|----|---------|

(b) Secured Credit Financing—On October 18, 2005, the Company entered into a credit agreement (2005 Senior Credit Facility) with a syndicate of banks. The 2005 Senior Credit Facility, as amended, consists of domestic and foreign credit facilities (Revolvers) that provide for the incurrence of indebtedness up to an aggregate principal amount of \$640,000 and matures in 2012. The domestic credit facility is a five-year, \$615,000 revolving credit facility (Domestic Revolver). The foreign credit facility is a five-year \$25,000 revolving credit facility (Foreign Revolver). The Revolvers provide for the issuance of letters of credit which, when issued, constitute usage and reduce availability under the Revolvers. The aggregate amount of letters of credit outstanding under the Revolvers was \$13,106 at September 30, 2010. After giving effect to letters of credit and \$436,000 in borrowings under the Revolvers, total availability under the Revolvers was \$190,894 as of September 30, 2010. Both credit facilities bear interest at a rate equal to the 2005 Senior Credit Facility's applicable margin, as determined in accordance with a performance pricing grid set forth in Amendment No. 3 (the variable interest rate and certain fees paid in connection with the 2005 Senior Credit Facility are subject to periodic adjustment based on changes in the consolidated leverage ratio), plus one of the following indexes: London Inter-Bank Offering Rate (LIBOR) and for U.S. dollar-denominated loans only, a base rate. The base rate of U.S. dollar-denominated loans is defined as the higher of the Bank of America prime rate or the Federal Funds rate plus .50%. The Company also pays an annual facility fee on the total amount of the 2005 Senior Credit Facility. The facility fee is calculated based on the consolidated leverage ratio and ranges from .125% to .25%.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

The 2005 Senior Credit Facility is guaranteed by Tempur-Pedic International, as well as certain other subsidiaries of Tempur-Pedic International, and is secured by certain fixed and intangible assets of Dan-Foam ApS and substantially all the Company's U.S. assets. The 2005 Senior Credit Facility contains certain financial covenants and requirements affecting the Company, including a consolidated interest coverage ratio and a consolidated leverage ratio. The Company was in compliance with all covenants as of September 30, 2010.

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

(4) Fair Value Measurements

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

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

The classification of fair value measurements within the hierarchy is based upon the lowest level of input that is significant to the measurement. At September 30, 2010 and December 31, 2009, the Company had an interest rate swap and foreign currency forward contracts recorded at fair value. The fair values of these instruments were measured using valuations based upon quoted prices for similar assets and liabilities in active markets (Level 2) and are valued by reference to similar financial instruments, adjusted for credit risk and restrictions and other terms specific to the contracts. The following table provides a summary by level of the fair value of financial instruments that are measured on a recurring basis:

| | September 30, 2010 | Fair Value Measurements at September 30, 2010 Using: | | |
|------------------------------------|-----------------------|---|---|--|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets: | | | | |
| Foreign currency forward contracts | \$ 99 | \$ — | \$ 99 | \$ — |
| Liabilities: | | | | |
| Interest rate swap | \$ 2,862 | \$ — | \$ 2,862 | \$ — |

Fair Value Measurements at December 31, 2009

| | December 31, 2009 | Using: | | |
|------------------------------------|----------------------|---|---|--|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Liabilities: | | | | |
| Foreign currency forward contracts | \$ 438 | \$ — | \$ 438 | \$ — |
| Interest rate swap | \$ 6,865 | \$ — | \$ 6,865 | \$ — |

The carrying value of Cash and cash equivalents, Accounts receivable and Accounts payable approximate fair value because of the short-term maturity of those instruments. Borrowings under the 2005 Senior Credit Facility (as defined in Note 3(b)) are at variable interest rates and accordingly their carrying amounts approximate fair value.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(5) Derivative Financial Instruments

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

Interest Rate Risk

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

As a result of this swap, the Company pays at a fixed rate and receives payment at a variable rate. The swap effectively fixed the floating LIBOR-based interest rate to 3.755% on \$350,000 of the outstanding balance under the 2005 Senior Credit Facility, with the outstanding balance subject to the swap declining over time. As of September 30, 2010 the total notional amount of the Company's interest rate swap agreement is \$200,000, amortizes to \$100,000 on November 28, 2010 and expires on May 31, 2011. The Company will select the LIBOR-based rate on the hedged portion of the 2005 Senior Credit Facility during the term of the swap. The effective portion of the change in value of the swap is reflected as a component of comprehensive income and recognized as Interest expense, net as payments are paid or accrued. The remaining gain or loss in excess of the cumulative change in the present value of the future cash flows of the hedged item, if any (i.e., the ineffective portion) or hedge components excluded from the assessment of effectiveness are recognized as Interest expense, net during the current period.

Within the next 12 months, the Company expects to reclassify \$2,862 of deferred losses on derivative instruments from Accumulated Other Comprehensive Loss (OCL) to earnings due to the payment of variable interest associated with the 2005 Senior Credit Facility.

Foreign Currency Exposures

The Company is exposed to foreign currency risk primarily related to intercompany debt and associated interest payments. To manage the risk associated with fluctuations in foreign currencies, the Company enters into foreign currency forward contracts. The Company does not designate any of these foreign currency forward contracts as hedging instruments, however, the Company considers the contracts as economic hedges. Accordingly, changes in the fair value of these instruments affect earnings during the current period. These foreign currency forward contracts protect against the reduction in value of forecasted foreign currency cash flows resulting from payments in foreign

currencies. The fair value of foreign currency agreements are estimated as described in Note 4, "Fair Value Measurements" taking into consideration foreign currency rates and the current creditworthiness of the counterparties or the Company, as applicable.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

As of September 30, 2010, the Company had foreign currency forward contracts with expiration dates ranging from October 1, 2010 through January 28, 2011. The changes in fair value of these foreign currency hedges are included as a component of Other (expense) income, net. As of September 30, 2010 the Company had the following outstanding foreign currency forward contracts:

| Currency | Currency Denomination |
|----------------------|-----------------------|
| Great Britain Pound | £ 6,953 |
| Japanese Yen | ¥ 445,101 |
| Swedish Krona | kr. 26,841 |
| Norwegian Krone | kr. 2,884 |
| Australian Dollar | \$ 2,165 |
| New Zealand Dollar | \$ 1,702 |
| Singapore Dollar | \$ 658 |
| United States Dollar | \$ 7,984 |

As of September 30, 2010 and December 31, 2009, the fair value of the Company's derivative instruments were recorded as follows:

| | Asset Derivatives | | | |
|---|---|------------|---|------------|
| | September 30, 2010 | | December 31, 2009 | |
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives not designated as hedging instruments | | | | |
| Foreign exchange forward contracts | Prepaid expenses and other current assets | \$ 99 | Prepaid expenses and other current assets | \$ — |
| | | \$ 99 | | \$ — |

| Liability Derivatives | |
|-----------------------|-------------------|
| September 30, 2010 | December 31, 2009 |

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| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
|---|--|------------|--|------------|
| Derivatives designated as hedging instruments | | | | |
| Interest rate swap | Accrued expenses and other current liabilities | \$ 2,862 | Other non-current liabilities | \$ 6,865 |
| Derivatives not designated as hedging instruments | | | | |
| Foreign exchange forward contracts | Accrued expenses and other current liabilities | \$ — | Accrued expenses and other current liabilities | \$ 438 |
| | | \$ 2,862 | | \$ 7,303 |

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

The effect of derivative instruments on the accompanying Condensed Consolidated Statements of Income for the three months ended September 30, 2010 was as follows:

| | Amount of Gain/(Loss) Recognized in Accumulated OCL on Derivative (Effective Portion) | Location of Gain/(Loss) Reclassified from Accumulated OCL into Income (Effective Portion) | Amount of Gain/(Loss) Reclassified from Accumulated OCL into Income (Effective Portion) | Location of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|--|--|---|---|--|--|
| Derivatives Designated as Cash Flow Hedging Relationships | | | | | |
| Interest rate swap | \$ 1,280 | Interest expense, net | \$ (1,734) | Interest expense, net | \$ — |
| Derivatives Not Designated as Hedging Instruments | | | Location of Gain/(Loss) Recognized in Income on Derivative | | Amount of Gain/(Loss) Recognized in Income on Derivative |
| Foreign exchange forward contracts | | Other (expense) | income, net | | \$ 38 |

For the three months ended September 30, 2009:

| | Amount of Gain/(Loss) Recognized in Accumulated OCL on Derivative (Effective Portion) | Location of Gain/(Loss) Reclassified from Accumulated OCL into Income (Effective Portion) | Amount of Gain/(Loss) Reclassified from Accumulated OCL into Income (Effective Portion) | Location of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|--|--|---|---|--|--|
| Derivatives Designated as Cash Flow Hedging Relationships | | | | | |
| Interest rate swap | \$ 794 | Interest expense, net | \$ (2,445) | Interest expense, net | \$ — |
| Derivatives Not Designated as Hedging Instruments | | | Location of Gain/(Loss) Recognized in Income on Derivative | | Amount of Gain/(Loss) Recognized in Income |

| | | | |
|------------------------------------|-----------------------------|---------------|----------|
| Foreign exchange forward contracts | Other (expense) income, net | on Derivative | \$ (222) |
|------------------------------------|-----------------------------|---------------|----------|

