TEMPUR PEDIC INTERNATIONAL INC
Form 10-Q
May 08, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2006

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

For the transition period from to

Commission file number 001-31922

TEMPUR-PEDIC INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

Delaware	**33-1022198**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1713 Jaggie Fox Way

Lexington, Kentucky 40511

(Address, including zip code, of registrant s principal executive offices)

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

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

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

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

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

The number of shares outstanding of the registrant s common stock as of April 30, 2006 was 84,532,839 shares.

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Special Note Regarding Forward-Looking Statements

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

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

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

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

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FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	March 31, 2006	December 31, 2005
	(Unaudited)	
ASSETS		
Current Assets:		
Cash and cash equivalents	**$ 13,181**	$ 17,855
Accounts receivable, net	**122,644**	111,726
Inventories	**78,248**	81,064
Prepaid expenses and other current assets	**10,944**	11,072
Income taxes receivable		19
Deferred income taxes	**7,098**	6,532
Total Current Assets	**232,115**	228,268
Property, plant and equipment, net	**199,858**	193,224
Goodwill	**199,868**	199,962
Other intangible assets, net	**73,109**	73,908
Deferred financing and other non-current assets, net	**7,238**	6,949
Total Assets	**$ 712,188**	$ 702,311
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	**$ 37,059**	$ 33,639
Accrued expenses and other	**63,797**	56,570
Income taxes payable	**16,427**	
Current portion of long-term debt	**26,440**	30,770
Total Current Liabilities	**143,723**	120,979
Long-term debt	**371,793**	313,711
Deferred income taxes	**40,307**	40,386
Other non-current liabilities	**471**	906
Total Liabilities	**556,294**	475,982
Commitments and contingencies see Note 8		
Stockholders Equity:		
Common stock $.01 par value; 300,000 shares authorized; 99,215 shares issued as of March 31, 2006 and December 31, 2005	**992**	992
Additional paid in capital	**255,653**	255,369
Deferred stock compensation net of amortization of $12,802 and $12,312 as of March 31, 2006 and December 31, 2005, respectively	**(1,706)**	(2,196)
Retained earnings	**72,237**	46,245
Accumulated other comprehensive income	**998**	1,137

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

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

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

(In thousands, except per share amounts)

(1) Summary of Significant Accounting Policies

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

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

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

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

(b) *Reclassifications* Certain prior period amounts have been reclassified to conform to the 2006 presentation. Income taxes payable is shown separately from Accrued expenses and other in the Condensed Consolidated Statement of Cash Flows.

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

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

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

(f) *Financial Instruments and Hedging* Derivative financial instruments are used within the normal course of business principally to manage foreign currency exchange rate risk. These instruments are generally short term

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

in nature and are subject to fluctuations in foreign exchange rates and credit risk. Credit risk is managed through the selection of sound financial institutions as counterparties. The changes in fair market value of foreign exchange derivatives are recognized currently through earnings. The changes in fair market value of derivative financial instruments used to manage interest rates are recognized through Accumulated other comprehensive income.

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

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

	March 31, 2006	December 31, 2005
Finished goods	**$ 58,334**	$ 61,071
Work-in-process	**7,546**	7,427
Raw materials and supplies	**12,368**	12,566
	$ 78,248	$ 81,064

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

(j) *Goodwill and Other Intangible Assets* The Company follows SFAS 142, Goodwill and Other Intangible Assets. SFAS 142 requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values and reviewed for impairment in accordance with SFAS 144. The Company performs an annual impairment test on all existing goodwill in the fourth quarter of each year. The Company performed the annual impairment test in the fourth quarter of 2005 on all existing goodwill and no impairment existed as of December 31, 2005. If facts and circumstances lead the Company s management to believe that one of the Company s other amortized intangible assets may be impaired, the Company will evaluate the extent to which the related cost is recoverable by comparing the future undiscounted cash flows estimated to be associated with that asset to the asset s carrying amount and write-down that carrying amount to fair value to the extent necessary.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

		March 31, 2006			December 31, 2005		
	Useful Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Unamortized indefinite life intangible assets:							
Trademarks		**$ 55,000**	**$**	**$ 55,000**	$ 55,000	$	$ 55,000
Amortized intangible assets:							
Technology	10	**$ 16,000**	**$ 5,467**	**$ 10,533**	$ 16,000	$ 5,067	$ 10,933
Patents	5-20	**6,010**	**3,512**	**2,498**	5,968	3,234	2,734
Customer database	5	**4,200**	**2,870**	**1,330**	4,200	2,660	1,540
Foam formula	10	**3,700**	**1,264**	**2,436**	3,700	1,172	2,528
Trademarks and other	5	**3,313**	**2,001**	**1,312**	3,146	1,973	1,173
Total		**$ 88,223**	**$ 15,114**	**$ 73,109**	$ 88,014	$ 14,106	$ 73,908

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

The changes in the carrying amount of Goodwill for the three months ended March 31, 2006 are related to changes in amounts for foreign currency translation as follows:

Balance as of December 31, 2005	$ 199,962
Foreign currency translation adjustments	(94)
Balance as of March 31, 2006	$ 199,868

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

	March 31, 2006	December 31, 2005
Domestic	**$ 89,452**	$ 89,452
International	**110,416**	110,510
	$ 199,868	$ 199,962

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

(l) *Accrued Sales Returns* Estimated sales returns are provided at the time of sale based on historical sales returns. The Company allows product returns up to 120 days following a sale. Accrued sales returns are included in Accrued expenses and other in the accompanying Condensed Consolidated Balance Sheets.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

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

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

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

(n) *Income Taxes* Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. In accordance with SFAS 5, Accounting for Contingencies, the Company accrues for probable foreign and domestic tax obligations as required by facts and circumstances in the various regulatory environments.

(o) *Revenue Recognition* Sales of products are recognized when the products are shipped to customers and the risks and rewards of ownership are transferred. No collateral is required on sales made in the normal course of business. The allowance for doubtful accounts is the Company s best estimate of the amount of probable credit losses in the Company s existing accounts receivable. The Company determines the allowance based on historical write-off experience. The Company reviews the adequacy of its allowance for doubtful accounts quarterly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Allowance for doubtful accounts was $4,988 and $5,436 as of March 31, 2006 and December 31, 2005, respectively. Deposits made by customers are recorded as a liability and recognized as a sale when product is shipped. The Company had $248 and $454 of deferred revenue included in Accrued expenses and other in the accompanying Condensed Consolidated Balance Sheets as of March 31, 2006 and December 31, 2005, respectively.

