

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

FORM 10-Q

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

For the quarterly period ended September 30, 2013

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 SEALY INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or  
organization)

33-1022198

(I.R.S. Employer Identification No.)

1000 Tempur Way  
Lexington, Kentucky 40511

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting  
company)

Smaller reporting company

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

The number of shares outstanding of the registrant's common stock as of November 6, 2013 was 60,485,184 shares.

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### Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q, including the information incorporated by reference herein, contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which includes information concerning our plans; objectives; goals; strategies; future events; future revenues or performance; the impact of the macroeconomic environment in both the U.S. and internationally on sales and our business segments; strategic long-term investments; changes in capital expenditures; consumer confidence and the availability of consumer financing; changes in interest rates; litigation and similar issues; changes in foreign tax rates and changes in tax laws generally, including the ability to utilize tax loss carry forwards; the outcome of pending tax audits or other tax proceedings; financial flexibility; the impact of initiatives to respond to increased levels of competition in our industry; the impact of initiatives to accelerate growth, expand market share and attract sales; efforts to expand business within established accounts, improve account productivity, reduce costs and operating expenses and improve manufacturing productivity; changing commodity costs; initiatives to improve gross margin; the vertical integration of our business; the development, rollout and market acceptance of new products; the efficiency and effectiveness of our advertising campaigns and other marketing programs; our ability to further invest in the business and in brand awareness; our ability to meet financial obligations and continue to comply with the terms of our credit facilities, including financial ratio covenants; effects of changes in foreign exchange rates on our reported earnings; our expected sources of cash flow; our ability to effectively manage cash; our ability to align costs with sales expectations; and our ability to successfully integrate Sealy Corporation (“Sealy”) into the Company’s operations and realize cost and revenue synergies and other benefits from the transaction, including expectations regarding product offerings, growth opportunities, value creation, and financial strength. 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,” “proposed,” “plans,” “intends,” “believes” and variations of such words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this report. There are important factors, many of which are beyond the Company’s control, that could cause our actual results to differ materially from those expressed as forward-looking statements in this report, including the risk factors discussed under the heading “Risk Factors” under ITEM IA of Part II of this report and under the heading “Risk Factors” under ITEM 1A of Part 1 of our Annual Report on Form 10-K for the year ended December 31, 2012 and under the heading “Risk Factors” under ITEM IA of Part II of our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2013 and June 30, 2013. There may be other factors that may cause our actual results to differ materially from the forward-looking statements.

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

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

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

*(In millions, except per common share amounts)**(Unaudited)*

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Net sales	\$ 735.5	\$ 347.9	\$ 1,786.2	\$ 1,061.8
Cost of sales	436.8	176.8	1,044.2	517.8
Gross profit	298.7	171.1	742.0	544.0
Selling and marketing expenses	150.9	76.2	377.1	243.2
General, administrative and other expenses	71.9	31.5	206.9	103.8
Equity income in earnings of unconsolidated affiliates	(1.2)	—	(2.5)	—
Royalty income, net of royalty expense	(4.1)	—	(9.2)	—
Operating income	81.2	63.4	169.7	197.0
Other expense, net:				
Interest expense, net	24.6	4.8	88.2	13.0
Other expense (income), net	0.9	(0.4)	4.0	(0.4)
Total other expense	25.5	4.4	92.2	12.6
Income before income taxes	55.7	59.0	77.5	184.4
Income tax provision	(15.5)	(61.0)	(26.9)	(101.1)
Net income (loss) before non-controlling interest	40.2	(2.0)	50.6	83.3
Less: Net (loss) attributable to non-controlling interest	—	—	(0.5)	—
Net income (loss) attributable to Tempur Sealy International, Inc.	\$ 40.2	\$ (2.0)	\$ 51.1	\$ 83.3
Earnings (loss) per common share:				
Basic	\$ 0.66	\$ (0.03)	\$ 0.85	\$ 1.34
Diluted	\$ 0.65	\$ (0.03)	\$ 0.83	\$ 1.31
Weighted average common shares outstanding:				
Basic	60.5	59.6	60.3	62.1
Diluted	61.6	59.6	61.6	63.6

See accompanying Notes to Condensed Consolidated Financial Statements.

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

*(In millions)**(Unaudited)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income (loss) including non-controlling interest	\$ 40.2	\$ (2.0)	\$ 50.6	\$ 83.3
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	9.4	5.5	(8.3)	1.0
Net change in unrecognized gain (loss) on interest rate swap	—	(0.5)	1.1	(1.4)
Other comprehensive income, net of tax	9.4	5.0	(7.2)	(0.4)
Comprehensive income	49.6	3.0	43.4	82.9
Less: Comprehensive loss attributable to non-controlling interest	—	—	(0.5)	—
Comprehensive income attributable to Tempur Sealy International, Inc.	\$ 49.6	\$ 3.0	\$ 43.9	\$ 82.9

See accompanying Notes to Condensed Consolidated Financial Statements.

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

*(In millions)*

	September 30, 2013	December 31, 2012
	(Unaudited)	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 126.6	\$ 179.3
Accounts receivable, net	349.3	129.8
Inventories, net	182.8	93.0
Receivable from escrow	—	375.0
Prepaid expenses and other current assets	52.7	41.4
Deferred income taxes	39.2	2.6
<b>Total Current Assets</b>	<b>750.6</b>	<b>821.1</b>
Property, plant and equipment, net	411.6	186.0
Goodwill	756.4	216.1
Other intangible assets, net	758.2	63.1
Deferred income taxes	9.7	10.4
Other non-current assets	75.0	16.3
<b>Total Assets</b>	<b>\$ 2,761.5</b>	<b>\$ 1,313.0</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 181.7	\$ 85.8
Accrued expenses and other current liabilities	220.4	81.4
Deferred income taxes	0.5	26.5
Income taxes payable	33.0	15.5
Current portion of long-term debt	39.7	—
<b>Total Current Liabilities</b>	<b>475.3</b>	<b>209.2</b>
Long-term debt	1,820.4	1,025.0
Deferred income taxes	287.2	31.4
Other non-current liabilities	85.2	25.1
<b>Total Liabilities</b>	<b>2,668.1</b>	<b>1,290.7</b>
Commitments and contingencies—see Note 12		
Redeemable non-controlling interest	10.9	—
<b>Total Stockholders' Equity</b>	<b>82.5</b>	<b>22.3</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 2,761.5</b>	<b>\$ 1,313.0</b>

See accompanying Notes to Condensed Consolidated Financial Statements.

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

*(In millions)**(Unaudited)*

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income before non-controlling interest	\$ 50.6	\$ 83.3
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	52.5	26.9
Amortization of stock-based compensation	13.8	3.7
Amortization of deferred financing costs	5.0	1.0
Write-off of deferred financing costs	4.7	—
Bad debt expense	0.1	1.7
Deferred income taxes	(56.4)	36.6
Equity income in earnings of unconsolidated affiliates	(2.3)	—
Non cash interest expense on convertible notes	2.4	—
Loss on sale of assets	0.6	—
Foreign currency adjustments and other	—	1.6
Changes in operating assets and liabilities	33.8	(1.2)
Net cash provided by operating activities	104.8	153.6
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Acquisition of business, net of cash acquired	(1,172.9)	(3.9)
Purchases of property, plant and equipment	(28.4)	(38.4)
Other	0.9	—
Net cash used in investing activities	(1,200.4)	(42.3)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from 2012 Credit Agreement	2,917.6	—
Repayments of 2012 Credit Agreement	(1,559.1)	—
Proceeds from issuance of Senior Notes	375.0	—
Proceeds from 2011 Credit Facility	46.5	284.5
Repayments of 2011 Credit Facility	(696.5)	(220.0)
Proceeds from issuance of common stock	6.0	10.6
Excess tax benefit from stock based compensation	3.7	9.7
Treasury shares repurchased	—	(152.6)
Payments of deferred financing costs	(52.0)	(0.1)
Other	(0.7)	(2.5)
Net cash provided by (used in) financing activities	1,040.5	(70.4)
NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	2.4	(0.6)
(Decrease) increase in cash and cash equivalents	(52.7)	40.3
CASH AND CASH EQUIVALENTS, beginning of period	179.3	111.4
CASH AND CASH EQUIVALENTS, end of period	\$ 126.6	\$ 151.7
<b>Supplemental cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 65.9	\$ 11.9
Income taxes, net of refunds	\$ 33.1	\$ 56.6

See accompanying Notes to Condensed Consolidated Financial Statements.

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited)

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

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

The Company develops, manufactures, markets and sells bedding products, which include mattresses, foundations and adjustable bases, and other products, which include pillows and other accessories. The Company also derives income from royalties by licensing Sealy® brands, technology and trademarks to other manufacturers. Additionally, the Company participates in several joint ventures in the Asia Pacific region as well as a joint venture in the U.S. with Comfort Revolution International, LLC (“Comfort Revolution”), a distributor and manufacturer of specialty foam and gel bedding products. The Company sells its products through three sales channels: Retail, Direct and Other.

On March 18, 2013, the Company completed the acquisition of Sealy Corporation and its historical subsidiaries (“Sealy”), which manufactures and markets a broad range of mattresses and foundations under the Sealy®, Sealy Posturepedic®, Optimum™ and Stearns & Foster® brands. The Company’s acquisition of Sealy is more fully described in Note 2, “Business Combination”. The results of operations for Sealy are reported within the Company’s Sealy reportable segment and includes results from March 18, 2013 to September 30, 2013 in the Company’s results for the nine months ended September 30, 2013. In connection with the acquisition, the Company borrowed \$1,900.0 million in aggregate principal to fund the purchase price and to repay all outstanding borrowings under the 2011 Credit Facility, which is described in Note 4, “Debt”.

As a result of the acquisition, the Company’s Condensed Consolidated Financial Statements include the results of Comfort Revolution, a 45.0% owned joint venture. Comfort Revolution constitutes a variable interest entity for which the Company is considered to be the primary beneficiary due to the Company’s disproportionate share of the economic risk associated with its equity contribution, debt financing and other factors that were considered in the related-party analysis surrounding the identification of the primary beneficiary. Comfort Revolution is not material to the Company’s Condensed Consolidated Financial Statements.

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and include all of the information and disclosures required by generally accepted accounting principles in the United States (“U.S. GAAP” or “GAAP”) for interim financial reporting. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements of the Company and related footnotes for the year ended December 31, 2012, included in the Company’s Annual Report on Form 10-K and Current Report on Form 8-K filed April 1, 2013 and related amendments filed on June 3, 2013 and July 12, 2013.

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.* The Company reclassified certain accrued expenses and other current liabilities to other non-current liabilities in the first quarter to conform to the 2013 presentation of the Condensed Consolidated Financial Statements. This change does not materially impact previously reported subtotals within the Condensed Consolidated Financial Statements for any previous period presented.

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

<i>(in millions)</i>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
Finished goods	\$ 118.9	\$ 68.5
Work-in-process	10.8	7.9
Raw materials and supplies	53.1	16.6
	<u>\$ 182.8</u>	<u>\$ 93.0</u>



**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)**

(d) *Accrued Sales Returns.* The Company allows product returns through certain sales channels and on certain products. Estimated sales returns are provided at the time of sale based on historical sales channel return rates. Estimated future obligations related to these products are provided by a reduction of sales in the period in which the revenue is recognized. Accrued sales returns are included in accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheets.

The Company had the following activity for sales returns from December 31, 2012 to September 30, 2013:

(in millions)

Balance as of December 31, 2012	\$ 5.1
Amounts accrued	74.0
Liabilities assumed as result of acquisition	19.9
Returns charged to accrual	(70.5)
Balance as of September 30, 2013	<u>\$ 28.5</u>

(e) *Warranties.* The Company provides warranties on certain products, which vary based by segment, product and brand. Estimated future obligations related to these products are charged to cost of sales in the period in which the related revenue is recognized. Estimates of warranty expenses are based primarily on historical claim experience and product testing.

The following summarizes the Company's warranty terms:

Segment	Product/Brand	Warranty Term (in years)
Tempur North America	Mattresses	25, prorated <sup>(1)</sup>
Tempur North America	Pillows	3
Tempur International	Mattresses	15, prorated <sup>(1)</sup>
Tempur International	Pillows	3
Sealy	Mattresses	10 - 25, prorated <sup>(2)</sup>

(1) The last 10 years of warranty period are prorated on a straight-line basis.

(2) Products have various warranty terms, generally non-prorated for the first 10 to 15 years and then prorated for the balance of the warranty term.