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

The effect of derivative instruments on the accompanying Condensed Consolidated Statements of Income for the nine months ended September 30, 2010 was as follows:

| | Amount of Gain/(Loss) Recognized in Accumulated OCL on Derivative (Effective Portion) | Location of Gain/(Loss) Reclassified from Accumulated OCL into Income (Effective Portion) | Amount of Gain/(Loss) Reclassified from Accumulated OCL into Income (Effective Portion) | Location of Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|--|--|---|---|--|---|
| Derivatives Designated as Cash Flow Hedging Relationships | | | | | |
| Interest rate swap | \$ 4,003 | Interest expense, net | \$ (5,222) | Interest expense, net | \$ — |

| Derivatives Not Designated as Hedging Instruments | Location of Gain/(Loss) Recognized in Income on Derivative | Amount of Gain/(Loss) Recognized in Income on Derivative |
|--|--|--|
| Foreign exchange forward contracts | Other (expense) income, net | \$ (1,315) |

For the nine months ended September 30, 2009:

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

| Derivatives Not Designated as Hedging Instruments | Location of Gain/(Loss) Recognized in Income on Derivative | Amount of Gain/(Loss) Recognized in Income |
|--|--|---|
| | | |

| | | |
|------------------------------------|-----------------------------|---------------|
| Foreign exchange forward contracts | Other (expense) income, net | on Derivative |
| | | \$ (2,367) |

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(6) Stockholders' Equity

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

(b) Share Repurchase Programs—On October 16, 2007, the Board of Directors authorized a repurchase authorization of up to \$300,000 of the Company's common stock. On January 13, 2010 the Board of Directors approved a share repurchase program of up to \$100,000 of the Company's common stock, which replaced the October 2007 authorization. The Company repurchased 3,694 shares of the Company's common stock for \$100,000 from the January 2010 authorization and completed the purchases from this authorization in February 2010. On April 15, 2010, the Board of Directors approved an additional share repurchase authorization of up to \$100,000 of the Company's common stock. The Company repurchased 2,992 shares of the Company's common stock for \$100,000 from the April 2010 authorization and completed the purchases from this authorization in May 2010. On July 15, 2010 the Board of Directors approved an additional share repurchase program of up to \$100,000 of the Company's common stock. The Company repurchased 1,814 shares of the Company's common stock for \$50,000 from the July 2010 authorization. As of September 30, 2010 the Company has \$50,000 remaining under the July 2010 authorization. Share repurchases under this authorization may be made through open market transactions, negotiated purchases or otherwise, at times and in such amounts as management and a committee of the Board deem appropriate; these repurchases may be funded by operating cash flows and/or borrowings under our credit facility. This share repurchase program may be limited, suspended or terminated at any time without notice.

(7) Other Items

(a) Property, plant and equipment—

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

| | September 30, 2010 | December 31, 2009 |
|---|-----------------------|----------------------|
| Land and buildings | \$ 121,858 | \$ 123,743 |
| Machinery and equipment, furniture and fixtures and other | 206,376 | 202,474 |
| Construction in progress | 12,871 | 8,107 |
| | 341,105 | 334,324 |
| Accumulated depreciation | (178,195) | (161,827) |
| Property, plant and equipment, net | \$ 162,910 | \$ 172,497 |

(b) Accrued expenses and other current liabilities—

Accrued expenses and other current liabilities consisted of the following:

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| | September 30, 2010 | December 31, 2009 |
|--|-----------------------|----------------------|
| Salary and related expenses | \$ 19,606 | \$ 18,131 |
| Accrued unrecognized tax benefits | 11,981 | 12,544 |
| Accrued sales and value added taxes | 13,464 | 11,472 |
| Warranty accrual | 4,100 | 4,052 |
| Sales returns | 5,271 | 4,233 |
| Interest rate swap | 2,862 | — |
| Other | 37,177 | 31,020 |
| Accrued expenses and other current liabilities | \$ 94,461 | \$ 81,452 |

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(c) Accumulated other comprehensive loss—

Accumulated other comprehensive loss consisted of the following:

| | September 30, 2010 | December 31, 2009 |
|---|-----------------------|----------------------|
| Derivative instruments accounted for as hedges, net of tax of \$1,117 and \$2,678, respectively | \$ (1,745) | \$ (4,187) |
| Foreign currency translation | (5,333) | (3,817) |
| Accumulated other comprehensive loss | \$ (7,078) | \$ (8,004) |

(d) Comprehensive income

The components of comprehensive income consisted of the following:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income attributable to common stockholders | \$ 44,198 | \$ 25,684 | \$ 110,852 | \$ 55,879 |
| Derivative instruments accounted for as hedges, net of taxes of \$499, \$310, \$1,561 and \$1,175, respectively | 781 | 484 | 2,442 | 1,837 |
| Cumulative translation adjustment | 11,804 | 2,423 | (1,516) | 3,152 |
| Comprehensive income attributable to common stockholders | 56,783 | 28,591 | 111,778 | 60,868 |
| Comprehensive loss (income) attributable to the noncontrolling interest | 60 | — | (44) | — |
| Total comprehensive income | \$ 56,723 | \$ 28,591 | \$ 111,822 | \$ 60,868 |

(8) Stock-Based Compensation

The Company currently has three stock-based compensation plans: the 2002 Option Plan (2002 Plan), the Amended and Restated 2003 Equity Incentive Plan (2003 Plan) and the 2003 Employee Stock Purchase Plan (ESPP), which are described under the caption “Stock-based Compensation” in the notes to the Consolidated Financial Statements of the Company’s Annual Report on Form 10-K for the year ended December 31, 2009. Effective February 1, 2010, the Company suspended offerings under the ESPP indefinitely.

In the first quarter of 2010, the Compensation Committee of the Board of Directors approved the terms of a Long-Term Incentive Program (LTIP), established under the 2003 Plan. For 2010, the LTIP awards consist of a mix of stock options and performance-based restricted stock units (PRSUs). Shares with respect to the PRSUs will be granted and vest following the end of the applicable performance period and achievement of applicable performance metrics as determined by the Compensation Committee of the Board of Directors.

The Company granted PRSUs during the nine months ended September 30, 2010. The maximum number of shares to be awarded under the PRSUs granted during the nine months ended September 30, 2010 will be 418 shares, and will vest, if earned, at the end of the three-year performance period ending on December 31, 2012. No PRSUs were granted during the three months ended September 30, 2010. Actual payout under the PRSUs granted in 2010 is dependent upon the achievement of certain financial goals, based on Net sales and Earnings Before Interest and Taxes (EBIT) margin targets. The Company recognized compensation expense of \$359 and \$822 associated with the 2010 PRSUs during the three and nine months ended September 30, 2010, respectively. Based on current estimates of the performance metrics, unrecognized compensation expense with respect to the PRSUs was \$3,085 as of September 30, 2010, which is expected to be recorded over the weighted average remaining life of 2.25 years. No PRSUs were granted during the nine months ended September 30, 2009.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

The Company granted options to purchase 30 and 192 shares of common stock during the three and nine months ending September 30, 2010. The Company recognized compensation expense of \$265 and \$545 associated with the 2010 grants during the three and nine months ended September 30, 2010, respectively. The Company granted new options to purchase 36 and 1,730 shares of common stock during the three and nine months ending September 30, 2009, respectively. The Company recognized compensation expense of \$559 and \$1,036 associated with the 2009 grants during the three and nine months ended September 30, 2009, respectively. As of September 30, 2010, there was \$2,020 of unrecognized compensation expense associated with the options granted in 2010, which is expected to be recorded over the weighted average remaining vesting period of 2.29 years. The options granted in the three months ended September 30, 2010 had a weighted average grant-date fair value of \$14.03 per option, as determined by the Black-Scholes option pricing model using the following assumptions:

| | |
|------------------------------------|---------------|
| Expected volatility of stock | 72.7 - 72.8 % |
| Expected life of options, in years | 4.0 |
| Risk-free interest rate | 1.1 % |
| Expected dividend yield on stock | 1.1 – 1.5 % |

The Company granted 188 awards during the nine months ended September 30, 2010 that consisted of restricted stock units (RSUs) and deferred stock units (DSUs). No RSUs or DSUs were granted during the three months ended September 30, 2010. The Company recognized compensation expense of \$497 and \$1,140 associated with the 2010 RSUs and DSUs during the three and nine months ended September 30, 2010, respectively. As of September 30, 2010, there was \$4,121 of unrecognized compensation expense associated with the RSUs and DSUs granted in 2010, which is expected to be recorded over the weighted average remaining vesting period of 2.15 years.

The Company recorded \$2,614 and \$2,355 of total stock-based compensation expense for the three months ended September 30, 2010 and 2009, respectively. The Company recorded \$7,953 and \$6,448 of total stock-based compensation expense for the nine months ended September 30, 2010 and 2009, respectively.

(9) Commitments and Contingencies

(a) Purchase Commitments—The Company will, from time to time, enter into limited purchase commitments for the purchase of certain raw materials. Amounts committed under these programs were not significant as of September 30, 2010 or December 31, 2009.

