

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

**FORM 10-Q**

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

For the quarterly period ended June 30, 2005

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-31922

**TEMPUR-PEDIC INTERNATIONAL INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
Identification No.)

**33-1022198**  
(I.R.S. Employer  
incorporation or organization)

**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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes  No

The number of shares outstanding of the registrant's common stock as of August 1, 2005 was 98,997,392 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, construction of our new manufacturing facility in New Mexico, repatriation of certain funds pursuant to the American Jobs Creation Act of 2004, the adoption of Statement of Financial Accounting Standards 123R, timing of product introductions, financing needs, and other information that is not historical information. Many of these statements appear, in particular, under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 2 of Part I of this report. When used in this report, the words “estimates,” “expects,” “anticipates,” “projects,” “plans,” “intends,” “believes” and variations of such words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct. When used in this report, 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.

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 2 of Part I. 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.

**PART I**  
**FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**(In thousands, except earnings per share)**

	Three Months Ended June 30, (Unaudited)		Six Months Ended June 30, (Unaudited)	
	2005	2004	2005	2004
Net sales	<b>\$ 192,615</b>	\$ 151,600	<b>\$ 414,994</b>	\$ 304,723
Cost of sales	<b>94,080</b>	70,787	<b>202,216</b>	142,571
Gross profit	<b>98,535</b>	80,813	<b>212,778</b>	162,152
Selling and marketing expenses	<b>38,149</b>	31,653	<b>83,118</b>	66,608
General and administrative expenses	<b>15,276</b>	15,929	<b>34,366</b>	31,291
Research and development expenses	<b>513</b>	242	<b>1,317</b>	730
Operating income	<b>44,597</b>	32,989	<b>93,977</b>	63,523
Other income (expense), net:				
Interest expense, net	<b>(4,864)</b>	(5,551)	<b>(10,227)</b>	(11,645)
Loss on extinguishment of debt	<b>—</b>	—	<b>(717)</b>	(5,381)
Other income (expense), net	<b>412</b>	116	<b>327</b>	196
Total other expense	<b>(4,452)</b>	(5,435)	<b>(10,617)</b>	(16,830)
Income before income taxes	<b>40,145</b>	27,554	<b>83,360</b>	46,693
Income tax provision	<b>15,295</b>	10,608	<b>31,760</b>	17,977
Net income	<b>\$ 24,850</b>	\$ 16,946	<b>\$ 51,600</b>	\$ 28,716
Earnings per share:				
Basic	<b>\$ 0.25</b>	\$ 0.17	<b>\$ 0.52</b>	\$ 0.29
Diluted	<b>\$ 0.24</b>	\$ 0.16	<b>\$ 0.50</b>	\$ 0.28
Weighted average shares outstanding:				
Basic	<b>98,792</b>	97,628	<b>98,607</b>	97,519
Diluted	<b>103,431</b>	103,119	<b>103,315</b>	103,010

See accompanying Notes to Condensed Consolidated Financial Statements.

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands)

	June 30, 2005	December 31, 2004
	(Unaudited)	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 28,168	\$ 28,368
Accounts receivable, net	96,701	93,804
Inventories	81,625	66,162
Prepaid expenses and other current assets	10,734	16,659
Deferred income taxes	9,842	8,853
<b>Total current assets</b>	<b>227,070</b>	<b>213,846</b>
Property, plant and equipment, net	168,086	138,457
Goodwill	201,407	200,810
Other intangible assets, net	75,174	76,122
Deferred financing and other non-current assets, net	8,247	10,388
<b>Total assets</b>	<b>\$ 679,984</b>	<b>\$ 639,623</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Short-term debt	\$ 35,000	\$ —
Accounts payable	30,512	34,771
Accrued expenses and other	57,075	55,600
Current portion of long-term debt	3,175	8,758
<b>Total current liabilities</b>	<b>125,762</b>	<b>99,129</b>
Long-term debt	254,434	280,913
Deferred income taxes	43,199	43,771
Other non-current liabilities	1,974	2,189
<b>Total liabilities</b>	<b>425,369</b>	<b>426,002</b>
Commitments and contingencies—see Note 9		
Stockholders' Equity:		
Common stock—\$.01 par value; 300,000 shares authorized; 98,964 and 98,194 shares issued and outstanding, respectively	990	982
Additional paid in capital	254,823	253,134
Deferred stock compensation—net of amortization of \$11,078 and \$9,429, respectively	(3,430)	(5,079)
Retained deficit	(1,023)	(52,623)
Accumulated other comprehensive income	3,255	17,207
<b>Total stockholders' equity</b>	<b>254,615</b>	<b>213,621</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 679,984</b>	<b>\$ 639,623</b>

See accompanying Notes to Condensed Consolidated Financial Statements.

**TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Six Months Ended June 30,	
	2005	2004
	(Unaudited)	(Unaudited)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 51,600	\$ 28,716
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,590	10,976
Amortization of deferred financing costs	1,303	1,207
Loss on extinguishment of debt	717	—
Stock based compensation amortization	1,649	2,990
Allowance for doubtful accounts	1,310	1,871
Deferred income taxes	(1,561)	2,290
Foreign currency adjustments	194	(338)
Loss on sale of equipment and other	575	349
Changes in operating assets and liabilities:		
Accounts receivable	(9,114)	(17,571)
Inventories	(18,057)	2,923
Prepaid expenses and other current assets	5,170	(3,051)
Accounts payable	(1,597)	(1,783)
Accrued expenses and other	4,345	1,122
Net cash provided by operating activities	49,124	29,701
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Payments for trademarks and other intellectual property	(1,138)	—
Purchases of property, plant and equipment	(48,726)	(13,796)
Proceeds from sale of equipment	182	64
Net cash used by investing activities	(49,682)	(13,732)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from short-term Revolving Credit Facility	35,000	—
Proceeds from long-term Revolving Credit Facility	18,000	20,512
Repayments of long-term Revolving Credit Facility	(17,000)	(26,670)
Repayments of term loans	(32,276)	(5,700)
Repayments of Senior Subordinated Notes	—	(52,500)
Payments of deferred financing costs	—	(1,083)
Cash held in trust for repayment of Senior Subordinated Notes	—	60,243
Proceeds from issuance of common stock	1,697	525
Net cash provided (used) by financing activities	5,421	(4,673)
NET EFFECT OF EXCHANGE RATE CHANGES ON CASH	(5,063)	(443)
Increase (decrease) in cash and cash equivalents	(200)	10,853
CASH AND CASH EQUIVALENTS, beginning of period	28,368	14,230
CASH AND CASH EQUIVALENTS, end of period	\$ 28,168	\$ 25,083

See accompanying Notes to Condensed Consolidated Financial Statements.

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

**(1) Summary of Significant Accounting Policies**

(a) *Basis of Presentation and Description of Business*—Tempur-Pedic International Inc. and subsidiaries (Tempur-Pedic International or the Company) is a U.S.-based, multinational corporation incorporated in Delaware. The Company manufactures, markets, and sells advanced viscoelastic products including pillows, mattresses, and other related products. The Company manufactures essentially all of its products at Dan Foam ApS in Denmark and Tempur Production USA, Inc. 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 60 countries and extends credit based on the creditworthiness of its customers.

The accompanying financial statements, prepared in accordance with the instructions to Form 10-Q and article 10 of Regulation S-X, are unaudited and do not include all of the information and disclosures required by generally accepted accounting principles in the U.S. for complete financial statements. Accordingly, these accompanying unaudited financial statements should be read in conjunction with the consolidated financial statements of the Company and related footnotes for the year ended December 31, 2004, included in the Company's Annual Report on Form 10-K.

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

(b) *Reclassifications*—Certain prior period amounts have been reclassified to conform to the 2005 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 accounting principles generally accepted in the United States (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 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.

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

(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:

	June 30, 2005	December 31, 2004
Finished goods	\$61,287	\$ 42,848
Work-in-process	6,712	8,086
Raw materials and supplies	13,626	15,228
	\$81,625	\$ 66,162

(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 2004 on all existing goodwill and no impairment existed as of December 31, 2004. If facts and circumstances lead the Company’s management to believe that one of its assets may be impaired, the Company will evaluate the extent to which that 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.

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

		June 30, 2005			December 31, 2004			
		Useful Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
<b>Unamortized indefinite life intangible assets:</b>								
Trademarks			\$ 55,000	\$ —	\$ 55,000	\$ 55,000	\$ —	\$ 55,000
<b>Amortized intangible assets:</b>								
Technology	10	\$ 16,000	\$ 4,267	\$ 11,733	\$ 16,000	\$ 3,467	\$ 12,533	
Patents	5-20	5,720	2,691	3,029	5,048	2,172	2,876	
Customer database	5	4,200	2,240	1,960	4,200	1,820	2,380	
Foam formula	10	3,700	987	2,713	3,700	802	2,898	
Non-competition agreements and other	5	2,665	1,926	739	2,325	1,890	435	
Total		\$ 87,285	\$ 12,111	\$ 75,174	\$ 86,273	\$ 10,151	\$ 76,122	



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

Amortization expense relating to Other intangible assets was \$985 and \$975 for the three months ended June 30, 2005 and June 30, 2004, respectively. For the six months ended June 30, 2005 and June 30, 2004, amortization expense relating to Other intangible assets was \$1,960 and \$2,242, respectively.

The changes in the carrying amount of Goodwill for the six months ended June 30, 2005 are as follows:

Balance as of December 31, 2004	\$ 200,810
Foreign currency translation adjustments and other	597
Balance as of June 30, 2005	<u>\$ 201,407</u>

In addition, Goodwill has been allocated to the Domestic and International segments as follows:

	June 30, 2005	December 31, 2004
Domestic	<u>\$ 90,043</u>	<u>\$ 87,627</u>
International	<u>111,364</u>	<u>113,183</u>
	<u>\$ 201,407</u>	<u>\$ 200,810</u>

(k) *Accrued Sales Returns*—Estimated sales returns are provided at the time of sale based on historical sales returns. Tempur-Pedic International allows product returns up to 120 days following a sale. Accrued sales returns are included in Accrued expenses and other in the accompanying Consolidated Balance Sheets.

Tempur-Pedic International had the following activity for sales returns from December 31, 2004 to June 30, 2005:

Balance as of December 31, 2004	\$ 6,562
Amounts accrued	20,426
Returns charged to accrual	<u>(21,395)</u>
Balance as of June 30, 2005	<u>\$ 5,593</u>

(l) *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 Consolidated Balance Sheets.

Tempur-Pedic International had the following activity for warranties from December 31, 2004 to June 30, 2005:

Balance as of December 31, 2004	\$ 3,749
Amounts accrued	3,103
Warranties charged to accrual	<u>(3,756)</u>
Balance as of June 30, 2005	<u>\$ 3,096</u>

(m) *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

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

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.

(n) *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 \$5,643 and \$5,508 as of June 30, 2005 and December 31, 2004, respectively. Deposits made by customers are recorded as a liability and recognized as a sale when product is shipped. Tempur-Pedic International had \$163 and \$301 of deferred revenue included in Accrued expenses and other in the accompanying Consolidated Balance Sheets as of June 30, 2005 and December 31, 2004, respectively.

Tempur-Pedic International 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 were approximately \$5,506 and \$4,940 for the three months ended June 30, 2005 and June 30, 2004, respectively. Amounts included in Net sales for shipping and handling were approximately \$12,656 and \$10,949 for the six months ended June 30, 2005 and June 30, 2004, respectively. Amounts included in Cost of sales for shipping and handling were approximately \$19,250 and \$13,524 for the three months ended June 30, 2005 and June 30, 2004, respectively. Amounts included in Cost of sales for shipping and handling were approximately \$39,283 and \$27,118 for the six months ended June 30, 2005 and June 30, 2004, respectively.

(o) *Advertising Costs*—Tempur-Pedic International 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 \$20,503 and \$10,847 for the three months ended June 30, 2005 and June 30, 2004, respectively. For the six months ended June 30, 2005 and June 30, 2004, advertising costs charged to expense were approximately \$46,283 and \$33,515, respectively. Advertising costs deferred and included in prepaid expenses and other current assets in the accompanying Consolidated Balance Sheets were approximately \$4,663 and \$6,228 as of June 30, 2005 and December 31, 2004, respectively.

(p) *Stock-Based Compensation*—In accordance with SFAS 123, "Accounting for Stock Based Compensation" (SFAS 123), the Company has elected to account for employee stock and option issuances under Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees" (APB 25). Under APB 25 no compensation expense is recognized in the statements of income for stock granted to employees and non-employee directors, if the exercise price at least equals the fair value of the underlying stock on the date of grant. Stock options are granted under various stock compensation programs to employees. For purposes of pro forma disclosures in accordance with SFAS 123, the estimated fair value of the options is amortized to expense over the options' vesting period.