The Company had the following activity for warranties from December 31, 2012 to September 30, 2013:

(in millions)

Balance as of December 31, 2012	\$ 4.8
Amounts accrued	15.6
Liabilities assumed as a result of acquisition	21.4
Warranties charged to accrual	(15.2)
Balance as of September 30, 2013	<u>\$ 26.6</u>

As of September 30, 2013 and December 31, 2012, \$16.3 million and \$1.9 million are included as a component of accrued expenses and other current liabilities and \$10.3 million and \$2.9 million are included in other non-current liabilities on the Company's accompanying Condensed Consolidated Balance Sheets, respectively. In estimating its warranty obligations, the Company considers the impact of recoverable salvage value on warranty costs by segment in determining its estimate of future warranty obligations. As a result of adjustments to the preliminary allocation of the purchase price related to the acquisition of Sealy, the Company increased the liabilities assumed as a result of acquisition.

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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company regularly reviews the adequacy of its allowance for doubtful accounts. The Company determines the allowance based on historical write-off experience and current economic conditions. It also considers factors such as customer credit, past transaction history with the customer and changes in customer payment terms when determining whether the collection of a receivable is reasonably assured. Account balances are charged off against the allowance after all reasonable means of collection have been exhausted and the potential for recovery is considered remote. The allowance for doubtful accounts included in accounts receivable, net in the accompanying Condensed Consolidated Balance Sheets was \$20.9 million and \$8.2 million as of September 30, 2013 and December 31, 2012, respectively.

(g) *Research and Development Expenses.* Research and development expenses for new products are expensed as they are incurred and included in general, administrative and other expenses in the accompanying Condensed Consolidated Statements of Income. Research and development costs charged to expense were \$5.4 million and \$3.9 million for the three months ended September 30, 2013 and 2012, respectively. Research and development costs charged to expense were \$14.8 million and \$11.1 million for the nine months ended September 30, 2013 and 2012, respectively.

(h) *Royalty Income and Expense.* The Company recognizes royalty income based on sales of Sealy® and Stearns & Foster® branded products by various licensees. The Company also pays royalties to other entities for the use of their names on products produced by the Company. These amounts are not material for the three and nine months ended September 30, 2013.

(i) *Environmental Obligations.* Accruals for environmental remediation are recognized when it is probable a liability has been incurred and the amount of that liability can be reasonably estimated. Such costs are charged to expense if they relate to the remediation of conditions caused by past operations or are not expected to mitigate or prevent contamination from future operations. Liabilities are recorded at estimated cost values based on experience, assessments and current technology, without regard to any third-party recoveries and are regularly adjusted as environmental assessments and remediation efforts continue.

(j) *Pension Obligations.* The Company has a noncontributory, defined benefit pension plan covering current and former hourly employees at four of its active Sealy plants and eight previously closed Sealy U.S. facilities. Sealy Canada, Ltd. (a 100.0% owned subsidiary of the Company) also sponsors a noncontributory, defined benefit pension plan covering hourly employees at one of its facilities. Both plans provide retirement and survivorship benefits based on the employees' credited years of service. The Company's funding policy provides for contributions of an amount between the minimum required and maximum amount that can be deducted for federal income tax purposes. The funded status is measured as the difference between the fair value of plan assets and the benefit obligation at December 31, the measurement date. The benefit obligation is the projected benefit obligation ("PBO"). The PBO represents the actuarial present value of benefits expected to be paid upon retirement based on estimated future compensation levels. The fair value of plan assets represents the current market value of assets held by an irrevocable trust fund for the sole benefit of participants. The measurement of the PBO is based on the Company's estimates and actuarial valuations. These valuations reflect the terms of the plans and use participant-specific information such as compensation, age and years of service, as well as certain assumptions that require significant judgment, including estimates of discount rates, expected return on plan assets, rate of compensation increases, interest crediting rates and mortality rates.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**(2) Business Combination**

On March 18, 2013, the Company completed the acquisition of Sealy (“Sealy Acquisition”). Pursuant to the merger agreement, each share of common stock of Sealy issued and outstanding immediately prior to the effective time of the Sealy Acquisition was cancelled and (other than shares held by Sealy or Tempur-Pedic or their subsidiaries or Sealy stockholders who properly exercised their appraisal rights) converted into the right to receive \$2.20 in cash. The total purchase price was \$1,172.9 million, which was funded using available cash and financing consisting of the Company’s 2012 Credit Agreement and Senior Notes (see Note 4, “Debt” for the definition of these terms and further discussion). The purchase price of Sealy consisted of the following items:

(in millions)

Cash consideration for stock	\$ 231.2 <sup>(1)</sup>
Cash consideration for share-based awards	14.2 <sup>(2)</sup>
Cash consideration for 8.0% Sealy Notes	442.1 <sup>(3)</sup>
Cash consideration for repayment of Sealy Senior Notes	260.7 <sup>(4)</sup>
Cash consideration for repayment of Sealy 2014 Notes	276.9 <sup>(5)</sup>
Total consideration	1,225.1
Cash acquired	(52.2) <sup>(6)</sup>
Net consideration transferred	<u>\$ 1,172.9</u>

- (1) The cash consideration for outstanding shares of Sealy common stock is the product of the agreed-upon cash per share price of \$2.20 and total Sealy shares of 105.1 million.
- (2) The cash consideration for share-based awards is the product of the agreed-upon cash per share price of \$2.20 and the total number of restricted stock units (“RSUs”) and deferred stock units (“DSUs”) outstanding and the “in the money” stock options net of the weighted average exercise price.
- (3) The cash consideration for Sealy’s 8.0% Senior Secured Third Lien Convertible Notes due 2016 (“8.0% Sealy Notes”) is the result of applying the adjusted equity conversion rate to the 8.0% Sealy Notes tendered for conversion and multiplying the result by the agreed-upon cash per share price of \$2.20. The 8.0% Sealy Notes that were converted represented the right to receive the same merger consideration that would have been payable to a holder of 201.0 million shares of Sealy common stock, subject to adjustment in accordance with the terms of the supplemental indenture governing the 8.0% Sealy Notes.
- (4) The cash consideration for Sealy’s 10.875% Senior Notes due 2016 (“Sealy Senior Notes”) reflects the repayment of the outstanding obligation.
- (5) The cash consideration for Sealy’s 8.25% Senior Subordinated Notes due 2014 (“Sealy 2014 Notes”) reflects the repayment of the outstanding obligation.
- (6) Represents the Sealy cash balance acquired at acquisition.

The Company incurred \$1.2 million and \$18.4 million of direct transaction costs for the three and nine months ended September 30, 2013, respectively. These costs are included in general, administrative and other expenses in the accompanying Condensed Consolidated Statements of Income. In addition, the Company incurred \$19.9 million of incremental interest expense for the nine months ended September 30, 2013, which includes interest and other fees on the Senior Notes and the 2012 Credit Agreement for the period prior to March 18, 2013, commitment fees associated with financing for the closing of the Sealy Acquisition, and the write off of deferred financing costs associated with the 2011 Credit Facility.

Sealy, headquartered in Trinity, North Carolina, owns one of the largest portfolios of bedding brands in the world, and manufactures and markets a complete line of bedding products under the Sealy®, Sealy Posturepedic®, Optimum™ and Stearns & Foster® brands. The results of operations of Sealy and Sealy’s historical subsidiaries are reported within the Company’s Sealy reportable segment.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

The Company accounted for the Sealy Acquisition using the acquisition method. The preliminary allocation of the purchase price is based on estimates of the fair value of assets acquired and liabilities assumed as of March 18, 2013. The Company is continuing to obtain information to complete its valuation of intangible assets, as well as to determine the acquired assets and liabilities, including tax assets, liabilities and other attributes. The components of the preliminary purchase price allocation are as follows:

(in millions)

Accounts receivable	\$	186.1
Inventory		75.1
Prepaid expenses and other current assets		39.3
Accounts payable		(77.9)
Accrued expenses		(134.2)
Property, plant and equipment		242.3
Other assets		36.9
Identifiable intangible assets:		
Indefinite-lived trade names		521.2
Contractual retailer/distributor relationships		91.1
Developed technology, including patents		87.1
Customer databases		3.9
Optimum™ trade name		2.3
Deferred income taxes, net		(246.9)
Sealy 8.0% Notes		(96.2)
Redeemable non-controlling interest		(11.3)
Other liabilities		(87.1)
Goodwill		541.2
Net consideration transferred	\$	<u>1,172.9</u>

The preliminary fair value of the intangible assets has been estimated using the income approach through a discounted cash flow analysis (except as noted below with respect to the trade names) with the cash flow projections discounted using rates ranging from 11.0% to 12.0%. The cash flows are based on estimates used to price the Sealy Acquisition, and the discount rates applied were benchmarked with reference to the implied rate of return from the Company's pricing model and the weighted average cost of capital.

The indefinite-lived trade names represent Sealy brand names as marketed through Sealy®, Sealy Posturepedic® and Stearns & Foster® brands. The Company applied the income approach through an excess earnings analysis to determine the preliminary fair value of the trade name assets.

The contractual retailer/distributor relationships pertain to Sealy's distribution network with their retailers, which is governed by contract. The Company used the income approach through an excess earnings analysis to determine the preliminary fair value of this asset.

The developed technology assets are comprised of know-how, patents and technologies embedded in Sealy's products and processes and relate to currently manufactured and marketed products. The Company applied the income approach through a relief-from-royalty analysis to determine the fair value of this asset.

The Company is amortizing the identifiable intangible assets, other than the indefinite-lived trade name, on a straight-line basis over the weighted average lives ranging from 5 to 15 years.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

The table below sets forth the preliminary valuation and amortization period of identifiable intangible assets:

(\$ in millions)

	<b>Preliminary Valuation</b>	<b>Amortization Period</b>
Identifiable intangible assets:		
Trade names	\$ 521.2	Indefinite
Contractual retailer/distributor relationships	91.1	15 years
Developed technology, including patents	87.1	10 years
Customer databases	3.9	5 years
Optimum™ trade name	2.3	5 years
Total	<u>\$ 705.6</u>	

The Company estimated the preliminary fair value of the acquired property, plant and equipment using a combination of the cost and market approaches, depending on the component. The preliminary fair value of property, plant and equipment consisted of real property of \$101.0 million and personal property of \$141.3 million.

The excess of the purchase price over the preliminary estimated fair value of the tangible net assets and identifiable intangible assets acquired was recorded as goodwill. The factors contributing to the recognition of the amount of goodwill are based on several strategic and synergistic benefits that are expected to be realized from the Sealy Acquisition. These benefits include a comprehensive portfolio of iconic brands, complementary product offerings, enhanced global footprint, and attractive synergy opportunities and value creation. None of the goodwill is expected to be deductible for income tax purposes and is entirely allocated to the Sealy reportable segment.

The following unaudited pro forma information presents the combined financial results for the Company and Sealy as if the Sealy Acquisition had been completed at the beginning of the Company's prior year, January 1, 2012. Prior to the Sealy Acquisition, Sealy used a 52-53 week fiscal year ending on the closest Sunday to November 30, but no later than December 2. Accordingly, the pro forma information set forth below for the three months ended September 30, 2012 includes Sealy's pro forma information for the quarterly period May 28, 2012 through August 26, 2012. The pro forma financial information set forth below for the nine months ended September 30, 2013 includes Sealy's pro forma information for the combined nine month period from December 3, 2012 through March 3, 2013 and April 1, 2013 through September 29, 2013 and the nine month period November 28, 2011 through August 26, 2012, respectively.

(in millions, except earnings per common share)

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>		<b>2013</b>	<b>2012</b>
Net sales	\$	713.4	\$ 2,079.1	\$ 2,051.6
Net (loss) income	\$	(1.8)	\$ 62.7	\$ 52.5
(Loss) earnings from continuing operations per common share – Diluted	\$	(0.03)	\$ 1.02	\$ 0.86

The information above does not include the pro forma adjustments that would be required under Regulation S-X for pro forma financial information, and does not reflect future events that may occur after September 30, 2013 or any operating efficiencies or inefficiencies that may result from the Sealy Acquisition and related financing. Therefore, the information is not necessarily indicative of results that would have been achieved had the businesses been combined during the periods presented or the results that the Company will experience going forward.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**(3) Goodwill and Other intangible assets**

During the nine months ending September 30, 2013, the Company's goodwill increased by approximately \$541.2 million related to the Sealy Acquisition. This amount is subject to change based upon the finalization of the allocation of the consideration transferred to the assets acquired and liabilities assumed related to Sealy.