(b) Antitrust Action—On January 5, 2007, a purported class action was filed against the Company in the United States District Court for the Northern District of Georgia, Rome Division (Jacobs v. Tempur-Pedic International, Inc. and Tempur-Pedic North America, Inc., or the Antitrust Action). The Antitrust Action alleges violations of federal antitrust law arising from the pricing of Tempur-Pedic mattress products by Tempur-Pedic North America and certain distributors. The action alleges a class of all purchasers of Tempur-Pedic mattresses in the United States since January 5, 2003, and seeks damages and injunctive relief. Count Two of the complaint was dismissed by the court on June 25, 2007, based on a motion filed by the Company. Following a decision issued by the United States Supreme Court in *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.* on June 28, 2007, the Company filed a motion to dismiss the remaining two counts of the Antitrust Action on July 10, 2007. On December 11, 2007, that motion was granted and, as a result, judgment was entered in favor of the Company and the plaintiffs' complaint was dismissed with prejudice. On December 21, 2007, the plaintiffs filed a "Motion to Alter or Amend Judgment," which was fully briefed.

On May 1, 2008, that motion was denied. The Jacobs appealed the dismissal of their claims, and the parties argued the appeal before the United States Circuit Court for the Eleventh Circuit on December 11, 2008. The matter has been taken under advisement by the court. The Company continues to strongly believe that the Antitrust Action lacks merit, and intends to defend against the claims vigorously. Based on the findings of the court to date and an assessment of the Company's meritorious defenses, the Company believes that it is remote that it will incur a loss with respect to this matter. However, due to the inherent uncertainties of litigation, the Company cannot predict the outcome of the Antitrust Action at this time, and can give no assurance that these claims will not have a material adverse affect on the Company's financial position or results of operation.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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(In thousands, except per common share amounts)

(c) New York Attorney General—In December 2008, the Office of the Attorney General of the State of New York, Antitrust Bureau (OAG) requested that the Company consider discontinuing its unilateral retail price policy (UPPL) in the State of New York, and informed the Company that it may bring an enforcement action against the Company under New York law if the Company chose not to do so. On March 29, 2010, the Office of the Attorney General filed suit in New York state court against the Company with respect to this matter. The complaint does not charge the Company with any violation of state or federal antitrust law; instead it claims the Company violated a 1975 New York state law which declares certain contractual provisions to be unenforceable and not actionable at law and seeks, among other things, a permanent injunction prohibiting the Company's UPPL as well as unspecified sums for restitution and disgorgement profits. The Company responded to the complaint and also filed motions to dismiss and to obtain discovery. On September 28, 2010, the court heard various motions filed by the parties and took them under advisement. The Company believes that its UPPL complies with state and federal law and intends to vigorously defend it. No claim for damages has been received by the Company. Based on the early stages of the litigation, the Company cannot make an estimate of the possible range of loss. However, due to the inherent uncertainties of this matter, the Company cannot at this time predict the outcome of the enforcement action and can give no assurance that these claims will not have a material adverse affect on its financial position or results of operation.

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

(10) Income Taxes

The Company's effective tax rate for the three and nine months ended September 30, 2010 was 30.5% and 31.9%, respectively. The Company's effective income tax rate for the three and nine months ended September 30, 2010 differed from the federal statutory rate of 35.0% principally because of the tax benefit from the release of a previously recorded foreign uncertain tax position, certain foreign tax rate differentials, state and local income taxes, foreign income currently taxable in the U.S., the production activities deduction and certain other permanent differences.

The Company's effective tax rate for the three and nine months ended September 30, 2009 was 32.7% and 34.1%, respectively. The Company's effective income tax rate for the three and nine months ended September 30, 2009 differed from the federal statutory rate of 35.0% principally because of certain foreign tax rate differentials, state and local income taxes, foreign income currently taxable in the U.S., the production activities deduction and certain other permanent differences.

The Company has not provided for U.S. federal and/or state income and foreign withholding taxes on \$219,056 of undistributed earnings from non-U.S. operations as of September 30, 2010 because Tempur-Pedic International intends to reinvest such earnings indefinitely outside of the United States. If these earnings were to be distributed, foreign tax credits may become available under current law to reduce the resulting U.S. income tax liability.

During the fourth quarter of 2007 the Company received an income tax assessment from the Danish Tax Authority with respect to the 2001, 2002 and 2003 tax years and an assessment with respect to the 2004 tax year during the third quarter of 2010. The tax assessments relate to the royalty paid by one of Tempur-Pedic International's U.S. subsidiaries to a Danish subsidiary and the position taken by the Danish Tax Authority could apply to subsequent years. The total tax assessment is approximately \$69,300 including interest and penalties. In the first quarter of 2008 and the third quarter of 2010, the Company filed timely complaints with the Danish National Tax Tribunal denying

the tax assessments. The National Tax Tribunal formally agreed to place the Danish tax litigation on hold pending the outcome of a Bilateral Advance Pricing Agreement (Bilateral APA) between the United States and the Danish Tax Authority. A Bilateral APA involves an agreement between the Internal Revenue Service (IRS) and the taxpayer, as well as a negotiated agreement with one or more foreign competent authorities under applicable income tax treaties. During the third quarter of 2008 the Company filed the Bilateral APA with the IRS and the Danish Tax Authority. The IRS began analyzing the Bilateral APA in the first quarter of 2009 and expects to finalize its position during 2011. The Company believes it has meritorious defenses to the proposed adjustments and will oppose the assessments in the Danish courts, as necessary. It is reasonably possible the amount of unrecognized tax benefits may change in the next twelve months. An estimate of the amount of such change cannot be made at this time.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

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

During the three months ended September 30, 2010, the liability for unrecognized tax benefits decreased by \$1,299 primarily related to a favorable determination by a foreign tax jurisdiction regarding a previously recorded uncertain tax position. During the nine months ended September 30, 2010, the liability for unrecognized tax benefits decreased by \$690 primarily related to a favorable determination by a foreign tax jurisdiction regarding a previously recorded uncertain tax position and interest on previously recorded liabilities.

(11) Earnings Per Common Share

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Numerator: | | | | |
| Net income attributable to common stockholders | \$ 44,198 | \$ 25,684 | \$ 110,852 | \$ 55,879 |
| Denominator: | | | | |
| Denominator for basic earnings per common share-weighted average shares | 69,199 | 74,938 | 71,065 | 74,902 |
| Effect of dilutive securities: | | | | |
| Employee stock options | 2,234 | 1,228 | 2,385 | 494 |
| Denominator for diluted earnings per common share-adjusted weighted average shares | 71,433 | 76,166 | 73,450 | 75,396 |
| Basic earnings per common share | \$ 0.64 | \$ 0.34 | \$ 1.56 | \$ 0.75 |
| Diluted earnings per common share | \$ 0.62 | \$ 0.34 | \$ 1.51 | \$ 0.74 |

The Company excluded 173 and 2,039 shares issuable upon exercise of outstanding stock options for the three months ended September 30, 2010 and 2009, respectively, and 120 and 4,372 shares issuable upon exercise of outstanding stock options for the nine month periods ended September 30, 2010 and 2009, respectively, from the Diluted earnings per common share computation because their exercise price was greater than the average market price of Tempur-Pedic International's common stock or they were otherwise anti-dilutive.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(12) Business Segment Information

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

The following table summarizes Total assets by segment:

| | September 30, 2010 | December 31, 2009 |
|---------------------------|-----------------------|----------------------|
| Total assets: | | |
| North America | \$ 568,915 | \$ 481,942 |
| International | 323,536 | 274,112 |
| Intercompany eliminations | (176,501) | (112,675) |
| | \$ 715,950 | \$ 643,379 |

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

The following table summarizes segment information:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net sales from external customers: | | | | |
| North America | | | | |
| Mattresses | \$ 150,941 | \$ 103,122 | \$ 405,013 | \$ 265,133 |
| Pillows | 18,307 | 13,216 | 46,494 | 34,090 |
| Other | 45,439 | 29,939 | 121,955 | 74,232 |
| | \$ 214,687 | \$ 146,277 | \$ 573,462 | \$ 373,455 |
| International | | | | |
| Mattresses | \$ 48,227 | \$ 46,688 | \$ 141,850 | \$ 128,149 |
| Pillows | 15,654 | 15,170 | 46,139 | 41,363 |
| Other | 17,217 | 15,947 | 51,267 | 43,395 |
| | \$ 81,098 | \$ 77,805 | \$ 239,256 | \$ 212,907 |
| | \$ 295,785 | \$ 224,082 | \$ 812,718 | \$ 586,362 |
| Inter-segment sales: | | | | |
| North America | 169 | — | 169 | — |
| International | \$ 634 | \$ 686 | \$ 1,295 | \$ 1,255 |
| Intercompany eliminations | (803) | (686) | (1,464) | (1,255) |
| | \$ — | \$ — | \$ — | \$ — |
| Gross profit: | | | | |
| North America | \$ 101,835 | \$ 63,786 | \$ 263,753 | \$ 157,032 |
| International | 48,919 | 42,923 | 139,851 | 117,869 |
| | \$ 150,754 | \$ 106,709 | \$ 403,604 | \$ 274,901 |
| Operating income: | | | | |
| North America | \$ 45,498 | \$ 21,710 | \$ 108,622 | \$ 43,737 |
| International | 22,656 | 20,966 | 65,672 | 53,982 |
| | \$ 68,154 | \$ 42,676 | \$ 174,294 | \$ 97,719 |
| Depreciation and amortization (including stock-based compensation amortization): | | | | |
| North America | \$ 8,545 | \$ 7,979 | \$ 25,148 | \$ 22,855 |
| International | 2,233 | 2,388 | 6,675 | 7,119 |
| | \$ 10,778 | \$ 10,367 | \$ 31,823 | \$ 29,974 |
| Capital expenditures: | | | | |
| North America | \$ 3,116 | \$ 2,548 | \$ 7,043 | \$ 4,636 |
| International | 2,516 | 1,685 | 5,287 | 4,325 |
| | \$ 5,632 | \$ 4,233 | \$ 12,330 | \$ 8,961 |

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

The following discussion and analysis should be read in conjunction with the Condensed Consolidated Financial Statements and accompanying notes included in this Form 10-Q. Unless otherwise noted, all of the financial information in this report is condensed consolidated information for Tempur-Pedic International Inc. or its predecessor. The forward-looking statements in this discussion regarding the mattress and pillow industries, our expectations regarding our future performance, liquidity and capital resources and other non-historical statements in this discussion include numerous risks and uncertainties, as described under "Special Note Regarding Forward-Looking Statements" and "Risk Factors" elsewhere in this quarterly report on Form 10-Q and in our annual report on Form 10-K for the year ended December 31, 2009. 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.