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

Pro forma information in accordance with SFAS 123 is as follows for Tempur-Pedic International:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income as Reported	<b>\$24,850</b>	\$16,946	<b>\$51,600</b>	\$28,716
Add: Stock-based employee compensation expense included in reported net income, net of related tax benefit	724	1,490	<b>1,566</b>	2,990
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax benefit	<b>(1,766)</b>	(2,365)	<b>(3,656)</b>	(4,713)
<b>Pro forma Net income</b>	<b>\$23,808</b>	\$16,071	<b>\$49,510</b>	\$26,993
<b>Earnings per share:</b>				
Basic as reported	<b>\$ 0.25</b>	\$ 0.17	<b>\$ 0.52</b>	\$ 0.29
Diluted as reported	<b>\$ 0.24</b>	\$ 0.16	<b>\$ 0.50</b>	\$ 0.28
Basic—Pro forma Net income	<b>\$ 0.24</b>	\$ 0.16	<b>\$ 0.50</b>	\$ 0.28
Diluted—Pro forma Net income	<b>\$ 0.23</b>	\$ 0.16	<b>\$ 0.48</b>	\$ 0.26

Certain options granted during the year prior to the initial public offering in 2003 have exercise prices that are less than the deemed market value of the underlying common stock at the date of grant. The resulting unearned stock-based compensation is amortized to compensation expense over the respective vesting term, based on the "graded vesting" methodology. The Company had unearned stock-based compensation of \$2,334, excluding restricted stock units, as of June 30, 2005. The Company recorded \$655 of compensation expense for the three months ended June 30, 2005 and \$1,430 for the six months ended June 30, 2005, also excluding restricted stock units. The future amortization of these unearned stock-based compensation costs will be \$1,015 for the remainder of 2005, \$1,105 in 2006, and \$214 in 2007.

In addition, the Company had unearned stock based compensation of \$1,096 related to restricted stock units as of June 30, 2005. The Company recorded compensation expense related to restricted stock units of \$110 for the three months ended June 30, 2005 and \$219 for the six months ended June 30, 2005. The future amortization of unearned stock-based compensation costs related to this restricted stock will be \$219 for the remainder of 2005, \$438 in 2006, and \$439 in 2007.

**(2) New Accounting Standards**

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS 151, "Inventory Costs" (SFAS 151), which is an amendment of ARB 43, Chapter 4. SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. In accordance with this standard, the Company adopted SFAS 151 on June 30, 2005. It did not have a material impact on the Consolidated Financial Statements.

In December 2004, the FASB issued SFAS 123 (revised 2004), "Share-Based Payment" (SFAS 123R) which is a revision of SFAS 123, "Accounting for Stock-Based Compensation." SFAS 123R requires all share-

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

based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure will no longer be an alternative to financial statement recognition. On April 14, 2005, the SEC announced it would permit most registrants additional time to implement this statement. The SEC will allow registrants to implement this statement at the beginning of their next fiscal year. In accordance with this revised standard, the Company plans to adopt SFAS 123R on January 1, 2006, and is still evaluating the expected impact it will have on the Consolidated Financial Statements.

**(3) Supplemental Cash Flow Information**

Cash paid for interest and cash paid for income taxes were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Interest	\$ 2,268	\$ 2,196	\$ 9,542	\$12,431
Income taxes, net of refunds	\$ 19,382	\$ 4,583	\$20,080	\$14,190

**(4) Property, Plant and Equipment**

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

	June 30, 2005	December 31, 2004
Land and buildings	\$ 67,248	\$ 71,606
Machinery and equipment	90,215	92,262
Construction in progress	55,439	12,330
	<b>212,902</b>	176,198
Total accumulated depreciation	<b>(44,816)</b>	(37,741)
	<b>\$ 168,086</b>	\$ 138,457

Construction in progress includes \$650 of capitalized interest related to the construction of the Albuquerque, New Mexico manufacturing facility as of June 30, 2005.

**(5) Financing Arrangements**

(a) *Unsecured Short-term Credit Facility*—In December 2004, Tempur Production USA, Inc. (Tempur Production), a subsidiary of Tempur-Pedic International Inc., entered into a short-term, unsecured revolving note facility with a bank (the Short-Term Facility). The Short-Term Facility bears interest at a rate equal to the prime rate minus one-half of one percent, is unsecured, and is guaranteed on an unsecured basis by a subsidiary of Tempur-Pedic International. The Short-Term Facility contains certain negative and affirmative covenants and requirements affecting Tempur Production. On April 1, 2005, Tempur Production amended the Short-Term Facility to increase the maximum principal amount available for borrowing to \$40,000 and to extend the maturity date to September 2, 2005. As of June 30, 2005, \$35,000 in principal was outstanding under the Short-Term Facility. On August 4, 2005, Tempur Production amended the Short-Term Facility to increase the maximum principal amount available for borrowing to \$50,000 and to extend the maturity to December 2, 2005.

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(b) *Long-term Debt*—Long-term debt for Tempur-Pedic International consisted of the following:

	June 30, 2005	December 31, 2004
<b>Senior Credit Facility:</b>		
U.S. Term Loan A payable to a lender, interest at IBOR plus margin (5.49% and 4.81% at June 30, 2005 and December 31, 2004, respectively), principal payments due quarterly through September 30, 2008 with a final payment on November 1, 2008	\$ 8,172	\$ 8,966
U.S. Term Loan B payable to a lender, interest at IBOR plus margin (5.74% and 4.81% at June 30, 2005 and December 31, 2004, respectively), principal payments due quarterly through June 30, 2009	132,300	132,975
European Term Loan A (USD Denominated) payable to a lender, interest at IBOR plus margin (4.81% at December 31, 2004); balance paid in full on March 31, 2005	—	17,642
European Term Loan A (EUR Denominated) payable to a lender, interest at IBOR plus margin (4.43% at December 31, 2004); balance paid in full on March 31, 2005	—	13,577
U.S. Long-Term Revolving Credit Facility payable to a lender, interest at IBOR or Index Rate plus applicable margin (5.22% at June 30, 2005 and 4.75% at December, 31 2004), commitment through and due November 1, 2008	18,000	17,000
European Long-Term Revolving Credit Facility (including the European Working Capital Loan Commitment) payable to a lender, interest at IBOR or Index Rate plus applicable margin, commitment through and due November 1, 2008	—	—
<b>Senior Subordinated Notes:</b>		
U.S. Senior Subordinated Notes payable to institutional investors, interest at 10.25%, due August 15, 2010	97,500	97,500
<b>Other:</b>		
Mortgages payable to a bank, secured by certain property, plant and equipment and other assets, bearing fixed interest at 4.0% to 5.1%	1,637	2,011
	<b>257,609</b>	<b>289,671</b>
Less: Current portion	<b>3,175</b>	<b>8,758</b>
<b>Long-term debt</b>	<b>\$ 254,434</b>	<b>\$ 280,913</b>

(c) *Secured Credit Financing*—At June 30, 2005, Tempur-Pedic International had \$40,000 of long-term Revolving and Working Capital Loan Commitments under the Senior Credit Facility, which was comprised of a \$20,000 U.S. Revolving Loan Commitment; a \$15,000 European Revolving Loan Commitment; and a \$5,000 European Working Capital Loan Commitment, collectively referred to as Revolving Loan Commitments. The U.S. and European Revolving Loan Commitments provide for the issuance of letters of credit which, when issued, constitute usage and reduces availability under the Revolving Loan Commitments. The aggregate amount of letters of credit outstanding at June 30, 2005 under the U.S. Revolving Loan Commitment and the European Revolving Loan Commitment was approximately \$76 and \$2,708, respectively. After giving effect to letters of credit and \$18,000 in borrowings under the U.S. Revolving Loan Commitment, total availability under the Senior Credit Facility at June 30, 2005 was \$19,216, of which \$5,000 was available under the European Working Capital Loan Commitment; \$12,292 was available under the European Revolving Credit Facility; and \$1,924 was available under the U.S. Revolving Credit Facility.

The Senior Credit Facility subjects Tempur-Pedic International Inc. and its subsidiaries to certain financial covenants, including: a minimum interest coverage ratio; a maximum leverage ratio, and a minimum fixed charge coverage ratio in each case as defined. The Company was in compliance with all covenants as of June 30, 2005.

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On March 31, 2005, the Company made prepayments of \$16,862 on its USD denominated and \$12,282 on its EUR denominated European Term A loans. In conjunction with these prepayments, the Company wrote off approximately \$717 of deferred financing fees which has been included in Loss on debt extinguishment in the Consolidated Statements of Income.

(d) *Senior Subordinated Notes*—In 2003, Tempur-Pedic, Inc. and Tempur Production USA, Inc. (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. The Senior Subordinated Notes have no mandatory redemption or sinking fund requirements; however, they do provide for partial redemption at the Issuer's option under certain circumstances prior to August 15, 2006, and full redemption at the Issuer's option on or after August 15, 2007 at a redemption price of 105.125%.

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 the Company. The Company reflected the \$5,381 redemption premium as a Loss on extinguishment of debt included in Other income (expense), net in the six months ended June 30, 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 June 30, 2005.

**(6) Stockholders' Equity**

The Company's authorized shares of capital stock are 300,000,000 shares of common stock and 10,000,000 shares of preferred stock. Subject to preferences that may be applicable to any outstanding preferred stock of the Company, holders of the Company's 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 Company's common stock are entitled to share ratably in all assets remaining after payment of liabilities, subject to prior distribution rights of preferred stock of the Company, if any, then outstanding.

**(7) Stock based Compensation**

(a) *2002 Option Plan*—On November 1, 2002, the Company adopted the 2002 Option Plan to provide for grants of options to purchase shares of Class B-1 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 of 1986, as amended (the Code), must have an exercise price of not less than the fair market value of the Company's Class B-1 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. Options can be exercised up to ten years from the grant date and up to five years from the date of grant for any stockholders who own 10% or more of the total combined voting power of all shares of stock of the Company. The Company currently anticipates there will be no additional options issued under this plan.

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(b) *Tempur-Pedic International 2003 Equity Incentive Plan*—The 2003 Equity Incentive 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 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.

(c) *Tempur-Pedic International 2003 Employee Stock Purchase Plan*—The 2003 Employee Stock Purchase Plan (2003 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 complies with the requirements of Section 423 of the Code. The Company may issue a maximum of 500,000 shares of its common stock under the 2003 ESPP.

**(8) Comprehensive Income**

Comprehensive income is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income	\$24,850	\$16,946	\$ 51,600	\$28,716
Other comprehensive income, net of tax:				
Financial instruments accounted for as hedges	13	(10)	25	(104)
Foreign currency translation	(7,931)	2,273	(13,977)	(2,045)
Comprehensive income	<u>\$16,932</u>	<u>\$19,209</u>	<u>\$ 37,648</u>	<u>\$26,567</u>

**(9) Commitments and Contingencies**

*Litigation*—The Company is party to various 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.

*Purchase Commitments*—As of June 30, 2005, the Company had outstanding commitments of approximately \$32,648 for capital expenditures related to the construction of the manufacturing facility in Albuquerque, New Mexico.

**(10) Income Taxes**

The effective tax rate for Tempur-Pedic International for the three months ended June 30, 2005 was 38.1%. Reconciling items between the federal statutory income tax rate of 35% and the effective tax rate include state

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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 prior to the initial public offering, and certain other permanent differences.

At June 30, 2005, the Company had undistributed earnings of \$144,762 from its foreign subsidiaries determined under U.S. generally accepted accounting principles for the period from November 1, 2002 through June 30, 2005. Provisions have been made for U.S. income taxes on \$11,945 of these undistributed earnings pursuant to Subpart F and Section 956 of the Code. No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining \$132,817 of undistributed earnings, as these earnings are considered permanently reinvested. In addition, the Company had undistributed earnings relating to the period prior to the acquisition of Tempur World, Inc. in 2002 by Tempur-Pedic International Inc. (the Tempur Acquisition) of \$69,276 determined under U.S. tax principles. Provisions have been made for U.S. income taxes on \$13,100 million of these undistributed earnings pursuant to Section 956 of the Code, as translated into U.S. dollars at the applicable exchange rates on November 1, 2002. No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining \$56,176 of undistributed earnings, as these earnings are considered indefinitely reinvested.

These undistributed earnings could become subject to U.S. income taxes and foreign withholding taxes (subject to a reduction of foreign tax credits) if these undistributed earnings were remitted as dividends, loaned to the U.S. parent company or a U.S. subsidiary, or if the Company should sell its stock in the subsidiaries. On October 22, 2004, the President signed the American Jobs Creation Act of 2004, which allows a temporary elective 85% dividends received deduction for cash dividends paid by foreign subsidiaries to their U.S. corporate shareholder in either 2004 or 2005. This provision could potentially allow Tempur-Pedic International to repatriate the undistributed earnings of its foreign subsidiaries in a tax efficient manner. The management of Tempur-Pedic International is in the process of evaluating the effects of this repatriation provision and expects to complete its evaluation during the third quarter of 2005. While no conclusions have been reached and any final decision is dependent upon further analysis and approval by the Company's Board of Directors, management currently believes that the Company may repatriate undistributed foreign earnings of up to \$175,000. The related income tax expense of such a repatriation is estimated to be up to \$5,370.

During the first quarter of 2005, the State of Kentucky enacted House Bill 272 (HB 272). HB 272 extensively reformed Kentucky's tax code and it may impact the Company as the corporate headquarters are located in Kentucky. The Company is currently evaluating the effects of HB 272.

**(11) Major Customers**

Five customers accounted for approximately 11% and 13% of Tempur-Pedic International sales for the three months ended June 30, 2005 and June 30, 2004, respectively. These same customers also accounted for approximately 16% and 12% of accounts receivable as of June 30, 2005 and June 30, 2004, respectively. Five customers accounted for approximately 10% and 13% of Tempur-Pedic International sales for the six months ended June 30, 2005 and June 30, 2004, respectively. These same customers also accounted for approximately 15% and 12% of accounts receivable as of June 30, 2005 and June 30, 2004, respectively. The loss of one or more of these customers could negatively impact the Company.