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

(in millions)

	Total	Tempur North America	Tempur International	Sealy
Balance as of December 31, 2012	\$ 216.1	\$ 108.9	\$ 107.2	\$ —
Goodwill resulting from acquisitions	541.2	—	—	541.2
Foreign currency translation adjustments	(0.9)	(0.6)	(0.3)	—
Balance as of September 30, 2013	<u>\$ 756.4</u>	<u>\$ 108.3</u>	<u>\$ 106.9</u>	<u>\$ 541.2</u>

The following table summarizes information relating to the Company's other intangible assets, net:

(\$ in millions)

	Useful Lives (Years)	September 30, 2013			December 31, 2012		
		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Unamortized indefinite life intangible assets:							
Trade name		\$ 575.5	\$ —	\$ 575.5	\$ 55.0	\$ —	\$ 55.0
Amortized intangible assets:							
Contractual distributor relationships	15	\$ 90.7	\$ 3.3	\$ 87.4	\$ —	\$ —	\$ —
Technology	10	90.1	20.0	70.1	16.0	16.0	—
Patents, other trademarks, & other trade names	5-20	29.7	11.5	18.2	12.9	9.9	3.0
Customer database	5	8.7	5.2	3.5	4.9	4.9	—
Foam formula	10	3.7	3.7	—	3.7	3.7	—
Reacquired rights	3	5.6	5.6	—	5.8	5.3	0.5
Customer relationships	5	6.7	3.2	3.5	6.7	2.1	4.6
Total		<u>\$ 810.7</u>	<u>\$ 52.5</u>	<u>\$ 758.2</u>	<u>\$ 105.0</u>	<u>\$ 41.9</u>	<u>\$ 63.1</u>

Amortization expense relating to intangible assets for the Company was \$4.3 million and \$1.4 million for the three months ended September 30, 2013 and 2012, respectively. Amortization expense relating to intangible assets for the Company was \$10.5 million and \$4.3 million for the nine months ended September 30, 2013 and 2012, respectively. No impairments of goodwill or other intangible assets have adjusted the gross carrying amount of these assets in any historical period.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**(4) Debt**

Debt. Debt for the Company consists of the following:

<i>(in millions)</i>	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>Debt:</b>		
\$375.0 million Senior Notes, interest at 6.875%, due December 15, 2020	\$ 375.0	\$ 375.0
Revolving credit facility, interest at Base Rate plus applicable margin, 2.25% or LIBOR plus applicable margin, 3.25% as of September 30, 2013, commitment through and due March 18, 2018	90.0	—
Term A Facility, interest at Base Rate plus applicable margin 1.5%, or LIBOR plus applicable margin, 2.5% as of September 30, 2013, commitment through and due March 18, 2018	529.4	—
Term B Facility, interest at Base Rate plus applicable margin 1.75%, or LIBOR plus applicable margin, 2.75% as of September 30, 2013, commitment through and due March 18, 2020	739.1	—
8.0% Sealy Notes, due July 15, 2016	98.4	—
Capital lease obligations and other	28.2	—
2011 Domestic long-term revolving credit facility payable to lenders, interest at Base Rate or LIBOR plus applicable margin (2.05% as of December 31, 2012), extinguished as of March 18, 2013	—	650.0
	<u>\$ 1,860.1</u>	<u>\$ 1,025.0</u>
Less current portion	(39.7)	—
	<u>\$ 1,820.4</u>	<u>\$ 1,025.0</u>

*Senior Notes*

On December 19, 2012, Tempur Sealy International issued \$375.0 million aggregate principal amount of 6.875% senior notes due 2020 (the “Senior Notes”) to qualified institutional buyers pursuant to Rule 144A of the Securities Act of 1933, as amended (the “Securities Act”), and to certain non-U.S. persons in accordance with Regulation S under the Securities Act. The Senior Notes were issued pursuant to an indenture, dated as of December 19, 2012 (the “Indenture”), among the Company, certain subsidiaries of Tempur Sealy International as guarantors (the “Guarantors”), and The Bank of New York Mellon Trust Company, N.A., as trustee (the “Trustee”). The Senior Notes are general unsecured senior obligations of Tempur Sealy International and are guaranteed on a senior unsecured basis by the Guarantors. The Senior Notes mature on December 15, 2020, and interest is payable semi-annually in arrears on each June 15 and December 15, beginning on June 15, 2013. The gross proceeds from the Senior Notes, were funded into escrow and these funds were released from escrow on March 18, 2013 and used as part of the funding of the Sealy Acquisition. Following the completion of the Sealy Acquisition, Sealy and certain of its subsidiaries became Guarantors of the Senior Notes.

Tempur Sealy International has the option to redeem all or a portion of the Senior Notes at any time on or after December 15, 2016. Starting on this date the initial redemption price is 103.438% of the principal amount, plus accrued and unpaid interest, if any. The redemption price will decline to 101.719% on December 15, 2017 and to 100.0% of the principal amount beginning on December 15, 2018. In addition, Tempur Sealy International has the option at any time prior to December 15, 2016 to redeem some or all of the Senior Notes at 100.0% of the original principal amount plus a “make-whole” premium and accrued and unpaid interest, if any. Tempur Sealy International may also redeem up to 35.0% of the Senior Notes prior to December 15, 2015, under certain circumstances with the net cash proceeds from certain equity offerings, at 106.875% of the principal amount plus accrued and unpaid interest, if any. Tempur Sealy International may make such redemptions only if, after any such redemption, at least 65.0% of the original aggregate principal amount of the Senior Notes issued remains outstanding.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

The Indenture restricts the ability of Tempur Sealy International and the ability of certain of its subsidiaries to, among other things: (i) incur, directly or indirectly, debt; (ii) make, directly or indirectly, certain investments and restricted payments; (iii) incur or suffer to exist, directly or indirectly, liens on its properties or assets; (iv) sell or otherwise dispose of, directly or indirectly, assets; (v) create or otherwise cause or suffer to exist any consensual restriction on the right of certain of the subsidiaries of Tempur Sealy International to pay dividends or make any other distributions on or in respect of their capital stock; (vi) enter into transactions with affiliates; (vii) engage in sale-leaseback transactions; (viii) purchase or redeem capital stock or subordinated indebtedness; (ix) issue or sell stock of restricted subsidiaries; and (x) effect a consolidation or merger. These covenants are subject to a number of exceptions and qualifications.

Also in conjunction with the issuance and sale of the Senior Notes, Tempur Sealy International and the Guarantors agreed through a Registration Rights Agreement to exchange the Senior Notes for a new issue of substantially identical senior notes registered under the Securities Act. Tempur Sealy International and the Guarantors would have been required to pay additional interest if the Senior Notes were not registered within the time periods specified within the Registration Rights Agreement. Tempur Sealy International filed a registration statement on Form S-4 on July 12, 2013 in connection with the registration of the Senior Notes, and the registration statement was declared effective by Securities and Exchange Commission on July 26, 2013, which was within the specified time period.

As a result of the Company's issuance of the Senior Notes, \$8.3 million of deferred financing costs were capitalized and are being amortized over seven years using the effective interest method.

*2012 Credit Agreement*

On December 12, 2012, Tempur Sealy International and certain subsidiaries of Tempur Sealy International as borrowers and guarantors, entered into a credit agreement (the "2012 Credit Agreement") with a syndicate of banks. The 2012 Credit Agreement initially provided for (i) a revolving credit facility of \$350.0 million (the "Revolver"), (ii) a term A facility of \$550.0 million (the "Term A Facility") and (iii) a term B facility of \$870.0 million (the "Term B Facility"). The Revolver includes a sublimit for letters of credit and swingline loans, subject to certain conditions and limits. The Revolver and the Term A Facility will mature on March 18, 2018 and the Term B Facility will mature on March 18, 2020. The Revolver, the Term A Facility and the Term B Facility closed and funded in connection with the Sealy Acquisition on March 18, 2013. In the first and second quarters of 2013, the outstanding balance of the Term A Facility and the Term B Facility were reduced by regularly scheduled payments. Additionally, on May 16, 2013, the outstanding balance of the Term B Facility was reduced by a voluntary prepayment of \$125.0 million. After giving effect to \$90.0 million in borrowings under the revolver portion of the 2012 Credit Agreement and letters of credit outstanding of \$22.4 million, total availability under the revolver was \$237.6 million as of September 30, 2013.

Borrowings under the 2012 Credit Agreement will generally bear interest, at the election of Tempur Sealy International and the other borrowers, at either (i) LIBOR plus the applicable margin or (ii) Base Rate plus the applicable margin. For the Revolver and the Term A Facility, (a) the initial applicable margin for LIBOR advances was 3.00% per annum and the initial applicable margin for Base Rate advances was 2.00% per annum, and (b) thereafter following the delivery of financial statements for the first full fiscal quarter after closing, such applicable margins will be determined by a pricing grid based on the consolidated total net leverage ratio of the Company. The Term B Facility was initially subject to a LIBOR floor of 1.0%. The applicable margin was initially 4.00% per annum for LIBOR advances and 3.00% per annum for Base Rate advances. On May 16, 2013, the applicable margin on the Term B Facility was reduced to 3.00% per annum and the LIBOR floor was reduced by 0.75% until maturity. On July 11, 2013, the applicable margin on the Term A Facility was reduced by 0.75% for each pricing level on the pricing grid based on the consolidated total net leverage ratio of the Company.



## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

Obligations under the 2012 Credit Agreement are guaranteed by Tempur Sealy International's existing and future direct and indirect wholly-owned domestic subsidiaries, subject to certain exceptions; and the 2012 Credit Agreement is secured by a security interest in substantially all Tempur Sealy International's and the other borrowers' domestic assets and the domestic assets of each subsidiary guarantor, whether owned as of the closing or thereafter acquired, including a pledge of 100.0% of the equity interests of each subsidiary guarantor that is a domestic entity (subject to certain limited exceptions) and 65.0% of the voting equity interests of any direct first tier foreign entity owned by a subsidiary guarantor. The 2012 Credit Agreement requires compliance with certain financial covenants providing for maintenance of a minimum consolidated interest coverage ratio and maintenance of a maximum consolidated total net leverage ratio. The consolidated total net leverage ratio is calculated using consolidated funded debt less qualified cash. Consolidated funded debt includes debt recorded on the Condensed Consolidated Balance Sheets as of the reporting date, plus letters of credit outstanding and short-term other debt. The Company is allowed to exclude 100.0% of the domestic qualified cash and 60.0% of foreign qualified cash, the aggregate of which cannot exceed \$150.0 million at the end of the reporting period. As of September 30, 2013, domestic qualified cash was \$62.0 million and foreign qualified cash was \$38.8 million.

The 2012 Credit Agreement contains certain customary negative covenants, which include limitations on liens, investments, indebtedness, dispositions, mergers and acquisitions, the making of restricted payments, changes in the nature of business, changes in fiscal year, transactions with affiliates, use of proceeds, prepayments of certain indebtedness, entry into burdensome agreements and changes to governing documents and other junior financing documents. The 2012 Credit Agreement also contains certain customary affirmative covenants and events of default, including upon a change of control.

Tempur Sealy International is required to pay a commitment fee on the unused portion of the Revolver, which initially is 0.50% per annum and which steps down to 0.375% per annum if the consolidated total net leverage ratio is less than or equal to 3.50:1.00. Such unused commitment fee is payable quarterly in arrears and on the date of termination or expiration of the commitments under the Revolver. Tempur Sealy International and the other borrowers also pay customary letter of credit issuance and other fees under the 2012 Credit Agreement.

The Company is in compliance with all applicable covenants at September 30, 2013.

*8.0% Sealy Notes*

In conjunction with the Sealy Acquisition, Sealy's obligations under its 8.0% Sealy Notes were amended. As a result of the Sealy Acquisition, the 8.0% Sealy Notes became convertible solely into cash, in an amount that declined slightly every day during the Make-Whole Period (as defined under the Supplemental Indenture governing the 8.0% Sealy Notes) that followed the Sealy Acquisition, and then became fixed thereafter. The Make-Whole Period effectively expired on April 12, 2013. As of April 12, 2013, approximately 83.0% of all the 8.0% Sealy Notes outstanding prior to the Sealy Acquisition were converted into cash and paid to the holders. Holders of the 8.0% Sealy Notes who converted on March 19, 2013 received approximately \$2,325.43 per \$1,000 Accreted Principal Amount of the 8.0% Sealy Notes being converted. The holders of the 8.0% Sealy Notes who convert after April 12, 2013 will receive \$2,200 per \$1,000 Accreted Principal Amount of the 8.0% Sealy Notes being converted. The Company calculated the preliminary fair value of the remaining 8.0% Sealy Notes as part of its preliminary purchase price allocation by first calculating the future payout of the remaining 17.0% aggregate principal amount of the 8.0% Sealy Notes still outstanding and the cumulative semi-annual interest payments at the July 15, 2016 maturity, and then calculated the present value using a market discount rate, which resulted in a fair value of \$96.2 million at the date of the opening balance sheet. As of September 30, 2013, the fair value of the 8.0% Sealy Notes are \$98.6 million, which includes \$2.4 million of accreted discount. The discount is accreted through non-cash interest expense over the life of the 8.0% Sealy Notes using the effective interest method. As of September 30, 2013, the 8.0% Sealy Notes had a carrying value of \$98.4 million, which includes \$2.4 million of accreted discount less conversion payments made to holders of certain 8.0% Sealy Notes that were tendered for conversion.