The Company reflects all amounts billed to customers for shipping and handling in Net sales and the costs incurred from shipping and handling product in Cost of sales. Amounts included in Net sales for shipping and handling on large quantity orders in our Retail sales channel were approximately $0 and $3,091 for the three months ended March 31, 2006 and March 31, 2005, respectively. We no longer separately invoice customers in the Retail channel for freight on large quantity orders. All other amounts included in Net sales for shipping and handling were approximately $3,199 and $4,059 for the three months ended March 31, 2006 and March 31, 2005, respectively. Amounts included in Cost of sales for shipping and handling were approximately $17,858 and $20,033 for the three months ended March 31, 2006 and March 31, 2005, respectively.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

(p) *Advertising Costs* The Company expenses advertising costs as incurred except for production costs and advance payments, which are deferred and expensed when advertisements run for the first time. Direct response advance payments are deferred and are amortized over the life of the program. Advertising costs charged to expense were approximately $26,138 and $25,780 for the three months ended March 31, 2006 and March 31, 2005, respectively. Advertising costs deferred and included in prepaid expenses and other current assets in the accompanying Condensed Consolidated Balance Sheets were approximately $5,081 and $6,064 as of March 31, 2006 and December 31, 2005, respectively.

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

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

(s) *Stock Based Compensation* The Company adopted SFAS 123R *Share-Based Payment* (SFAS 123R) on January 1, 2006 using the modified prospective method for the transition. SFAS 123R requires compensation expense relating to share-based payments be recognized in the financial statements. The cost is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the estimable life of the equity award. Additionally, SFAS 123R requires that the benefit of tax deductions in excess of recognized compensation expense be reported as a financing cash flow rather than an operating cash flow in the accompanying consolidated statement of cash flows. Financial results including cash flow from operating results for 2005 have not been restated for the adoption of SFAS 123R.

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

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

In December 2005, the Company accelerated the vesting of certain unvested incentive stock options which had exercise prices greater than the fair market value of the stock on the date of acceleration. Options to purchase approximately 467 shares of common stock, or approximately 18% of the Company s outstanding unvested options, were subject to the acceleration. Options subject to the acceleration had exercise prices ranging from $13.94 to $24.40 per share and a weighted average remaining life of 9 years. The weighted average exercise price of the options subject to the acceleration was $18.51. The purpose of the acceleration was to enable the Company to avoid recognizing compensation expense associated with these options in future periods in its financial statements, upon adoption of SFAS 123R. The acceleration resulted in an increase of $2,842 in the pro forma employee stock option stock-based compensation expense for the fourth quarter and year ended December 31, 2005. See Note 6 for further discussion of the Company s adoption of SFAS 123R. The adoption did not have a material effect on the Company s condensed consolidated financial statements.

(2) Recently Issued Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154 is a replacement of Accounting Principles Board No. 20, Accounting Changes and FASB Statement No. 3 Reporting Accounting Changes in Interim Financial

Statements. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections and is effective for accounting changes and corrections of errors made in fiscal years beginning after December 31, 2005. The Company adopted this pronouncement on January 1, 2006. The adoption did not have a material effect on the Company s condensed consolidated financial statements.

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

(3) Property, Plant and Equipment

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

	March 31, 2006	December 31, 2005
Land and buildings	**$ 68,072**	$ 67,193
Machinery and equipment	**98,224**	96,298
Construction in progress	**92,245**	82,775
	258,541	246,266
Total accumulated depreciation	**(58,683)**	(53,042)
	$ 199,858	$ 193,224

Construction in progress is primarily comprised of the costs for the construction of the Company s New Mexico facility and includes capitalized interest costs of $3,757 and $2,567 as of March 31, 2006 and December 31, 2005, respectively, in connection with the construction of assets. Additionally, Construction in progress includes $1,437 and $843 that is included in Accounts payable as of March 31, 2006 and December 31, 2005, respectively. These amounts have been excluded from Cash flows from investing activities in the Consolidated Statements of Cash Flows in their respective periods.

(4) Long-term Debt

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

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

Foreign Term Loan (EUR Denominated) payable to lenders, interest at Index Rate or LIBOR plus margin (3.80% and 3.46% as of March 31, 2006 and December 31, 2005, respectively), principal payments due quarterly through June 30, 2010 with a final payment on October 18, 2010		
Domestic Long-Term Revolving Credit Facility payable to lenders, interest at Index Rate or LIBOR plus applicable margin (5.77% and 5.28% as of March 31, 2006 and December 31, 2005, respectively), commitment through and due October 18, 2010	**162,000**	83,000
2005 Industrial Revenue Bonds:		
Variable Rate Industrial Revenue Bonds Series 2005A, interest rate determined by remarketing agent (4.65% and 4.35% as of March 31, 2006 and December 31, 2005, respectively), interest due monthly and principal due quarterly through September 1, 2030	**53,925**	53,925
Senior Subordinated Notes:		
U.S. Senior Subordinated Notes payable to institutional investors, interest at 10.25%, due August 15, 2010	**97,500**	97,500
Other:		
Mortgages payable to a bank, secured by certain property, plant and equipment and other assets, bearing fixed interest at 4.0% to 5.1%	**1,464**	1,491
	398,233	344,481
Less: Current portion	**(26,440)**	(30,770)
Long-term debt	**$ 371,793**	$ 313,711

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

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

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

The 2005 Senior Credit Facility is guaranteed by Tempur-Pedic International Inc., Tempur World, LLC and Tempur World Holdings, LLC, as well as certain other subsidiaries of the Company, and is secured by certain fixed and intangible assets of Dan Foam ApS and substantially all U.S. assets. The maturity date of the 2005 Senior Credit Facility is October 18, 2010. The 2005 Senior Credit Facility contains certain financial covenants and requirements affecting the Company and its subsidiaries, among the most significant of which are a fixed charge coverage ratio requirement and a consolidated leverage ratio requirement. The Company was in compliance with all covenants as of March 31, 2006.

