TEMPUR PEDIC INTERNATIONAL INC
Form 10-Q
May 08, 2006
Table of Contents

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 March 31, 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, including zip code, of registrant s principal executive offices)

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

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

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 April 30, 2006 was 84,532,839 shares.

Table of Contents

TABLE OF CONTENTS

Table of Contents

Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q, including the information incorporated by reference herein, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which include information concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, the impact of the adoption of recently issued accounting pronouncements, the Company s intention to repurchase shares of its common stock from time to time under its share repurchase program, the putative securities class action lawsuits and related lawsuits recently filed, the rollout and market acceptance of new products, plans to increase sales and reduce costs, the impact of increases in raw materials costs, the construction of our new manufacturing facility in New Mexico, and other information that is not historical information. Many of these statements appear, in particular, under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations in ITEM 2 of Part I of this report. When used in this report, the words estimates, expects, anticipates, projects, plans, intends, believes and variations of such 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 terms Tempur-Pedic International and the Company refer to Tempur-Pedic International Inc. only, and the terms we, our, ours and us refer to Tempur-Pedic International Inc. and its consolidated subsidiaries.

Table of Contents

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

	Three Months Ended March 31,	
	2006	**2005**
	(Unaudited)	**(Unaudited)**
Net sales	**$ 228,586**	$ 222,379
Cost of sales	**117,332**	108,136
Gross profit	**111,254**	114,243
Selling and marketing expenses	**44,742**	44,969
General and administrative expenses	**18,455**	19,090
Research and development expenses	**840**	804
Operating income	**47,217**	49,380
Other income (expense), net:		
Interest expense, net	**(4,457)**	(5,363)
Loss on extinguishment of debt		(717)
Other expense, net	**(93)**	(85)
Total other expense	**(4,550)**	(6,165)
Income before income taxes	**42,667**	43,215
Income tax provision	**15,774**	16,465
Net income	**$ 26,893**	$ 26,750
Earnings per share:		
Basic	**$ 0.30**	$ 0.27
Diluted	**$ 0.29**	$ 0.26
Weighted average shares outstanding:		
Basic	**89,346**	98,420
Diluted	**93,089**	103,392

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	March 31, 2006	December 31, 2005
	(Unaudited)	
ASSETS		
Current Assets:		
Cash and cash equivalents	**$ 13,181**	$ 17,855
Accounts receivable, net	**122,644**	111,726
Inventories	**78,248**	81,064
Prepaid expenses and other current assets	**10,944**	11,072
Income taxes receivable		19
Deferred income taxes	**7,098**	6,532
Total Current Assets	**232,115**	228,268
Property, plant and equipment, net	**199,858**	193,224
Goodwill	**199,868**	199,962
Other intangible assets, net	**73,109**	73,908
Deferred financing and other non-current assets, net	**7,238**	6,949
Total Assets	**$ 712,188**	$ 702,311
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	**$ 37,059**	$ 33,639
Accrued expenses and other	**63,797**	56,570
Income taxes payable	**16,427**	
Current portion of long-term debt	**26,440**	30,770
Total Current Liabilities	**143,723**	120,979
Long-term debt	**371,793**	313,711
Deferred income taxes	**40,307**	40,386
Other non-current liabilities	**471**	906
Total Liabilities	**556,294**	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 March 31, 2006 and December 31, 2005	**992**	992
Additional paid in capital	**255,653**	255,369
Deferred stock compensation net of amortization of $12,802 and $12,312 as of March 31, 2006 and December 31, 2005, respectively	**(1,706)**	(2,196)
Retained earnings	**72,237**	46,245
Accumulated other comprehensive income	**998**	1,137

Treasury stock, at cost; 14,676 and 6,767 shares as of March 31, 2006 and December 31, 2005, respectively	**(172,280)**	(75,218)
Total Stockholders Equity	**155,894**	226,329
Total Liabilities and Stockholders Equity	**$ 712,188**	$ 702,311

See accompanying Notes to Condensed Consolidated Financial Statements.