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

**(12) Earnings Per Share**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
<b>Numerator:</b>				
Net income	\$ 24,850	\$ 16,946	\$ 51,600	\$ 28,716
<b>Denominator:</b>				
Denominator for basic earnings per share—weighted average shares	98,791,851	97,628,376	98,606,984	97,519,024
Effect of dilutive securities:				
Employee stock options	4,639,554	5,490,979	4,707,707	5,490,614
Denominator for diluted earnings per share—adjusted weighted average shares	103,431,405	103,119,355	103,314,691	103,009,638
<b>Basic earnings per share</b>	<b>\$ 0.25</b>	<b>\$ 0.17</b>	<b>\$ 0.52</b>	<b>\$ 0.29</b>
<b>Diluted earnings per share</b>	<b>\$ 0.24</b>	<b>\$ 0.16</b>	<b>\$ 0.50</b>	<b>\$ 0.28</b>

**(13) 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:

	June 30, 2005	December 31, 2004
<b>Total assets:</b>		
Corporate	\$ 563,002	\$ 393,202
Domestic	516,210	439,845
International	321,723	345,040
Intercompany eliminations	(720,951)	(538,464)
	<b>\$ 679,984</b>	<b>\$ 639,623</b>

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

The following table summarizes other segment information:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
<b>Net sales from external customers:</b>				
Corporate	\$ —	\$ —	\$ —	\$ —
Domestic	124,054	91,739	271,984	184,697
International	68,561	59,861	143,010	120,026
	<u>\$ 192,615</u>	<u>\$ 151,600</u>	<u>\$ 414,994</u>	<u>\$ 304,723</u>
<b>Inter-segment sales:</b>				
Corporate	\$ —	\$ —	\$ —	\$ —
Domestic	—	—	—	—
International	11,514	3,116	23,914	8,372
Intercompany eliminations	(11,514)	(3,116)	(23,914)	(8,372)
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
<b>Operating income/(loss):</b>				
Corporate	\$ (3,430)	\$ (4,396)	\$ (7,702)	\$ (8,647)
Domestic	27,062	21,670	60,626	41,360
International	20,965	15,715	41,053	30,810
	<u>\$ 44,597</u>	<u>\$ 32,989</u>	<u>\$ 93,977</u>	<u>\$ 63,523</u>
<b>Depreciation and amortization (excluding stock-based compensation amortization):</b>				
Corporate	\$ 109	\$ 133	\$ 213	\$ 510
Domestic	2,838	2,538	5,752	4,497
International	3,113	2,910	6,625	5,969
	<u>\$ 6,060</u>	<u>\$ 5,581</u>	<u>\$ 12,590</u>	<u>\$ 10,976</u>

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Mattresses	\$ 130,788	\$ 93,176	\$ 284,880	\$ 186,356
Pillows	28,579	32,393	61,910	67,245
All other	33,248	26,031	68,204	51,122
	<u>\$ 192,615</u>	<u>\$ 151,600</u>	<u>\$ 414,994</u>	<u>\$ 304,723</u>

During the course of normal operations, the Domestic segment purchases inventory from the Danish manufacturing facility. 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 \$1,692 and \$752 for the three months ended June 30, 2005 and June 30, 2004, respectively, and \$3,439 and \$1,799 for the six months ended June 30, 2005 and June 30, 2004, respectively.

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

The Issuers issued \$150,000 aggregate principal amount of Senior Subordinated Notes in 2003. 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. During 2004, one of the Issuers established a new legal entity (Tempur-Pedic Retail, Inc.). Accordingly, Tempur-Pedic Retail, Inc. has been reflected as a Combined Guarantor Subsidiary.

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

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

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net sales	\$ —	\$ 2,129	\$ —	\$ 121,925	\$ 80,075	\$ (11,514)	\$ 192,615
Cost of goods sold	—	961	(271)	66,422	38,482	(11,514)	94,080
Gross profit	—	1,168	271	55,503	41,593	—	98,535
Operating expenses	1,035	3,670	2,666	25,939	20,628	—	53,938
Operating income	(1,035)	(2,502)	(2,395)	29,564	20,965	—	44,597
Interest income (expense), net	—	(3,851)	(1,064)	5	46	—	(4,864)
Other income (loss)	13	23,131	191	(23,078)	155	—	412
Income taxes	—	7,170	(892)	1,587	7,430	—	15,295
Net income (loss)	\$(1,022)	\$ 9,608	\$ (2,376)	\$ 4,904	\$ 13,736	\$ —	\$ 24,850

**Condensed Consolidating Statements of Income**  
**For the Three Months Ended June 30, 2004**  
(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net sales	\$ —	\$ 1,707	\$ —	\$ 90,032	\$ 62,977	\$ (3,116)	\$ 151,600
Cost of goods sold	—	(6,641)	(199)	53,646	27,097	(3,116)	70,787
Gross profit	—	8,348	199	36,386	35,880	—	80,813
Operating expenses	1,813	4,441	2,781	19,375	19,414	—	47,824
Operating income	(1,813)	3,907	(2,582)	17,011	16,466	—	32,989
Interest income (expense), net	—	(4,386)	(613)	5	(557)	—	(5,551)
Other income (loss)	—	15,679	9	(15,584)	12	—	116
Income taxes	—	5,686	(1,034)	543	5,413	—	10,608
Net income (loss)	\$(1,813)	\$ 9,514	\$ (2,152)	\$ 889	\$ 10,508	\$ —	\$ 16,946

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

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

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net sales	\$ —	\$ 4,483	\$ —	\$ 267,501	\$ 166,924	\$ (23,914)	\$ 414,994
Cost of goods sold	—	2,163	(593)	143,510	81,050	(23,914)	202,216
Gross profit	—	2,320	593	123,991	85,874	—	212,778
Operating expenses	2,743	9,070	5,552	56,615	44,821	—	118,801
Operating income	(2,743)	(6,750)	(4,959)	67,376	41,053	—	93,977
Interest income (expense), net	—	(7,740)	(2,056)	11	(442)	—	(10,227)
Other income (loss)	15	49,435	347	(49,861)	391	—	327
Loss on extinguishment of debt	—	—	—	—	(717)	—	(717)
Income taxes	—	16,572	(1,434)	3,386	13,236	—	31,760
Net income (loss)	\$(2,728)	\$ 18,373	\$ (5,234)	\$ 14,140	\$ 27,049	\$ —	\$ 51,600

**Condensed Consolidating Statements of Income**  
**For the Six Months Ended June 30, 2004**  
(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net sales	\$ —	\$ 2,881	\$ —	\$ 181,816	\$ 128,398	\$ (8,372)	\$ 304,723
Cost of goods sold	—	(14,657)	(400)	108,398	57,602	(8,372)	142,571
Gross profit	—	17,538	400	73,418	70,796	—	162,152
Operating expenses	3,626	8,357	5,421	43,037	38,188	—	98,629
Operating income	(3,626)	9,181	(5,021)	30,381	32,608	—	63,523
Interest income (expense), net	—	(9,153)	(1,194)	20	(1,318)	—	(11,645)
Other income (loss)	—	31,145	86	(31,050)	15	—	196
Loss on extinguishment of debt	—	(5,381)	—	—	—	—	(5,381)
Income taxes	—	9,206	(1,154)	(247)	10,172	—	17,977
Net income (loss)	\$(3,626)	\$ 16,586	\$ (4,975)	\$ (402)	\$ 21,133	\$ —	\$ 28,716

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

**Condensed Consolidating Balance Sheets**  
**As of June 30, 2005**  
(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Current assets	\$ 3,255	\$ 119,896	\$ 3,351	\$ 52,117	\$ 124,047	\$ (75,596)	\$ 227,070
Property, plant and equipment, net	—	103,194	578	4,882	59,432	—	168,086
Other noncurrent assets	190,783	293,120	365,035	1,448	138,244	(703,802)	284,828
<b>Total assets</b>	<b>\$ 194,038</b>	<b>\$ 516,210</b>	<b>\$ 368,964</b>	<b>\$ 58,447</b>	<b>\$ 321,723</b>	<b>\$ (779,398)</b>	<b>\$ 679,984</b>
Current liabilities	\$ 212	\$ 30,054	\$ 47,205	\$ 76,151	\$ 47,736	\$ (75,596)	\$ 125,762
Noncurrent liabilities	—	488,416	198,182	50	151,438	(538,479)	299,607
Equity (deficit)	193,826	(2,260)	123,577	(17,754)	122,549	(165,323)	254,615
<b>Total liabilities and equity (deficit)</b>	<b>\$ 194,038</b>	<b>\$ 516,210</b>	<b>\$ 368,964</b>	<b>\$ 58,447</b>	<b>\$ 321,723</b>	<b>\$ (779,398)</b>	<b>\$ 679,984</b>

**Condensed Consolidating Balance Sheets**  
**As of December 31, 2004**

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Current assets	\$ 3,470	\$ 84,322	\$ 13,569	\$ 48,112	\$ 133,162	\$ (68,789)	\$ 213,846
Property, plant and equipment, net	—	63,538	613	4,235	70,071	—	138,457
Other noncurrent assets	108,538	291,986	267,011	891	141,808	(522,914)	287,320
<b>Total assets</b>	<b>\$ 112,008</b>	<b>\$ 439,846</b>	<b>\$ 281,193</b>	<b>\$ 53,238</b>	<b>\$ 345,041</b>	<b>\$ (591,703)</b>	<b>\$ 639,623</b>
Current liabilities	\$ 1,046	\$ (24,047)	\$ 50,767	\$ 84,670	\$ 55,482	\$ (68,789)	\$ 99,129
Noncurrent liabilities	—	505,015	198,182	96	180,196	(556,616)	326,873
Equity (deficit)	110,962	(41,122)	32,244	(31,528)	109,363	33,702	213,621
<b>Total liabilities and equity (deficit)</b>	<b>\$ 112,008</b>	<b>\$ 439,846</b>	<b>\$ 281,193</b>	<b>\$ 53,238</b>	<b>\$ 345,041</b>	<b>\$ (591,703)</b>	<b>\$ 639,623</b>

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

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

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net (loss) income	\$(2,728)	\$ 18,373	\$ (5,234)	\$ 14,140	\$ 27,049	\$ —	\$ 51,600
Non-cash expenses	1,634	6,588	264	1,051	7,240	—	16,777
Changes in working capital	(1,136)	(15,474)	5,804	(14,472)	6,025	—	(19,253)
Net cash (used in) / provided by operating activities	(2,230)	9,487	834	719	40,314	—	49,124
Net cash used for investing activities	—	(44,346)	(1,278)	(938)	(3,120)	—	(49,682)
Net cash provided by / (used in) financing activities	1,712	34,246	333	—	(30,870)	—	5,421
Effect on exchange rate changes on cash	—	—	—	—	(5,063)	—	(5,063)
Net (decrease) increase in cash and cash equivalents	(518)	(613)	(111)	(219)	1,261	—	(200)
Cash and cash equivalents at beginning of period	970	551	607	219	26,021	—	28,368
Cash and cash equivalents at end of period	\$ 452	\$ (62)	\$ 496	\$ —	\$ 27,282	\$ —	\$ 28,168

**Condensed Consolidating Statements of Cash Flows**  
**For the Six Months Ended June 30, 2004**  
(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net (loss) income	\$(3,626)	\$ 16,586	\$ (4,975)	\$ (402)	\$ 21,133	\$ —	\$ 28,716
Non-cash expenses	2,990	3,539	3,123	2,163	7,530	—	19,345
Changes in working capital	(3,834)	(27,194)	2,600	1,855	8,213	—	(18,360)
Net cash (used in) / provided by operating activities	(4,470)	(7,069)	748	3,616	36,876	—	29,701
Net cash used for investing activities	—	(3,029)	(391)	(3,616)	(6,696)	—	(13,732)
Net cash provided by / (used in) financing activities	525	15,472	(977)	—	(19,693)	—	(4,673)
Effect on exchange rate changes on cash	—	—	—	—	(443)	—	(443)
Net (decrease) increase in cash and cash equivalents	(3,945)	5,374	(620)	—	10,044	—	10,853
Cash and cash equivalents at beginning of period	4,756	931	1,545	—	6,998	—	14,230
Cash and cash equivalents at end of period	\$ 811	\$ 6,305	\$ 925	\$ —	\$ 17,042	\$ —	\$ 25,083

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

*The following discussion and analysis should be read in conjunction with the Condensed Consolidated Financial Statements and accompanying notes thereto included herein. The forward-looking statements in this discussion regarding the mattress and pillow industries, our expectations regarding our future performance, liquidity and capital resources and other non-historical statements in this discussion include numerous risks and uncertainties, as described under "Special Note Regarding Forward-Looking Statements" and "Risk Factors" and elsewhere in this quarterly report on form 10-Q. Our actual results may differ materially from those contained in any forward-looking statements. Except as may be required by law, we undertake no obligation to publicly update or revise any of the forward-looking statements contained herein.*

### Executive Overview

*General*—We are a rapidly growing, market leading, vertically-integrated manufacturer, marketer and distributor of premium mattresses and pillows that we sell globally in 60 countries primarily under the TEMPUR® and Tempur-Pedic® brands. We believe our premium mattresses and pillows are more comfortable than standard bedding products because our proprietary viscoelastic pressure relieving material is temperature sensitive, has a high density, and conforms to the body to therapeutically align the neck and spine, thus reducing neck and lower back pain, two of the most common complaints about other sleep surfaces.