At March 31, 2006, the Company had a total of $280,000 of long-term revolving credit facilities under the 2005 Senior Credit Facility, which was comprised of the $260,000 Domestic Revolver and the $20,000 Foreign Revolver (collectively, the Revolvers). The Revolvers provide for the issuance of letters of credit which, when issued, constitute usage and reduce availability under the Revolvers. The aggregate amount of letters of credit outstanding under the Revolvers was $56,535 at March 31, 2006. After giving effect to letters of credit and $162,000 in borrowings under the Domestic Revolver, total availability under the Revolvers was $61,465 at March 31, 2006. There were no borrowings under the Foreign Revolver as of March 31, 2006.

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

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

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

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

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

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

The Senior Subordinated Notes contain certain nonfinancial and financial covenants which include restrictions on: the declaration or payment of dividends and distributions; the payment, purchase, redemption, defeasance, acquisition or retirement of subordinated indebtedness; the granting of liens; the making of loans and the transfer of properties and assets; mergers; consolidations or sale of assets; the acquisition or creation of additional subsidiaries; and the sale and leaseback of assets. The Company was in compliance with all covenants as of March 31, 2006.

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(In thousands, except per share amounts)

(5) Stockholders Equity

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

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

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

(6) Stock Based Compensation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

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

(7) Accumulated Other Comprehensive Income

The components of Accumulated other comprehensive income are as follows:

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

(8) Commitments and Contingencies

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

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

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

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

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

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

(9) Income Taxes

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

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

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

(10) Major Customers

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

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(11) Earnings Per Share

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

(12) Business Segment Information

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

The following table summarizes Total assets by segment:

	March 31, 2006	December 31, 2005

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

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The following tables summarize other segment information:

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

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

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

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

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(13) Condensed Consolidating Interim Financial Information

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

Condensed Consolidating Statements of Income

For the Three Months Ended March 31, 2006

(Unaudited)

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

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Condensed Consolidating Statements of Income

For the Three Months Ended March 31, 2005

(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net sales	$	$ 2,354	$	$ 145,576	$ 86,849	$ (12,400)	$ 222,379
Cost of goods sold		1,202	(322)	77,088	42,568	(12,400)	108,136
Gross profit		1,152	322	68,488	44,281		114,243
Operating expenses	1,708	5,400	2,886	30,676	24,193		64,863
Operating income (loss)	(1,708)	(4,248)	(2,564)	37,812	20,088		49,380
Interest income (expense), net		(3,889)	(992)	6	(488)		(5,363)
Other income (loss)	2	26,304	156	(26,783)	(481)		(802)
Income taxes		9,402	(542)	1,799	5,806		16,465
Net income (loss)	$ (1,706)	$ 8,765	$ (2,858)	$ 9,236	$ 13,313	$	$ 26,750

Condensed Consolidating Balance Sheets

As of March 31, 2006

(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Current assets	$ 1,273	$ 185,105	$ 3,682	$ 67,012	$ 104,089	$ (129,046)	$ 232,115
Property, plant and equipment, net		138,124	357	5,308	56,069		199,858
Other noncurrent assets	237,205	296,646	350,944		137,315	(741,895)	280,215

Total assets	$ 238,478	$ 619,875	$ 354,983	$ 72,320	$ 297,473	$ (870,941)	$ 712,188
Current liabilities	$ 115,005	$ (2,065)	$ 5,233	$ 88,145	$ 66,450	$ (129,045)	$ 143,723
Noncurrent liabilities		569,207	88,870		215,403	(460,909)	412,571
Equity (deficit)	123,473	52,733	260,880	(15,825)	15,620	(280,987)	155,894
Total liabilities and equity (deficit)	$ 238,478	$ 619,875	$ 354,983	$ 72,320	$ 297,473	$ (870,941)	$ 712,188

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

Condensed Consolidating Balance Sheets

As of December 31, 2005

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Current assets	$ 647	$ 76,888	$ 19,917	$ 56,428	$ 107,156	$ (32,768)	$ 228,268
Property, plant and equipment, net		130,608	472	5,543	56,601		193,224
Other noncurrent assets	132,997	286,374	218,308	1,967	137,707	(496,534)	280,819
Total assets	$ 133,644	$ 493,870	$ 238,697	$ 63,938	$ 301,464	$ (529,302)	$ 702,311
Current liabilities	$ 15,866	$ (25,446)	$ 19,297	$ 80,072	$ 63,957	$ (32,767)	$ 120,979
Noncurrent liabilities		482,170	89,327	50	236,060	(452,604)	355,003
Equity (deficit)	117,778	37,146	130,073	(16,184)	1,447	(43,931)	226,329
Total liabilities and equity (deficit)	$ 133,644	$ 493,870	$ 238,697	$ 63,938	$ 301,464	$ (529,302)	$ 702,311

Condensed Consolidating Statements of Cash Flows

For the Three Months Ended March 31, 2006

(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net (loss) income	$ (1,323)	$ 8,764	$ (1,673)	$ 6,815	$ 14,310	$	$ 26,893
Non-cash expenses	793	3,281	(11)	415	3,425		7,903
Changes in working capital	98,288	(79,657)	1,815	(9,017)	5,330		16,759
Net cash (used in) / provided by operating activities	97,758	(67,612)	131	(1,787)	23,065		51,555
Net cash used for investing activities		(10,426)	(200)	1,787	(615)		(9,454)

Net cash provided by / (used in) financing activities	(97,968)	78,575	(57)		(27,755)		(47,205)
Effect on exchange rate changes on cash					430		430
Net (decrease) increase in cash and cash equivalents	(210)	537	(126)		(4,875)		(4,674)
Cash and cash equivalents at beginning of period	451	2,044	502		14,858		17,855
Cash and cash equivalents at end of period	$ 241	$ 2,581	$ 376	$	$ 9,983	$	$ 13,181

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

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

(In thousands, except per share amounts)

Condensed Consolidating Statements of Cash Flows

For the Three Months Ended March 31, 2005

(Unaudited)

	Ultimate Parent	Combined Issuer Subsidiaries	Combined Guarantor Parents	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated
Net (loss) income	$ (1,706)	$ 8,765	$ (2,858)	$ 9,236	$ 13,313	$	$ 26,750
Non-cash expenses	882	3,380	148	642	4,586		9,638
Changes in working capital	(642)	3,334	3,368	(9,135)	780		(2,295)
Net cash (used in) / provided by operating activities	(1,466)	15,479	658	743	18,679		34,093
Net cash used for investing activities		(16,901)	(502)	(483)	(1,243)		(19,129)
Net cash provided by / (used in) financing activities	692	2,286	111		(31,244)		(28,155)
Effect on exchange rate changes on cash					(2,182)		(2,182)
Net (decrease) increase in cash and cash equivalents	(774)	864	267	260	(15,990)		(15,373)
Cash and cash equivalents at beginning of period	970	551	607	219	26,021		28,368
Cash and cash equivalents at end of period	$ 196	$ 1,415	$ 874	$ 479	$ 10,031	$	$ 12,995

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

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

Executive Overview

General We are the leading global manufacturer, marketer and distributor of premium mattresses and pillows, which we sell globally in over 70 countries under the TEMPUR® and Tempur-Pedic® brands. We believe our premium mattresses and pillows are more comfortable than standard bedding products because our proprietary, pressure-relieving TEMPUR® material is temperature sensitive, has a high density, and conforms to the body to therapeutically align the neck and spine, thus reducing neck and lower back pain, two of the most common complaints about other sleep surfaces.