5

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Three Months Ended March 31,	
	2006	**2005**
	(Unaudited)	**(Unaudited)**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 26,893**	$ 26,750
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**6,105**	6,530
Amortization of deferred financing costs	**403**	793
Loss on extinguishment of debt		717
Amortization of stock-based compensation	**789**	884
Allowance for doubtful accounts	**930**	913
Deferred income taxes	**(658)**	(1,384)
Foreign currency adjustments	**136**	675
Loss on sale of equipment and other	**198**	510
Changes in operating assets and liabilities:		
Accounts receivable	**(10,803)**	(8,186)
Inventories	**3,078**	(8,874)
Prepaid expenses and other current assets	**385**	981
Accounts payable	**2,639**	253
Accrued expenses and other	**5,072**	(3,649)
Income taxes payable/receivable	**16,388**	17,180
Net cash provided by operating activities	**51,555**	34,093
CASH FLOWS FROM INVESTING ACTIVITIES:		
Payments for trademarks and other intellectual property	**(202)**	(474)
Purchases of property, plant and equipment	**(9,260)**	(18,738)
Proceeds from sale of equipment	**8**	83
Net cash used by investing activities	**(9,454)**	(19,129)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term revolving credit facility	**83,000**	15,000
Repayments of long-term revolving credit facility	**(4,000)**	(12,000)
Repayments of long-term debt	**(27,623)**	(31,845)
Common stock issued, including reissuances of treasury stock	**194**	690
Treasury stock repurchased	**(98,157)**	
Payments for deferred financing costs	**(619)**	
Net cash used by financing activities	**(47,205)**	(28,155)
NET EFFECT OF EXCHANGE RATE CHANGES ON CASH	430	(2,182)
Decrease in cash and cash equivalents	**(4,674)**	(15,373)

CASH AND CASH EQUIVALENTS, beginning of period	**17,855**	28,368
CASH AND CASH EQUIVALENTS, end of period	**$ 13,181**	$ 12,995
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	**$ 8,683**	$ 7,274
Income taxes, net of refunds	**$ 63**	$ 698

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

(In thousands, except per share amounts)

(1) Summary of Significant Accounting Policies

(a) *Basis of Presentation and Description of Business* Tempur-Pedic International Inc. and subsidiaries is a U.S.-based, multinational corporation incorporated in Delaware and is referred to herein with its subsidiaries as the Company.

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 and distribution companies operating in the U.S., Europe, and Asia Pacific. In addition, the Company has third party distributor arrangements in certain other countries where it does not have distribution companies. The Company sells its products in over 70 countries 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 at December 31, 2005 has been derived from the audited financial statements at 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. Income taxes payable is shown separately from Accrued expenses and other in the Condensed Consolidated Statement of Cash Flows.

(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 average rates of exchange prevailing during the period. The adjustment resulting from translating the financial statements of such foreign subsidiaries are included in Accumulated other comprehensive income, a component of Stockholders Equity. Foreign currency transaction gains and losses are reported in results of operations.

(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

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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 earnings. 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 consisted of the following:

	March 31, 2006	December 31, 2005
Finished goods	**$ 58,334**	$ 61,071
Work-in-process	**7,546**	7,427
Raw materials and supplies	**12,368**	12,566
	$ 78,248	$ 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. The Company performed the annual impairment test in the fourth quarter of 2005 on all existing goodwill and no impairment existed as of December 31, 2005. 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.

8

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

		March 31, 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**	**$ 5,467**	**$ 10,533**	$ 16,000	$ 5,067	$ 10,933
Patents	5-20	**6,010**	**3,512**	**2,498**	5,968	3,234	2,734
Customer database	5	**4,200**	**2,870**	**1,330**	4,200	2,660	1,540
Foam formula	10	**3,700**	**1,264**	**2,436**	3,700	1,172	2,528
Trademarks and other	5	**3,313**	**2,001**	**1,312**	3,146	1,973	1,173
Total		**$ 88,223**	**$ 15,114**	**$ 73,109**	$ 88,014	$ 14,106	$ 73,908

Amortization expense relating to intangible assets for Tempur-Pedic International was $1,008 and $975 for the three months ended March 31, 2006 and March 31, 2005, respectively.