The 8.0% Sealy Notes mature on July 15, 2016 and bear interest at 8.0% per annum accruing semi-annually in arrears on January 15 and July 15 of each year. Sealy does not pay interest in cash to the holders of the 8.0% Sealy Notes, but instead increases the principal amount of the 8.0% Sealy Notes by an amount equal to the accrued interest for the interest period then ended ("Paid-In-Kind" or "PIK interest"). The amount of the accrued interest for each interest period is calculated on the basis of the accreted principal amount as of the first day of such interest period. PIK interest accrued on the most recent interest period then ended on the 8.0% Sealy Notes converted between interest payment dates is forfeited.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

All material negative covenants (apart from the lien covenant and related collateral requirements) were eliminated from the supplemental indenture governing the 8.0% Sealy Notes, as well as certain events of default and certain other provisions. In addition, Tempur Sealy International and its non-Sealy subsidiaries do not provide any guarantees of any obligations with respect to the 8.0% Sealy Notes.

*Capital Leases*

As a result of the Sealy Acquisition, the Company is party to capital leases and has recorded the preliminary fair value of the obligation on its condensed balance sheet as of March 18, 2013, the acquisition date. The approximate remaining life of the leases is 10 years.

*2011 Credit Facility*

In conjunction with the closing of the Sealy Acquisition on March 18, 2013, the Company repaid all outstanding borrowings on the 2011 Credit Facility and terminated this facility. The 2011 Credit Facility consisted of domestic and foreign credit facilities (the “2011 Revolvers”) that provided for the incurrence of indebtedness up to an aggregate principal amount of \$770.0 million. The domestic credit facility was a five-year, \$745.0 million revolving credit facility.

*Deferred Financing Costs*

As a result of the Company’s issuance of the Senior Notes and in conjunction with entering into the 2012 Credit Agreement, \$54.3 million of deferred financing costs were capitalized and will be amortized as interest expense over the respective debt instrument period, ranging from five to eight years, using the effective interest method.

In conjunction with the repayment of all outstanding borrowings on the 2011 Credit Facility, the Company wrote off the associated \$4.7 million of deferred financing costs.

Deferred financing costs are recorded within other non-current assets in the accompanying Condensed Consolidated Balance Sheets and interest expense, net in the accompanying Condensed Consolidated Statements of Income.

*Interest Rate Swap*

On August 8, 2011, the Company entered into a four-year interest rate swap agreement to manage interest costs and the risk associated with changing interest rates associated with variable portions of the Company’s debt outstanding. Refer to Note 7, “Derivative Financial Instruments,” for additional information regarding the Company’s interest rate swap.

**(5) Unconsolidated Affiliate Companies**

The Company has ownership interests in a group of joint ventures to develop markets for Sealy® branded products in the Asia-Pacific region. The Company’s ownership interest in these joint ventures is 50.0% and they are accounted for under the equity method. The Company’s share of earnings is recorded in equity income in earnings of unconsolidated affiliates in the accompanying Condensed Consolidated Statements of Income. The Company’s investment in unconsolidated affiliate companies is recorded in other non-current assets in the accompanying Condensed Consolidated Balance Sheets.

**(6) Fair Value Measurements**

The classification of fair value measurements within the established three-level hierarchy is based upon the lowest level of input that is significant to the measurement. There were no transfers between levels for the three or nine months ended September 30, 2013. At September 30, 2013, the Company had an interest rate swap recorded at fair value. The fair value of the interest rate swap is calculated using standard industry models based on observable forward yield curves. The Company also utilizes foreign currency forward contracts to manage the risk associated with exposures to foreign currency risk related to intercompany debt and associated interest payments. The foreign currency forward contracts are not material to the accompanying Condensed Consolidated Financial Statements. The fair values of all derivative instruments are adjusted for credit risk and restrictions and other terms specific to the contracts.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

The following table provides a summary by level of the fair value of financial instruments that are measured on a recurring basis:

(in millions)

	Fair Value Measurements at September 30, 2013 Using:			
	September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:				
Interest rate swap	\$ 2.8	\$ —	\$ 2.8	\$ —

(in millions)

	Fair Value Measurements at December 31, 2012 Using:			
	December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:				
Interest rate swap	\$ 4.3	\$ —	\$ 4.3	\$ —

The carrying value of cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term maturity of those instruments. Borrowings under the 2012 Credit Agreement are at variable interest rates and accordingly their carrying amounts approximate fair value. The fair value of the Senior Notes was approximately \$391.9 million at September 30, 2013. The fair value of the Sealy 8.0% Notes was approximately \$98.6 million at September 30, 2013.

**(7) Derivative Financial Instruments**

In the normal course of business, the Company is exposed to certain risks related to fluctuations in interest rates. The Company uses interest rate swaps to manage risks from these market fluctuations. The financial instruments used by the Company are straight-forward, non-leveraged instruments. The counterparties to these financial instruments are financial institutions with strong credit ratings. The Company maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit ratings of these institutions. The Company also utilizes foreign currency forward contracts to manage the risk associated with exposures to foreign currency risk related to intercompany debt and associated interest payments and certain accounts receivable. However, these foreign currency forward contracts are not material to the Consolidated Financial Statements.

The Company is exposed to changes in interest rates on its variable rate debt. In order to manage this risk, on August 8, 2011, the Company entered into a four-year interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. The Company designated this interest rate swap as a cash flow hedge of floating rate borrowings and expects the hedge to be highly effective in offsetting fluctuations in the designated interest payments resulting from changes in the benchmark interest rate. The gains and losses on the designated swap agreement will offset losses and gains on the transactions being hedged. The Company formally documented the effectiveness of this qualifying hedge instrument (both at the inception of the swap and on an ongoing basis) in offsetting changes in cash flows of the hedged transaction. The fair value of the interest rate swap is calculated as described in Note 6, "Fair Value Measurements," taking into consideration current interest rates and the current creditworthiness of the counterparties or the Company, as applicable.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

As a result of this swap, the Company pays interest at a fixed rate and receives payments at a variable rate which began on December 30, 2011. The swap effectively fixes the floating LIBOR-based interest rate to 1.25% plus the applicable margin on \$250.0 million of the outstanding balance under the Company's variable rate debt, with the outstanding balance subject to the swap declining over time. The interest rate swap expires on December 30, 2015. The Company has selected the LIBOR-based rate on the hedged portion of the Company's variable rate debt during the term of the swap. The effective portion of the change in value of the swap is reflected as a component of comprehensive income and recognized as interest expense, net as payments are paid or accrued. The remaining gain or loss in excess of the cumulative change in the present value of the future cash flows of the hedged item, if any (i.e., the ineffective portion) or hedge components excluded from the assessment of effectiveness are recognized as interest expense, net during the current period.

As of September 30, 2013 and December 31, 2012, the fair value of the Company's derivative instruments included in the accompanying Condensed Consolidated Balance Sheets were recorded as follows:

(in millions)

	Balance Sheet Location	Liability Derivatives	
		Fair Value	
		September 30, 2013	December 31, 2012
Derivatives designated as hedging instruments			
Interest rate swap - current	Accrued expenses and other current liabilities	\$ 1.7	\$ 2.3
Interest rate swap - non-current	Other non-current liabilities	1.1	2.0
		<u>\$ 2.8</u>	<u>\$ 4.3</u>

**(8) Stockholders' Equity**

Tempur Sealy International's authorized shares of capital stock are 300.0 million shares of common stock and 0.01 million 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.

**(9) Defined Benefit Plans**

As of September 30, 2013, the Company's liability related to its sponsored defined benefit plans acquired with the Sealy Acquisition was \$12.2 million. The net periodic pension cost for the period March 18 through September 30, 2013 was not material.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**(10) Other Items**

(a) *Property, plant and equipment.* Property, plant and equipment, net consisted of the following:

(in millions)

	September 30, 2013	December 31, 2012
Land and buildings	\$ 263.6	\$ 138.0
Machinery and equipment	259.9	160.9
Computer equipment and software	69.8	52.5
Furniture and fixtures	56.6	40.8
Construction in progress	23.5	17.3
	673.4	409.5
Accumulated depreciation	(261.8)	(223.5)
	<u>\$ 411.6</u>	<u>\$ 186.0</u>

(b) *Accrued expenses and other current liabilities.* Accrued expenses and other current liabilities consisted of the following:

(in millions)

	September 30, 2013	December 31, 2012
Wages and Benefits	\$ 54.8	\$ 18.7
Advertising	28.8	10.5
Sales Returns	28.5	5.1
Rebates	18.0	4.1
Warranty	16.3	1.9
Interest	8.7	0.5
Freight	6.3	2.5
Professional Fees	4.6	5.3
Sales and VAT Tax	4.2	7.0
Insurance	3.8	0.9
Other	46.4	24.9
	<u>\$ 220.4</u>	<u>\$ 81.4</u>

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

(c) *Accumulated other comprehensive income.* On January 1, 2013, the Company adopted changes issued by the Financial Accounting Standards Board to the reporting of amounts reclassified out of accumulated other comprehensive income. These changes require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required to be reclassified in its entirety to net income. For other amounts that are not required to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures that provide additional detail about those amounts. These requirements are to be applied to each component of accumulated other comprehensive income. Other than the additional disclosure requirements (as described below), the adoption of these changes had no impact on the accompanying Condensed Consolidated Financial Statements.

The changes in accumulated other comprehensive income by component consisted of the following:

(in millions)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
<b>Foreign Currency Translation</b>				
Balance at beginning of period	\$ (22.6)	\$ (17.7)	\$ (4.9)	\$ (13.2)
Other comprehensive (loss) income:				
Foreign currency translation adjustments <sup>(1)</sup>	9.4	5.5	(8.3)	1.0
Balance at end of period	\$ (13.2)	\$ (12.2)	\$ (13.2)	\$ (12.2)
<b>Interest Rate Swap</b>				
Balance at beginning of period	\$ (1.6)	\$ (2.5)	\$ (2.7)	\$ (1.6)
Other comprehensive (loss) income:				
Net change from period revaluations:	0.8	1.3	4.0	1.4
Tax (expense) <sup>(2)</sup>	—	(0.5)	(1.1)	(0.5)
Total other comprehensive income before reclassifications, net of tax	\$ 0.8	\$ 0.8	\$ 2.9	\$ 0.9
Net amount reclassified to earnings <sup>(3)</sup>	(0.8)	(1.6)	(2.4)	(3.2)
Tax benefit <sup>(2)</sup>	—	0.3	0.6	0.9
Total amount reclassified from accumulated other comprehensive loss, net of tax	\$ (0.8)	\$ (1.3)	\$ (1.8)	\$ (2.3)
Total other comprehensive (loss) income	—	(0.5)	1.1	(1.4)
Balance at end of period	\$ (1.6)	\$ (3.0)	\$ (1.6)	\$ (3.0)

(1) In all periods presented, there were no tax impacts related to rate changes and no amounts were reclassified to earnings.

(2) These amounts were included in the income tax provision on the accompanying Condensed Consolidated Statements of Income.

(3) This amount was included in interest expense, net on the accompanying Condensed Consolidated Statements of Income.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**(11) Stock-Based Compensation**

The Company's stock-based compensation expense for the three and nine months ended September 30, 2013 included performance-based restricted stock units ("PRSUs"), non-qualified stock options, RSUs and DSUs. A summary of the Company's stock-based compensation expense is presented below:

(in millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
PRSU expense (benefit)	\$ 1.6	\$ (5.2)	\$ 3.6	\$ (1.1)
Option expense	2.1	1.0	6.3	3.2
RSU/DSU Expense	1.9	0.5	3.9	1.6
Total stock based compensation expense (benefit)	\$ 5.6	\$ (3.7)	\$ 13.8	\$ 3.7

A summary of the Company's PRSU activity and related information for the nine months ended September 30, 2013 is presented below:

(shares in millions)

	Number of Shares	Weighted- Average Grant Date Fair Value	Aggregate Intrinsic Value
Awards outstanding at December 31, 2012	0.3	\$ 58.52	
Granted	0.3	39.34	
Vested	—	—	
Forfeited	(0.3)	56.92	
Awards outstanding at September 30, 2013	0.3	\$ 39.04	\$ 11.0

The maximum number of shares to be awarded under the PRSUs granted during the three and nine months ended September 30, 2013 will be 0.6 million and will vest, if earned, at the end of the two-year performance period ending on December 31, 2014.

During the nine months ended September 30, 2013, PRSUs with an aggregate intrinsic value of \$14.9 million were issued from treasury stock following the satisfaction of certain financial metrics over the performance period. The PRSUs were issued from treasury stock at 282.0% of the target award, out of a maximum payout of 300.0%.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

A summary of the Company's stock option activity and related information for the nine months ended September 30, 2013 is presented below:

(shares in millions)

	Number of Shares	Weighted- Average Grant Date Fair Value	Weighted- Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options outstanding December 31, 2012	2.9	\$ 17.00		
Granted	0.6	39.71		
Forfeited	(0.1)	39.38		
Exercised	(0.5)	13.14		
Options outstanding at September 30, 2013	2.9	\$ 21.60	6.20	\$ 60.4
Options exercisable at September 30, 2013	2.0	\$ 14.51	4.70	\$ 59.7

The aggregate intrinsic value of options exercised during the three months ended September 30, 2013 and 2012 was \$1.1 million and \$0.1 million, respectively. The aggregate intrinsic value of options exercised during the nine months ended September 30, 2013 and 2012 was \$13.4 million and \$32.2 million, respectively.