Business Segment Information We have two operating business segments: Domestic and International. These reportable segments are strategic business units that are managed separately. The Domestic operating segment consists of our U.S. manufacturing facility whose customers include our U.S. distribution subsidiary and certain North 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 2006:

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

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

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

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

Results of Operations

Key financial highlights for quarter ended March 31, 2006 were as follows:

Net sales rose 3% to $228.6 million from $222.4 million in the first quarter of 2005. Retail channel sales worldwide increased 8%. Sales in the U.S. retail channel grew 7%. Sales in the U.S. furniture retail channel grew 14%. Sales in the international retail channel increased 12%. The U.S. dollar strengthened compared to first quarter 2005, which resulted in a negative foreign exchange rate impact of $7.0 million on total net sales in the first quarter of 2006 as compared to the first quarter of 2005, or approximately 3% of total net sales and approximately 9% of international sales.

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Earnings per share rose 12% to $0.29 per diluted share in the first quarter of 2006 from $0.26 per diluted share in the first quarter of 2005.

Cash flow provided by operations increased to $51.6 million in the first quarter of 2006 from $34.1 million in the first quarter of 2005. The increase was principally driven by improved working capital.

We made a voluntary prepayment of $21.8 million on the Foreign Term Loan, in excess of our scheduled principal payment of $5.8 million for a total principal reduction of $27.6 million under our 2005 Senior Credit Facility.

During the first quarter, we purchased 8.0 million shares of our common stock at a total cost of $98.2 million.

The following table sets forth the various components of our Condensed Consolidated Statements of Income, and expresses each component as a percentage of Net Sales:

(In millions, except percentages and earnings per share)	**Three Months Ended March 31, 2006**		**Three Months Ended March 31, 2005**	
Net sales	**$ 228.6**	**100%**	$ 222.4	100%
Cost of sales	**117.3**	**51**	108.2	49
Gross profit	**111.3**	**49**	114.2	51
Selling and marketing expenses	**44.7**	**20**	45.0	20
General and administrative and other	**19.4**	**8**	19.8	9
Operating income	**47.2**	**21**	49.4	22
Interest expense, net	**(4.4)**	**(2)**	(5.4)	(3)
Loss on debt extinguishment			(0.7)	
Other expense, net	**(0.1)**		(0.1)	
Income before income taxes	**42.7**	**19**	43.2	19
Income tax provision	**15.8**	**7**	16.4	7
Net income	**$ 26.9**	**12%**	$ 26.8	12%
Earnings per share:				
Basic	**0.30**		$ 0.27	
Diluted	**0.29**		$ 0.26	
Weighted average shares outstanding:				
Basic	**89,346**		98,420	
Diluted	**93,089**		103,392	

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Three Months Ended March 31, 2006 Compared with Three Months Ended March 31, 2005

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

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Three Months Ended March 31,		Three Months Ended March 31,		Three Months Ended March 31,	
(Millions)	2006	2005	2006	2005	2006	2005
Retail	**$ 183.5**	$ 169.3	**$ 125.2**	$ 117.2	**$ 58.3**	$ 52.1
Direct	**22.0**	28.6	**19.5**	25.4	**2.5**	3.2
Healthcare	**11.1**	12.8	**3.1**	3.0	**8.0**	9.8
Third Party	**12.0**	11.7	**3.7**	2.3	**8.3**	9.4
	$ 228.6	$ 222.4	**$ 151.5**	$ 147.9	**$ 77.1**	$ 74.5
Domestic	**$ 151.5**	$ 147.9				
International	**77.1**	74.5				
Total	**$ 228.6**	$ 222.4				

A summary of Net sales by product is below:

	CONSOLIDATED		DOMESTIC		INTERNATIONAL	
	Three Months Ended March 31,		Three Months Ended March 31,		Three Months Ended March 31,	
(Millions)	2006	2005	2006	2005	2006	2005
Net sales:						
Mattresses	**$ 159.9**	$ 154.0	**$ 112.6**	$ 111.0	**$ 47.3**	$ 43.0
Pillows	**28.5**	33.4	**13.3**	13.8	**15.2**	19.6
Other	**40.2**	35.0	**25.6**	23.1	**14.6**	11.9
	$ 228.6	$ 222.4	**$ 151.5**	$ 147.9	**$ 77.1**	$ 74.5
Units sold [(1)]:						
Mattresses	**195,178**	184,319	**113,949**	111,813	**81,229**	72,506

Pillows	**557,903**	630,261	**260,951**	258,132	**296,952**	372,129

(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 March 31, 2006 increased to $228.6 million from $222.4 million for the same period in 2005, an increase of $6.2 million, or 3%. This increase was primarily attributable to an increase in mattress sales in our Retail channel. Mattress sales increased $5.9 million, or 4%. For the three months ended March 31, 2006, our Retail channel increased to $183.5 million from $169.3 million for the same period in 2005, an increase of $14.2 million, or 8%. Our Third Party channel increased by 3%, which was primarily due to an increase in our Domestic segment. Consolidated pillow sales decreased approximately $4.9 million from the first quarter of 2005, primarily attributable to a decline in our International sales in Asia to certain Third Party distributors. Our Direct and Healthcare channels declined 23% and 13%, respectively. The Direct channel decline in our Domestic segment is due primarily to the growth in our Retail channel. The decline in our International segment is due to Retail channel growth and due to our decision to focus our international direct model in the U.K. only.