The changes in the carrying amount of Goodwill for the three months ended March 31, 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	(94)
Balance as of March 31, 2006	$ 199,868

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

	March 31, 2006	December 31, 2005
Domestic	**$ 89,452**	$ 89,452
International	**110,416**	110,510
	$ 199,868	$ 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 returns. The Company allows product returns up to 120 days following a sale. Accrued sales returns are included in Accrued expenses and other in the accompanying Condensed Consolidated Balance Sheets.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

Balance as of December 31, 2005	$ 6,304
Amounts accrued	11,406
Returns charged to accrual	(10,921)
Balance as of March 31, 2006	$ 6,789

(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 March 31, 2006:

Balance as of December 31, 2005	$ 3,107
Amounts accrued	685
Warranties charged to accrual	(917)
Balance as of March 31, 2006	$ 2,875

(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. In accordance with SFAS 5, Accounting for Contingencies, 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 $4,988 and $5,436 as of March 31, 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 $248 and $454 of deferred revenue included in Accrued expenses and other in the accompanying Condensed Consolidated Balance Sheets as of March 31, 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. Amounts included in Net sales for shipping and handling on large quantity orders in our Retail sales channel were approximately $0 and $3,091 for the three months ended March 31, 2006 and March 31, 2005, respectively. We no longer separately invoice customers in the Retail channel for freight on large quantity orders. All other amounts included in Net sales for shipping and handling were approximately $3,199 and $4,059 for the three months ended March 31, 2006 and March 31, 2005, respectively. Amounts included in Cost of sales for shipping and handling were approximately $17,858 and $20,033 for the three months ended March 31, 2006 and March 31, 2005, respectively.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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 in all periods for which financial statements are 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 $26,138 and $25,780 for the three months ended March 31, 2006 and March 31, 2005, respectively. Advertising costs deferred and included in prepaid expenses and other current assets in the accompanying Condensed Consolidated Balance Sheets were approximately $5,081 and $6,064 as of March 31, 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 our Board of Directors authorized a share repurchase program (Share Repurchase Program). Shares repurchased under the Company 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.

(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. Additionally, SFAS 123R requires that the benefit of tax deductions in excess of recognized compensation expense be reported as a financing cash flow rather than an operating cash flow in the accompanying consolidated statement of cash flows. Financial results including cash flow from operating results for 2005 have not been restated for the adoption of SFAS 123R.

The effect of the adoption of SFAS 123R on the Company s results of operations was not material and is included in the Consolidated Statements of Income for the period ended March 31, 2006. The Company did not have any excess tax benefit related to the exercise of stock-options.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

Pro forma information in accordance with SFAS 123 for the Company for the three months ended March 31, 2005 is as follows:

	Three Months Ended March 31, 2005
Net income as Reported	$ 26,750
Add: Stock-based employee compensation expense included in reported net income, net of related tax benefit	843
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax benefit	(1,884)
Pro forma Net income	$ 25,709
Earnings per share:	
Basic as reported	$ 0.27
Diluted as reported	$ 0.26
Basic Pro forma Net income	$ 0.26
Diluted Pro forma Net income	$ 0.25

In December 2005, the Company 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 the Company 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. The adoption did not have a material effect on the Company s condensed consolidated financial statements.

(2) Recently Issued Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 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 did not have a material effect on the Company s condensed consolidated financial statements.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

(3) Property, Plant and Equipment

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

	March 31, 2006	December 31, 2005
Land and buildings	**$ 68,072**	$ 67,193
Machinery and equipment	**98,224**	96,298
Construction in progress	**92,245**	82,775
	258,541	246,266
Total accumulated depreciation	**(58,683)**	(53,042)
	$ 199,858	$ 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 $3,757 and $2,567 as of March 31, 2006 and December 31, 2005, respectively, in connection with the construction of assets. Additionally, Construction in progress includes $1,437 and $843 that is included in Accounts payable as of March 31, 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 Tempur-Pedic International consisted of the following:

	March 31, 2006	December 31, 2005
2005 Senior Credit Facility:		
	$ 83,344	$ 108,565