A summary of the Company's RSU and DSU activity and related information for the three and nine months ended September 30, 2013 is presented below:

(shares in millions)

	Number of Shares	Weighted- Average Grant Date Fair Value	Aggregate Intrinsic Value
Awards outstanding at December 31, 2012	0.2	\$ 32.03	
Granted	0.2	45.56	
Vested	(0.2)	29.59	
Forfeited	—	—	
Awards outstanding at September 30, 2013	0.2	\$ 46.98	\$ 9.1

The RSUs granted during the three and nine months ended September 30, 2013 will vest over one to two year periods, varying by the terms of each grant. DSUs granted during the nine months ended September 30, 2013 will vest over one year.

The aggregate intrinsic value of RSUs issued from treasury stock during the nine months ended September 30, 2013 was \$6.4 million.



## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

A summary of total unrecognized stock-based compensation expense based on current performance estimates related to the PRSUs, options and RSUs/DSUs granted during the nine months ended September 30, 2013 is presented below:

(\$ in millions)

	September 30, 2013	Weighted Average Remaining Vesting Period (Years)
Unrecognized PRSU expense	\$ 6.3	0.73
Unrecognized stock option expense	6.3	1.39
Unrecognized RSU/DSU expense	4.7	1.01
Total unrecognized stock-based compensation expense	<u>\$ 17.3</u>	<u>1.04</u>

**(12) Commitments and Contingencies**

(a) *Purchase Commitments.* The Company will, from time to time, enter into limited purchase commitments for the purchase of certain raw materials. Amounts committed under these programs are not significant as of September 30, 2013 and December 31, 2012.

(b) *Norfolk County Retirement System, Individually and on behalf of all others similarly situated, Plaintiff v. Tempur-Pedic International Inc., Mark A. Sarvary and Dale E. Williams; filed June 20, 2012*

*Arthur Benning, Jr., Individually and on behalf of all others similarly situated, Plaintiff v. Tempur-Pedic International Inc., Mark A. Sarvary and Dale E. Williams; filed June 25, 2012*

On June 20 and 25, 2012, the above suits were filed against the Company and two named executive officers in the United States District Court for the Eastern District of Kentucky, purportedly on behalf of a proposed class of shareholders who purchased the Company's stock between January 25, 2012 and June 5, 2012. The complaints assert claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, alleging, among other things, false and misleading statements and concealment of material information concerning the Company's competitive position, projected net sales, earnings per diluted share and related financial performance for the Company's 2012 fiscal year. The plaintiffs seek damages, interest, costs, attorney's fees, expert fees and unspecified equitable/injunctive relief. The Company strongly believes that the shareholder suits lack merit and intends to defend against the claims vigorously. The outcome of these matters is uncertain, however, and although the Company does not currently expect to incur a loss with respect to these matters, the Company cannot currently predict the manner and timing of the resolution of the suits, an estimate of a range of losses or any minimum loss that could result in the event of an adverse verdict in these suits, or whether the Company's applicable insurance policies will provide sufficient coverage for these claims. Accordingly, the Company can give no assurance that these matters will not have a material adverse effect on the Company's financial position or results of operations.

(c) *Sealy Mattress Company of JY, Inc., David Hertz, individually, as trustee of, respectively, the Allison Lindsay Hertz Trust, the Samuel Douglas Hertz Trust, the Sydney Lauren Hertz Trust, the U/A DTD 08/21/97 Andrew Michael Marcus Trust, the U/A DTD 08/21/97 Julia Robyn Marcus Trust, and the U/A DTD 08/21/97 James Daniel Marcus Trust, and as executor of the Estate of Walter Hertz, Lisa Marcus, Rose Naiman, Michael Shoobs, and Diane Shoobs, individually and as custodian of the Robert S. Shoobs UTMA NJ v. Sealy Corporation, filed June 27, 2013.* With respect to the Sealy Acquisition, holders of approximately 3.1 million shares of Sealy common stock sent notices to Sealy purporting to exercise their appraisal rights in accordance with the Merger Agreement executed on September 26, 2012. In order to preserve these appraisal rights, any such former stockholder was required to commence an appraisal proceeding in the Delaware courts within 120 days after March 18, 2013. Sealy has expressly reserved its rights to contest that any or all of such notices were not delivered timely or otherwise not in the form required under Delaware law. On June 27, 2013, an appraisal proceeding was commenced in the Delaware Court of Chancery (the "Appraisal Action"). If the fair value of the Sealy common stock formerly held by the former Sealy stockholders seeking the appraisal is determined to be greater than the \$2.20 per share paid pursuant to the Merger Agreement, Sealy would be required to pay such difference, plus interest at the statutory rate, which could impact the Company's financial condition and liquidity.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

(d) *Michael Dodson, Alvin Todd, and Henry and Mary Thompson, individually and on behalf of all others similarly situated, Plaintiffs v. Tempur Sealy International, Inc., formerly known as Tempur-Pedic International, Inc. and Tempur-Pedic North America, LLC, Defendants; filed October 25, 2013*

On October 25, 2013, a suit was filed against Tempur Sealy International and one of its domestic subsidiaries in the United States District Court for the Northern District of California, purportedly on behalf of a proposed class of “consumers” as defined by Cal. Civ. Code § 1761(d) who purchased, not for resale, a Tempur-Pedic mattress or pillow in the State of California. The purported class seeks certification of claims under California law. As of the date of the filing of this quarterly report on Form 10-Q, the complaint has not been served on the Company.

The complaint alleges that the Company engaged in unfair business practices, false advertising, and misrepresentations or omissions related to the sale of certain products. The plaintiffs seek restitution, injunctive relief and all other relief allowed under applicable California law, interest, attorneys’ fees and costs. The purported class does not seek damages for physical injuries. The Company believes the case lacks merit and intends to defend against the claims vigorously. This matter is at a very preliminary stage, and the outcome is uncertain. As a result, the Company is unable to reasonably estimate the possible loss or range of losses, if any, arising from this litigation, or whether the Company’s applicable insurance policies will provide sufficient coverage for these claims. Accordingly, the Company can give no assurance that this matter will not have a material adverse effect on the Company’s financial position or results of operations.

(e) *Environmental.* The Company is currently conducting an environmental cleanup at a formerly owned facility in South Brunswick, New Jersey pursuant to the New Jersey Industrial Site Recovery Act. Sealy and one of its subsidiaries are parties to an Administrative Consent Order issued by the New Jersey Department of Environmental Protection. Pursuant to that order, Sealy and its subsidiary agreed to conduct soil and groundwater remediation at the property. The Company does not believe that its manufacturing processes were the source of contamination. The Company sold the property in 1997. The Company retained primary responsibility for the required remediation. Previously, the Company removed and disposed of contaminated soil from the site with the New Jersey Department of Environmental Protection approval, and the Company has installed a groundwater remediation system on the site. During 2005, with the approval of the New Jersey Department of Environmental Protection, the Company removed and disposed of sediment in Oakeys Brook adjoining the site. The Company continues to monitor ground water at the site. During 2012, with the approval of the New Jersey Department of Environmental Protection, the Company commenced the removal and disposal of additional contaminated soil from the site. The Company has recorded a reserve as a component of other accrued expenses and other noncurrent liabilities in the accompanying Consolidated Balance Sheets as of September 30, 2013 for \$2.9 million associated with this remediation project.

The Company has also undertaken a remediation of soil and groundwater contamination at an inactive facility located in Oakville, Connecticut. Although the Company is conducting the remediation voluntarily, it obtained Connecticut Department of Energy and Environmental Protection (“DEEP”) approval of the remediation plan. The Company believes that it has essentially completed its remediation of the site. In 2012, the Company submitted separate closure reports to the Connecticut DEEP for the lower portion of the site and the upper portion of the site. The Connecticut DEEP approved the Company’s closure report for the upper portion of the site and also gave conditional approval to the Company’s closure report for the lower portion of the site. The conditional approval for the lower portion closure requires the Company to perform additional water monitoring on the lower portion of the site to demonstrate compliance with applicable standards. The Company is currently performing that monitoring. The Company has recorded a liability of approximately \$0.1 million associated with the completion of the closure of its remediation efforts at the site. The Company believes the contamination is attributable to the manufacturing operations of previous, unrelated, unaffiliated occupants of the facility.

The Company cannot predict the ultimate timing or costs of the South Brunswick and Oakville environmental matters. Based on facts currently known, the Company believes that the accruals recorded are adequate and does not believe the resolution of these matters will have a material effect on the financial position or future operations of the Company. However, in the event of an adverse decision by the agencies involved, or an unfavorable result in the New Jersey natural resources damages matter, these matters could have a material effect on the Company’s financial position or results of operations.

In 1998, the Company sold an inactive facility located in Putnam, Connecticut. Recently, the Company received a letter from the attorney for the current owner of that property claiming that the Company may have some responsibility for an environmental condition on the property. The Company continues to investigate the factual background on this matter, but intends to vigorously defend the claim of the current owner against the Company.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

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

**(13) Income Taxes**

The Company's effective tax rate for the three months ended September 30, 2013 and 2012 was 27.8% and 103.4%, respectively. The Company's tax rate for the nine months ended September 30, 2013 and 2012 was 34.7% and 54.8%, respectively. The Company's income tax rate for the three and nine months ended September 30, 2013 and 2012 differed from the U.S. federal statutory rate of 35.0% principally due to changes in estimates related to the tax cost of the Company's foreign earnings repatriation, changes in the Company's uncertain tax positions during the three and nine months ended September 30, 2013, certain foreign tax rate differentials, state and local income taxes, foreign income currently taxable in the U.S., the production activities deduction, certain Sealy Acquisition costs, and certain other permanent differences.

In conjunction with the Sealy Acquisition, in the quarter ended March 31, 2013, the Company repatriated substantially all of its current and accumulated foreign earnings associated with the Tempur North America and Tempur International subsidiaries, in a taxable transaction. The Company had previously tax effected those earnings and at December 31, 2012 had recorded a \$48.1 million deferred tax liability on such earnings. As a result of the Sealy Acquisition, the Company recognized the benefit of certain foreign tax credit attributes associated with Sealy's foreign subsidiaries' earnings. These foreign tax credits could not be taken into account in calculating the Company's tax on the book to tax basis difference of its foreign subsidiaries until the Sealy Acquisition closed. As a result of the taxable transaction and taking into consideration the application of these foreign tax credits for the three months ended March 31, 2013, the tax recognized on the repatriation transaction was approximately \$37.1 million, based on the preliminary allocation of purchase price related to the Sealy Acquisition. Consequently, the Company recorded an \$11.0 million tax benefit for the difference between that tax previously accrued on foreign earnings and the current estimate of taxes payable on the repatriation of such earnings. During the three months ended June 30, 2013, the Company adjusted the tax on the repatriation transaction by approximately \$5.5 million as a result of further adjustments to the valuation of Sealy's international business. During the three months ended September 30, 2013, there were no changes in the Company's estimate of the tax due related to the repatriation of the Company's foreign earnings, as described above. Accordingly, the Company has recorded a cumulative total of \$42.6 million related to the foreign cash repatriated in connection with the Sealy Acquisition. At September 30, 2013, the tax basis of the Company's investment in its foreign subsidiaries exceeds the Company's basis. Accordingly, no deferred taxes have been recorded related to this basis difference as it is not apparent that the difference will reverse in the foreseeable future.

