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

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

For the transition period from to

Commission file number 001-31922

TEMPUR-PEDIC INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

Delaware	**33-1022198**

(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1713 Jaggie Fox Way

Lexington, Kentucky 40511

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

(800) 878-8889

(Registrant s telephone number, including area code)

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

The number of shares outstanding of the registrant s common stock as of October 31, 2006 was 83,007,896 shares.

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Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q, including the information incorporated by reference herein, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which include information concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, the impact of the adoption of recently issued accounting pronouncements, the putative securities class action lawsuits and related lawsuits, the Company s increased presence in U.S. and International retail stores, the rollout and market acceptance of new products, our investments to increase our global brand awareness, the Company s expectations regarding its gross margin for the full year of 2006, the Company s expectations regarding additional opportunities for growth, plans to increase sales and reduce costs, the impact of increases in raw materials costs, the construction of our new manufacturing facility in New Mexico, and other information that is not historical information. Many of these statements appear, in particular, under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations in ITEM 2 of Part I of this report. When used in this report, the words estimates, expects, anticipates, projects, plans, intends, believes an variations of such words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this report. Important factors that could cause our actual results to differ materially from those expressed as forward-looking statements are set forth in this report, including under the heading Risk Factors under ITEM 1A of Part II. There may be other factors that may cause our actual results to differ materially from the forward-looking statements.

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

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

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

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

Total Stockholders Equity	**177,169**	226,329
Total Liabilities and Stockholders Equity	**$ 717,868**	$ 702,311

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)

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

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

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 share amounts)

(1) Summary of Significant Accounting Policies

(a) *Basis of Presentation and Description of Business* Tempur-Pedic International Inc., a Delaware corporation, together with its subsidiaries is a U.S.-based, multinational company. As used herein, the term Tempur-Pedic International refers to Tempur-Pedic International Inc. only, and the term Company refers to Tempur-Pedic International Inc. and its subsidiaries.

The Company manufactures, markets, and sells viscoelastic products including pillows, mattresses, and other related products. The Company manufactures essentially all its pressure-relieving TEMPUR® products at two manufacturing facilities, with one located in Denmark and one in the U.S. The Company has sales distribution subsidiaries operating in the U.S., Europe, and Asia Pacific and has third party distribution arrangements in certain other countries where it does not have subsidiaries. The Company sells its products in over 70 countries. The Company sells its products through four sales channels: Retail, Direct, Healthcare, and Third party, and extends credit based on the creditworthiness of its customers.

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information and disclosures required by generally accepted accounting principles in the United States (U.S. GAAP) for complete financial statements. Accordingly, these unaudited Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements of the Company and related footnotes for the year ended December 31, 2005, included in the Company s Annual Report on Form 10-K. The balance sheet as of December 31, 2005 has been derived from the audited consolidated financial statements as of that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

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

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

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

(d) *Use of Estimates* The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

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

	September 30, 2006	December 31, 2005
Finished goods	**$ 43,888**	$ 61,071
Work-in-process	**6,854**	7,427
Raw materials and supplies	**13,012**	12,566
	$ 63,754	$ 81,064

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

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

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

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

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

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

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

	September 30, 2006	December 31, 2005
Domestic	**$ 89,930**	$ 89,452
International	**109,328**	110,510
	$ 199,258	$ 199,962

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

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

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

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

(m) *Warranties* The Company provides a 20-year warranty for U.S. sales and a 15-year warranty for non-U.S. sales on mattresses, each prorated for the last 10 years. The Company also provides a 2-year to 3-year warranty on pillows. Estimated future obligations related to these products are provided by charges to operations in the period in which the related revenue is recognized. Warranties are included in Accrued expenses and other in the Condensed Consolidated Balance Sheets.

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

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

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

(o) *Revenue Recognition* Sales of products are recognized when the products are shipped to customers and the risks and rewards of ownership are transferred. No collateral is required on sales made in the normal course of business. The allowance for doubtful accounts is the Company s best estimate of the amount of probable credit losses in the Company s existing accounts receivable. The Company determines the allowance based on historical write-off experience. The Company reviews the adequacy of its allowance for doubtful accounts quarterly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Allowance for doubtful accounts was $5,875 and $5,436 as of September 30, 2006 and December 31, 2005, respectively. Deposits made by customers are recorded as a liability and recognized as a sale when product is shipped. The Company had $304 and $454 of deferred revenue related to such deposits included in Accrued expenses and other in the accompanying Condensed Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005, respectively.