Foreign Term Loan (EUR Denominated) payable to lenders, interest at Index Rate or LIBOR plus margin (3.80% and 3.46% as of March 31, 2006 and December 31, 2005, respectively), principal payments due quarterly through June 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 (5.77% and 5.28% as of March 31, 2006 and December 31, 2005, respectively), commitment through and due October 18, 2010	**162,000**	83,000
2005 Industrial Revenue Bonds:		
Variable Rate Industrial Revenue Bonds Series 2005A, interest rate determined by remarketing agent (4.65% and 4.35% as of March 31, 2006 and December 31, 2005, respectively), interest due monthly and principal due quarterly through September 1, 2030	**53,925**	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%	**1,464**	1,491
	398,233	344,481
Less: Current portion	**(26,440)**	(30,770)
Long-term debt	**$ 371,793**	$ 313,711

13

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

(b) *Secured Credit Financing* On October 18, 2005, Tempur-Pedic International Inc. 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, Inc., 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, Tempur-Pedic International Inc. 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). 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 Inc., Tempur World, LLC and Tempur World Holdings, LLC, as well as certain other subsidiaries of the Company, and is secured by certain fixed and intangible assets of Dan Foam ApS and substantially all 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 and its subsidiaries, 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 March 31, 2006.

At March 31, 2006, the Company had a total of $280,000 of long-term revolving credit facilities under the 2005 Senior Credit Facility, which was comprised of the $260,000 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 $56,535 at March 31, 2006. After giving effect to letters of credit and $162,000 in borrowings under the Domestic Revolver, total availability under the Revolvers was $61,465 at March 31, 2006. There were no borrowings under the Foreign Revolver as of March 31, 2006.

(c) Industrial Revenue Bonds On October 27, 2005, Tempur Production USA, Inc. (Tempur Production), a subsidiary of Tempur-Pedic International Inc., 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.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

(d) *Senior Subordinated Notes* In 2003, Tempur-Pedic, Inc. and Tempur Production (Issuers) issued $150,000 aggregate principal amount of 10.25% Senior Subordinated Notes due 2010 (Senior Subordinated Notes). The Senior Subordinated Notes are unsecured senior subordinated indebtedness of the Issuers and are fully and unconditionally, and jointly and severally, guaranteed on an unsecured senior subordinated basis by the Issuers ultimate parent, Tempur-Pedic International Inc., and certain other subsidiaries of Tempur-Pedic International Inc. 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 Inc. or any of Tempur-Pedic International Inc. 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.

On January 23, 2004, the Issuers redeemed an aggregate principal amount of $52,500 of outstanding Senior Subordinated Notes. The redemption price was 110.25% of the principal amount plus accrued interest, and the redemption was funded with a portion of the net proceeds from the initial public offering of Tempur-Pedic International Inc. The Company reflected the $5,381 redemption premium as a Loss on extinguishment of debt included in Other income (expense), net in the year ended December 31, 2004.

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 March 31, 2006.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

(5) Stockholders Equity

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

On January 25, 2006, the Board of Directors amended the share repurchase program described above to increase the total authorization by an additional $100,000 resulting in a total authorization to purchase up to $180,000 of Tempur-Pedic International Inc. s common stock. From January 1, 2006 through March 31, 2006, the Company repurchased an additional 8,012 shares at a total cost of $98,157. At March 31, 2006, the Company had $5,843 in remaining authorization. The share repurchases have been and will continue to be funded from borrowings under the 2005 Senior Credit Facility and funds from operations.

(6) Stock Based Compensation

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

The 2002 Option Plan was adopted on November 1, 2002 by Tempur-Pedic International Inc. and provides for grants of options to purchase shares of common stock to employees and directors of the Company. Options granted under the 2002 Option Plan which qualify as incentive stock options, as defined by the Internal Revenue Code (the Code), must have an exercise price of not less than the fair market value of Tempur-Pedic International Inc. s common stock at the date of grant. The determination of the exercise price was made by the Board of Directors. Options granted under the 2002 Option Plan provided for vesting terms as determined by the Board of Directors at the time of grant, which are generally based on 4 years of continuous service. Options can be exercised up to 10 years from the grant date and up to 5 years from the grant date for any stockholders who own 10% or more of the total combined voting power of all shares of stock of Tempur-Pedic International Inc. The total number of shares of common stock subject to issuance under the 2002 Option Plan did not exceed 6,534 shares, which was subject to certain adjustment provisions. The Company currently anticipates there will be no additional options issued under this plan.