The Company has received income tax assessments from the Danish Tax Authority ("SKAT") with respect to the tax years 2001 through 2007 relating to the royalty paid by one of Tempur Sealy International's U.S. subsidiaries to a Danish subsidiary. The 2007 income tax assessment was received in May 2013. The cumulative total tax assessment for all years is approximately \$200.3 million including interest and penalties. The Company filed timely protests with the Danish National Tax Tribunal (the "Tribunal") challenging the tax assessments. The National Tax Tribunal formally agreed to place the Danish tax litigation on hold pending the outcome of a Bilateral Advance Pricing Agreement ("Bilateral APA") between the United States and SKAT. A Bilateral APA involves an agreement between the Internal Revenue Service ("IRS") and the taxpayer, as well as a negotiated agreement with one or more foreign competent authorities under applicable income tax treaties. During the third quarter of 2008, the Company filed the Bilateral APA with the IRS and SKAT. U.S. and Danish competent authorities have met to discuss the Company's Bilateral APA. SKAT and the IRS met several times since 2011, most recently in February 2013, to discuss the matter. At the conclusion of the February 2013 meeting the IRS and SKAT concluded that a mutually acceptable agreement on the matter could not be reached and, as a result, the Bilateral APA process was terminated. The Company now expects the Tribunal proceedings to be reconvened later in 2013. The Tribunal is a branch of SKAT that is independent of the discussions and negotiations that have taken place to date. If the Tribunal does not rule to the satisfaction of one or both parties, the party seeking redress may choose to litigate the issue in the Danish court system. In the quarter ended September 30, 2013, the Company was notified by SKAT that SKAT has granted a deferral to 2017 of the requirement to post a cash deposit or other form of security for the taxes that have been assessed for the period 2001 through 2007. The Company believes it has meritorious defenses to the proposed adjustments and will oppose the assessments before the Tribunal and in the Danish courts, as necessary. The impact of terminating the Bilateral APA program has been considered by the Company in its September 30, 2013 estimate of uncertain tax benefits. It is reasonably possible the amount of unrecognized tax benefits may change in the next twelve months. An estimate of the amount of such change cannot be made at this time. If the Company is not successful in defending its position before the Tribunal or in the Danish courts, the Company could be required to pay significant amounts to SKAT, which could impair or reduce its liquidity and profitability. During the three months ended September 30, 2013 the Company received correspondence from SKAT requesting information regarding the royalty for the years 2008 through 2011. The correspondence indicated that SKAT would be evaluating the royalty

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

paid for each of the years under examination. The Company has responded to SKAT's request for information. As of September 30, 2013 the Company has not been notified of any proposed adjustments with respect to any of the transactions discussed.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. During the three months ended June 30, 2013, the Company concluded the tax examination of the Tempur-Pedic International Inc. U.S. federal income tax return for the years 2008 and 2009. With respect to the Company's income tax returns, in August 2013 the Company was advised by the IRS that the years 2010 and 2011 would not be examined but that 2012 would be examined. That examination has not yet begun. With few exceptions, the Company is no longer subject to tax examinations by the U.S., state, and local municipalities for periods prior to 2006, and in non-U.S. jurisdictions for periods prior to 2001. As it relates to Sealy for years prior to the Sealy Acquisition, Sealy or one of its subsidiaries was required to file income tax returns in the U.S. federal jurisdiction, various states and foreign jurisdictions. Sealy's U.S. federal income tax returns and with few exceptions its foreign income tax returns are no longer subject to examination for years prior to 2004. Generally Sealy's state and local jurisdiction income tax returns are no longer subject to examination for years prior to 2000.

Additionally, the Company is currently under examination by various tax authorities around the world. The Company anticipates it is reasonably possible an increase or decrease in the amount of unrecognized tax benefits could be made in the next twelve months as a result of the statute of limitations expiring and/or the examinations being concluded on these returns. However, the Company does not presently anticipate that any increase or decrease in unrecognized tax benefits will be material to the consolidated financial statements. Other than the changes discussed in the preceding paragraph, there were no significant changes to the liability for unrecognized tax benefits during the nine months ended September 30, 2013.

**(14) Major Customers**

The top five customers accounted for approximately 33.9% and 25.9% of the Company's net sales for the three months ended September 30, 2013 and 2012, respectively. The top five customers accounted for approximately 27.0% and 23.2% of the Company's net sales for the nine months ended September 30, 2013 and 2012, respectively. Net sales from one customer (Mattress Firm Holding Corp.) represented more than 10.0% of net sales for the three and nine months ended September 30, 2013. The top five customers also accounted for approximately 27.2% and 25.3% of accounts receivable as of September 30, 2013 and 2012, respectively.

**(15) Earnings Per Common Share**

(in millions, except per common share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Numerator:</b>				
Net income (loss) attributable to Tempur Sealy International, Inc.	\$ 40.2	\$ (2.0)	\$ 51.1	\$ 83.3
<b>Denominator:</b>				
Denominator for basic earnings per common share-weighted average shares	60.5	59.6	60.3	62.1
Effect of dilutive securities:				
Employee stock-based compensation	1.1	—	1.3	1.5
Denominator for diluted earnings per common share-adjusted weighted average shares	61.6	59.6	61.6	63.6
<b>Basic earnings (loss) per common share</b>	<b>\$ 0.66</b>	<b>\$ (0.03)</b>	<b>\$ 0.85</b>	<b>\$ 1.34</b>
<b>Diluted earnings (loss) per common share</b>	<b>\$ 0.65</b>	<b>\$ (0.03)</b>	<b>\$ 0.83</b>	<b>\$ 1.31</b>

The Company excluded 0.3 million shares issuable upon exercise of outstanding stock options for the three months ended September 30, 2013, and 0.3 million and 0.1 million for the nine months ended September 30, 2013 and 2012 respectively, from

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

the diluted earnings per common share computation because their exercise price was greater than the average market price of Tempur Sealy International's common stock or they were otherwise anti-dilutive. Holders of non-vested stock-based compensation awards do not maintain voting rights or maintain rights to receive any dividends thereon.

**(16) Business Segment Information**

The Company operates in three business segments: Tempur North America, Tempur International and Sealy. As a result of the Sealy Acquisition, the Company now has a new reportable business segment which represents Sealy's results of operations. These reportable segments are strategic business units that are managed separately based on the fundamental differences in their operations. The Tempur North America segment consists of the two U.S. manufacturing facilities and the Tempur North America distribution subsidiaries. The Tempur International segment consists of the manufacturing facility in Denmark, whose customers include all of the distribution subsidiaries and third party distributors outside the Tempur North America segment. The Sealy segment consists of manufacturing and distribution subsidiaries related to Sealy. The Company evaluates segment performance based on net sales and operating income. The Company includes certain corporate operating expenses in the Tempur North America segment, which were \$16.7 million and \$8.7 million for the three months ended September 30, 2013 and 2012, respectively. Certain corporate operating expenses included in the Tempur North America segment for the nine months ended September 30, 2013 and 2012, were \$67.0 million and \$39.1 million, respectively. There were no material allocations of corporate operating expenses to the Tempur International or Sealy segments for the three or nine months ended September 30, 2013 and 2012. The Company's Tempur North America, Tempur International and Sealy segment assets include investments in subsidiaries which are appropriately eliminated in the Company's accompanying Condensed Consolidated Financial Statements. The remaining inter-segment eliminations are comprised of intercompany accounts receivable. The effect of the elimination of the investments in subsidiaries is included in the inter-segment eliminations as shown below.

The following table summarizes total assets by segment:

(in millions)

	<u>September 30, 2013</u>	<u>December 31, 2012</u>
Total assets:		
Tempur North America	\$ 2,098.5	\$ 1,160.4
Tempur International	536.7	504.1
Sealy	1,901.7	—
Investment in subsidiaries	(991.2)	(347.6)
Other intercompany eliminations	(784.2)	(3.9)
	<u>\$ 2,761.5</u>	<u>\$ 1,313.0</u>

The following table summarizes long-lived assets by segment:

(in millions)

	<u>September 30, 2013</u>	<u>December 31, 2012</u>
Long-lived assets:		
Tempur North America	\$ 391.2	\$ 395.7
Tempur International	68.0	69.5
Sealy	1,467.0	—
	<u>\$ 1,926.2</u>	<u>\$ 465.2</u>

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

The following table summarizes net sales by geographic region:

(in millions)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
United States	\$ 537.5	\$ 228.0	\$ 1,264.9	\$ 705.0
Canada	64.1	12.9	135.2	31.5
Other International	133.9	107.0	386.1	325.3
	<u>\$ 735.5</u>	<u>\$ 347.9</u>	<u>\$ 1,786.2</u>	<u>\$ 1,061.8</u>
Total International	<u>\$ 198.0</u>	<u>\$ 119.9</u>	<u>\$ 521.3</u>	<u>\$ 356.8</u>

The following table summarizes segment information:

(in millions)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Net sales to external customers:				
Tempur North America				
Bedding	\$ 220.6	\$ 220.1	\$ 624.7	\$ 675.1
Other products	21.8	20.8	59.1	61.4
	<u>\$ 242.4</u>	<u>\$ 240.9</u>	<u>\$ 683.8</u>	<u>\$ 736.5</u>
Tempur International				
Bedding	\$ 76.5	\$ 80.3	\$ 239.7	\$ 248.2
Other products	26.7	26.7	81.5	77.1
	<u>\$ 103.2</u>	<u>\$ 107.0</u>	<u>\$ 321.2</u>	<u>\$ 325.3</u>
Sealy				
Bedding	\$ 365.2	\$ —	\$ 735.0	\$ —
Other products	24.7	—	46.2	—
	<u>\$ 389.9</u>	<u>\$ —</u>	<u>\$ 781.2</u>	<u>\$ —</u>
	<u>\$ 735.5</u>	<u>\$ 347.9</u>	<u>\$ 1,786.2</u>	<u>\$ 1,061.8</u>
Inter-segment sales:				
Tempur North America	\$ 0.1	\$ 0.4	\$ 0.2	\$ 0.8
Tempur International	0.3	1.4	0.5	1.4
Sealy	1.5	—	1.5	—
Intercompany eliminations	(1.9)	(1.8)	(2.2)	(2.2)
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Gross profit:				
Tempur North America	\$ 102.1	\$ 105.1	\$ 294.0	\$ 348.5
Tempur International	61.9	66.0	198.7	195.5
Sealy	134.7	—	249.3	—
	<u>\$ 298.7</u>	<u>\$ 171.1</u>	<u>\$ 742.0</u>	<u>\$ 544.0</u>

Operating income:

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

Tempur North America	\$ 17.9	\$ 34.9	\$ 44.0	\$ 120.3
Tempur International	22.9	28.5	78.1	76.7
Sealy	40.4	—	47.6	—
	<u>\$ 81.2</u>	<u>\$ 63.4</u>	<u>\$ 169.7</u>	<u>\$ 197.0</u>
Income (loss) before income taxes:				
Tempur North America	\$ (3.3)	\$ 30.4	\$ (37.9)	\$ 107.8
Tempur International	22.3	28.6	75.0	76.6
Sealy	36.7	—	40.4	—
	<u>\$ 55.7</u>	<u>\$ 59.0</u>	<u>\$ 77.5</u>	<u>\$ 184.4</u>
Depreciation and amortization (including stock-based compensation amortization):				
Tempur North America	\$ 11.8	\$ 2.7	\$ 32.4	\$ 22.4
Tempur International	3.2	2.9	9.4	8.2
Sealy	11.7	—	24.5	—
	<u>\$ 26.7</u>	<u>\$ 5.6</u>	<u>\$ 66.3</u>	<u>\$ 30.6</u>
Intercompany royalties:				
Tempur North America	\$ 1.6	\$ 3.0	\$ 4.3	\$ 9.4
Tempur International	(1.6)	(3.0)	(4.3)	(9.4)
Sealy	—	—	—	—
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Capital expenditures:				
Tempur North America	\$ 2.9	\$ 14.6	\$ 13.8	\$ 27.7
Tempur International	2.6	3.1	7.3	10.7
Sealy	3.6	—	7.3	—
	<u>\$ 9.1</u>	<u>\$ 17.7</u>	<u>\$ 28.4</u>	<u>\$ 38.4</u>

**(17) Guarantor/Non-Guarantor Financial Information**

The Senior Notes are general unsecured senior obligations of Tempur Sealy International and are fully and unconditionally guaranteed on a senior unsecured basis, jointly and severally, by all of Tempur Sealy International's 100% directly or indirectly owned current and future domestic subsidiaries (the "Combined Guarantor Subsidiaries"). The foreign subsidiaries (the "Combined Non-Guarantor Subsidiaries") represent the foreign operations of the Company and do not guarantee the Senior Notes. A subsidiary guarantor will be released from its obligations under the indenture governing the Senior Notes when: (a) the subsidiary guarantor is sold or sells all or substantially all of its assets; (b) the subsidiary is declared "unrestricted" under the indenture governing the Senior Notes; (c) the subsidiary's guarantee of indebtedness under the 2012 Credit Agreement (as it may be amended, refinanced or replaced) is released (other than a discharge through repayment); or (d) the requirements for legal or covenant defeasance or discharge of the indenture have been satisfied. The principal elimination entries relate to investments in subsidiaries and intercompany balances and transactions, including transactions with the Company's wholly-owned subsidiary guarantors and non-guarantor subsidiaries. The Company has accounted for its investments in its subsidiaries under the equity method.

The following financial information presents Condensed Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012, and the related Condensed Consolidated Statements of Income and Comprehensive Income and Cash Flows for the three and nine months ended September 30, 2013 and 2012, for Tempur Sealy International, Combined Guarantor Subsidiaries and Combined Non-Guarantor Subsidiaries.