For purposes of this Management's Discussion and Analysis of Financial Condition and Results of Operations, the terms "we," "our," "ours" and "us" refer to Tempur-Pedic International Inc. and its consolidated subsidiaries, and the terms "Tempur-Pedic International" and the "Company" refer to Tempur-Pedic International Inc. only.

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

### Strategy and Outlook

Our long-term goal is to become the world's largest bedding company. In order to achieve this goal, we expect to continue to pursue certain key strategies in 2005:

- We currently intend to maintain our focus primarily on premium mattresses and pillows and to regularly introduce new products. In January 2005, we began shipping our new futon product for the Japanese market. We launched 'The EuroBed by Tempur-Pedic™' and 'The BodyPillow by Tempur-Pedic™' in the U.S during this past year. We also recently unveiled 'The OriginalBed by Tempur-Pedic™.'
- We plan to continue to invest in increasing our global brand awareness through targeted marketing and advertising campaigns that further associate our brand name with better overall sleep and premium quality products.
- We plan to continue to extend our presence in furniture and bedding retail stores in both the U.S. and internationally.
- We plan to continue to invest in our operating infrastructure to meet the requirements of our rapidly growing business, including increases in our manufacturing capacity and our research and development capacity.



## Factors That May Affect Future Performance

*Managing Rapid Growth*—We have grown rapidly, with our Net sales increasing from \$221.5 million in 2001 to \$684.9 million for 2004, and to \$415.0 million for the six months ended June 30, 2005. Our growth has placed, and will continue to place, a strain on our management, production, product distribution network, information systems and other resources. In response to these challenges, management has continued to invest in increased production capacity, enhanced operating and financial infrastructure and systems, and continued expansion of the human resources in our operations. Our expenditures for advertising and other marketing-related activities are made as advertising rates are favorable to us and as the continued growth in the business allows us the ability to invest in building our brand.

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

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

*Significant Growth Opportunities*—As of June 30, 2005, our products were offered in approximately 4,830 furniture and bedding stores and 1,500 specialty stores domestically, and approximately 3,650 stores internationally. For the three months ended June 30, 2005, we added a net of approximately 400 stores in the U.S. and approximately 180 stores internationally to our Retail channel. For the six months ended June 30, 2005, we added a net of approximately 730 stores in the U.S. and approximately 350 stores internationally to our Retail channel. In addition, we have a significant installed pillow base in our Asia market that we believe creates an opportunity to develop a successful mattress market. We are continuing to develop products that are responsive to consumer demand in our markets internationally. We are also continuing to expand our direct response business in Europe to reach a greater number of consumers and increase our brand awareness.

In addition to these growth opportunities, management believes that there are many opportunities in our Healthcare channel. Clinical evidence indicates that our products are both effective and cost efficient for the prevention and treatment of decubitis, or bed sores, a major problem for elderly and bed-ridden patients. A change in the U.S. Medicare and Medicaid reimbursement policies toward prevention of bed sores and away from treatment could expand our growth potential in this market.

*Financial Leverage*—As of June 30, 2005, we had \$257.6 million of Long-term debt outstanding, and our Stockholders' Equity was \$254.6 million. Higher financial leverage makes us more vulnerable to general adverse competitive, economic and industry conditions. We believe that operating margins combined with the inherent operating leverage in the business will enable us to continue de-leveraging the business in a manner consistent with historical experience. There can be no assurance, however, that our business will generate sufficient cash flow from operations to enable us to continue to de-leverage the business or that future borrowings will be available under our senior secured credit facility (the Senior Credit Facility), or otherwise.

*Exchange Rates*—As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. We use foreign exchange forward contracts to manage a portion of the exposure to the risk of the eventual net cash inflows and outflows resulting

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from foreign currency denominated transactions between Tempur-Pedic subsidiaries and their customers and suppliers, as well as between the Tempur-Pedic subsidiaries themselves. The hedging transactions may not succeed in managing our foreign currency exchange rate risk. See “Item 3. Quantitative and Qualitative Disclosures About Market Risk—Foreign Currency Exposures” under Part I of this report.

Foreign currency exchange rate movements also create a degree of risk by affecting the U.S. dollar value of sales made and costs incurred in foreign currencies. We do not enter into hedging transactions to hedge this risk. Consequently, our reported earnings and financial position could fluctuate materially as a result of foreign exchange gains or losses. Our outlook assumes no significant changes in currency values from current rates. Should currency rates change sharply, our results could be negatively impacted. See “Item 3. Quantitative and Qualitative Disclosures About Market Risk—Foreign Currency Exposures” under Part I of this report.

### **Critical Accounting Policies and Estimates**

Our management is responsible for our financial statements and has evaluated the accounting policies to be used in their preparation. Our management believes these policies are reasonable and appropriate. The following discussion identifies those accounting policies that we believe are critical in the preparation of our financial statements, the judgments and uncertainties affecting the application of those policies, and the possibility that materially different amounts will be reported under different conditions or using different assumptions.

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires that the management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of commitments and contingencies 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.

*Revenue Recognition*—Our estimates of sales returns are a critical component of our revenue recognition. We recognize sales, net of estimated returns, when we ship our products to customers and the risks and rewards of ownership are transferred to them. Estimated sales returns are provided at the time of sale, based on our level of historical sales returns. We allow returns for up to 120 days following a sale, depending on the channel and promotion. Our level of sales returns differs by channel, with our direct channel typically experiencing the highest rate of returns. Our level of returns has been consistent with our estimates and has been improving steadily over the last year as our retail channel, which historically experiences lower returns than other sales channels, continues to grow as a percentage of overall Net sales.

*Warranties*—Cost of sales includes estimated costs to service warranty claims of our customers. Our estimate is based on our historical claims experience and extensive product testing that we perform from time to time. We provide 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. Because our products have not been in use by our customers for the full warranty period, we rely on the combination of historical experience and product testing for the development of our estimate for warranty claims. Our estimate of warranty claims could be adversely affected if our historical experience ultimately proves to be greater than the performance of the product in our product testing. We also provide 2-year to 3-year warranties 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. Our estimated obligation for warranty claims as of June 30, 2005 was \$3.1 million. As of December 31, 2004, our estimated obligation for warranty claims was \$3.7 million.

*Impairment of Goodwill, Intangibles and Long-Lived Assets*—Goodwill reflected in our Consolidated Balance Sheets consists of the purchase price from the acquisition of Tempur World, Inc. in November 2002 (the Tempur Acquisition) in excess of the estimated fair values of identifiable net assets as of the date of the Tempur Acquisition. Intangibles consist of tradenames for various brands under which our products are sold. Other intangibles include our customer database for our direct channel, process technology and the formulation of our viscoelastic, pressure-relieving material.

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We follow Statement of Financial Accounting Standards (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. We perform an annual impairment test on all existing goodwill in the fourth quarter of each year. We performed the annual impairment test in the fourth quarter of 2004 on all existing goodwill and no impairment existed as of December 31, 2004. If facts and circumstances lead our management to believe that one of its assets may be impaired, we will evaluate the extent to which that 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. Although we believe our estimates and judgments are reasonable, different assumptions and judgments could result in different impairment, if any, of some or all of our recorded Goodwill and indefinite-lived intangibles of \$276.6 million as of June 30, 2005 and \$276.9 million as of December 31, 2004.

In accordance with 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. Although we believe that our estimates of cash flows in our application of SFAS 144 are reasonable, and based upon all available information, including historical cash flow data about the prior use of our assets, such estimates nevertheless require substantial judgments and are based upon material assumptions about future events.

*Income Tax Accounting*—Income taxes are accounted for in accordance with SFAS 109, "Accounting for Income Taxes." SFAS 109 requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities. These deferred taxes are measured by applying the provisions of tax laws in effect at the balance sheet date.

We recognize Deferred tax assets in our Consolidated Balance Sheets, and these deferred tax assets typically represent items deducted currently from operating income in the financial statements that will be deducted in future periods in tax returns. In accordance with SFAS 109, a valuation allowance is recorded against these deferred tax assets to reduce the total deferred tax assets to an amount that will, more likely than not, be realized in future periods. The valuation allowance is based, in part, on our estimate of future taxable income, the expected utilization of tax loss carryforwards, both domestic and foreign, and the expiration dates of tax loss carryforwards. Significant assumptions are used in developing the analysis of future taxable income for purposes of determining the valuation allowance for deferred tax assets which, in our opinion, are reasonable under the circumstances.

At June 30, 2005, the Company had undistributed earnings of \$144.8 million from its foreign subsidiaries determined under U.S. generally accepted accounting principles for the period November 1, 2002 through June 30, 2005. Provisions have been made for U.S. income taxes on \$12.0 million of these undistributed earnings pursuant to Subpart F and Section 956 of the Internal Revenue Code (Code). No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining \$132.8 million of undistributed earnings, as these earnings are considered permanently reinvested.

In addition, the Company had undistributed earnings relating to the period prior to the Tempur Acquisition of \$69.3 million determined under U.S. tax principles. Provisions have been made for U.S. income taxes on \$13.1 million of these undistributed earnings pursuant to Section 956 of the Code, as translated into U.S. dollars at the applicable exchange rates on November 1, 2002. No provisions have been made for U.S. income taxes or foreign withholding taxes on the remaining \$56.2 million of undistributed earnings, as these earnings are considered indefinitely reinvested.

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These undistributed earnings could become subject to U.S. income taxes and foreign withholding taxes (subject to a reduction for foreign tax credits) if these undistributed earnings were remitted as dividends, loaned to Tempur-Pedic International or a U.S. subsidiary, or if the Company should sell its stock in the applicable subsidiaries. On October 22, 2004, the President signed the American Jobs Creation Act of 2004, which allows a temporary elective 85% dividends received deduction for cash dividends paid by foreign subsidiaries to their U.S. corporate shareholder in either 2004 or 2005. This provision could potentially allow Tempur-Pedic International to repatriate the undistributed earnings of its foreign subsidiaries in a tax efficient manner. The management of Tempur-Pedic International is in the process of evaluating the effects of this repatriation provision and expects to complete its evaluation during the third quarter of 2005. While no conclusions have been reached and any final decision is dependent upon further analysis and approval by the Company's Board of Directors, management currently believes that the Company may repatriate undistributed foreign earnings of up to \$175.0 million. The related income tax expense of such a repatriation is estimated to be up to \$5.4 million.

*Stock-Based Compensation*—We currently account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board (APB) Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations, and comply with the disclosure provisions of SFAS 123, "Accounting for Stock-Based Compensation." In December 2004, the FASB issued SFAS 123 (revised 2004), "Share-Based Payment" (SFAS 123R) which is a revision of SFAS 123, "Accounting for Stock-Based Compensation". SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure will no longer be an alternative to financial statement recognition. On April 14, 2005, the SEC announced it would permit most registrants additional time to implement this statement. The SEC will allow registrants to implement this statement at the beginning of their next fiscal year. In accordance with this revised standard, the Company plans to adopt SFAS 123R on January 1, 2006 and is still evaluating the expected impact it will have on the Consolidated Financial Statements.

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**Results of Operations**

The following table sets forth the various components of our Condensed Consolidated Statements of Income:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
<i>(In millions, except earnings per share)</i>				
Net sales	\$ 192.6	\$ 151.6	\$ 415.0	\$ 304.7
Cost of sales	94.1	70.8	202.2	142.5
Gross profit	98.5	80.8	212.8	162.2
Selling and marketing expenses	38.1	31.7	83.1	66.6
General and administrative and other	15.8	16.1	35.7	32.1
Operating income	44.6	33.0	94.0	63.5
Interest expense, net	(4.9)	(5.5)	(10.2)	(11.6)
Loss on extinguishment of debt	—	—	(0.7)	(5.4)
Other income (expense), net	0.4	0.1	0.3	0.2
Income before income taxes	40.1	27.6	83.4	46.7
Income tax provision	15.3	10.7	31.8	18.0
Net income	\$ 24.8	\$ 16.9	\$ 51.6	\$ 28.7
Earnings per share:				
Basic	\$ 0.25	\$ 0.17	\$ 0.52	\$ 0.29
Diluted	\$ 0.24	\$ 0.16	\$ 0.50	\$ 0.28
Weighted average shares outstanding:				
Basic	98.8	97.6	98.6	97.5
Diluted	103.4	103.1	103.3	103.0

The following table sets forth the various components of our Condensed Consolidated Statements of Income, expressed as a percentage of Net sales:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net sales	100%	100%	100%	100%
Cost of sales	49	47	49	47
Gross profit	51	53	51	53
Selling expenses	20	21	20	22
General and administrative and other	8	10	8	10
Operating income	23	22	23	21
Interest expense, net	(2)	(4)	(3)	(4)
Loss on extinguishment of debt	—	—	—	(2)
Other income/(expense), net	—	—	—	—
Income before income taxes	21	18	20	15
Income tax provision	8	7	8	6
Net income	13%	11%	12%	9%

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**Three Months Ended June 30, 2005 Compared with Three Months Ended June 30, 2004**

We generate sales through four distribution channels: Retail, Direct, Healthcare and Third party. The Retail channel sells to furniture, specialty and department stores. The Direct channel sells directly to consumers. The Healthcare channel sells to hospitals, nursing homes, healthcare professionals and medical retailers. The Third party channel sells to distributors in countries where we do not operate our own distribution. The following table sets forth Net sales information, by channel, for the periods indicated:

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,	
	2005	2004	2005	2004	2005	2004
(\$ in millions)						
Retail	\$ 143.7	\$ 106.1	\$ 97.1	\$ 68.5	\$ 46.6	\$ 37.6
Direct	26.1	22.8	22.2	18.9	3.9	3.9
Healthcare	10.6	10.4	2.6	2.6	8.0	7.8
Third Party	12.2	12.3	2.2	1.7	10.0	10.6
	<b>\$ 192.6</b>	<b>\$ 151.6</b>	<b>\$ 124.1</b>	<b>\$ 91.7</b>	<b>\$ 68.5</b>	<b>\$ 59.9</b>
Domestic	\$ 124.1	\$ 91.7				
International	68.5	59.9				
Total	<b>\$ 192.6</b>	<b>\$ 151.6</b>				

A summary of Net sales by product is below:

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,	
	2005	2004	2005	2004	2005	2004
(\$ in millions)						
Net sales:						
Mattresses	\$ 130.7	\$ 93.2	\$ 91.0	\$ 64.9	\$ 39.7	\$ 28.3
Pillows	28.7	32.4	12.1	10.5	16.6	21.9
Other	33.2	26.0	21.0	16.3	12.2	9.7
	<b>\$ 192.6</b>	<b>\$ 151.6</b>	<b>\$ 124.1</b>	<b>\$ 91.7</b>	<b>\$ 68.5</b>	<b>\$ 59.9</b>
Units sold (1):						
Mattresses	152,837	120,773	86,436	70,572	66,401	50,201
Pillows	585,257	695,606	252,327	210,036	332,930	485,570

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

**Net sales.** Net sales for the three months ended June 30, 2005 increased to \$192.6 million from \$151.6 million for the same period in 2004, an increase of \$41.0 million, or 27%. This increase in Net sales was primarily attributable to an increase in mattress sales. Mattress sales in the second quarter of 2005 increased \$37.5 million, or 40%, over the second quarter of 2004. Consolidated pillow sales decreased approximately 12% from the second quarter of 2004, primarily attributable to a decline in our International sales in Asia to certain Third Party distributors. The increase in Net sales was realized in all channels, except Third Party, with the largest growth in our Retail channel. For the three months ended June 30, 2005, our Retail channel increased to \$143.7 million from \$106.1 million for the same period in 2004, an increase of \$37.6 million, or 35%. Our Direct and Healthcare channels increased 14% and 2%, respectively. Our Third Party channel declined by 1%.

**Domestic.** Domestic Net sales for the three months ended June 30, 2005 increased to \$124.1 million from \$91.7 million for the same period in 2004, an increase of \$32.4 million, or 35%. Our Domestic Retail channel

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continues to be our largest channel, with \$97.1 million in Net sales for the three months ended June 30, 2005. This is an increase of \$28.6 million, or 42% over the prior year quarter. This increase is primarily a result of our strategy to expand distribution for our products into additional retail furniture stores. Our Direct and Third Party channels increased 17% and 29%, respectively. Domestic mattress sales in the second quarter of 2005 increased \$26.1 million, or 40%, over the same period in 2004. In addition, pillow sales increased \$1.6 million, or 15%.

*International.* International Net sales for the three months ended June 30, 2005 increased to \$68.5 million from \$59.9 million for the same period in 2004, an increase of \$8.6 million, or 14%. Our largest channel in our International segment was our Retail channel, which increased \$9.0 million, or 24%, for the three months ended June 30, 2005. In addition, our Healthcare channel increased \$0.2 million, or 3%. Our Direct channel sales remained flat, while our Third party sales decreased 6%. International mattress sales in the second quarter of 2005 increased \$11.4 million, or 40%, over the second quarter of 2004. Pillow sales for the second quarter of 2005 decreased \$5.3 million, or 24%, as compared to the second quarter of 2004. The decrease in pillow sales and International Third Party channel sales is primarily due to the implementation of strategic changes in our International Third Party channel in Asia. We are taking steps to establish and grow our own subsidiary distribution in certain markets rather than sell through Third Party distributors.

*Gross profit.* Gross profit for the three months ended June 30, 2005 increased to \$98.5 million from \$80.8 million for the same period in 2004, an increase of \$17.7 million, or 22%. Our margins are impacted by the relative rate of growth in our Retail channel. Sales in our Retail channel are generally at wholesale prices. The overall shift in our product mix to mattresses is also a factor because our mattresses generally carry lower margins than our pillows. We expect continued downward pressure on our margins as a result of the continued, rapid growth in our Retail channel and in mattress sales. In addition, due to our strong growth in the U.S., we began importing mattresses into the U.S. from Europe in the first quarter of 2005, utilizing the manufacturing capacity we added in Europe in 2004. We incur additional shipping costs to bring this inventory from Europe, and we expect this will continue until our new manufacturing facility in New Mexico comes on line, which we expect will occur in the second quarter of 2006. Our margins are also impacted by changes in our manufacturing capacity, which affects our utilization.

Cost of sales includes the cost of raw material purchases, manufacturing costs and distribution costs associated with the production and sale of products to our customers. The cost of delivering our products to customers is also included in Cost of sales. Cost of sales increased to \$94.1 million for the three months ended June 30, 2005 as compared to \$70.8 million for the three months ended June 30, 2004, an increase of \$23.3 million, or 33%.

*Domestic.* Domestic Gross profit for the three months ended June 30, 2005 increased to \$56.9 million from \$44.9 million for the same period in 2004, an increase of \$12.0 million, or 27%. The Gross profit margin in our Domestic segment was 46% and 49% for the three months ended June, 2005 and June, 2004, respectively. For the three months ended June 30, 2005, the Gross profit margin for our Domestic segment was impacted by the increase in our Retail channel sales and the increased freight costs of importing products from our Danish manufacturing facility. Our Domestic Cost of sales for the three months ended June 30, 2005 increased to \$67.2 million from \$46.8 million for the same period in 2004, an increase of \$20.4 million, or 44%.

*International.* International Gross profit for the three months ended June 30, 2005 increased to \$41.6 million from \$35.9 million for the same period in 2004, an increase of \$5.7 million, or 16%. The Gross profit margin in our International segment was 61% and 60% for the three months ended June 30, 2005 and June 30, 2004, respectively. For the three months ended June 30, 2005, the Gross profit margin for our International segment was impacted by product and geographic mix. Our International Cost of sales for the three months ended June 30, 2005 increased to \$26.9 million from \$24.0 million for the same period in 2004, an increase of \$2.9 million, or 12%.

*Selling and marketing expenses.* Selling and marketing expenses include advertising and media production associated with our Direct channel; other marketing materials such as catalogs, brochures, videos, product

samples, direct customer mailings and point of purchase materials; and sales force compensation and customer service. We also include in Selling and marketing expenses our new product development costs, including market research and testing for new products. Selling and marketing expenses increased to \$38.1 million for the three months ended June 30, 2005 as compared to \$31.7 million for the three months ended June 30, 2004, an increase of \$6.4 million, or 20%. The increase in Selling and marketing expenses was due to additional spending on advertising, sales compensation and point of purchase materials. Selling and marketing expenses as a percentage of Net sales decreased to 20% during the three months ended June 30, 2005 from 21% for the three months ended June 30, 2004. The decrease as a percentage of Net sales was primarily due to an increase in the Net sales of our Retail channel. Our Retail channel has lower selling expenses than our other channels.

**General and administrative and other expenses.** General and administrative and other expenses include management salaries, information technology, professional fees, depreciation of furniture and fixtures, leasehold improvements and computer equipment, expenses for finance, accounting, human resources and other administrative functions, and research and development costs associated with our new product developments. General and administrative and other expenses decreased to \$15.8 million for the three months ended June 30, 2005 as compared to \$16.1 million for the months ended June 30, 2004, a decrease of \$0.3 million, or 2%. While costs such as depreciation, salary expenses, and property and franchise taxes increased in connection with the continued growth of the Company, other costs such as stock-based compensation and compliance with Sarbanes-Oxley requirements decreased. General and administrative and other expenses as a percentage of Net sales was 8% and 10% for the three months ended June 30, 2005 and June 30, 2004, respectively. The decrease as a percentage of sales was due in part to the factors previously discussed, as well as to the increasing operating leverage from fixed administrative costs.

Certain options granted during the year prior to the initial public offering in 2003 have exercise prices that are less than the deemed market value of the underlying common stock at the date of grant. The resulting unearned stock-based compensation is amortized to compensation expense over the respective vesting term, based on the "graded vesting" methodology. The Company had unearned stock-based compensation of \$2.3 million, excluding restricted stock units, as of June 30, 2005. The Company recorded \$0.7 million of compensation expense for the three months ended June 30, 2005, also excluding restricted stock units. The future amortization of these unearned stock-based compensation costs will be \$1.0 million for the remainder of 2005, \$1.1 million in 2006, and \$0.2 million in 2007.

In addition, the Company had unearned stock based compensation of \$1.1 million related to restricted stock units as of June 30, 2005. The Company recorded compensation expense related to restricted stock units of \$0.1 million for the three months ended June 30, 2005. The future amortization of unearned stock-based compensation costs related to this restricted stock will be \$0.2 million for the remainder of 2005, \$0.4 million in 2006, and \$0.5 million in 2007.

**Interest expense, net.** Interest expense, net, includes the interest costs associated with our borrowings and the amortization of deferred financing costs related to those borrowings. Interest expense, net, decreased to \$4.9 million for the three months ended June 30, 2005, as compared to \$5.5 million for the three months ended June 30, 2004, a decrease of \$0.6 million, or 11%. This decrease in interest expense is attributable to lower average debt levels in 2005 and capitalized interest costs of \$0.5 million for the three months ended June 30, 2005 related to the construction of our new manufacturing facility.

**Income tax provision.** Our Income tax provision includes income taxes associated with taxes currently payable and deferred taxes and includes the impact of net operating losses for certain of our domestic and foreign operations. Our effective income tax rates for the three months ended June 30, 2005 and for the three months ended June 30, 2004 differed from the federal statutory rate principally because of the effect of certain foreign tax rate differentials, state and local income taxes, valuation allowances on certain domestic and foreign net operating losses, and compensation expense associated with certain options granted prior to the initial public offering. Our effective tax rate for the three months ended June 30, 2005 was 38.1% as compared to 38.5% for the three months ended June 30, 2004.



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**Six Months Ended June 30, 2005 Compared with Six Months Ended June 30, 2004**

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

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004	2005	2004
<i>(\$ in millions)</i>						
Retail	\$ 313.0	\$ 210.8	\$ 214.3	\$ 136.0	\$ 98.7	\$ 74.8
Direct	54.7	47.8	47.6	40.4	7.1	7.4
Healthcare	23.4	22.2	5.6	5.4	17.8	16.8
Third Party	23.9	23.9	4.5	2.9	19.4	21.0
	<b>\$ 415.0</b>	<b>\$ 304.7</b>	<b>\$ 272.0</b>	<b>\$ 184.7</b>	<b>\$ 143.0</b>	<b>\$ 120.0</b>
Domestic	\$ 272.0	\$ 184.7				
International	143.0	120.0				
Total	<b>\$ 415.0</b>	<b>\$ 304.7</b>				

A summary of Net sales by product is below:

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004	2005	2004
<i>(\$ in millions)</i>						
<b>Net sales:</b>						
Mattresses	\$ 284.7	\$ 186.4	\$ 202.0	\$ 129.7	\$ 82.7	\$ 56.7
Pillows	62.1	67.2	25.9	22.7	36.2	44.5
Other	68.2	51.1	44.1	32.3	24.1	18.8
	<b>\$ 415.0</b>	<b>\$ 304.7</b>	<b>\$ 272.0</b>	<b>\$ 184.7</b>	<b>\$ 143.0</b>	<b>\$ 120.0</b>
<b>Units sold (1):</b>						
Mattresses	337,156	242,768	198,249	141,512	138,907	101,256
Pillows	1,215,518	1,399,705	510,459	462,653	705,058	937,052

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

**Net sales.** Net sales for the six months ended June 30, 2005 increased to \$415.0 million from \$304.7 million for the same period in 2004, an increase of \$110.3 million, or 36%. This increase in Net sales was primarily attributable to an increase in mattress sales. Mattress sales increased \$98.3 million, or 53%, in the six months ended June 30, 2005 compared to the six months ended June 30, 2004. Consolidated pillow sales decreased approximately 8% from the six months ended June 30, 2004, which is primarily attributable to a decline in our International sales in Asia to certain Third Party distributors. The increase in Net sales was realized in all channels, except Third Party, with the largest growth in our Retail channel. For the six months ended June 30, 2005, our Retail channel increased to \$313.0 million from \$210.8 million for the same period in 2004, an increase of \$102.2 million, or 48%. Our Direct and Healthcare channels increased 14% and 5%, respectively.

**Domestic.** Domestic Net sales for the six months ended June 30, 2005 increased to \$272.0 million from \$184.7 million for the same period in 2004, an increase of \$87.3 million, or 47%. Our Domestic Retail channel continues to be our largest channel, with \$214.3 million in Net sales for the six months ended June 30, 2005. This is an increase of \$78.3 million, or 58% over the prior year. This increase is primarily a result of our strategy to expand distribution for our products into additional retail furniture stores. Our Direct, Healthcare, and Third Party channels increased 18%, 4% and 55%, respectively. Domestic mattress sales in the six months ended June 30, 2005 increased \$72.3 million, or 56%, over the same period in 2004. In addition, pillow sales increased \$3.2 million, or 14%.