In this discussion and analysis, the Company explains the financial condition and results of operations for Tempur-Pedic International Inc. for the three and nine month periods ended September 30, 2010 and 2009 that includes the following points:

- An overview of our business and strategy;
- Our Net sales and costs in the periods presented as well as changes between periods;
- Discussion of new initiatives that may affect our future results of operations and financial condition;
- Expected future expenditures for capital projects and sources of liquidity for future operations; and
- The effect of the foregoing on our overall financial performance and condition, as well as factors that could affect our future performance.

Executive Overview

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

We sell our premium mattresses and pillows through four distribution channels: Retail (furniture and bedding, specialty and department stores); Direct (direct response and internet); Healthcare (chiropractors, medical retailers, hospitals and other healthcare markets); and Third party distributors in countries where we do not sell directly through our own subsidiaries.

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

On April 1, 2010, we purchased our Third party distributor in Canada. Accordingly, Net sales in the Canadian market are reported in the appropriate channels within the North American segment. As Canada represented essentially all sales through the North American Third party channel, we will no longer be reporting Third party sales in this segment.

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Strategy and Outlook

Our goal is to become the world's favorite mattress and pillow brand. In order to achieve this long-term goal while managing through the current economic environment, we expect to continue to pursue certain key strategic goals using the related strategies discussed below.

- Make sure everyone knows that they would sleep better on a Tempur-Pedic - we plan to continue to invest in increasing our global brand awareness through advertising campaigns that further associate our brand name with overall sleep and premium quality products.
- Make sure there is a Tempur-Pedic bed and pillow that appeals to everyone – we plan to continue to maintain our focus on premium mattresses and pillows and regularly introducing new products.
- Make sure that Tempur-Pedic is available to everyone - we plan to expand our points of distribution and the effectiveness of our distribution channels.
- Make sure that Tempur-Pedic continues to deliver the best sleep – we plan to continue to invest in product research and development.

In pursuing these strategic goals, we expect to continue to optimize our cost structure in order to enable these marketing and product development investments.

Results of Operations

Key financial highlights for the three and nine months ended September 30, 2010 include the following:

- Earnings per common share (EPS) were \$0.62 per diluted common share for the three months ended September 30, 2010 compared to \$0.34 for the three months ended September 30, 2009. For the nine months ended September 30, 2010 EPS were \$1.51 compared to \$0.74 for the same period in 2009.
- Net sales for the three months ended September 30, 2010 rose to \$295.8 million from \$224.1 million for the three months ended September 30, 2009. Net sales for the nine months ended September 30, 2010 increased to \$812.7 million from \$586.4 million for the same period in 2009.
 - Our Gross profit margin for the three months ended September 30, 2010 was 51.0% compared to 47.6% for the three months ended September 30, 2009. For the nine months ended September 30, 2010 our Gross profit margin was 49.7% compared to 46.9% for the same period in 2009.
- During the nine months ended September 30, 2010, we repurchased 8.5 million shares of our common stock at a total cost of \$250.0 million. These purchases were funded by increased borrowings under our domestic revolving credit facility and operating cash flow.

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| (In thousands, except per common share amounts) | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|--|-------------------------------------|--------|------------|--------|------------------------------------|--------|------------|--------|
| | 2010 | | 2009 | | 2010 | | 2009 | |
| Net sales | \$ 295,785 | 100.0% | \$ 224,082 | 100.0% | \$ 812,718 | 100.0% | \$ 586,362 | 100.0% |
| Cost of sales | 145,031 | 49.0 | 117,373 | 52.4 | 409,114 | 50.3 | 311,461 | 53.1 |
| Gross profit | 150,754 | 51.0 | 106,709 | 47.6 | 403,604 | 49.7 | 274,901 | 46.9 |
| Selling and marketing expenses | 53,215 | 18.0 | 39,272 | 17.5 | 146,273 | 18.0 | 108,335 | 18.5 |
| General, administrative and other expenses | 29,385 | 10.0 | 24,761 | 11.0 | 83,037 | 10.2 | 68,847 | 11.7 |
| Operating income | 68,154 | 23.0 | 42,676 | 19.1 | 174,294 | 21.5 | 97,719 | 16.7 |
| Interest expense, net | (4,068) | (1.4) | (4,311) | (1.9) | (11,043) | (1.4) | (13,359) | (2.3) |
| Other (expense) income, net | (624) | (0.1) | (214) | (0.1) | (525) | (0.1) | 404 | 0.1 |
| Income before income taxes | 63,462 | 21.5 | 38,151 | 17.1 | 162,726 | 20.0 | 84,764 | 14.5 |
| Income tax provision | 19,324 | 6.5 | 12,467 | 5.6 | 51,830 | 6.4 | 28,885 | 4.9 |
| Net income | 44,138 | 15.0 | 25,684 | 11.5 | 110,896 | 13.6 | 55,879 | 9.6 |
| Net loss (income) attributable to the noncontrolling interest | 60 | — | — | — | (44) | — | — | — |
| Net income attributable to common stockholders | \$ 44,198 | 15.0 % | \$ 25,684 | 11.5 % | \$ 110,852 | 13.6 % | \$ 55,879 | 9.6 % |
| Earnings per common share: | | | | | | | | |
| Basic | \$ 0.64 | | \$ 0.34 | | \$ 1.56 | | \$ 0.75 | |
| Diluted | 0.62 | | 0.34 | | 1.51 | | 0.74 | |
| Weighted average common shares outstanding: | | | | | | | | |
| Basic | 69,199 | | 74,938 | | 71,065 | | 74,902 | |
| Diluted | 71,433 | | 76,166 | | 73,450 | | 75,396 | |

Three Months Ended September 30, 2010 Compared with Three Months Ended September 30, 2009

A summary of Net sales, by channel and by segment, is set forth below:

| (in thousands) | CONSOLIDATED Three Months Ended September 30, | | NORTH AMERICA Three Months Ended September 30, | | INTERNATIONAL Three Months Ended September 30, | |
|----------------|---|------|--|------|--|------|
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |

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| | | | | | | |
|-------------|------------|------------|------------|------------|-----------|-----------|
| Retail | \$ 261,425 | \$ 191,012 | \$ 197,586 | \$ 129,883 | \$ 63,839 | \$ 61,129 |
| Direct | 17,072 | 12,245 | 14,192 | 10,600 | 2,880 | 1,645 |
| Healthcare | 8,158 | 8,942 | 2,909 | 2,804 | 5,249 | 6,138 |
| Third Party | 9,130 | 11,883 | — | 2,990 | 9,130 | 8,893 |
| | \$ 295,785 | \$ 224,082 | \$ 214,687 | \$ 146,277 | \$ 81,098 | \$ 77,805 |

A summary of Net sales, by product and by segment, is set forth below:

| (in thousands) | CONSOLIDATED | | NORTH AMERICA | | INTERNATIONAL | |
|----------------|--------------------|------------|--------------------|------------|--------------------|-----------|
| | Three Months Ended | | Three Months Ended | | Three Months Ended | |
| | September 30, | | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Mattresses | \$ 199,168 | \$ 149,810 | \$ 150,941 | \$ 103,122 | \$ 48,227 | \$ 46,688 |
| Pillows | 33,961 | 28,386 | 18,307 | 13,216 | 15,654 | 15,170 |
| Other | 62,656 | 45,886 | 45,439 | 29,939 | 17,217 | 15,947 |
| | \$ 295,785 | \$ 224,082 | \$ 214,687 | \$ 146,277 | \$ 81,098 | \$ 77,805 |

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Net sales. Net sales for the three months ended September 30, 2010 increased to \$295.8 million from \$224.1 million for the same period in 2009, an increase of \$71.7 million, or 32.0%. In 2009 our industry was adversely affected by an unstable macroeconomic environment which had an adverse impact on our Net sales. However, during 2010, we have experienced a significant improvement in Net sales. We believe our revenues have been gaining momentum primarily as a result of investments made in marketing, research and development and product introductions. We were well positioned to make these investments because we maintained our financial flexibility during the economic downturn. Consolidated Mattress sales increased \$49.4 million, or 32.9% compared to the third quarter of 2009. The increase in Mattress sales occurred primarily in our Retail channel with Net sales increasing to \$261.4 million from \$191.0 million for the same period in 2009, an increase of \$70.4 million, or 36.9%. Consolidated Pillow sales increased approximately \$5.6 million, or 19.6%, from the third quarter of 2009. Consolidated Other, which includes adjustable bed bases, foundations and other related products, increased \$16.8 million, or 36.5%. Many of our Pillows and Other products are sold with mattress purchases. Therefore, when Mattress sales increase, Pillows and Other products are also impacted. The principal factors that impacted Net sales for each segment are discussed below, in the respective segment discussion.