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Statements of Income and Comprehensive Income**  
**Three Months Ended September 30, 2013**  
*(in millions)*

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non- Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	\$ —	\$ 543.0	\$ 198.4	\$ (5.9)	\$ 735.5
Cost of sales	—	339.1	103.6	(5.9)	436.8
Gross profit	—	203.9	94.8	—	298.7
Selling and marketing expenses	0.7	111.6	38.6	—	150.9
General, administrative and other expenses	5.5	45.8	20.6	—	71.9
Equity income in earnings of unconsolidated affiliates	—	—	(1.2)	—	(1.2)
Royalty income, net of royalty expense	—	(4.1)	—	—	(4.1)
Operating (loss) income	(6.2)	50.6	36.8	—	81.2
Other expense, net:					
Interest expense, net	14.7	8.9	1.0	—	24.6
Other expense (income), net	—	—	0.9	—	0.9
Total other expense	14.7	8.9	1.9	—	25.5
Income from equity investees	52.8	25.3	—	(78.1)	—
Income before income taxes	31.9	67.0	34.9	(78.1)	55.7
Income tax benefit (provision)	8.3	(14.2)	(9.6)	—	(15.5)
Net income	40.2	52.8	25.3	(78.1)	40.2
Less: net income attributable to non-controlling interest	—	—	—	—	—
Net income attributable to Tempur Sealy International, Inc.	\$ 40.2	\$ 52.8	\$ 25.3	\$ (78.1)	\$ 40.2
Comprehensive income	\$ 49.6	\$ 52.8	\$ 34.6	\$ (87.4)	\$ 49.6



## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Statements of Income and Comprehensive Income**  
**Nine Months Ended September 30, 2013**  
*(in millions)*

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non- Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	\$ —	\$ 1,281.8	\$ 521.8	\$ (17.4)	\$ 1,786.2
Cost of sales	—	805.7	255.9	(17.4)	1,044.2
Gross profit	—	476.1	265.9	—	742.0
Selling and marketing expenses	2.1	264.3	110.7	—	377.1
General, administrative and other expenses	13.7	137.9	55.3	—	206.9
Equity income in earnings of unconsolidated affiliates	—	—	(2.5)	—	(2.5)
Royalty income, net of royalty expense	—	(9.2)	—	—	(9.2)
Operating (loss) income	(15.8)	83.1	102.4	—	169.7
Other expense, net:					
Interest expense, net	45.4	40.6	2.2	—	88.2
Other (income) expense, net	—	(0.3)	4.3	—	4.0
Total other expense	45.4	40.3	6.5	—	92.2
Income from equity investees	91.3	71.6	—	(162.9)	—
Income before income taxes	30.1	114.4	95.9	(162.9)	77.5
Income tax (provision) benefit	20.5	(23.1)	(24.3)	—	(26.9)
Net income	50.6	91.3	71.6	(162.9)	50.6
Less: net income attributable to non-controlling interest	(0.5)	(0.5)	—	0.5	(0.5)
Net income attributable to Tempur Sealy International, Inc.	\$ 51.1	\$ 91.8	\$ 71.6	\$ (163.4)	\$ 51.1
Comprehensive income	\$ 43.9	\$ 92.4	\$ 66.4	\$ (158.8)	\$ 43.9

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Statements of Income and Comprehensive Income**  
**Three Months Ended September 30, 2012**  
*(in millions)*

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non- Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	\$ —	\$ 234.4	\$ 120.6	\$ (7.1)	\$ 347.9
Cost of sales	—	132.4	51.5	(7.1)	176.8
Gross profit	—	102.0	69.1	—	171.1
Selling and marketing expenses	(0.5)	47.3	29.4	—	76.2
General, administrative and other expenses	(2.8)	23.2	11.1	—	31.5
Equity income in earnings of unconsolidated affiliates	—	—	—	—	—
Royalty income, net of royalty expense	—	—	—	—	—
Operating income	3.3	31.5	28.6	—	63.4
Other expense, net:					
Interest expense (income), net	8.3	(3.7)	0.2	—	4.8
Other (income), net	—	—	(0.4)	—	(0.4)
Total other expense (income)	8.3	(3.7)	(0.2)	—	4.4
Income from equity investees	1.2	21.7	—	(22.9)	—
Income before income taxes	(3.8)	56.9	28.8	(22.9)	59.0
Income tax benefit (provision)	1.8	(55.7)	(7.1)	—	(61.0)
Net (loss) income	(2.0)	1.2	21.7	(22.9)	(2.0)
Less: net income attributable to non-controlling interest	—	—	—	—	—
Net (loss) income attributable to Tempur Sealy International, Inc.	\$ (2.0)	\$ 1.2	\$ 21.7	\$ (22.9)	\$ (2.0)
Comprehensive income	\$ 3.0	\$ 0.7	\$ 27.2	\$ (27.9)	\$ 3.0

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Statements of Income and Comprehensive Income**  
**Nine Months Ended September 30, 2012**  
*(in millions)*

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non- Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	\$ —	\$ 723.6	\$ 358.2	\$ (20.0)	\$ 1,061.8
Cost of sales	—	383.4	154.4	(20.0)	517.8
Gross profit	—	340.2	203.8	—	544.0
Selling and marketing expenses	1.4	148.8	93.0	—	243.2
General, administrative and other expenses	3.5	67.8	32.5	—	103.8
Equity income in earnings of unconsolidated affiliates	—	—	—	—	—
Royalty income, net of royalty expense	—	—	—	—	—
Operating (loss) income	(4.9)	123.6	78.3	—	197.0
Other expense, net:					
Interest expense (income), net	23.1	(10.5)	0.4	—	13.0
Other (income), net	—	—	(0.4)	—	(0.4)
Total other expense (income)	23.1	(10.5)	—	—	12.6
Income from equity investees	103.8	62.7	—	(166.5)	—
Income before income taxes	75.8	196.8	78.3	(166.5)	184.4
Income tax (provision) benefit	7.5	(93.0)	(15.6)	—	(101.1)
Net income	83.3	103.8	62.7	(166.5)	83.3
Less: net income attributable to non-controlling interest	—	—	—	—	—
Net income attributable to Tempur Sealy International, Inc.	\$ 83.3	\$ 103.8	\$ 62.7	\$ (166.5)	\$ 83.3
Comprehensive income	\$ 82.9	\$ 102.4	\$ 75.2	\$ (177.6)	\$ 82.9

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Balance Sheets**  
**September 30, 2013**  
*(in millions)*

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non- Guarantor Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>					
Current Assets:					
Cash and cash equivalents	\$ —	\$ 61.9	\$ 64.7	\$ —	\$ 126.6
Accounts receivable, net	—	197.4	151.9	—	349.3
Inventories	—	131.2	51.6	—	182.8
Escrow Receivable	—	—	—	—	—
Income taxes payable	112.0	—	—	(112.0)	—
Prepaid expenses and other current assets	0.3	37.9	14.5	—	52.7
Deferred income taxes	10.0	24.5	4.7	—	39.2
<b>Total Current Assets</b>	<b>122.3</b>	<b>452.9</b>	<b>287.4</b>	<b>(112.0)</b>	<b>750.6</b>
Property, plant and equipment, net	—	335.3	76.3	—	411.6
Goodwill	—	575.5	180.9	—	756.4
Other intangible assets, net	—	628.0	130.2	—	758.2
Deferred tax asset	—	—	9.7	—	9.7
Other non-current assets	7.8	50.8	16.4	—	75.0
Net investment in subsidiaries	732.8	—	—	(732.8)	—
Due from affiliates	1,309.9	2,345.8	0.8	(3,656.5)	—
<b>Total Assets</b>	<b>\$ 2,172.8</b>	<b>\$ 4,388.3</b>	<b>\$ 701.7</b>	<b>\$ (4,501.3)</b>	<b>\$ 2,761.5</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current Liabilities:					
Accounts payable	\$ —	\$ 140.1	\$ 41.6	\$ —	\$ 181.7
Accrued expenses and other current liabilities	7.8	150.3	62.3	—	220.4
Deferred income taxes	—	—	0.5	—	0.5
Income taxes payable	—	131.7	13.3	(112.0)	33.0
Current portion of long-term debt	—	36.5	3.2	—	39.7
<b>Total Current Liabilities</b>	<b>7.8</b>	<b>458.6</b>	<b>120.9</b>	<b>(112.0)</b>	<b>475.3</b>
Long-term debt	375.0	1,445.4	—	—	1,820.4
Deferred income taxes	—	252.3	34.9	—	287.2
Other non-current liabilities	—	78.5	6.7	—	85.2
Due to affiliates	1,696.6	1,420.7	959.1	(4,076.4)	—
<b>Total Liabilities</b>	<b>2,079.4</b>	<b>3,655.5</b>	<b>1,121.6</b>	<b>(4,188.4)</b>	<b>2,668.1</b>
Redeemable non-controlling interest	10.9	10.9	—	(10.9)	10.9
<b>Total Stockholders' Equity</b>	<b>82.5</b>	<b>721.9</b>	<b>(419.9)</b>	<b>(302.0)</b>	<b>82.5</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 2,172.8</b>	<b>\$ 4,388.3</b>	<b>\$ 701.7</b>	<b>\$ (4,501.3)</b>	<b>\$ 2,761.5</b>

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Balance Sheets**  
**December 31, 2012**  
*(in millions)*

	<u>Tempur Sealy International, Inc. (Ultimate Parent)</u>	<u>Combined Guarantor Subsidiaries</u>	<u>Combined Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
<b>ASSETS</b>					
Current Assets:					
Cash and cash equivalents	\$ —	\$ 19.2	\$ 160.1	\$ —	\$ 179.3
Accounts receivable, net	—	57.1	72.7	—	129.8
Inventories	—	55.7	37.3	—	93.0
Escrow Receivable	375.0	—	—	—	375.0
Prepaid expenses and other current assets	86.2	26.4	15.0	(86.2)	41.4
Deferred income taxes	11.7	—	2.6	(11.7)	2.6
<b>Total Current Assets</b>	<b>472.9</b>	<b>158.4</b>	<b>287.7</b>	<b>(97.9)</b>	<b>821.1</b>
Property, plant and equipment, net	—	132.7	53.3	—	186.0
Goodwill	—	89.9	126.2	—	216.1
Other intangible assets, net	—	42.9	20.2	—	63.1
Deferred tax asset	—	—	10.4	—	10.4
Other non-current assets	—	13.4	2.9	—	16.3
Net investment in subsidiaries	1,213.0	300.2	—	(1,513.2)	—
Due from affiliates	28.0	1,460.0	3.4	(1,491.4)	—
<b>Total Assets</b>	<b>\$ 1,713.9</b>	<b>\$ 2,197.5</b>	<b>\$ 504.1</b>	<b>\$ (3,102.5)</b>	<b>\$ 1,313.0</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current Liabilities:					
Accounts payable	\$ —	\$ 60.0	\$ 25.8	\$ —	\$ 85.8
Accrued expenses and other current liabilities	0.2	46.2	35.0	—	81.4
Deferred income taxes	—	37.6	0.6	(11.7)	26.5
Income taxes payable	—	89.3	12.4	(86.2)	15.5
<b>Total Current Liabilities</b>	<b>0.2</b>	<b>233.1</b>	<b>73.8</b>	<b>(97.9)</b>	<b>209.2</b>
Long-term debt	375.0	650.0	—	—	1,025.0
Deferred income taxes	—	28.9	2.5	—	31.4
Other non-current liabilities	—	23.5	1.6	—	25.1
Due to affiliates	1,316.4	49.0	126.0	(1,491.4)	—
<b>Total Liabilities</b>	<b>1,691.6</b>	<b>984.5</b>	<b>203.9</b>	<b>(1,589.3)</b>	<b>1,290.7</b>
<b>Total Stockholders' Equity</b>	<b>22.3</b>	<b>1,213.0</b>	<b>300.2</b>	<b>(1,513.2)</b>	<b>22.3</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 1,713.9</b>	<b>\$ 2,197.5</b>	<b>\$ 504.1</b>	<b>\$ (3,102.5)</b>	<b>\$ 1,313.0</b>

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Statements of Cash Flows**  
**Nine Months Ended September 30, 2013**  
*(in millions)*