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*International.* International Net sales for the six months ended June 30, 2005 increased to \$143.0 million from \$120.0 million for the same period in 2004, an increase of \$23.0 million, or 19%. Our largest channel in our International segment was our Retail channel, which increased \$23.9 million, or 32%, for the six months ended June 30, 2005. In addition, our Healthcare channel increased \$1.0 million, or 6%. Our Direct and Third Party channels decreased 4% and 8%, respectively. International mattress sales increased \$26.0 million, or 46%, for the six months ended June 30, 2005. Pillow sales decreased \$8.3 million, or 19%, as compared to the six months ended June 30, 2004. The decrease in pillow sales and International Third Party channel sales in Asia is primarily due to the implementation of strategic changes in our International Third Party channel. We are taking steps to establish and grow our own subsidiary distribution in certain markets rather than sell through Third Party distributors.

**Gross profit.** Gross profit for the six months ended June 30, 2005 increased to \$212.8 million from \$162.2 million for the same period in 2004, an increase of \$50.6 million, or 31%. Our margins are impacted by the relative rate of growth in our Retail channel. Sales in our Retail channel are generally at wholesale prices. The overall shift in our product mix to mattresses is also a factor because our mattresses generally carry lower margins than our pillows. We expect continued downward pressure on our margins as a result of the continued rapid growth in our Retail channel and in mattress sales. In addition, due to our strong growth in the U.S., we began importing mattresses into the U.S. from Europe in the first quarter of 2005, utilizing the manufacturing capacity we added in Europe in 2004. We incur additional shipping costs to bring this inventory from Europe, and we expect this will continue as necessary until our new manufacturing facility in New Mexico comes on line, which we expect will occur in the second quarter of 2006. Our margins are also impacted by changes in our manufacturing capacity, which affects our utilization. Cost of sales increased to \$202.2 million for the six months ended June 30, 2005 as compared to \$142.5 million for the six months ended June 30, 2004, an increase of \$59.7 million, or 42%.

*Domestic.* Domestic Gross profit for the six months ended June 30, 2005 increased to \$126.9 million from \$91.4 million for the same period in 2004, an increase of \$35.5 million, or 39%. The Gross profit margin in our Domestic segment was 47% and 49% for the six months ended June, 2005 and June 30, 2004, respectively. For the six months ended June 30, 2005, the Gross profit margin for the Domestic segment was impacted by the increase in our Retail channel sales and the increased freight costs of importing products from our Danish manufacturing facility. Our Domestic Cost of sales for the six months ended June 30, 2005 increased to \$145.1 million from \$93.3 million for the same period in 2004, an increase of \$51.8 million, or 56%.

*International.* International Gross profit for the six months ended June 30, 2005 increased to \$85.9 million from \$70.8 million for the same period in 2004, an increase of \$15.1 million, or 21%. The Gross profit margin in our International segment was 60% and 59% for the six months ended June 30, 2005 and June 30, 2004, respectively. For the six months ended June 30, 2005, the Gross profit margin for the International segment was impacted by product and geographic mix. Our International Cost of sales for the six months ended June 30, 2005 increased to \$57.1 million from \$49.2 million for the same period in 2004, an increase of \$7.9 million, or 16%.

**Selling and marketing expenses.** Selling and marketing expenses increased to \$83.1 million for the six months ended June 30, 2005, as compared to \$66.6 million for the six months ended June 30, 2004, an increase of \$16.5 million, or 25%. The increase in Selling and marketing expenses was due to additional spending on advertising, sales compensation and point of purchase materials. Selling and marketing expenses as a percentage of Net sales decreased to 20% during the six months ended June 30, 2005 from 22% for the six months ended June 30, 2004. The decrease as a percentage of Net sales was primarily due to an increase in the Net sales of our Retail channel. Our Retail channel has lower selling expenses than our other channels.

**General and administrative and other expenses.** General and administrative and other expenses increased to \$35.7 million for the six months ended June 30, 2005 as compared to \$32.1 million for the six months ended June 30, 2004, an increase of \$3.6 million, or 11%. This increase was attributable to higher depreciation costs, salary expenses, and property and franchise taxes, all of which are associated with the continued growth of the

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Company. General and administrative and other expenses as a percentage of Net sales was 8% and 10% for the six months ended June 30, 2005 and June 30, 2004, respectively. The decrease as a percentage of sales was due to increased operating leverage from fixed administrative costs. Additionally, the costs of complying with Sarbanes-Oxley requirements were substantially less than the prior year, when we were incurring the costs of first year compliance.

The Company recorded \$1.4 million of compensation expense for the six months ended June 30, 2005, excluding restricted stock units. The Company recorded compensation expense related to restricted stock units of \$0.2 million for the six months ended June 30, 2005.

**Interest expense, net.** Interest expense, net decreased to \$10.2 million for the six months ended June 30, 2005, as compared to \$11.6 million for the six months ended June 30, 2004, a decrease of \$1.4 million, or 12%. This decrease in interest expense is attributable to lower average debt levels in 2005 and capitalized interest costs of \$0.7 million for the six months ended June 30, 2005 related to the construction of our new manufacturing facility.

**Loss on debt extinguishment.** Loss on debt extinguishment for the six months ended June 30, 2005 was \$0.7 million and relates to the write-off of deferred financing fees associated with the European Term A Loan, which was prepaid on March 31, 2005. Loss on debt extinguishment for the six months ended June 30, 2004 was \$5.4 million and relates to the Company's redemption in January 2004 of \$52.5 million aggregate principal amount of the outstanding Senior Subordinated Notes.

**Income tax provision.** Our effective income tax rates for six months ended June 30, 2005 and for the six months ended June 30, 2004 differed from the federal statutory rate principally because of the effect of certain foreign tax rate differentials, state and local income taxes, valuation allowances on certain domestic and foreign net operating losses, and compensation expense associated with certain options granted prior to the initial public offering. Our effective tax rate for the six months ended June 30, 2005 was 38.1% as compared to 38.5 % for the six months ended June 30, 2004.

## **Liquidity and Capital Resources**

### *Liquidity*

At June 30, 2005, we had working capital of \$101.3 million including cash and cash equivalents of \$28.2 million as compared to working capital of \$114.7 million including \$28.4 million in Cash and cash equivalents as of December 31, 2004. The \$13.4 million decrease in working capital was driven by two partially offsetting factors. Our inventory balance has increased \$15.4 million, from December 31, 2004 to June 30, 2005; and our current debt has increased \$29.4 million, from December 31, 2004 to June 30, 2005.

The Company is managing inventory levels in the U.S. to help meet the increasing demand for our products. In 2004, capacity was increased at both the U.S. and European manufacturing facilities and is now being utilized to meet current demand. In order to meet anticipated future demands, the Company also commenced construction of our third manufacturing facility in September 2004, located in Albuquerque, New Mexico. The new facility is expected to be completed in the second quarter of 2006. Our expected capital expenditures related to this facility are approximately \$90.0 million, and the Company has borrowed \$35.0 million through June 30, 2005 under an unsecured short-term revolving note facility to help finance the construction. Management expects to refinance the short-term borrowings under a long-term financing arrangement in the third quarter of 2005. The new facility will allow us to meet the demands for our products primarily in the western U.S., as well as Canada, Mexico and South America.

While debt levels are increasing in the U.S. to accommodate the liquidity demands of constructing the new manufacturing facility, cash is accumulating in the International segment of our operations. Since December 31,

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2004, the Company has used the increasing cash levels to repay \$31.5 million of USD and EUR denominated European Term A loans under our Senior Credit Facility. As cash levels continue to build internationally, the Company is evaluating the possibility of repatriating undistributed earnings from its foreign subsidiaries under the American Jobs Creation Act of 2004 and expects to complete its evaluation in the third quarter of 2005. While no conclusions have been reached and any final decision is dependent upon further analysis and approval by the Company's Board of Directors, management currently believes that the Company may repatriate undistributed foreign earnings of up to \$175.0 million. The related income tax expense of such a repatriation is estimated to be up to \$5.4 million.

Our principal sources of funds are cash flows from operations and borrowings under our Senior Credit Facility. Our principal uses of funds consist of capital expenditures and payments of principal and interest on our outstanding debt facilities. Capital expenditures totaled \$48.7 million for six months ended June 30, 2005, including \$0.7 million in capitalized interest costs, and \$13.8 million for the six months ended June 30, 2004. We currently expect capital expenditures for the remainder of 2005 to be approximately \$43.1 million, including approximately \$30.9 million associated with the construction of our Albuquerque manufacturing facility.

Our cash flow from operations increased to \$49.1 million for the six months ended June 30, 2005 as compared to \$29.7 million for the six months ended June 30, 2004. The increase in operating cash flows was primarily related to the increase in our net income and changes in certain operating assets and liabilities. Net income for the six months ended June 30, 2005 increased by \$22.9 million compared to the six months ended June 30, 2004. Due to the limited capacity in our U.S. manufacturing operations and the longer lead time required to import our products from Europe, we increased our inventory levels \$18.1 million for the six months ended June 30, 2005, compared to a decrease of \$2.9 million for the six months ended June 30, 2004. In addition, as our Retail channel grows we continue to experience increases in our Accounts receivable because this is largely a credit-based sales channel. During the first six months of 2005, Accounts receivable increased \$9.1 million compared to an increase of \$17.6 for the six months ended June 30, 2004. Other operating assets and liabilities provided \$8.0 million of working capital for the six months ended June 30, 2005, compared to a use of \$3.8 million for the six months ended June 30, 2004, mainly due to the timing of certain income tax payments. Together, these result in \$19.4 million of increased operating cash flows for the six months ended June 30, 2005 compared to the prior year.

Net cash used in investing activities increased to \$49.7 million for the six months ended June 30, 2005 as compared to \$13.7 million for the six months ended June 30, 2004, an increase of \$36.0 million. Investing activities in the six months ended June 30, 2005 consisted primarily of \$42.5 million related to the construction of our Albuquerque manufacturing facility.

Cash flow provided by financing activities was \$5.4 million for the six months ended June 30, 2005 as compared to cash flow used by financing activities of \$4.7 million for the six months ended June 30, 2004, representing an increase in cash flow provided of \$10.1 million. This increase is due primarily to borrowings under an unsecured short-term revolving note facility of \$35.0 million. These borrowings were offset by prepayments on March 31, 2005 of \$16.9 million on the USD denominated and \$12.3 million on the EUR denominated European Term A loans.

At June 30, 2005, Tempur-Pedic International had \$40.0 million of long-term Revolving and Working Capital Loan Commitments under the Senior Credit Facility, which was comprised of a \$20.0 million U.S. Revolving Loan Commitment; a \$15.0 million European Revolving Loan Commitment; and a \$5.0 million European Working Capital Loan Commitment, collectively referred to as Revolving Loan Commitments. The U.S. and European Revolving Loan Commitments provide for the issuance of letters of credit which, when issued, constitute usage and reduces availability under the Revolving Loan Commitments. The aggregate amount of letters of credit outstanding at June 30, 2005 under the U.S. Revolving Loan Commitment and the European Revolving Loan Commitment was approximately \$1.1 million and \$2.7 million, respectively. After giving effect to letters of credit and \$18.0 million in borrowings under the U.S. Revolving Loan Commitment, total

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availability at June 30, 2005 was \$19.2 million, of which \$5.0 million was available under the European Working Capital Loan Commitment; \$12.3 million under the European Revolving Credit Facility, and \$1.9 million under the U.S. Revolving Credit Facility.

Under the Senior Credit Facility, total term loans outstanding as of June 30, 2005 were \$140.5 million. In addition to the amounts outstanding under the Senior Credit Facility, at June 30, 2005, we had \$35.0 million in borrowings outstanding under a \$40.0 million short-term unsecured revolving note facility with a bank. Borrowings under this facility have been used to finance the construction of our third manufacturing facility in Albuquerque. This unsecured revolving facility was amended and restated on August 4, 2005 to increase the total borrowing availability to \$50.0 million and to extend the maturity to December 2, 2005.

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

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS 151, "Inventory Costs" (SFAS 151), which is an amendment of ARB 43, Chapter 4. SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. In accordance with this standard, the Company adopted SFAS 151 on June 30, 2005. It did not have a material impact on the Consolidated Financial Statements.

In December 2004, the FASB issued SFAS 123 (revised 2004), "Share-Based Payment" (SFAS 123R) which is a revision of SFAS 123, "Accounting for Stock-Based Compensation". SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure will no longer be an alternative to financial statement recognition. On April 14, 2005, the SEC announced it would permit most registrants additional time to implement this statement. The SEC will allow registrants to implement this statement at the beginning of their next fiscal year. In accordance with this revised standard, the Company plans to adopt SFAS 123R on January 1, 2006 and is still evaluating the expected impact it will have on the Consolidated Financial Statements.

### **Risk Factors**

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

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

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

Our largest competitors have significant financial, marketing and manufacturing resources and strong brand name recognition, and sell their products through broad and well established distribution channels. Additionally, we believe that a number of our significant competitors now offer mattress products claimed to be similar to our viscoelastic mattresses and pillows. These competitors or other mattress manufacturers may aggressively pursue the viscoelastic mattress market. Any such competition by established manufacturers or new entrants into the market could have a material, adverse effect on our business, financial condition and operating results by causing our products to lose market share. In addition, should any of our competitors reduce prices on premium mattress products, we may be required to implement price reductions in order to remain competitive, which could

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significantly impair our liquidity and profitability. The pillow industry is characterized by a large number of competitors, none of which is dominant, but many of which have greater resources than us and greater brand recognition than our brand.