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Domestic. Domestic Net sales for the three months ended March 31, 2006 increased to $151.5 million from $147.9 million for the same period in 2005, an increase of $3.6 million, or 2%. Our Domestic Retail channel continues to be our largest channel, with $125.2 million in Net sales for the three months ended March 31, 2006. This is an increase of $8.0 million, or 7% over the prior year quarter. This increase is primarily a result of our strategy to expand distribution for our products into additional targeted retail furniture stores. Our Third Party channel increased 61% due to the continued growth in our existing Third Party distributors. Our Direct channel decreased 23%. Domestic mattress sales in the first quarter of 2006 increased $1.6 million, or 1%, over the same period in 2005. In addition, pillow sales decreased $0.5 million, or 4%.

International. International Net sales for the three months ended March 31, 2006 increased to $77.1 million from $74.5 million for the same period in 2005, an increase of $2.6 million, or 3%. The largest channel in our International segment continues to be our Retail channel, which increased $6.2 million, or 12%, for the three months ended March 31, 2006. Our Direct channel sales decreased 22%, primarily attributable to our decision to focus our international direct model in the U.K. only. Our Third party sales decreased 12%, primarily due to the decrease in sales to certain Third Party distributors selling into Asia. In addition, our Healthcare channel decreased $1.8 million, or 18%. International mattress sales in the first quarter of 2006 increased $4.3 million, or 10%, over the first quarter of 2005. Pillow sales for the first quarter of 2006 decreased $4.4 million, or 22%, as compared to the first quarter of 2005. The decrease in pillow sales is primarily related to our efforts to limit unauthorized sales by third parties into certain existing markets in Asia.

Gross profit. Gross profit for the three months ended March 31, 2006 decreased to $111.3 million from $114.2 million for the same period in 2005, a decrease of $2.9 million, or 3%. 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 and are sold with lower margin products such as foundations and bed frames. We expect continued downward pressure on our margins as a result of the continued growth in our Retail channel and in mattress sales.

Increases in raw material costs also reduced our gross margin. We currently believe that there will continue to be cost pressures from the recent rise in chemical prices, driven primarily by natural gas increases and fuel surcharges for the transportation and delivery of our products. During the second half of 2005, we started a number of productivity and efficiency initiatives, including negotiated discounts for many of our chemical purchases, reverse auctions on certain material purchases, purchasing leverage on consolidated global buying, and implementation of warehousing and shipping efficiencies. In the first quarter of 2006, these initiatives mitigated some but not all of the impact of raw material cost increases, and we currently expect that increased raw material costs will impact our gross margin for the remainder of 2006. Our gross margin was also negatively impacted in the first quarter as a result of the opening of several major new accounts, because of our business practice of providing discounted floor models which can temporarily reduce our average selling price for mattresses. Our gross margin could be similarly impacted going forward in connection with the opening of additional major new accounts.

Domestic. Domestic Gross profit for the three months ended March 31, 2006 decreased to $66.7 million from $70.0 million for the same period in 2005, a decrease of $3.3 million, or 5%. The Gross profit margin in our Domestic segment was 44% and 47% for the three months ended March 31, 2006 and March 31, 2005, respectively. For the three months ended March 31, 2006, the Gross profit margin for our Domestic segment was impacted by the increase in our Retail channel sales and increases in raw materials costs. Our Domestic cost of sales increased to $84.8 million for the three months ended March 31, 2006 as compared to $77.9 million for the three months ended March 31, 2005, an increase of $6.9 million, or 9%.

International. International Gross profit for the three months ended March 31, 2006 increased to $44.6 million from $44.2 million for the same period in 2005, an increase of $0.4 million, or 1%. The Gross profit margin in our International segment was 58% and 59% for the three months ended March 31, 2006 and

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March 31, 2005, respectively. For the three months ended March 31, 2006, the Gross profit margin for our International segment was impacted by the continued growth of the Retail channel and product and geographic mix. Pillow sales have declined in Asia which negatively impacts the gross margins in this segment of our business. Our International Cost of sales for the three months ended March 31, 2006 increased to $32.5 million from $30.3 million for the same period in 2005, an increase of $2.2 million, or 7%.

Selling and marketing expenses. Selling and marketing expenses include advertising and media production associated with our Direct channel; other marketing materials such as catalogs, brochures, videos, product samples, direct customer mailings and point of purchase materials; and sales force compensation and customer service. We also include in Selling and marketing expenses certain new product development costs, including market research and testing for new products. Selling and marketing expenses decreased to $44.7 million for the three months ended March 31, 2006 as compared to $45.0 million for the three months ended March 31, 2005. Selling and marketing expenses as a percentage of Net sales remained relatively flat for the three months ended March 31, 2006 compared to the same period for 2005. This is consistent with our strategy to maintain our advertising spending with our revenues in order to drive growth in our brand awareness.

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 $19.4 million for the three months ended March 31, 2006 as compared to $19.8 million for the three months ended March 31, 2005, a slight decrease of $0.4 million.

General and administrative and other expenses as a percentage of Net sales were 8% and 9% for the three months ended March 31, 2006 and March 31, 2005, respectively. The decrease as a percentage of Net sales was due to increased operating leverage from fixed administrative costs and the timing of audit and legal expenses.

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 $4.4 million for the three months ended March 31, 2006, as compared to $5.4 million for the three months ended March 31, 2005, a decrease of $1.0 million, or 19%. This decrease in interest expense for the three months ended March 31, 2006 is primarily attributable to lower weighted average interest rates on our long-term debt and increased capitalized interest costs 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 foreign operations. Our effective income tax rates for the three months ended March 31, 2006 and for the three months ended March 31, 2005 differed from the federal statutory rate principally because of certain foreign tax rate differentials, state and local income taxes, valuation allowances on certain domestic and foreign net operating losses, compensation expense associated with certain options granted prior to the initial public offering, and the production activities deduction as defined in the 2004 Jobs Creation Act.

Our effective tax rate for the three months ended March 31, 2006 was 37.0%. For the same period in 2005, the effective tax rate was 38.1%. The decrease in the effective tax rate is due to a reduction in state tax expense, which resulted from a favorable state tax ruling we received in the fourth quarter of 2005.