The 2003 Plan is administered by the Compensation Committee of the Board of Directors, which, together with the Board of Directors, has the exclusive authority, including the power to determine eligibility to receive

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

awards, the types and number of shares of stock subject to the awards, the price and timing of awards and the acceleration or waiver of any vesting, and performance of forfeiture restriction. The Compensation Committee, however, does not have the authority to waive any performance restrictions for performance-based awards. Any of the Company s employees, non-employee directors, consultants and Company advisors, as determined by the Compensation Committee, may be selected to participate in the 2003 Plan. The 2003 Plan provides for awards of stock options, stock appreciation rights, restricted stock and stock unit awards, performance shares, stock grants and performance based awards. The awards generally vest based on 4 years of continuous service and have 10-year contractual terms. The Company may issue a maximum of 8,000 shares of its common stock under the 2003 Plan.

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

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

The assumptions used in the Black-Scholes pricing model for the three months ended March 31, 2006 and March 31, 2005 are set forth in the following table. Expected volatility is based on the historical volatility of the Company s common stock. The expected life of the options represents the period of time that the Company expects the options granted are expected to be outstanding. The risk-free rate is based on the expected yield of the option over the period during its contractual life. The assumptions used in the Black-Scholes pricing model for the three months ended March 31, 2006 and March 31, 2005 are as follows:

	Three months ended March 31,	
	2006	**2005**
Expected volatility of stock	46%	34%
Expected life of option, in years	5	5
Risk-free interest rate	3%	3%
Expected dividend yield on stock	0%	0%

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

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

A summary of stock options activity under the 2002 Option Plan and 2003 Plan for the three months ended March 31, 2006 is presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options outstanding at December 31, 2005	5,979	5.13		
Granted				
Exercised	(102)	1.61		
Forfeited or expired				
Options outstanding at March 31, 2006	5,877	$ 5.22	7.5	$ 52,466
Options exercisable at March 31, 2006	3,199	$ 5.19		$ 28,675

The total intrinsic value of options exercised during the three months ended March 31, 2006 and March 31, 2005 was $1,101 and $6,626, respectively. No options were granted during the three months ended March 31, 2006 and March 31, 2005.

A summary of the Company s unvested shares as of March 31, 2006, and changes during the three months ended March 31, 2006, is presented below:

	Shares	Weighted Average Grant Date Fair Value
Options unvested at December 31, 2005	3,807	$ 6.34
Granted		
Vested	(540)	2.64
Forfeited		
Options unvested at March 31, 2006	3,267	$ 7.01

The Black-Scholes pricing model amortizes compensation expenses on a straight-line basis, and the expense is expected to be recognized over a weighted-average period of 3.7 years. The total fair value of shares vested during the three months ended March 31, 2006 and March 31, 2005 was $6,649 and $10,377, respectively. For the three months ended March 31, 2006, the Company recognized $299 of stock-based compensation expense in General and administrative expenses related to stock options granted under the 2003 Plan which were subject to SFAS 123R. As of March 31, 2006, there was $4,436 of unearned stock-based compensation expense related to these options. The future amortization of these unearned stock-based compensation costs will be $897 for the remainder of 2006, $1,196 in 2007, $1,196 in 2008 and $1,147 in 2009.

For the three months ended March 31, 2006, the Company recognized $381 of stock-based compensation expense related to options granted under the 2002 Option Plan prior to the initial public offering in 2003 which have exercise prices that are less than the deemed market value of the underlying common stock at the date of grant. As of March 31, 2006, there was $939 of unearned stock-based compensation expense. The resulting unearned stock-based compensation is amortized to compensation expense over the respective vesting term, based on the graded vesting methodology. The future amortization of these unearned stock-based compensation costs will be $724 for the remainder of 2006 and $215 in 2007.

For the three months ended March 31, 2006, the Company recognized $110 of stock-based compensation expense related to restricted stock units (RSUs) granted in December 2004. As of March 31, 2006, there was

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

$767 of unearned stock-based compensation expense related to the RSUs. The resulting unearned stock-based compensation is amortized to compensation expense over the respective vesting term on a straight-line basis. The future amortization of these unearned stock-based compensation costs will be $329 for the remainder of 2006 and $438 in 2007.