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

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

(p) *Advertising Costs* The Company expenses advertising costs as incurred except for production costs and advance payments, which are deferred and expensed when advertisements run for the first time. Direct response advance payments are deferred and are amortized over the life of the program. Advertising costs charged to expense were approximately $22,276 and $23,630 for the three months ended September 30, 2006 and September 30, 2005, respectively. For the nine months ended September 30, 2006 and September 30, 2005, advertising costs charged to expense were approximately $71,146 and $69,913, respectively. Advertising costs deferred and included in Prepaid expenses and other current assets in the accompanying Condensed Consolidated Balance Sheets were approximately $5,783 and $6,064 as of September 30, 2006 and December 31, 2005, respectively.

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

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

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

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

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

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

(2) Recently Issued Accounting Pronouncements

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

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

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

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

(3) Property, Plant and Equipment

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

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

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

(4) Long-term Debt

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

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

principal payments due quarterly through September 30, 2010 with a final payment on October 18, 2010		
Domestic Long-Term Revolving Credit Facility payable to lenders, interest at Index Rate or LIBOR plus applicable margin (6.83% and 5.28% as of September 30, 2006 and December 31, 2005, respectively), commitment through and due October 18, 2010	**180,000**	83,000
2005 Industrial Revenue Bonds:		
Variable Rate Industrial Revenue Bonds Series 2005A, interest rate determined by remarketing agent not to exceed the lesser of (a) the highest rate under state law or (b) 12% per annum (5.31% and 4.35% as of September 30, 2006 and December 31, 2005, respectively), interest due monthly and principal due quarterly through September 1, 2030	**50,085**	53,925
Senior Subordinated Notes:		
U.S. Senior Subordinated Notes payable to institutional investors, interest at 10.25%, due August 15, 2010	**97,500**	97,500
Other:		
Mortgages payable to a bank, secured by certain property, plant and equipment and other assets, bearing fixed interest at 4.0% to 5.1%	**1,406**	1,491
	373,476	344,481
Less: Current portion	**(19,051)**	(30,770)
Long-term debt	**$ 354,425**	$ 313,711

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

The 2005 Senior Credit Facility, as amended, consists of domestic and foreign credit facilities that provide for the incurrence of indebtedness up to an aggregate principal amount of $390,000. The domestic credit facility is a five-year, $260,000 revolving credit facility (Domestic Revolver). Availability under the Domestic Revolver is reduced by $3,000 each quarter, beginning with the second quarter of 2006. The foreign credit facilities consist of a $20,000 revolving credit facility (Foreign Revolver) and $110,000 term loan (Foreign Term Loan). The various credit facilities bear interest at a rate equal to the 2005 Senior Credit Facility s applicable margin, as determined in accordance with a performance pricing grid set forth in the 2005 Senior Credit Facility, plus one of the following indexes: (i) LIBOR and (ii) for U.S. dollar-denominated loans only, a base rate (defined as the higher of (a) the Bank of America prime rate and (b) the Federal Funds rate plus .50%). The Company also pays an annual facility fee on the total amount of the 2005 Senior Credit Facility. The facility fee is calculated based on the consolidated leverage ratio and ranges from .175% to .35%.

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

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

(c) Industrial Revenue Bonds On October 27, 2005, Tempur Production USA, Inc. (Tempur Production), a subsidiary of Tempur-Pedic International, completed an industrial revenue bond financing for the construction and equipping of Tempur Production s new manufacturing facility (the Project) located in Bernalillo County, New Mexico (Bernalillo County). Under the terms of the financing, Bernalillo County will issue up to $75,000 of Series 2005A Taxable Variable Rate Industrial Revenue Bonds (the Series A Bonds). The Series A Bonds are marketed to third parties by a remarketing agent and secured by a letter of credit issued under the Company s Domestic Revolver and purchased by qualified investors. The Series A Bonds have a final maturity date of September 1, 2030. The interest rate on the Series A Bonds is a weekly rate set by the remarketing agent, in its sole discretion, though the interest rate may not exceed the lesser of (i) the highest rate allowed under New Mexico law or (ii) 12% per annum. On October 27, 2005, Tempur Production made an initial draw of $53,925 on the Series A Bonds. The Company used proceeds from the Bonds to pay down the prior domestic revolving credit facility, among other things.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

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

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

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

(5) Stockholders Equity

(a) *Capital Stock* Tempur-Pedic International authorized shares of capital stock are 300,000 sh