### ***We may be unable to effectively manage our growth, which could reduce our liquidity and profitability.***

We have grown rapidly, with our Net sales increasing from approximately \$221.5 million in 2001 to approximately \$684.9 million for the year ended December 31, 2004, and to \$415.0 million for the six months ended June 30, 2005. Our growth has placed, and will continue to place, a strain on our management, production, product distribution network, information systems and other resources. Our growth may strain these resources to the point where they are no longer adequate to support our operations, which would require us to make significant expenditures in these areas. In addition, demand for our products may grow at a rate faster than anticipated, which may result in our inability to produce mattresses and pillows in the quantity demanded. To manage growth effectively, we must:

- continue to significantly increase the volume of products manufactured at our manufacturing facilities in time to meet the anticipated demand for our products;
- continue to enhance our operational, financial and management systems, including our database management, tracking of inquiries, inventory control and product distribution network; and to manage our growing base of retailers, including ensuring compliance with distributor agreements and maintaining adequate credit controls; and
- expand, train and manage our human resources.

We may not be able to effectively manage this expansion in any one or more of these areas, and any failure to do so could significantly harm our business, financial condition and operating results.

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

Our ability to service our indebtedness depends, to a significant extent, on our ability to grow our business while maintaining profitability. We may not be able to sustain growth or profitability on a quarterly or annual basis in future periods. Further, our future growth and profitability will depend upon a number of factors, including without limitation:

- the level of competition in the mattress and pillow industry;
- our ability to continue to successfully execute our strategic initiatives and growth strategy;
- our ability to effectively sell our products through our distribution channels in volumes sufficient to drive growth and leverage our cost structure and advertising spending;
- our ability to continuously improve our products to offer new and enhanced consumer benefits, better quality and reduced costs;
- our ability to maintain efficient, timely and cost-effective production and delivery of our products;
- the efficiency and effectiveness of our advertising campaign and other marketing programs in building product and brand awareness, driving traffic to our distribution channels and increasing sales;
- our ability to successfully identify and respond to emerging trends in the mattress and pillow industry;
- our ability to maintain public association of our brand with premium products, including overcoming any impact on our brand caused by some of our customers seeking to sell our products at a discount to our recommended price;
- the level of consumer acceptance of our products; and
- general economic conditions and consumer confidence.

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We may not be successful in executing our growth strategy and even if we achieve our strategic plan, we may not be able to sustain profitability. Failure to successfully execute any material part of our strategic plan or growth strategy could significantly impair our ability to service our indebtedness and make investments in our business.

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

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

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

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

***Our product development and enhancements may not be successful, which could reduce our ability to compete and reduce our revenues and profitability.***

Our business focuses on mattresses and pillows made with our viscoelastic material, and we are vulnerable to shifting consumer tastes and demands. Our growth and future success will depend, in part, upon our ability to enhance our existing products and to develop and market new products on a timely basis that respond to customer needs and achieve market acceptance. We may not be successful in developing or marketing enhanced or new products and such products may not be accepted by the market.

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

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

Our marketing and advertising practices could also become the subject of proceedings before regulatory authorities or the subject of claims by other parties. In addition, we are subject to federal, state and local laws and

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regulations relating to pollution, environmental protection and occupational health and safety. We may not be in complete compliance with all such requirements at all times. We have made and will continue to make capital and other expenditures to comply with environmental and health and safety requirements. If a release of hazardous substances occurs on or from our properties or any associated offsite disposal location, or if contamination from prior activities is discovered at any of our properties, we may be held liable and the amount of such liability could be material.

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

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

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

Part of our Domestic marketing and advertising strategy in certain Domestic channels focuses on providing up to a 120-day money back guarantee under which customers may return their mattress and obtain a refund of the purchase price. For the three and six months ended June 30, 2005, in the U.S. we had approximately \$8.2 million and \$17.7 million in returns for a return rate of approximately 7% and 6% of our Net sales in the U.S, respectively. As we expand our sales, our return rates may not remain within our historical levels. An increase in return rates could significantly impair our liquidity and profitability. We also currently provide our customers with a limited 20-year warranty on mattresses sold in the U.S. and a limited 15-year warranty on mattresses sold outside of the U.S. However, as we have only been selling mattresses in significant quantities since 1992, and have released new products in recent years, many are fairly early in their product life cycles. We also provide 2-year to 3-year warranties on pillows. Because our products have not been in use by our customers for the full warranty period, we rely on the combination of historical experience and product testing for the development of our estimate for warranty claims. However, our actual level of warranty claims could prove to be greater than the level of warranty claims we estimated based on our products' performance during product testing. If our warranty reserves are not adequate to cover future warranty claims, their inadequacy could have a materially adverse effect on our liquidity and profitability.

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

We currently conduct international operations in 14 countries directly and in 46 additional countries through distributors, and we may pursue additional international opportunities. We generated approximately 36% and 34% of our Net sales from non-U.S. operations during the three and six months ended June 30, 2005, respectively. International suppliers provided a significant portion of our manufacturing material during this period. Our international operations are subject to the customary risks of operating in an international environment, including complying with foreign laws and regulations and the potential imposition of trade or foreign exchange restrictions, tariff and other tax increases, fluctuations in exchange rates, inflation and unstable political situations, the potential unavailability of intellectual property protection and labor issues.



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***We are subject to the possible loss of our third party distributor arrangements and disruption in product distribution in markets outside the range of our wholly-owned subsidiaries, which would reduce our sales and profitability.***

We have third party distributor arrangements in the Asia/Pacific, Middle East, Eastern Europe, Central and South America, and Canada and Mexico markets that are currently outside the range of our wholly-owned subsidiaries. Most of these arrangements provide for exclusive rights for such distributors in a designated territory. If our third party distributors cease distributing our products, sales of our products may be adversely affected because we may not be able to find replacement third party distributors or negotiate arrangements with such replacement third party distributors that are as favorable to us. In addition, under the laws of the applicable countries, we may have difficulty terminating these third party distributor arrangements if we choose to do so. We are currently taking steps to establish and grow our own subsidiary distribution in certain markets rather than sell through third party distributors, and our sales in these markets could be adversely impacted by this transition to a different distribution model.

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

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

- create greater awareness of our products and brand name;
- determine the appropriate creative message and media mix for future advertising expenditures;
- effectively manage advertising costs, including creative and media, to maintain acceptable costs per inquiry, costs per order and operating margins; and
- convert inquiries into actual orders.

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

We rely on trade secrets to protect the design, technology and function of our viscoelastic material and our products. To date, we have not sought U.S. or international patent protection for our principal product formula and manufacturing processes. Accordingly, we may not be able to prevent others from developing viscoelastic material and products that are similar to or competitive with our products. Our ability to compete effectively with other companies also depends, to a significant extent, on our ability to maintain the proprietary nature of our owned and licensed intellectual property. We own several patents on aspects of our products and have patent applications pending on aspects of our manufacturing processes. However, the principal product formula and manufacturing processes for our viscoelastic material and our products are not patented. We own 11 U.S. patents, and we have 12 U.S. patent applications pending. Further, we own approximately 40 foreign patents, and we have approximately 25 foreign patent applications pending. In addition, we hold approximately 392 trademark registrations and applications worldwide. We own U.S. and foreign registered trade names and service marks and have applications for the registration of trade names and service marks pending domestically and abroad. We also license certain intellectual property rights from third parties.

Although our trademarks are currently registered in the U.S. and registered or pending in at least 50 foreign countries, they could be circumvented, or violate the proprietary rights of others, or we could be prevented from using them if challenged. A challenge to our use of our trademarks could result in a negative ruling regarding our use of our trademarks, their validity or their enforceability, or could prove expensive and time consuming in

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terms of legal costs and time spent defending against it. Any loss of trademark protection could result in a decrease in sales or cause us to spend additional amounts on marketing, either of which could decrease our liquidity and profitability. In addition, if we incur significant costs defending our trademarks that could also decrease our liquidity and profitability. In addition, we may not have the financial resources necessary to enforce or defend our trademarks. Furthermore, our patents may not provide meaningful protection and patents may never be issued for our pending patent applications. It is also possible that others could bring claims of infringement against us, as our principal product formula and manufacturing processes are not patented, and that any licenses protecting our intellectual property could be terminated. If we were unable to maintain the proprietary nature of our intellectual property and our significant current or proposed products, this loss of a competitive advantage could result in decreased sales or increased operating costs, either of which would decrease our liquidity and profitability.

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

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

Our top five customers, collectively, accounted for 11% and 10% of our Net sales for the three and six months ended June 30, 2005, respectively. Our largest customer accounted for 3.5% of our Net sales during the three and six months ended June 30, 2005. Many of our customer arrangements are by purchase order or are terminable at will at the option of either party. A substantial decrease or interruption in business from our significant customers could result in write-offs or in the loss of future business and could reduce our liquidity and profitability.

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

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

The major raw materials that we purchase for production are polyol, an industrial commodity based on petroleum, and proprietary additives. The price and availability of these raw materials are subject to market conditions affecting supply and demand. Our financial condition or results of operations may be materially and adversely affected by increases in raw material costs to the extent we are unable to pass those higher costs to our customers.

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

We currently obtain all of the materials used to produce our viscoelastic material from outside sources. We currently acquire almost all of our polyol from two suppliers with multiple manufacturing facilities. If we were

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unable to obtain polyol from these suppliers, we would have to find replacement suppliers. Any substitute arrangements for polyol might not be on terms as favorable to us. In addition, we purchase proprietary additives from a number of vendors. We may not be able to prevent an interruption of production if any supplier were to discontinue supplying us for any reason. We maintain relatively small supplies of our raw materials on-site, and any disruption in the on-going shipment of supplies to us could interrupt production of our products, which could result in a decrease of our sales, or could cause an increase in our cost of sales, and either of these results could decrease our liquidity and profitability. In addition, we outsource much of the sewing and cutting of our mattress and pillow covers to Poland and the Ukraine. If we were no longer able to outsource this labor, we could source it elsewhere at a higher cost. To the extent we are unable to pass those higher costs to our customers; those costs could reduce our gross profit margin, which could result in a decrease in our liquidity and profitability.

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

Approximately 36% and 34% of our Net sales were received or denominated in foreign currency for the three and six months ended June 30, 2005, respectively. As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. We use foreign exchange forward contracts to manage a portion of the exposure to the risk of the eventual net cash inflows and outflows resulting from foreign currency denominated transactions between Tempur-Pedic subsidiaries and their customers and suppliers, as well as between the Tempur-Pedic subsidiaries themselves. The hedging transactions may not succeed in managing our foreign currency exchange rate risk. See “Item 3. Quantitative and Qualitative Disclosures About Market Risk—Foreign Currency Exposures” under Part I of this report.

Foreign currency exchange rate movements also create a degree of risk by affecting the U.S. dollar value of sales made and costs incurred in foreign currencies. We do not enter into hedging transactions to hedge this risk. Consequently, our reported earnings and financial position could fluctuate materially as a result of foreign exchange gains or losses. Our outlook assumes no significant changes in currency values from current rates. Should currency rates change sharply, our results could be negatively impacted. See “Item 3. Quantitative and Qualitative Disclosures About Market Risk—Foreign Currency Exposures” under Part I of this report.

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

We manufacture all of our products at our two facilities in Aarup, Denmark and Duffield, Virginia. An interruption in production capabilities at these plants as a result of equipment failure could result in our inability to produce our products, which would reduce our sales and earnings for the affected period. In addition, we generally deliver our products only after receiving the order from the customer or the retailer and thus do not hold large inventories. In the event of a stoppage in production at either of our manufacturing facilities, even if only temporary, or if we experience delays as a result of events that are beyond our control, delivery times could be severely affected. For example, our third party carrier could potentially be unable to deliver our products within acceptable time periods due to a labor strike or other disturbance in its business. Any significant delay in deliveries to our customers could lead to increased returns or cancellations and cause us to lose future sales. Any increase in freight charges could increase our costs of doing business and harm our profitability. We have introduced new distribution programs to increase our ability to deliver products on a timely basis, but if we fail to deliver products on a timely basis, we may lose sales which could decrease our liquidity and profitability. Our manufacturing facilities are also subject to the risk of catastrophic loss due to unanticipated events such as fires, explosions or violent weather conditions. We may in the future experience material plant shutdowns or periods of reduced production as a result of equipment failure, delays in deliveries or catastrophic loss.

In September 2004, we commenced construction on our third manufacturing facility, located in Albuquerque, New Mexico. This facility is currently expected to require capital expenditures of approximately

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\$90.0 million and to be completed in the second quarter of 2006. If construction of this manufacturing facility is delayed, we may not have the manufacturing capacity necessary to meet anticipated future demand for our products. In addition, if our capital expenditures exceed our estimates, our liquidity and profitability could be impaired.

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

As of June 30, 2005, we had approximately 1,400 full-time employees, with approximately 600 in the U.S., 300 in Denmark and 500 in the rest of the world. The employees in Denmark are under a government labor union contract, but those in the U.S. are not. Any significant increase in our labor costs could decrease our liquidity and profitability and any deterioration of employee relations, slowdowns or work stoppages at any of our locations, whether due to union activities, employee turnover or otherwise, could result in a decrease in our Net sales or an increase in our costs, either of which could decrease our liquidity and profitability.

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

We depend on the continued services of our senior management team. The loss of such key personnel could have a material, adverse effect on our ability to execute our business strategy and on our financial condition and results of operations. We do not maintain key-person insurance for members of our senior management team other than Robert B. Trussell, Jr. We may have difficulty replacing members of our senior management team who leave and, therefore, the loss of the services of any of these individuals could harm our business.