Liquidity and Capital Resources

Liquidity

Our principal sources of funds are cash flows from operations and borrowings. Our principal uses of funds consist of capital expenditures, payments of principal and interest on our debt facilities, and share repurchases made from time to time pursuant to a share repurchase program. At March 31, 2006, we had working capital of

$88.4 million including Cash and cash equivalents of $13.2 million as compared to working capital of $107.3 million including $17.9 million in Cash and cash equivalents as of December 31, 2005. Increased Accounts payable, Income taxes payable and Accrued expenses, coupled with decreases in inventory and cash, led to an 18% decrease in working capital from December 31, 2005 to March 31, 2006.

Our cash flow from operations increased to $51.6 million for the three months ended March 31, 2006 as compared to $34.1 million for the three months ended March 31, 2005. The increase in operating cash flows was primarily related to changes in certain operating assets and liabilities. Decreases in our inventory levels provided additional operating flows of $12.0 million for the three months ended March 31, 2006 as compared to the same period in 2005. Changes in the remaining operating assets and liabilities provided additional operating cash flow of $8.2 million, primarily increases in Accounts payable and Accrued expenses.

Net cash used in investing activities decreased to $9.5 million for the three months ended March 31, 2006 as compared to $19.1 million for the three months ended March 31, 2005, a decrease of $9.6 million. Investing activities in the three months ended March 31, 2006 consisted primarily of $7.0 million related to the construction of our new manufacturing facility in New Mexico, as compared to $15.7 million in construction costs for the three months ended March 31, 2005.

Cash flow used by financing activities was $47.2 million for the three months ended March 31, 2006 as compared to cash flow used by financing activities of $28.2 million for the three months ended March 31, 2005, representing an increase in cash flow used of $19.0 million. This increase is due primarily to our share repurchases of $98.2 million, which were largely offset by an increase of $68.0 million in associated borrowings on our revolving credit facilities.

Capital Expenditures

Capital expenditures totaled $9.3 million for the three months ended March 31, 2006, including $1.2 million in capitalized interest costs related to the construction of our new manufacturing facility in New Mexico discussed below. Capital expenditures totaled $18.7 million for the three months ended March 31, 2005. For the remainder of 2006 we expect our capital expenditures to be approximately $25.7 million including approximately $8.0 million for the completion of the new manufacturing facility. As of March 31, 2006, we had commitments of $6.2 million associated with the construction of our new plant.

In order to meet anticipated future demands for our products, we commenced construction of our third manufacturing facility in September 2004, located in Albuquerque, New Mexico. The new facility is expected to be completed in the fourth quarter of 2006. Our expected capital expenditures related to this facility are approximately $90.0 million to $95.0 million. This facility will allow us to meet the demands for our products primarily in the western U.S. as well as certain third party distributors.

Debt Service

For the three months ended March 31, 2006, there were two primary factors affecting our debt levels. Our total long-term debt increased to $371.8 million as of March 31, 2006 from $313.7 million as of December 31, 2005. On March 31, 2006, we made a voluntary prepayment of $21.8 million on our Foreign Term Loan, in excess of the scheduled principal payment of $5.8 million, for a total principal reduction of $27.6 million. The prepayment was funded entirely from the strong operating cash flows in our International segment. Additionally, during the three months ended March 31, 2006, we increased borrowings on our domestic revolving credit facility by $79.0 million in order to fund our share repurchase program, through which we purchased 8.0 million shares at a total cost of $98.2 million.

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

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Stockholders Equity

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

On January 25, 2006, our Board of Directors amended the share repurchase program described above to increase the total authorization by an additional $100.0 million resulting in a total authorization to purchase up to $180.0 million of Tempur-Pedic International Inc. s common stock. From January 1, 2006 through March 31, 2006, we repurchased an additional 8.0 million shares at a total cost of $98.2 million. At March 31, 2006, the Company had $5.8 million in remaining authorization. The share repurchases have been and will continue to be funded from borrowings under the 2005 Senior Credit Facility and funds from operations.

Factors That May Affect Future Performance

Managing Growth We have grown rapidly, with our Net sales increasing from $221.5 million in 2001 to $836.7 million for 2005 and $228.6 million for the three months ended March 31, 2006. Our growth has placed, and will continue to place, a strain on our management, production, product distribution network, information systems and other resources. In response to these challenges, management has continued to invest in increased production capacity, enhanced operating and financial infrastructure and systems and continued expansion of the human resources in our operations. Our expenditures for advertising and other marketing-related activities are made as advertising rates are favorable to us and as the continued growth in the business allows us the ability to invest in building our brand.

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

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

Significant Growth Opportunities Our products are currently sold in approximately 5,600 furniture and bedding retail stores in the U. S., out of a total of approximately 10,000 stores we have identified as appropriate targets. Within this addressable market of approximately 10,000 stores, our plan is to increase our total penetration to a total of 7,000 and 8,000 stores over time. Our products are also sold in approximately 4,300 furniture retail and department stores outside the U.S., out of a total of approximately 7,000 stores that we have identified as appropriate targets. For the three months ended March 31, 2006, we added a net of approximately 290 stores in the U.S. and approximately 200 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.

In addition to these growth opportunities, management believes that we currently supply only a small percentage of approximately 15,400 nursing homes and 5,000 hospitals in the U.S., with a collective bed count in excess of 2.7 million. Clinical evidence indicates that our products are both effective and cost efficient for the prevention and treatment of pressure ulcers, or bed sores, a major problem for elderly and bed-ridden patients. 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 March 31, 2006, we had $371.8 million of Long-term debt outstanding, and our Stockholders Equity was $155.9 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 or that future borrowing will be available under our 2005 Senior Credit Facility, or otherwise, to enable us to de-leverage the business.

Exchange Rates As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. We use foreign exchange forward contracts to manage a portion of the exposure to the risk of the eventual net cash inflows and outflows resulting from foreign currency denominated transactions between Tempur-Pedic subsidiaries and their customers and suppliers, as well as between the Tempur-Pedic subsidiaries themselves. These hedging transactions may not succeed in managing our foreign currency exchange rate risk. See ITEM 3. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exposures under Part I of this report.

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

Critical Accounting Policies and Estimates

For a discussion of our critical accounting policies and estimates, see ITEM 7. Management s Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the year ended December 31, 2005. There have been no material changes to our critical accounting policies and estimates in 2006, except as follows:

Stock-Based Compensation In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123 (revised 2004), Share-Based Payment (SFAS 123R), which is a revision of SFAS 123, Accounting for Stock Based Compensation (SFAS 123). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Pro forma disclosure is no longer an alternative to financial statement recognition. On April 14, 2005, the U.S. Securities and Exchange Commission (SEC) approved a delay to the effective date of SFAS 123R. Under the new SEC rule, SFAS 123R is effective for annual periods that begin after June 15, 2005.