North America. North American Net sales for the three months ended September 30, 2010 increased to \$214.7 million from \$146.3 million for the same period in 2009, an increase of \$68.4 million, or 46.8%. Our North American Retail channel contributed \$197.6 million in Net sales for the three months ended September 30, 2010 for an increase of \$67.7 million, or 52.1%, compared to the same period in 2009. The introduction of our new product line, the TEMPUR-Cloud™ collection, in the third quarter of 2009 has been well received by retailers and consumers. During the third quarter of 2010 we began the rollout of the third product in the Cloud line, the TEMPUR-Cloud Luxe™. We believe these products appeal to a new consumer segment and have increased our Net sales. Additionally, we believe that our “Ask Me” advertising campaign has had a positive impact on our performance. As a result, North American mattress sales in the third quarter of 2010 increased \$47.8 million, or 46.4%, over the same period in 2009, driven by an increase in our Retail channel. Net sales in the Direct channel increased by \$3.6 million, or 33.9%. We believe increased sales in the Direct channel are a result of our focus on building brand awareness and encouraging consumers to visit our website through our advertisements. Pillow sales increased \$5.1 million, or 38.5% for the three months ended September 30, 2010. Other Net sales increased \$15.5 million, or 51.8%, compared to the same period in 2009. Many of our Pillows and Other products are sold with mattress purchases. Therefore, when Mattress sales increase, Pillows and Other products are also impacted. Additionally, we have emphasized and are experiencing improved attach rates on adjustable bed bases which are sold at a higher price point than traditional foundations.

International. International Net sales for the three months ended September 30, 2010 increased to \$81.1 million from \$77.8 million for the same period in 2009, an increase of \$3.3 million, or 4.2%. On a constant currency basis, our International Net sales increased approximately 10.6%. We have experienced some stabilization of the global economic slowdown in our international markets, which also impacted Net sales in the third quarter of 2009. The International Retail channel increased \$2.7 million, or 4.4%, for the three months ended September 30, 2010. Third party Net sales increased \$0.2 million or 2.7%. Our introduction of the Sensation mattress line in the International segment has continued to be well accepted by retailers and consumers. As a result, International Mattress sales in the third quarter of 2010 increased \$1.5 million, or 3.3%, over the third quarter of 2009. Pillow sales for the third quarter of 2010 increased \$0.5 million, or 3.2%, as compared to the third quarter of 2009. Other Net sales increased \$1.3 million, or 8.0%, as compared to the third quarter of 2009. Many of our Pillows and Other products are sold with mattress purchases. Therefore, when Mattress sales increase, Pillows and Other products are also impacted.

Gross profit. Gross profit for the three months ended September 30, 2010 increased to \$150.8 million from \$106.7 million for the same period in 2009, an increase of \$44.0 million, or 41.3%. The Gross profit margin for the three months ended September 30, 2010 was 51.0% as compared to 47.6% for the same period in 2009. Our Gross profit margin is impacted by, among other factors, geographic mix between segments. The principal factors that impacted Gross profit margin during the quarter are identified and discussed below in the respective segment discussions.

North America. North American Gross profit for the three months ended September 30, 2010 increased to \$101.8 million, an improvement of \$38.0 million, or 59.7%. The Gross profit margin in our North American segment was 47.4% and 43.6% for the three months ended September 30, 2010 and 2009, respectively. Improvements in our North American Gross profit margin were primarily driven by fixed cost leverage related to higher production volumes, improved efficiencies in manufacturing and favorable product and channel mix. These factors were partially offset by higher commodity costs. Additionally, the North American segment pays a royalty to our International segment based on its production volume, which has the effect of lowering the segment's reported Gross profit margin. North American Cost of sales for the three months ended September 30, 2010 increased to \$112.9 million from \$82.5 million for the same period in 2009, an increase of \$30.4 million, or 36.8%.

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International. International Gross profit for the three months ended September 30, 2010 increased to \$48.9 million, an improvement of \$6.0 million, or 14.0%. The Gross profit margin in our International segment was 60.3% and 55.2% for the three months ended September 30, 2010 and September 30, 2009, respectively. Improvements in our International Gross profit margin were primarily driven by fixed cost leverage related to higher production volumes, improved efficiencies in manufacturing and favorable product and channel mix. These factors were partially offset by higher commodity costs. Additionally, the International segment receives a royalty from our North American segment based on their production volume, which has the effect of increasing the segment's reported Gross profit margin. Our International Cost of sales for the three months ended September 30, 2010 decreased to \$32.2 million from \$34.9 million for the same period in 2009, a decrease of \$2.7 million, or 7.7%.

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. We also include in Selling and marketing expense certain new product development costs, including market research and new product testing. In the third quarter of 2010, Selling and marketing expenses increased to \$53.2 million as compared to \$39.3 million for the three months ended September 30, 2009. Selling and marketing expenses as a percentage of Net sales were 18.0% and 17.5% for the three months ended September 30, 2010 and 2009, respectively. Our advertising expense for the three months ended September 30, 2010 was \$25.4 million or 8.6% of Net sales compared to \$18.6 million or 8.3% for the same period in 2009. Our objective is to align advertising costs to reflect our sales expectations. During the third quarter of 2010 we continued to make investments in advertising to support future growth. For example, our marketing and advertising campaign "Ask Me," which launched in 2009, focuses on increasing awareness of our products and the benefits they offer through word-of-mouth and social networking outlets.

General, administrative and other expenses. General, administrative and other expenses include management compensation, information technology, professional fees, depreciation of furniture and fixtures, leasehold improvements and computer equipment, expenses for administrative functions and research and development costs. General, administrative and other expenses increased to \$29.4 million for the three months ended September 30, 2010 as compared to \$24.8 million for the three months ended September 30, 2009. The increase in General, administrative and other expenses are primarily a result of a larger bonus pool in the third quarter of 2010 compared to 2009 and an increase in professional fees related to strategic research studies. The effects of these items have been partially offset by a decrease in legal fees in 2010 compared to 2009. Research and Development expense for the three months ended September 30, 2010 was \$1.7 million compared to \$1.5 million for the same period in 2009. In 2010 we have increased our investment in research and development in order to improve our existing product lines and continue to introduce new and differentiated products. General, administrative and other expenses as a percentage of Net sales were 10.0% and 11.0% in the third quarter of 2010 and 2009, respectively.

Interest expense, net. Interest expense, net, includes the interest costs associated with our borrowings and the amortization of deferred financing costs related to those borrowings. Interest expense, net, decreased to \$4.1 million for the three months ended September 30, 2010, as compared to \$4.3 million for the three months ended September 30, 2009, a decrease of \$0.2 million, or 5.6%. The decrease in interest expense is primarily attributable to a decrease in the portion of the underlying debt subject to our interest rate swap, offset by an increase in debt outstanding not subject to the interest rate swap. As we increase our borrowings, we are subject to variable rate debt that is not protected under the interest rate swap described below. Currently, the interest rate on our variable rate debt is lower than the fixed rate of the interest rate swap. Accordingly, if interest rates increase we may incur a higher level of interest expense. The variable interest rate and certain fees that we pay in connection with the 2005 Senior Credit Facility are subject to periodic adjustment based on changes in our consolidated leverage ratio. In May 2008, we entered into an interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. Under this swap, we pay at a fixed rate and receive payments at a variable rate. The swap effectively fixes the floating London Inter-bank Offering Rate (LIBOR) based interest rate to 3.755% on \$200.0 million of the outstanding balance as of September 30, 2010 under the 2005 Senior Credit Facility, with the outstanding balance subject to the

swap declining to \$100.0 million on November 28, 2010 and expiring on May 31, 2011.

Income tax provision. Income tax provision includes income taxes associated with taxes currently payable and deferred taxes, and it includes the impact of net operating losses for certain of our domestic and foreign operations. Our effective tax rate for the three months ended September 30, 2010 and September 30, 2009 was 30.5% and 32.7%, respectively. The primary difference between the September 30, 2010 and September 30, 2009 effective tax rate is the tax benefit from the release of a previously recorded foreign uncertain tax position.