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

As of June 30, 2005, we had \$257.6 million in Long-term debt outstanding. In addition, as of June 30, 2005, our Stockholders' Equity was \$254.6 million. Our high degree of leverage could have important consequences to our investors, such as:

- limiting our flexibility in planning for, or reacting to, changes in our business and the industries in which we compete and increasing our vulnerability to general, adverse economic and industry conditions;
- limiting our ability to obtain in the future additional financing we may need to fund future working capital, capital expenditures, product development, acquisitions or other corporate requirements;
- requiring the dedication of a substantial portion of our cash flow from operations to the payment of principal and interest on our debt, which will reduce the availability of cash flow to fund working capital, capital expenditures, product development, acquisitions and other corporate requirements; and
- placing us at a competitive disadvantage compared to competitors who are less leveraged and have greater financial and other resources.

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

Our ability to meet our debt obligations and to reduce our indebtedness will depend on our future performance, which depends partly on general economic conditions and financial, business, political and other factors that are beyond our control. We may not be able to continue to generate cash flow from operations at or above current levels and meet our cash interest payments on all of our debt and other liquidity needs. If our cash

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flow and capital resources are insufficient to allow us to make scheduled payments on our Senior Subordinated Notes or our other debt, we may have to sell assets, seek additional capital or restructure or refinance our debt. We may not be able to pay or refinance our debt on acceptable terms or at all. Our ability to refinance all or a portion of our debt or to obtain additional financing is substantially limited under the terms of the indenture governing the Senior Subordinated Notes and our Senior Credit Facility. Under the terms of our debt instruments, we and our subsidiaries may be able to incur substantial additional indebtedness in the future, which would exacerbate the risks associated with our substantial leverage.

If our business plans change or if general economic, financial or political conditions in any of our markets or competitive practices in our industry change materially from those currently prevailing or from those now anticipated, or if other presently unexpected circumstances arise that have a material effect on the cash flow or profitability of our business, the anticipated cash needs of our business as well as the conclusions as to the adequacy of the available sources could change significantly. Any of these events or circumstances could involve significant additional funding needs in excess of the identified currently available sources, and could require us to raise additional capital to meet those needs. However, our ability to raise additional capital, if necessary, is subject to a variety of additional factors, including the commercial success of our operations, the volatility and demand of the capital and lending markets and the future market prices of our securities.

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

We are subject to interest rate risk in connection with our issuance of variable rate debt under our Senior Credit Facility and unsecured short-term revolving note facility. Interest rate changes could increase the amount of our interest payments and thus, negatively impact our future earnings and cash flows. We estimate that our annual interest expense on our floating rate indebtedness would increase by \$1.9 million for each 1% increase in interest rates until IBOR reaches 5%. After IBOR reaches 5% our annual interest expense on the unhedged portion of our floating rate indebtedness would increase by \$1.3 million for each 1% increase in interest rates. See “Item 3. Quantitative and Qualitative Disclosures About Market Risk—Interest Rate Risk” under Part I of this report.

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

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

- actual or anticipated variations in our quarterly operating results, including those resulting from seasonal variations in our business;
- introductions or announcements of technological innovations or new products by us or our competitors;
- disputes or other developments relating to proprietary rights, including patents, litigation matters, and our ability to patent our products and technologies;
- changes in our financial estimates by securities analysts;
- conditions or trends in the specialty bedding industry;
- additions or departures of key personnel;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- announcements by our competitors of their quarterly operating results or announcements by our competitors of their views on trends in the bedding industry;
- regulatory developments in the U.S. and abroad;

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- economic and political factors; and
- public announcements or filings with the SEC indicating that significant stockholders, directors or officers are selling shares of common stock.

In addition, the stock market in general has experienced significant price and volume fluctuations that have often been unrelated or disproportionate to operating performance. These broad market factors may seriously harm the market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted. A securities class action suit against us could result in potential liabilities, substantial costs, and the diversion of our management's attention and resources, regardless of the outcome.

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

The market price of our common stock could decline as a result of sales of substantial amounts of our common stock in the public market, or the perception that these sales could occur. In addition, these factors could make it more difficult for us to raise funds through future offerings of common stock. As of August 1, 2005, there were 98,997,392 shares of our common stock outstanding. All of our shares of our common stock are freely transferable without restriction or further registration under the Securities Act of 1933, except for certain shares of our common stock held by our executive officers, directors, principal stockholders, and some related parties. As previously disclosed in Current Reports on Form 8-K filed on March 22, 2005 and April 27, 2005, our two largest stockholders made partial distributions to their investors of a total of 11.0 million shares of our common stock in March 2005, and one of these stockholders made an additional distribution to its investors of 7.0 million shares in April 2005. Additionally, one of these stockholders sold 5.3 million shares in June 2005. These stockholders may choose to make additional distributions or sales of our common stock in the future.

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

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

As of June 30, 2005, our executive officers, directors, current principal stockholders, and their respective affiliates beneficially own, in the aggregate, approximately 32% of our outstanding common stock on a fully diluted basis, after giving effect to the weighted average vesting of all unvested options. These stockholders, as a group, are able to control substantially all matters requiring approval by our stockholders, including mergers, sales of assets, the election of all directors, and approval of other significant corporate transactions, in a manner with which you may not agree or that may not be in your best interest.

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

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

These provisions include:

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

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- the requirements that our stockholders provide advance notice when nominating our directors; and
- the inability of our stockholders to convene a stockholders' meeting without the chairperson of the board, the president, or a majority of the board of directors first calling the meeting.

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

We do not anticipate paying any dividends in the foreseeable future. We currently intend to retain our future earnings, if any, to fund the development and growth of our business. In addition, the terms of the instruments governing our existing debt and any future debt or credit facility may preclude us from paying any dividends.

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

### **Foreign Currency Exposures**

Our earnings, as a result of our global operating and financing activities, are exposed to changes in foreign currency exchange rates, which may adversely affect our results of operations and financial position. Our outlook assumes no significant changes in currency values from current rates. Should currency rates change sharply, our results could be negatively impacted. A sensitivity analysis indicates the potential loss in fair value on foreign currency forward contracts outstanding at June 30, 2005, resulting from a hypothetical 10% adverse change in all foreign currency exchange rates against the U.S. Dollar, is approximately \$2.9 million. Such losses would be largely offset by gains from the revaluation or settlement of the underlying Assets and Liabilities that are being protected by the foreign currency forward contracts.

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

### **Interest Rate Risk**

We are exposed to changes in interest rates. All of our indebtedness under our Senior Credit Facility and unsecured short-term revolving note facility is variable-rate debt. Interest rate changes generally do not affect the market value of such debt but do impact the amount of our interest payments and therefore, our future earnings and cash flows, assuming other factors are held constant. On June 30, 2005, we had variable-rate debt of approximately \$193.5 million. Holding other variables constant including levels of indebtedness, a one hundred basis point increase in interest rates on our variable-rate debt would cause an estimated reduction in income before income taxes for the next year of approximately \$1.9 million. We are required under the terms of our Senior Credit Facility to have at least \$60.0 million of our total indebtedness subject to either a fixed interest rate or interest rate protection through March 31, 2006.

In January 2003, we paid premiums to purchase two three-year interest rate caps for the purpose of protecting \$60.0 million of the existing variable-rate debt outstanding, at any given time, against LIBOR rates rising above 5%. Under the terms of the interest rate caps, we paid premiums to receive payments based on the difference between 3-month LIBOR and 5% during any period in which the 3-month LIBOR rate exceeds 5%. The interest rate caps settle on the last day of March, June, September and December until expiration, on March 31, 2006.

As a result of entering into the interest rate caps, we have mitigated our exposure to interest rate fluctuations above the predetermined level. As the interest payments on long-term debt are based on 3-month LIBOR and we receive a payment based on the difference between the set ceiling (5%) and 3-month LIBOR from the interest rate cap counter-party, we have eliminated any impact to rising interest rates above the stated ceiling, for an amount equal to \$60.0 million of our total debt outstanding.

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The fair value carrying amount of these instruments at June 30, 2005 and December 31, 2004 are presented below:

<i>(\$ in millions)</i>	June 30, 2005	December 31, 2004
Foreign exchange receivable	\$ —	\$ 0.5
Foreign exchange payable	(0.8)	—
<b>Total</b>	<b>\$ (0.8)</b>	<b>\$ 0.5</b>

### ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934, as amended (Exchange Act), as of the end of the period covered by this report. Based on that evaluation, our management, including our principal executive officer and principal financial officer, concluded that our disclosure controls and procedures were effective as of June 30, 2005 and designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

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



**PART II  
OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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

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

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

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

None

**ITEM 5. OTHER INFORMATION**

(a) On August 4, 2005, Tempur Production USA, Inc. ("Tempur Production"), a subsidiary of Tempur-Pedic International Inc., entered into a Second Amended and Renewed Revolving Promissory Note (the "Amended Note") with Fifth Third Bank to provide a \$50.0 million revolving line of credit. The Amended Note represents an amendment and renewal of the Amended and Renewed Revolving Promissory Note, dated April 1, 2005, in the maximum principal amount of \$40.0 million. Tempur Production entered into the Amended Note in order to increase the maximum principal amount available for borrowing to \$50.0 million and to extend the maturity date to December 2, 2005.

The Amended Note is unsecured, has a maturity date of December 2, 2005, and is guaranteed on an unsecured basis by Tempur-Pedic, Inc., another subsidiary of Tempur-Pedic International. The Amended Note will accrue interest at a rate equal to the prime rate minus one-half of one percent. Interest is payable monthly and the principal balance matures on December 2, 2005.

Upon occurrence of an event of default the interest rate on the entire principal balance and all matured interest installments outstanding shall automatically increase by two percent (2%) per annum and shall continue at that rate until the event of default is cured. Fifth Third Bank has the right to accelerate the payment of the Amended Note upon the occurrence of an event of default. The Amended Note specifies that the following are events of default: (i) Tempur Production's failure to pay any installment of principal or interest within 3 business days of its due date, (ii) the breach of any representation or warranty made by Tempur Production in the Amended Note, (iii) the breach of any covenant in the Amended Note which is not cured within 30 days of Tempur Production receiving notice of the breach, (iv) Tempur Production's failure to pay its other indebtedness having a principal amount in excess of \$5.0 million, (v) Tempur Production's insolvency or commencement of bankruptcy proceedings, (vi) the failure to pay any judgments or decrees against Tempur Production in excess of \$5.0 million for a period of 30 days, (vii) the Amended Note and its associated documents becoming invalid, (viii) a reportable event that would permit Tempur Production's employee benefit plan to be terminated, or (ix) the termination, dissolution or liquidation of Tempur Production.

The Amended Note contains certain negative and affirmative covenants and requirements affecting Tempur Production. Subject to certain important exceptions and qualifications set forth in the Amended Note, these

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covenants limit the ability of Tempur Production to (i) liquidate, merge or consolidate into another entity, (ii) sell assets of Tempur Production, (iii) change the name or state of organization of Tempur Production, (iv) effect any material change in Tempur Production's capital structure or allow a change in ownership of more than 10% of its outstanding stock, (v) create or authorize additional securities of Tempur Production, (vi) enter into transactions with affiliates, or (vii) become subject to any law, regulation or list of any governmental agency that prevents Fifth Third Bank from making an extension of credit to Tempur Production. These covenants also require Tempur Production to maintain its corporate existence, pay all liabilities and taxes, maintain proper books in accordance with GAAP, comply with the Amended Note and its associated documents, operate its business in substantially the same manner, and cure any defects in the Amended Note upon the request of Fifth Third Bank.

Tempur Production intends to use the proceeds from the Amended Note as bridge financing pending the completion of other long term financing for Tempur-Pedic International's new manufacturing plant in Albuquerque, New Mexico.

(b) Not applicable.

### **ITEM 6. EXHIBITS**

#### Exhibits

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

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\* This exhibit shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that Section, nor shall it be deemed incorporated by reference in any filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**TEMPUR-PEDIC INTERNATIONAL INC.**

*(Registrant)*

Date: August 8, 2005

By: \_\_\_\_\_ /s/ DALE E. WILLIAMS  
Dale E. Williams  
Senior Vice President, Chief Financial Officer,  
Secretary and Treasurer

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO  
SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Robert B. Trussell, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tempur-Pedic International Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 8, 2005

/s/ ROBERT B. TRUSSELL, JR.

Robert B. Trussell, Jr.  
Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO  
SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Dale E. Williams, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tempur-Pedic International Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 8, 2005

/s/ DALE E. WILLIAMS

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

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND  
CHIEF FINANCIAL OFFICER PURSUANT TO  
18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

Each of the undersigned hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, in his capacity as an officer of Tempur-Pedic International Inc. (the "Company"), that, to his knowledge, the Quarterly Report of the Company on Form 10-Q for the period ended June 30, 2005, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) and that the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of the Company. This written statement is being furnished to the Securities and Exchange Commission as an exhibit to such Form 10-Q. A signed original of this statement has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

Date: August 8, 2005

By: \_\_\_\_\_ /s/ ROBERT B. TRUSSELL, JR.

**Robert B. Trussell Jr.**  
**Chief Executive Officer**

Date: August 8, 2005

By: \_\_\_\_\_ /s/ DALE E. WILLIAMS

**Dale E. Williams**  
**Senior Vice President, Chief Financial Officer,**  
**Secretary and Treasurer**