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

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We adopted SFAS 123R on January 1, 2006 using the modified prospective method for the transition and expect to recognize approximately $1.2 million, pre-tax, in additional expense in 2006 based on option grants outstanding as of December 31, 2005. The impact of adoption of SFAS 123R on future grants cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. Additionally, we have continued to use the Black-Scholes option pricing model to calculate the fair value of share based payments under SFAS 123R. Compensation amounts so determined will be expensed over the applicable estimated life. See Note 6 in the Notes to Condensed Consolidated Financial Statements in ITEM 1 for further discussion of our adoption of SFAS 123R.

Impact of Recently Issued Accounting Pronouncements

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exposures

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

We protect a portion of our currency exchange exposure with foreign currency forward contracts. A sensitivity analysis indicates the potential loss in fair value on foreign currency forward contracts outstanding at March 31, 2006, resulting from a hypothetical 10% adverse change in all foreign currency exchange rates against the U.S. Dollar, is approximately $0.4 million. Such losses would be largely offset by gains from the revaluation or settlement of the underlying assets and liabilities that are being protected by the foreign currency forward contracts.

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

Interest Rate Risk

We are exposed to changes in interest rates. Our 2005 Senior Credit Facility and the Series A bonds issued in connection with our New Mexico facility are variable-rate debt. We currently do not expect our debt levels under the 2005 Senior Credit Facility to have a materially different impact on our interest rate risk from that associated with our prior senior credit facility.

Interest rate changes generally do not affect the market value of such debt but do impact the amount of our interest payments and therefore, our future earnings and cash flows, assuming other factors are held constant. On March 31, 2006, we had variable-rate debt of approximately $299.3 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 $3.0 million.

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

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act), as of the end of the period covered by this report. Based on that evaluation, our management, including our principal executive officer and principal financial officer, concluded that our disclosure controls and procedures were effective as of March 31, 2006 and designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and that such information is accumulated and communicated to our management, including our principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

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

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PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

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

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

ITEM 1A. RISK FACTORS

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

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

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

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

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

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

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

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

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

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

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

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

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

The major raw materials that we purchase for production are chemicals and proprietary additives. The price and availability of these raw materials are subject to market conditions affecting supply and demand, and prices have risen substantially on certain materials in 2005. Our financial condition and results of operations may be materially and adversely affected by increases in raw material costs to the extent we are unable to pass those higher costs to our customers.

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

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

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.

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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 34% of our Net sales were denominated in foreign currency for the three months ended March 31, 2006. As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. We use foreign exchange forward contracts to manage a portion of the exposure to the risk of the eventual net cash inflows and outflows resulting from foreign currency denominated transactions between Tempur-Pedic subsidiaries and their customers and suppliers, as well as between Tempur-Pedic subsidiaries themselves from time to time. The hedging transactions may not succeed in managing our foreign currency exchange rate risk. See ITEM 3. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exposures under Part I of this report.

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

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

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

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

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 months ended March 31, 2006, in the U.S. we had approximately $9.6 million in returns for a return rate of approximately 6% of our Net sales in the U.S. As we expand our sales, our return rates may not remain within our historical levels. An increase in return rates could significantly impair our liquidity and profitability. We also currently provide our customers with a limited, pro-rata 20-year warranty on mattresses sold in the U.S. and a limited 15-year warranty on mattresses sold outside of the U.S. However, as we have only been selling mattresses in significant quantities since 1992, and have released new products in recent years, many are fairly early in their product life cycles. We also provide 2-year to 3-year warranties on pillows.

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

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

We currently conduct international operations in 14 countries directly and in over 50 additional countries through distributors, and we may pursue additional international opportunities. We generated approximately 34% of our Net sales from non-U.S. operations during the three months ended March 31, 2006, and international suppliers provided a significant portion of our manufacturing material during this period. Our international operations are subject to the customary risks of operating in an international environment, including complying with foreign laws and regulations and the potential imposition of trade or foreign exchange restrictions, tariff and other tax increases, fluctuations in exchange rates, inflation and unstable political situations, the potential unavailability of intellectual property protection and labor issues.

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

We rely on trade secrets to protect the design, technology and function of our TEMPUR® material and our products. To date, we have not sought U.S. or international patent protection for our principal product formula and manufacturing processes. Accordingly, we may not be able to prevent others from developing viscoelastic material and products that are similar to or competitive with our products. Our ability to compete effectively with other companies also depends, to a significant extent, on our ability to maintain the proprietary nature of our owned and licensed intellectual property. We own several patents on aspects of our products and have patent applications pending on aspects of our manufacturing processes. However, the principal product formula and manufacturing processes for our TEMPUR® material and our products are not patented and we must maintain these as trade secrets in order to protect this intellectual property. We own 11 U.S. patents, and we have 16 U.S. patent applications pending. Further, we own 46 foreign patents, and we have 31 foreign patent applications pending. In addition, we hold approximately 200 trademark registrations worldwide. We own U.S. and foreign registered trade names and service marks and have applications for the registration of trade names and service marks pending domestically and abroad. We also license certain intellectual property rights from third parties.

Although our trademarks are currently registered in the U.S. and registered or pending in 59 foreign countries, they could be circumvented, or violate the proprietary rights of others, or we could be prevented from using them if challenged. A challenge to our use of our trademarks could result in a negative ruling regarding our use of our trademarks, their validity or their enforceability, or could prove expensive and time consuming in terms of legal costs and time spent defending against it. Any loss of trademark protection could result in a decrease in sales or cause us to spend additional amounts on marketing, either of which could decrease our liquidity and profitability. In addition, if we incur significant costs defending our trademarks that could also decrease our liquidity and profitability. In addition, we may not have the financial resources necessary to enforce or defend our trademarks. Furthermore, our patents may not provide meaningful protection and patents may never be issued for our pending patent applications. It is also possible that others could bring claims of infringement against us, as our principal product formula and manufacturing processes are not patented, and that any licenses protecting our intellectual property could be terminated. If we were unable to maintain the proprietary nature of our intellectual property and our significant current or proposed products, this loss of a competitive advantage could result in decreased sales or increased operating costs, either of which would decrease our liquidity and profitability.