Cash received from options exercised under all stock-based compensation plans, including cash received from options issued from treasury shares, for the three months ended March 31, 2006 and March 31, 2005 was $194 and $690, respectively. The Company did not realize any excess tax benefits related to option exercises for the three months ended March 31, 2006 and March 31, 2005.

(7) Accumulated Other Comprehensive Income

The components of Accumulated other comprehensive income are as follows:

	March 31, 2006	December 31, 2005
Financial instruments accounted for as hedges	**$ (483)**	$ (478)
Foreign currency translation	**1,481**	1,615
Accumulated other comprehensive income	**$ 998**	$ 1,137

(8) Commitments and Contingencies

(a) *Purchase Commitments* As of March 31, 2006, the Company had outstanding commitments of approximately $6,696 for capital expenditures, primarily related to the construction of the production facility in Albuquerque, New Mexico. The Company will, from time to time, enter into limited purchase commitments for the purchase of certain raw materials. Amounts committed under these programs are not significant as of March 31, 2006.

(b) *Litigation* Between October 7, 2005 and November 21, 2005, five complaints were filed against Tempur-Pedic International Inc. and certain of its directors and officers in the United States District Court for the Eastern District of Kentucky (Lexington Division) purportedly on behalf of a class of shareholders who purchased Tempur-Pedic International Inc. s stock between April 22, 2005 and September 19, 2005. On

December 29, 2005, the court consolidated these five actions (the Securities Law Action). Lead plaintiffs filed a consolidated complaint on February 27, 2006. In their consolidated complaint, lead plaintiffs assert claims arising under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Lead plaintiffs allege that certain of Tempur-Pedic International Inc. s public disclosures regarding its financial performance between April 22, 2005 and September 19, 2005 were false and/or misleading. The principal allegation set forth in the Securities Law Action is that Tempur-Pedic International Inc. did not disclose the impact of competition on its prospects. The plaintiffs seek compensatory damages, costs, fees and other relief within the Court s discretion. The Company strongly believes that the Securities Law Action lacks merit, and the Company intends to defend against the claims vigorously. However, due to the inherent uncertainties of litigation, the Company cannot predict the outcome of the Securities Law Action at this time, and the Company can give no assurance that these claims will not have a material adverse affect on the Company s financial position or results of operations.

On November 10, 2005 and December 15, 2005, complaints were filed in the state courts of Delaware and Kentucky, respectively, against certain officers and directors of Tempur-Pedic International Inc., purportedly derivatively on behalf of Tempur-Pedic International Inc. (the Derivative Complaints). The Derivative

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

The Company is also party to various other legal proceedings generally incidental to its business. Although the ultimate disposition of these proceedings is not presently determinable, management does not believe that adverse determinations in any or all of such proceedings will have a materially adverse effect upon the financial condition, liquidity or results of operations of the Company.

(9) Income Taxes

The Company s effective tax rate for the three months ended March 31, 2006 was 37.0%. Reconciling items between the federal statutory income tax rate of 35.0% and the effective tax rate include state income taxes, differences in U.S. statutory rates and foreign tax rates, foreign income currently taxable in the U.S., compensation expense associated with certain options granted, production activities deduction, and certain other permanent differences. The effective tax rate was 38.1% for the three months ended March 31, 2005.

At March 31, 2006, Tempur-Pedic International had remaining undistributed earnings of $7,965 from its foreign subsidiaries determined under U.S. tax principles as of November 1, 2002 related to the period prior to the acquisition of Tempur World Inc. by Tempur-Pedic International Inc, translated into U.S. dollars at the applicable exchange rate on March 31, 2006. All pre-acquisition earnings of $60,810 related to Dan Foam ApS were distributed as part of the $155,650 repatriation plan under the Jobs Creation Act in 2005. The remaining balance of $7,965 relates to other foreign subsidiaries. No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining $7,965 of undistributed earnings, as these earnings are considered indefinitely reinvested.

In addition, Tempur-Pedic International had remaining undistributed earnings from its foreign subsidiaries determined under U.S. generally accepted accounting principles for the period November 1, 2002 through March 31, 2006 of $84,886. No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining $84,886 of undistributed earnings, as these earnings are considered indefinitely reinvested.