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Nine Months Ended September 30, 2010 Compared with Nine Months Ended September 30, 2009

A summary of Net sales, by channel and by segment, is set forth below:

| (In thousands) | CONSOLIDATED | | NORTH AMERICA | | INTERNATIONAL | |
|----------------|-------------------|------------|-------------------|------------|-------------------|------------|
| | Nine Months Ended | | Nine Months Ended | | Nine Months Ended | |
| | September 30, | | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Retail | \$ 701,316 | \$ 497,109 | \$ 513,969 | \$ 328,870 | \$ 187,347 | \$ 168,239 |
| Direct | 51,813 | 32,759 | 44,950 | 28,506 | 6,863 | 4,253 |
| Healthcare | 25,954 | 26,105 | 9,200 | 8,184 | 16,754 | 17,921 |
| Third Party | 33,635 | 30,389 | 5,343 | 7,895 | 28,292 | 22,494 |
| | \$ 812,718 | \$ 586,362 | \$ 573,462 | \$ 373,455 | \$ 239,256 | \$ 212,907 |

A summary of Net sales, by product and by segment, is set forth below:

| (In thousands) | CONSOLIDATED | | NORTH AMERICA | | INTERNATIONAL | |
|----------------|-------------------|------------|-------------------|------------|-------------------|------------|
| | Nine Months Ended | | Nine Months Ended | | Nine Months Ended | |
| | September 30, | | September 30, | | September 30, | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Mattresses | \$ 546,863 | \$ 393,282 | \$ 405,013 | \$ 265,133 | \$ 141,850 | \$ 128,149 |
| Pillows | 92,633 | 75,453 | 46,494 | 34,090 | 46,139 | 41,363 |
| Other | 173,222 | 117,627 | 121,955 | 74,232 | 51,267 | 43,395 |
| | \$ 812,718 | \$ 586,362 | \$ 573,462 | \$ 373,455 | \$ 239,256 | \$ 212,907 |

Net sales. Net sales for the nine months ended September 30, 2010 increased to \$812.7 million from \$586.4 million for the same period in 2009, an increase of \$226.4 million, or 38.6%. In 2009 our industry was adversely affected by an unstable macroeconomic environment which had an adverse impact on our Net sales. However, during 2010, we have experienced a significant improvement in Net sales. We believe our revenues have been gaining momentum primarily as a result of investments made in marketing, research and development and product introductions. We were well positioned to make these investments because we maintained our financial flexibility during the economic downturn. Consolidated Mattress sales increased \$153.6 million, or 39.1%, compared to the nine months ended September 30, 2009. The increase in Mattress sales occurred primarily in our Retail channel with Net sales for the nine months increasing to \$701.3 million from \$497.1 million for the same period in 2009, an increase of \$204.2 million, or 41.1%. Consolidated Pillow sales increased to \$92.6 million from \$75.5 million for the same period in 2009, an increase of \$17.2 million, or 22.8%. Consolidated Other Net sales increased to \$173.2 million from \$117.6 million for the same period in 2009, an increase of \$55.6 million or 47.3%. Many of our Pillows and Other products are sold with mattress purchases. Therefore, when Mattress sales increase, Pillows and Other products are also impacted. The principal factors that impacted Net sales for each segment are discussed below, in the respective segment discussion.

North America. North American Net sales for the nine months ended September 30, 2010 increased to \$573.5 million from \$373.5 million for the same period in 2009, an increase of \$200.0 million, or 53.6%. Our North American Retail channel contributed \$514.0 million in Net sales for the nine months ended September 30, 2010 for an increase of \$185.1 million, or 56.3%, compared to the same period in 2009. The introduction of our new product line, the TEMPUR-Cloud™ collection, in the third quarter of 2009 has been well received by retailers and consumers. We believe these products appeal to a new consumer segment and have increased our Net sales. In January 2010, we launched the second mattress in this line, the TEMPUR-Cloud™. During the third quarter of 2010 we began the rollout of the third mattress in this line, the TEMPUR-Cloud Luxe™. Additionally, we believe that our “Ask Me” advertising campaign has had a positive impact on our performance. As a result, North American Mattress sales increased \$139.9

million, or 52.8%, over the same period in 2009, driven by the increase in our Retail channel. Net sales in the Direct channel increased to \$45.0 million from \$28.5 million during the same period in 2009, an increase of \$16.4 million, or 57.7%. We believe increased sales in the Direct channel are a result of our focus on building brand awareness and encouraging consumers to visit our website through our advertisements. Pillow sales increased \$12.4 million, or 36.4%, over the same period in 2009. Other Net sales increased \$47.7 million, or 64.3%, compared to the same period in 2009. Many of our Pillows and Other products are sold with mattress purchases. Therefore, when Mattress sales increase, Pillows and Other products are also impacted. Additionally, we have emphasized and are experiencing improved attach rates on adjustable bed bases which are sold at a higher price point than traditional foundations.

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International. International Net sales for the nine months ended September 30, 2010 increased to \$239.3 million from \$212.9 million for the same period in 2009, an increase of \$26.3 million, or 12.4%. On a constant currency basis, our International Net sales increased approximately 13.2%. We have experienced some stabilization of the global economic slowdown in our international markets, which also impacted Net sales in 2009. The International Retail channel increased \$19.1 million, or 11.4%, for the nine months ended September 30, 2010. Third party Net sales increased \$5.8 million or 25.8%. Our introduction of the Sensation mattress line in the International segment has continued to be well accepted by retailers and consumers. As a result, International Mattress sales increased \$13.7 million, or 10.7%, as compared to 2009. Pillow sales for 2010 increased \$4.8 million, or 11.5%, compared to the same period in 2009. Other product Net sales increased \$7.9 million, or 18.1%, as compared to 2009. Many of our Pillows and Other products are sold with mattress purchases. Therefore, when Mattress sales increase, Pillows and Other products are also impacted.

Gross profit. Gross profit for the nine months ended September 30, 2010 increased to \$403.6 million from \$274.9 million for the same period in 2009, an increase of \$128.7 million, or 46.8%. The Gross profit margin for the nine months ended September 30, 2010 was 49.7% as compared to 46.9% for the same period in 2009. Our Gross profit margin is impacted by, among other factors, geographic mix between segments. The principal factors that affected Gross profit margin during the year are identified and discussed below, in the respective segment discussion.

North America. North American Gross profit for the nine months ended September 30, 2010 increased to \$263.8 million from \$157.0 million for the same period in 2009, an increase of \$106.7 million, or 68.0%. The Gross profit margin in our North American segment was 46.0% and 42.0% for the nine months ended September 30, 2010 and September 30, 2009, respectively. Improvements in our North American Gross profit margin were primarily driven by fixed cost leverage related to higher production volumes and improved efficiencies in manufacturing. These factors were partially offset by new product introductions and higher commodity costs. Additionally, the North American segment pays a royalty to our International segment based on its production volume, which has the effect of lowering the segment's reported Gross profit margin. Our North American cost of sales increased to \$309.7 million for the nine months ended September 30, 2010 as compared to \$216.4 million for the nine months ended September 30, 2009, an increase of \$93.3 million, or 43.1%.

International. International Gross profit for the nine months ended September 30, 2010 increased to \$139.9 million from \$117.9 million for the same period in 2009, an increase of \$22.0 million, or 18.6%. The Gross profit margin in our International segment was 58.5% and 55.4% for the nine months ended September 30, 2010 and September 30, 2009, respectively. For the nine months ended September 30, 2010, improvements in our International Gross profit margin were primarily driven by fixed cost leverage related to higher production volumes and improved efficiencies in manufacturing. These factors were partially offset by new product introductions and higher commodity costs. Additionally, the International segment receives a royalty from our North American segment based on their production volume, which has the effect of increasing the segment's reported Gross profit margin. Our International Cost of sales for the nine months ended September 30, 2010 increased to \$99.4 million from \$95.0 million for the same period in 2009, an increase of \$4.4 million, or 4.6%.

Selling and marketing expenses. Selling and marketing expenses increased to \$146.3 million for the nine months ended September 30, 2010 as compared to \$108.3 million for the nine months ended September 30, 2009. Selling and marketing expenses as a percentage of Net sales decreased to 18.0% for the nine months ended September 30, 2010 from 18.5% for the same period for 2009. Our advertising expense for the nine months ended September 30, 2010 was \$70.6 million or 8.7% of Net sales compared to \$48.1 million or 8.2% for the same period in 2009. During 2010 we have continued to make investments in advertising to support future growth. For example, our marketing and advertising campaign "Ask Me," which launched in 2009, focuses on increasing awareness of our products and the benefits they offer through word-of-mouth and social networking outlets.

General, administrative and other expenses. General, administrative and other expenses increased to \$83.0 million for the nine months ended September 30, 2010 as compared to \$68.8 million for the nine months ended September 30, 2009, an increase of \$14.2 million, or 20.6%. The increase in General, administrative and other expenses are primarily a result of a larger bonus pool in 2010 compared to 2009 and an increase in professional fees related to strategic research studies. The effects of these items have been partially offset by a lower level of bad debt expense in 2010 compared to 2009. Research and Development expense for the nine months ended September 30, 2010 was \$5.3 million compared to \$4.6 million for the same period in 2009. In 2010 we have increased our investment in research and development in order to improve our existing product lines and continue to introduce new and differentiated products. General, administrative and other expenses as a percentage of Net sales was 10.2% and 11.7% for the nine months ended September 30, 2010 and September 30, 2009, respectively.

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Interest expense, net. Interest expense, net, decreased to \$11.0 million for the nine months ended September 30, 2010, as compared to \$13.4 million for the nine months ended September 30, 2009, a decrease of \$2.3 million, or 17.3%. The decrease in interest expense is primarily attributable to a decrease in the portion of the underlying debt subject to our interest rate swap, offset slightly by an increase in debt outstanding not subject to the interest rate swap. As we increase our borrowings, we are subject to variable rate debt that is not protected under the interest rate swap described below. Currently, the interest rate on our variable rate debt is lower than the fixed rate of the interest rate swap. Accordingly, if interest rates increase we may incur a higher level of interest expense. The variable interest rate and certain fees that we pay in connection with the 2005 Senior Credit Facility are subject to periodic adjustment based on changes in our consolidated leverage ratio. In May 2008, we entered into an interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. Under this swap, we pay at a fixed rate and receive payments at a variable rate. The swap effectively fixes the floating LIBOR based interest rate to 3.755% on \$200.0 million of the outstanding balance as of September 30, 2010 under the 2005 Senior Credit Facility, with the outstanding balance subject to the swap declining to \$100.0 million on November 28, 2010 and expiring on May 31, 2011.