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

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

Our top five customers, collectively, accounted for 13% of our Net sales for the three months ended March 31, 2006. Many of our customer arrangements are by purchase order or are terminable at will at the option of either party. A substantial decrease or interruption in business from our significant customers could result in write-offs or in the loss of future business and could reduce our liquidity and profitability.

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

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

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

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

As of March 31, 2006, we had approximately 1,300 full-time employees, with approximately 600 in the U.S., 300 in Denmark and 400 in the rest of the world. The employees in Denmark are under a government labor union contract, but those in the U.S. are not. Any significant increase in our labor costs could decrease our liquidity and profitability and any deterioration of employee relations, slowdowns or work stoppages at any of our locations, whether due to union activities, employee turnover or otherwise, could result in a decrease in our Net sales or an increase in our costs, either of which could decrease our liquidity and profitability.

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

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

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

As of March 31, 2006, we had $398.2 million in total Long-term debt outstanding. In addition, as of March 31, 2006, our Stockholders Equity was $155.9 million. In October 2005, we announced an $80.0 million share repurchase program. In January 2006, our Board of Directors amended the share repurchase program to increase the total authorized purchase by $100.0 million resulting in a total authorization of $180.0 million, of which $174.2 million had been spent as of March 31, 2006, leaving $5.8 million in remaining unspent authorization under the share repurchase program. We intend to fund the repurchase in part through borrowings under our 2005 Senior Credit Facility, which will increase leverage. Our degree of leverage could have important consequences to our investors, such as:

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

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

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.

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

We are subject to interest rate risk in connection with our issuance of variable rate debt under our new global senior credit facility. Interest rate changes could increase the amount of our interest payments and thus, negatively impact our future earnings and cash flows. We estimate that our annual interest expense on our floating rate indebtedness would increase by $3.0 million for each 1% increase in interest rates. See ITEM 3. Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk under Part I of this report.

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

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

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

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

- actual or anticipated variations in our quarterly operating results, including those resulting from seasonal variations in our business;
- introductions or announcements of technological innovations or new products by us or our competitors;
- disputes or other developments relating to proprietary rights, including patents, litigation matters, and our ability to patent our products and technologies;
- changes in estimates by securities analysts of our financial performance;
- conditions or trends in the specialty bedding industry, or the mattress industry generally;
- additions or departures of key personnel;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- announcements by our competitors of their quarterly operating results or announcements by our competitors of their views on trends in the bedding industry;
- regulatory developments in the U.S. and abroad;
- economic and political factors; and
- public announcements or filings with the SEC indicating that significant stockholders, directors or officers are selling shares of common stock.

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

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

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

The market price of our common stock could decline as a result of sales of substantial amounts of our common stock in the public market, or the perception that these sales could occur. In addition, these factors could make it more difficult for us to raise funds through future offerings of common stock. As of April 30, 2006, there were 84.5 million shares of our common stock outstanding. All of our shares of our common stock are freely transferable without restriction or further registration under the Securities Act of 1933, except for certain shares of our common stock which were purchased by our executive officers, directors, principal stockholders, and some related parties. During 2005 our two largest stockholders, private equity funds that invested in the Company in 2002 in connection with the acquisition of our predecessor, made partial distributions to their investors totaling approximately 18.0 million shares of our common stock, and one of these stockholders also sold 5.3 million shares in June 2005. In February 2006, one of these stockholders made an additional distribution of the 5.8 million shares of remaining common stock that they held in the Company, and in May 2006 the other stockholder sold 6.3 million shares. Our largest stockholder continues to hold 15.6 million shares of our common stock and may choose to make additional distributions or sales of our common stock in the future.

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

Our current directors, officers, and their affiliates own a large percentage of our common stock and could limit you from influencing corporate decisions.

As of May 5, 2006, our executive officers and directors and private equity funds associated with two of our directors, and their respective affiliates, owned in the aggregate, approximately 24% of our outstanding common stock on a fully diluted basis, after giving effect to the vesting of all unvested options. These stockholders, as a group, are able to influence all matters requiring approval by our stockholders, including mergers, sales of assets, the election of all directors, and approval of other significant corporate transactions, in a manner with which you may not agree or that may not be in your best interest.

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

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

These provisions include:

- our ability to issue preferred stock with rights senior to those of the common stock without any further vote or action by the holders of our common stock;
- the requirements that our stockholders provide advance notice when nominating our directors; and
- the inability of our stockholders to convene a stockholders meeting without the chairperson of the board, the president, or a majority of the board of directors first calling the meeting.

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

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

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

(a) Not applicable.

(b) Not applicable.

(c) Issuer Purchases of Equity Securities

The following table sets forth purchases of our common stock for the three months ended March 31, 2006:

Period	(a) Total number of shares purchased	(b) Average Price Paid per Share	(c) Total number of shares purchased as part of publicly announced plans or programs	(d) Maximum number of shares (or approximate dollar value) of shares that may yet be purchased under the plans or programs (in millions)
January 1, 2006 January 31, 2006	933,000	11.89	933,000	92.9
February 1, 2006 February 28, 2006	3,298,200	11.67	3,298,200	54.4
March 1, 2006 March 31, 2006	3,781,100	12.84	3,781,100	5.8
Total	8,012,300		8,012,300	

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

On January 25, 2006, our Board of Directors amended the share repurchase program described above to increase the total authorization by an additional $100.0 million resulting in a total authorization to purchase up to $180.0 million of Tempur-Pedic International Inc. s common stock. From January 1, 2006 through March 31, 2006, we repurchased an additional 8.0 million shares at a total cost of $98.2 million. At March 31, 2006, the Company had $5.8 million in remaining authorization. The share repurchases have been and will continue to be funded from borrowings under the Senior Credit Facility and funds from operations.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None

ITEM 5. OTHER INFORMATION

(a) Not applicable.

(b) Not applicable.

ITEM 6. EXHIBITS

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

10.1	Amendment No. 1 to Credit Agreement, dated as of February 8, 2006, among Tempur-Pedic, Inc., Tempur Production USA, Inc., Dan-Foam ApS, certain other subsidiaries of Tempur-Pedic International, Inc., Banc of America, N.A., as administrative agent, Nordea Bank Denmark A/S, Suntrust Bank, and Fifth Third Bank.
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.

* 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.

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SI GNATURES

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: May 8, 2006

By: /s/ Dale E. Williams

Dale E. Williams

Senior Vice President, Chief Financial Officer,

Secretary and Treasurer