(10) Major Customers

Five customers accounted for approximately 13% of Tempur-Pedic International sales for the three months ended March 31, 2006. The top five customers also accounted for approximately 15% of accounts receivable as of March 31, 2006. The loss of one or more of these customers could negatively impact the Company. The composition of our top 5 customers varies between the periods ended March 31, 2006 and March 31, 2005.

20

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

(11) Earnings Per Share

	Three Months Ended March 31,	
	2006	**2005**
Numerator:		
Net income	**$ 26,893**	$ 26,750
Denominator:		
Denominator for basic earnings per share-weighted average shares	**89,346**	98,420
Effect of dilutive securities:		
Employee stock options	**3,743**	4,972
Denominator for basic earnings per share-adjusted weighted average shares	**93,089**	103,392
Basic earnings per share	**$ 0.30**	$ 0.27
Diluted earnings per share	**$ 0.29**	$ 0.26

(12) Business Segment Information

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

The following table summarizes Total assets by segment:

	March 31, 2006	December 31, 2005

Total assets:		
Corporate	**$ 593,461**	$ 372,341
Domestic	**619,875**	493,871
International	**297,472**	301,465
Intercompany eliminations	**(798,620)**	(465,366)
	$ 712,188	$ 702,311

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

The following tables summarize other segment information:

	Three Months Ended March 31,	
	2006	**2005**
Net sales from external customers:		
Corporate	$	$
Domestic	**151,516**	147,930
International	**77,070**	74,449
	$ 228,586	$ 222,379
Inter-segment sales:		
Corporate	$	$
Domestic		
International	**629**	12,400
Intercompany eliminations	**(629)**	(12,400)
	$	**$**
Operating income/(loss):		
Corporate	**$ (3,523)**	$ (4,272)
Domestic	**28,768**	33,564
International	**21,972**	20,088
	$ 47,217	$ 49,380
Depreciation and amortization (excluding stock-based compensation amortization):		
Corporate	**$ 125**	$ 104
Domestic	**3,157**	2,914
International	**2,823**	3,512
	$ 6,105	$ 6,530

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

	Three Months Ended March 31,	
	2006	**2005**
Mattresses	**$ 159,915**	$ 154,092
Pillows	**28,479**	33,331
All other	**40,192**	34,956
	$ 228,586	$ 222,379

During the course of normal operations, the Domestic segment may purchase inventory from the Danish manufacturing facility from time to time. These purchases are included in the International segment as Intercompany sales. The Intercompany profits on these sales are eliminated from the International segment when the manufacturing profit in ending finished goods inventory is eliminated during the consolidation of the Company s results. These manufacturing profits were $143 and $1,747 for the three months ended March 31, 2006 and March 31, 2005, respectively.

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

(13) Condensed Consolidating Interim Financial Information

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

Condensed Consolidating Statements of Income

For the Three Months Ended March 31, 2006

(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net sales	$	$ 1,047	$	$ 150,469	$ 77,699	$ (629)	$ 228,586
Cost of goods sold		611	(336)	84,543	33,143	(629)	117,332
Gross profit		436	336	65,926	44,556		111,254
Operating expenses	1,214	5,005	2,645	32,588	22,585		64,037
Operating income (loss)	(1,214)	(4,569)	(2,309)	33,338	21,971		42,217
Interest income (expense), net	(105)	(3,824)	505		(1,033)		(4,457)
Other income (loss)	(4)	26,247	(60)	(26,286)	10		(93)
Income taxes		9,090	(192)	237	6,639		15,774
Net income (loss)	$ (1,323)	$ 8,764	$ (1,672)	$ 6,815	$ 14,309	$	$ 26,893

23

Table of Contents

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

Condensed Consolidating Statements of Income

For the Three Months Ended March 31, 2005

(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net sales	$	$ 2,354	$	$ 145,576	$ 86,849	$ (12,400)	$ 222,379
Cost of goods sold		1,202	(322)	77,088	42,568	(12,400)	108,136
Gross profit		1,152	322	68,488	44,281		114,243
Operating expenses	1,708	5,400	2,886	30,676	24,193		64,863
Operating income (loss)	(1,708)	(4,248)	(2,564)	37,812	20,088		49,380
Interest income (expense), net		(3,889)	(992)	6	(488)		(5,363)
Other income (loss)	2						