Income tax provision. Our effective tax rate for the nine months ended September 30, 2010 was 31.9%. For the same period in 2009, the effective tax rate was 34.1%. The decrease in the effective tax rate is primarily due to the tax benefit from the release of a previously recorded foreign uncertain tax position and a tax charge on a previously recognized foreign tax benefit taken in the first quarter of 2009.

Liquidity and Capital Resources

Liquidity

Our principal sources of funds are cash flows from operations and borrowings made pursuant to the 2005 Senior Credit Facility. Principal uses of funds consist of share repurchases made from time to time pursuant to share repurchase authorizations, acquisition of certain former third party distributors, payments of principal and interest on our debt facilities and capital expenditures. At September 30, 2010, we had working capital of \$90.8 million including Cash and cash equivalents of \$38.0 million compared to working capital of \$72.5 million including \$14.0 million in Cash and cash equivalents as of December 31, 2009. Working capital increased in the third quarter of 2010 primarily as a result of an increase in Cash and cash equivalents as of September 30, 2010.

Our cash flow from operations increased to \$139.7 million for the nine months ended September 30, 2010 from \$120.4 million for the nine months ended September 30, 2009. The increase in operating cash flow for the nine month period ended September 30, 2010 compared to the nine month period ended September 30, 2009 was primarily driven by Net income growth, offset by changes in operating assets and liabilities. The increases in Accounts receivable, Inventories and Income taxes payable are related to increased sales.

Net cash used in investing activities increased to \$31.2 million for the nine months ended September 30, 2010 as compared to \$9.0 million for the nine months ended September 30, 2009, primarily related to the acquisition of our former third party distributor in Canada and an increase in capital expenditures. In 2010 we are investing in capital projects that we believe will create operational efficiencies and support future growth.

Cash flow used by financing activities was \$84.7 million for the nine months ended September 30, 2010 as compared to \$103.1 million used for the nine months ended September 30, 2009, representing a decrease in cash flow used of \$18.4 million, primarily related to an increase in current borrowings under the 2005 Senior Credit Facility. These borrowings were primarily utilized to complete \$250.0 million in share repurchases of our common stock. Additionally, we received \$22.0 million in proceeds from stock option exercises during the nine months ended September 30, 2010 as compared to no proceeds for the same period in 2009.

Capital Expenditures

Capital expenditures totaled \$12.3 million for the nine months ended September 30, 2010 and \$9.0 million for the nine months ended September 30, 2009. We currently expect our 2010 capital expenditures to be approximately \$20.0 million. This expected increase in capital expenditures in 2010 is attributable to projects that we believe will create operational efficiencies and support future growth.

Debt Service

Our Long-term debt increased to \$436.0 million as of September 30, 2010 from \$297.5 million as of December 31, 2009 due primarily to our share repurchase program. After giving effect to \$436.0 million in borrowings under the 2005 Senior Credit Facility and letters of credit outstanding, total availability under the Revolvers was \$190.9 million as of September 30, 2010.

As of September 30, 2010, we are in compliance with our debt covenants. The table below sets forth the calculation of our compliance with the Funded debt to Adjusted Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) covenant. Both Funded debt and Adjusted EBITDA are terms that are not recognized under U.S. GAAP and do not purport to be alternatives to Net income as a measure of operating performance or Total debt.

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Reconciliation of Net Income to Adjusted EBITDA

The following table sets forth the reconciliation of our reported Net income to the calculation of Adjusted EBITDA for the three months ended December 31, 2009, March 31, 2010, June 30, 2010 and September 30, 2010 as well as the twelve months ended September 30, 2010:

| (In thousands) | December 31, 2009 | Three Months Ended | | | Twelve Months Ended |
|---|----------------------|--------------------|------------------|-----------------------|---------------------------|
| | | March 31, 2010 | June 30, 2010 | September 30, 2010 | September 30, 2010 |
| GAAP Net income attributable to common stockholders | \$ 29,114 | \$ 33,148 | \$ 33,506 | \$ 44,198 | \$ 139,966 |
| Plus: | | | | | |
| Interest expense | 3,990 | 3,189 | 3,786 | 4,068 | 15,033 |
| Income taxes | 14,159 | 16,021 | 16,485 | 19,324 | 65,989 |
| Depreciation & Amortization | 10,239 | 9,996 | 11,049 | 10,778 | 42,062 |
| Other (1) | — | 361 | 202 | — | 563 |
| Adjusted EBITDA | \$ 57,502 | \$ 62,715 | \$ 65,028 | \$ 78,368 | \$ 263,613 |

(1) Includes professional costs incurred in connection with the acquisition of our Canadian distributor, which closed on April 1, 2010. In accordance with our 2005 Senior Credit Facility, this amount is excluded from the calculation of Adjusted EBITDA for purposes of calculating compliance with the ratio of Funded debt to Adjusted EBITDA.

Reconciliation of Total debt to Funded debt

The following table sets forth the reconciliation of our reported Total debt to the calculation of Funded debt and Funded debt to Adjusted EBITDA ratio as of September 30, 2010:

| (In thousands) | As of September 30, 2010 |
|--------------------------------|--------------------------------|
| GAAP basis Total debt | \$ 436,000 |
| Plus: | |
| Letters of credit outstanding | 13,106 |
| Funded debt | \$ 449,106 |
| Adjusted EBITDA | \$ 263,613 |
| Funded debt to Adjusted EBITDA | 1.70 times |

The ratio of Funded debt to Adjusted EBITDA was 1.70 times, within the covenant in the 2005 Senior Credit Facility, which requires that this ratio not exceed 3.0 times.

Stockholders' Equity

Share Repurchase Program—On October 16, 2007, our Board of Directors authorized a share repurchase authorization of up to \$300.0 million of our common stock. On January 13, 2010 our Board of Directors approved a share repurchase program of up to \$100.0 million of our common stock which replaced the October 2007 authorization. During the three months ended March 31, 2010, we repurchased 3.7 million shares of our common stock for \$100.0 million and completed the January 2010 authorization. On April 15, 2010 our Board of Directors approved an

additional authorization to purchase up to \$100.0 million of our common stock. During the three months ended June 30, 2010 we repurchased 3.0 million shares of our common stock for \$100.0 million and completed the April 2010 authorization. On July 15, 2010 our Board of Directors approved an additional authorization to purchase up to \$100.0 million of our common stock. During the three months ended September 30, 2010 we repurchased 1.8 million shares of our common stock for \$50.0 million. On October 15, 2010 our Board of Directors approved the purchase of an additional \$50.0 million of our common stock under the previously approved July 2010 authorization, increasing the total available for repurchase to \$100.0 million as of October 15, 2010. Share repurchases under this authorization may be made through open market transactions, negotiated purchases or otherwise, at times and in such amounts as management and a committee of the Board deem appropriate; these repurchases may be funded by operating cash flows and/or borrowings under our credit facility. This share repurchase program may be limited, suspended or terminated at any time without notice.

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Use of Non-GAAP Measures

We provide information regarding Adjusted EBITDA and Funded debt which are not recognized terms under U.S. GAAP and do not purport to be alternatives to Net income as a measure of operating performance or Total debt. Because not all companies use identical calculations, these presentations may not be comparable to other similarly titled measures of other companies. A reconciliation of our Net income to Adjusted EBITDA and a reconciliation of Total debt to Funded debt have been provided in this Management's Discussion and Analysis and we believe the use of these non-GAAP financial measures provide investors with additional useful information with respect to our 2005 Senior Credit Facility and our compliance with the related debt covenants.

Factors That May Affect Future Performance

General Business and Economic Conditions—Our business has been affected by general business and economic conditions, and these conditions could have an impact on future demand for our products. The U.S. macroeconomic environment was challenging in 2009 and was the primary factor in a slowdown in the mattress industry. In 2010 the U.S. macroeconomic environment has improved slightly, but still remains uncertain. In addition, our International segment experienced weakening as a result of general business and economic conditions in several European and Asian markets. We expect the economic environment in the U.S. and internationally to continue to be challenging.

In light of the macroeconomic environment, we took steps to further align our cost structure with our anticipated level of Net sales. During the remainder of 2010, we expect to continue to pursue certain key strategies including: maintaining focus on premium mattresses and pillows and regularly introducing new products; investing in increasing our global brand awareness; extending our presence and improving our Retail account productivity; investing in our operating infrastructure to meet the requirements of our business; and taking actions to further strengthen our business.

Managing Growth—Over the last few years, we have had to manage our business both through periods of rapid growth and the current recovering economic environment. Our Net sales increased from \$221.5 million in 2001 to \$1,106.7 million in 2007 and decreased to \$927.8 million in 2008 and \$831.2 million for the year ended December 31, 2009. For the nine months ended September 30, 2010, our Net sales were \$812.7 million. In the past, our growth has placed, and may continue to place, a strain on our management, production, product distribution network, information systems and other resources. In response to these types of challenges, management has continued to enhance operating and financial infrastructure, as appropriate. In addition, during 2007 through 2009, we had to manage a decline in sales as a result of the macroeconomic environment. During this period, we had to manage our cost structure to contain costs. Going forward, we expect that expenditures to enhance our operating and financial infrastructure, as well as expenditures for advertising and other marketing-related activities, will continue to be made as the continued growth in the business allows us the ability to invest. However, these expenditures may be limited by lower than planned sales or an inflationary cost environment.

Gross Margins—Our gross margin is primarily impacted by fixed cost leverage, the cost of raw materials, operational efficiency, product, channel and geographic mix, volume incentives offered to certain retail accounts and costs associated with new product introductions. At the end of 2009 and into 2010 we experienced increases in our raw material pricing. Future increases in raw material prices could have a negative impact on our gross margin if we do not raise prices to cover increased cost. Our gross margin can also be impacted by our operational efficiencies, including the particular levels of utilization at our three manufacturing facilities. We have made significant investments in our manufacturing infrastructure and have significant available manufacturing capacity. If we increase our Net sales significantly the effect of this operating leverage could have a significant positive impact on our gross margin. Our margins are also impacted by the growth in our Retail channel as sales in our Retail channel are at wholesale prices whereas sales in our Direct channel are at retail prices. Additionally, our overall product mix has shifted to mattresses and other products over the last several years, which has impacted our gross margins because

mattresses generally carry lower margins than pillows and are sold with lower margin products such as foundations and bed frames. We expect our gross margins to be up for the full year 2010 through sales leverage and productivity programs partially offset by geographic segment mix and increased commodity costs.

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

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

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Significant Growth Opportunities—We believe there are significant opportunities to take market share from the innerspring mattress industry as well as other sleep surfaces. Our market share of the overall mattress industry is relatively small in terms of both dollars and units, which we believe provides us with a significant opportunity for growth. By broadening our brand awareness and offering superior sleep surfaces, we believe consumers will over time adopt our products at an increasing rate, which should expand our market share. However, our business may be affected by general business and economic conditions that could have an impact on demand for our products. Additionally, by expanding distribution within our existing accounts, we believe we have the opportunity to grow our business. By extending our product line and our new segmentation of products, we should be able to continue to expand the number of Tempur-Pedic models offered at the retail store level, which should lead to increased sales. Based on this strategy we believe a focus on expanding distribution within our existing accounts provides for continued growth opportunities and market share gains. However, our business may continue to be affected by general business and economic conditions that could have an impact on demand for our products, which could limit our market share and decrease sales. Our products are currently sold in approximately 6,900 furniture and bedding retail stores in the North American segment, out of a total of approximately 11,500 stores we have identified as appropriate targets. Within this addressable market, our plan is to increase our total penetration to a total of 8,000 to 9,000 over time. Our products are also sold in approximately 5,150 furniture retail and department stores in the International segment, out of a total of approximately 7,000 stores that we have identified as appropriate targets. We are continuing to develop products that are responsive to consumer demand in our markets internationally.

Financial Leverage—As of September 30, 2010, we had \$436.0 million of total Long-term debt outstanding, and our Equity attributable to common stockholders was \$66.6 million. Higher financial leverage makes us more vulnerable to general adverse competitive, economic and industry conditions. Since December 31, 2007, we have reduced our total debt outstanding by \$166.0 million. Our repatriation of foreign earnings in 2008 and 2009, suspension of our quarterly cash dividend and modest debt rebalancing between our North American and International segments, together with productivity improvements and cost containment initiatives enabled us to decrease our financial leverage and increase our financial flexibility. During the first nine months of 2010, we increased our total debt by \$138.5 million; however our improved financial performance over this period has mitigated the impact of this increased debt on our leverage ratios. We currently are targeting a Funded debt to Adjusted EBITDA ratio between 1.5 to 2.0 times although we may exceed this range on a temporary basis or change the target range. There can be no assurance however, that our business will generate sufficient cash flow from operations or that future borrowings will be available under our 2005 Senior Credit Facility. In May 2008, we entered into an interest rate swap to manage interest costs and the risk associated with changing interest rates. See “ITEM 3. Quantitative and Qualitative Disclosures About Market Risk—Interest Rate Risk” under Part I of this report.

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 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 effectively managing our foreign currency exchange rate risk. We typically do not apply hedge accounting to these contracts. See “ITEM 3. Quantitative and Qualitative Disclosures About Market Risk—Foreign Currency Exposures” under Part I of this report.

Critical Accounting Policies and Estimates

For a discussion of our critical accounting policies and estimates, see “ITEM 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our annual report on Form 10-K for the year ended December 31, 2009. There have been no material changes to our critical accounting policies and estimates in 2010.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exposures

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

We protect a portion of our currency exchange exposure with foreign currency forward contracts. A sensitivity analysis indicates the potential change in fair value on foreign currency forward contracts outstanding at September 30, 2010, resulting from a hypothetical 10% adverse change in all foreign currency exchange rates against the U.S. dollar, is approximately \$0.01 million. Such changes would be largely offset by gains or losses from the revaluation or settlement of the underlying assets and liabilities that are being protected by the foreign currency forward contracts.

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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 has a variable rate. In May 2008, we entered into a three year interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. Under this swap, we pay at a fixed rate and receive payments at a variable rate. The swap effectively fixes the floating LIBOR-based interest rate to 3.755% on \$350.0 million of the outstanding balance under the 2005 Senior Credit Facility, with the outstanding balance subject to the swap declining over time. As of September 30, 2010 the total notional amount of our interest rate swap agreement is \$200.0 million, amortizes to \$100.0 million on November 28, 2010 and expires on May 31, 2011.

Interest rate changes generally do not affect the market value of such debt, but do impact the amount of our interest payments and therefore, our future earnings and cash flows, assuming other factors are held constant. On September 30, 2010, we had variable-rate debt of approximately \$236.0 million. Holding other variables constant, including levels of indebtedness, a one hundred basis point increase in interest rates on our variable-rate debt would cause an estimated reduction in income before income taxes for the next year of approximately \$2.4 million.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), of the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (Exchange Act) as of the end of the period covered by this report. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of September 30, 2010 and designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

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

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

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

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "ITEM 1A. Risk Factors" in our annual report on Form 10-K for the year ended December 31, 2009, which could materially affect our business, financial condition or future results. The risks described in our annual report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and operating results.

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

During the fourth quarter of 2007 we received an income tax assessment from the Danish Tax Authority with respect to the 2001, 2002 and 2003 tax years and an assessment with respect to the 2004 tax year during the third quarter of 2010. The tax assessments relate to the royalty paid by one of Tempur-Pedic International's U.S. subsidiaries to a Danish subsidiary and the position taken by the Danish Tax Authority could apply to subsequent years. The total tax assessment is approximately \$69.3 million including interest and penalties. In the first quarter of 2008 and the third quarter of 2010, we filed timely complaints with the Danish National Tax Tribunal denying the tax assessments. The National Tax Tribunal formally agreed to place the Danish tax litigation on hold pending the outcome of a Bilateral Advance Pricing Agreement (Bilateral APA) between the United States and the Danish Tax Authority. A Bilateral APA involves an agreement between the Internal Revenue Service (IRS) and the taxpayer, as well as a negotiated agreement with one or more foreign competent authorities under applicable income tax treaties. During the third quarter of 2008 we filed the Bilateral APA with the IRS and the Danish Tax Authority. The IRS began analyzing the Bilateral APA in the first quarter of 2009 and expects to finalize its position during 2011. We believe we have meritorious defenses to the proposed adjustments and will oppose the assessments in the Danish courts, as necessary. It is reasonably possible the amount of unrecognized tax benefits may change in the next twelve months. An estimate of the amount of such change cannot be made at this time.

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

(a) Not applicable.

(b) Not applicable.

(c) Issuer Purchases of Equity Securities

The following table sets forth purchases of our common stock for the three months ended September 30, 2010:

| Period | (a) Total | (c) Total number of | (d) Maximum number of |
|--------|-----------|---------------------|-----------------------|
|--------|-----------|---------------------|-----------------------|

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| | number of shares purchased | (b) Average Price Paid per Share | shares purchased as part of publicly announced plans or programs | shares (or approximate dollar value) of shares that may yet be purchased under the plans or programs (in millions) |
|--|----------------------------------|-------------------------------------|--|--|
| July 1, 2010 – July 31, 2010 | — | — | — | — |
| August 1, 2010 – August 31, 2010 | 1,018,200 | \$26.75 | 1,018,200 | \$73.3 |
| September 1, 2010 – September 30, 2010 | 795,635 | \$28.54 | 795,635 | \$50.0 |
| Total | 1,813,835 | | 1,813,835 | |

On July 15, 2010, the Board of Directors authorized the repurchase of up to \$100.0 million of our common stock. On October 15, 2010 our Board of Directors approved the purchase of an additional \$50.0 million of our common stock under the previously approved July 2010 authorization.

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ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 5. OTHER INFORMATION

(a) Not applicable.

(b) Not applicable.

ITEM 6. EXHIBITS

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

| | |
|---------------|---|
| <u>10.1</u> | <u>Amended and Restated Employment and Non-Competition Agreement between Tempur-Pedic International Inc. and Brad Patrick effective as of September 1, 2010 (1)</u> |
| <u>31.1</u> | <u>Certification of Chief Executive Officer, pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>31.2</u> | <u>Certification of Chief Financial Officer, pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.1</u> * | <u>Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| 101 | The following materials from Tempur-Pedic International Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2010, formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statements of Income, (ii) the Condensed Consolidated Balance Sheets, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) the Notes to the Condensed Consolidated Financial Statements, tagged as blocks of text. |

(1) Indicates management contract or compensatory plan or arrangement.

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

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SIGNATURES

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

TEMPUR-PEDIC INTERNATIONAL INC.
(Registrant)

Date: October 28,
2010

By:

/s/ DALE E. WILLIAMS

Dale E. Williams
Executive Vice President and Chief Financial
Officer