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non- Guarantor Subsidiaries	Eliminations	Consolidated
Net cash (used in) provided by operating activities	\$ (44.4)	\$ 80.9	\$ 68.3	\$ —	\$ 104.8
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>					
Acquisition of business, net of cash acquired	—	(1,035.3)	(137.6)	—	(1,172.9)
Purchases of property, plant and equipment	—	(20.4)	(8.0)	—	(28.4)
Other	—	(53.0)	53.9	—	0.9
Net cash provided by (used in) investing activities	—	(1,108.7)	(91.7)	—	(1,200.4)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>					
Proceeds from 2012 Credit Agreement	—	2,917.6	—	—	2,917.6
Repayments 2012 Credit Agreement	—	(1,559.1)	—	—	(1,559.1)
Proceeds from issuance of Senior Notes	375.0	—	—	—	375.0
Proceeds from 2011 Credit Facility	—	46.5	—	—	46.5
Repayments of 2011 Credit Facility	—	(696.5)	—	—	(696.5)
Net activity in investment in and advances (to) from subsidiaries and affiliates	(797.1)	871.6	(74.5)	—	—
Payment of deferred financing costs	(8.4)	(43.6)	—	—	(52.0)
Proceeds from issuance of common stock	6.0	—	—	—	6.0
Excess tax benefit from stock based compensation	3.7	—	—	—	3.7
Treasury stock repurchased	465.2	(465.2)	—	—	—
Other	—	(0.8)	0.1	—	(0.7)
Net cash (used in) provided by financing activities	44.4	1,070.5	(74.4)	—	1,040.5
<b>NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>					
	—	—	2.4	—	2.4
Increase (decrease) in cash and cash equivalents	—	42.7	(95.4)	—	(52.7)
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	—	19.2	160.1	—	179.3
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ —</b>	<b>\$ 61.9</b>	<b>\$ 64.7</b>	<b>\$ —</b>	<b>\$ 126.6</b>

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited) (continued)

**TEMPUR SEALY INTERNATIONAL, INC.**  
**Supplemental Condensed Consolidated Statements of Cash Flows**  
**Nine Months Ended September 30, 2012**  
*(in millions)*

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non- Guarantor Subsidiaries	Eliminations	Consolidated
Net cash (used in) provided by operating activities	\$ (20.5)	\$ 41.1	\$ 62.7	\$ —	\$ 83.3
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>					
Acquisition of business, net of cash acquired	—	11.8	(15.7)	—	(3.9)
Purchase of property, plant and equipment	—	(27.6)	(10.8)	—	(38.4)
Other	—	—	—	—	—
Net cash (used in) investing activities	—	(15.8)	(26.5)	—	(42.3)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>					
Proceeds from 2012 Credit Agreement	—	284.5	—	—	284.5
Repayments of the 2012 Credit Agreement	—	(220.0)	—	—	(220.0)
Proceeds from the 2011 Credit Facility	—	—	—	—	—
Repayments of the 2011 Credit Facility	—	—	—	—	—
Net activity in investment in and advances from (to) subsidiaries and affiliates	166.6	(167.7)	1.1	—	—
Payment of deferred financing costs	—	—	(0.1)	—	(0.1)
Proceeds from issuance of common stock	10.6	—	—	—	10.6
Excess tax benefit from stock based compensation	9.7	—	—	—	9.7
Treasury stock repurchased	(152.6)	—	—	—	(152.6)
Other	—	—	(2.5)	—	(2.5)
Net cash provided by (used in) financing activities	34.3	(103.2)	(1.5)	—	(70.4)
<b>NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>					
Increase in cash and cash equivalents	—	3.7	36.6	—	40.3
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>					
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ —	\$ 14.5	\$ 137.2	\$ —	\$ 151.7

## 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 accompanying Condensed Consolidated Financial Statements and accompanying notes included in this Form 10-Q. Unless otherwise noted, all of the financial information in this report is condensed consolidated information for the Company. 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 include numerous risks and uncertainties, as described under "Special Note Regarding Forward-Looking Statements" and "Risk Factors" elsewhere in this quarterly report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2012 and our quarterly reports on Form 10-Q for the quarters ended March 31, 2013 and June 30, 2013. Our actual results may differ materially from those contained in any forward-looking statements. Except as may be required by law, we undertake no obligation to publicly update or revise any of the forward-looking statements contained herein.

In this discussion and analysis, we discuss and explain the financial condition and results of our operations for the three and nine months ended September 30, 2013 and 2012, including the following points:

- An overview of our business, including the acquisition of Sealy Corporation and its historical subsidiaries ("Sealy");
- Our net sales and costs in the periods presented as well as changes between periods;
- Expected sources of liquidity for future operations; and
- The effect of the foregoing on our overall financial performance and condition.

### Executive Overview

*General.* We are the world's largest bedding provider. We develop, manufacture, market, and distribute bedding products, which we sell globally. Our brand portfolio includes many of the most highly recognized brands in the industry, including TEMPUR®, Tempur-Pedic®, Sealy®, Sealy Posturepedic®, Optimum™, and Stearns & Foster®. Our comprehensive suite of bedding products offers a variety of products to consumers across a broad range of channels.

We sell our products through three distribution channels in each operating business segment: Retail (furniture and bedding retailers, department stores, specialty retailers and warehouse clubs); Direct (e-commerce platform, company-owned stores, and call center); and Other (third party distributors, hospitality and healthcare customers).

*Business Segments.* We have three reportable business segments: Tempur North America, Tempur International, and Sealy. As a result of the Sealy Acquisition, we now have a new reportable business segment based on the Sealy domestic and international business. These reportable segments are strategic business units that are managed separately based on the fundamental differences in their operations. Our Tempur North America segment consists of two U.S. manufacturing facilities and our Tempur North America distribution subsidiaries. Our Tempur International segment consists of our manufacturing facility in Denmark, whose customers include all of our distribution subsidiaries and third party distributors outside our Tempur North America and Sealy segments. Our Sealy segment consists of company-owned and operated bedding and component manufacturing facilities located around the world, along with distribution subsidiaries and joint ventures. We evaluate segment performance based on net sales and operating income.



## Strategy

We are the world’s largest bedding provider and the only provider with global scale. We believe our future growth potential is significant in our existing markets and through expansion into new markets. In order to achieve our long-term growth potential while managing the current economic and competitive environment, we will focus on the key strategic growth initiatives discussed below:

- **Product Innovation:** We will continue to invest in research and development to leverage the combined technologies of our comprehensive portfolio of products to deliver a stream of innovative products. Our goal is to provide consumers the best bed and best sleep of their life and to provide our retailers a complete and optimal offering across brands, products, and prices to drive growth. We will also pursue opportunities to enter or develop new product categories.
- **Marketing:** We will increase our investment in advertising to increase consumer awareness, preference and loyalty for each of our key brands. We will also invest in in-store marketing and direct sales to maximize our sales opportunity driven from national brand and retailer advertising.
- **New Market Expansion:** We will pursue opportunities to expand into new international markets and over time into non-consolidated markets where our brands are currently represented under licensee, joint venture or third party distributor agreements.
- **Supply Chain (“Easier To Do Business With”):** We are committed to building a world-class supply chain that is “easier to do business with.” Our goal is to significantly improve efficiencies related to purchasing and delivery, as well as inventory management to drive sales growth.

Our strategic growth initiatives will be supported by cost synergies realized from the Sealy acquisition as well as through our ongoing cost productivity initiatives.

## Sealy Acquisition

On March 18, 2013, we completed the acquisition of Sealy (“Sealy Acquisition”). Refer to Note 2, “Business Combinations”, in our Condensed Consolidated Financial Statements included in Part I, ITEM I of this report for a discussion of the Sealy Acquisition. Pursuant to the merger agreement, each share of common stock of Sealy issued and outstanding immediately prior to the effective time of the Sealy Acquisition was cancelled and (other than shares held by Sealy or Tempur-Pedic or their subsidiaries or Sealy stockholders who properly exercised their appraisal rights) converted into the right to receive \$2.20 in cash. The total purchase price was \$1,172.9 million, which was funded using available cash and financing consisting of our 2012 Credit Agreement and Senior Notes. Refer to Note 4, “Debt”, in our Condensed Consolidated Financial Statements included in Part I, ITEM I of this report for the definition of these terms and further discussion. The purchase price of Sealy, including debt assumed, consisted of the following items:

(in millions)

Cash consideration for stock	\$	231.2 <sup>(1)</sup>
Cash consideration for share-based awards		14.2 <sup>(2)</sup>
Cash consideration for 8.0% Sealy Notes		442.1 <sup>(3)</sup>
Cash consideration for repayment of Sealy Senior Notes		260.7 <sup>(4)</sup>
Cash consideration for repayment of Sealy 2014 Notes		276.9 <sup>(5)</sup>
Total consideration		1,225.1
Cash acquired		(52.2) <sup>(6)</sup>
Net consideration given	\$	1,172.9

(1) The cash consideration for outstanding shares of Sealy common stock is the product of the agreed-upon cash per share price of \$2.20 and total Sealy shares of 105.1 million.

(2) The cash consideration for share-based awards is the product of the agreed-upon cash per share price of \$2.20 and the total number of restricted stock units and deferred stock units outstanding and the “in the money” stock options net of the weighted average exercise price.

(3) The cash consideration for Sealy’s 8.0% Senior Secured Third Lien Convertible Notes due 2016 (“8.0% Sealy Notes”) is the result of applying the adjusted equity conversion rate to the 8.0% Sealy Notes tendered for conversion and multiplying the result by the agreed-upon cash per share price of \$2.20. The 8.0% Sealy Notes that were converted represented the right to receive the same merger consideration that would have been payable to a holder of 201.0 million shares of Sealy common stock, subject to adjustment in accordance with the terms of the supplemental indenture governing the 8.0% Sealy Notes.

- (4) The cash consideration for Sealy's 10.875% Senior Notes due 2016 ("Sealy Senior Notes") reflects the repayment of the outstanding obligation.
- (5) The cash consideration for Sealy's 8.25% Senior Subordinated Notes due 2014 ("Sealy 2014 Notes") reflects the repayment of the outstanding obligation.
- (6) Represents the Sealy cash balance acquired at acquisition.

Sealy, headquartered in Trinity, North Carolina, owns one of the largest portfolios of bedding brands in the world, and manufactures and markets a complete line of bedding products under the Sealy®, Sealy Posturepedic®, Optimum™, and Stearns & Foster® brands. Sealy's results of operations are reported within the our Sealy reportable segment. The combination brings together two highly complementary companies with iconic brands and significant opportunities for global innovation and growth. We will have products for almost every consumer preference and price point, distribution through all key channels, in-house expertise on most key bedding technologies, and a world-class research and development team. In addition, the combined operations have a global footprint that includes over 80 countries. We believe the shared know-how and improved efficiencies of the combined company will result in tremendous value for its consumers, retailers and stockholders.

## **Results of Operations**

A summary of our results for the three and nine months ended September 30, 2013, which include the Sealy segment results of operations for the period from March 18, 2013 through September 30, 2013, but do not include the Sealy segment results of operations for the 2012 periods, include the following:

- Net sales for the three months ended September 30, 2013 increased to \$735.5 million from \$347.9 million for the same period in 2012. Net sales for the nine months ended September 30, 2013 increased to \$1,786.2 million from \$1,061.8 million for the same period in 2012.
- Earnings per diluted common share (EPS) was \$0.65 for the three months ended September 30, 2013 compared to loss per diluted common share of \$0.03 for the three months ended September 30, 2012. For the nine months ended September 30, 2013 EPS were \$0.83 compared to \$1.31 for the same period in 2012.

(In millions, except per common share amounts)

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
Net sales	\$ 735.5	100.0 %	\$ 347.9	100.0 %	\$ 1,786.2	100.0 %	\$ 1,061.8	100.0 %
Cost of sales	436.8	59.4 %	176.8	50.8 %	1,044.2	58.5 %	517.8	48.8 %
Gross profit	298.7	40.6 %	171.1	49.2 %	742.0	41.5 %	544.0	51.2 %
Selling and marketing expenses	150.9	20.5 %	76.2	21.9 %	377.1	21.1 %	243.2	22.9 %
General, administrative and other expenses	71.9	9.9 %	31.5	9.1 %	206.9	11.5 %	103.8	9.8 %
Equity income in earnings of unconsolidated affiliates	(1.2)	(0.2)%	—	— %	(2.5)	(0.1)%	—	— %
Royalty income, net of royalty expense	(4.1)	(0.6)%	—	— %	(9.2)	(0.5)%	—	— %
Operating income	81.2	11.0 %	63.4	18.2 %	169.7	9.5 %	197.0	18.5 %
Interest expense, net	24.6	3.3 %	4.8	1.4 %	88.2	4.9 %	13.0	1.1 %
Other expense (income), net	0.9	0.1 %	(0.4)	(0.1)%	4.0	0.2 %	(0.4)	— %
Income before income taxes	55.7	7.6 %	59.0	16.9 %	77.5	4.4 %	184.4	17.4 %
Income tax provision	(15.5)	(2.1)%	(61.0)	(17.5)%	(26.9)	(1.5)%	(101.1)	(9.5)%
Net income (loss) before non-controlling interest	40.2	5.5 %	(2.0)	(0.6)%	50.6	2.9 %	83.3	7.9 %
Less: Net (loss) attributable to non-controlling interest	—	— %	—	— %	(0.5)	— %	—	— %
Net income (loss) attributable to common stockholders	\$ 40.2	5.5 %	\$ (2.0)	(0.6)%	\$ 51.1	2.9 %	\$ 83.3	7.9 %
Earnings (loss) per common share:								
Basic	\$ 0.66		\$ (0.03)		\$ 0.85		\$ 1.34	
Diluted	\$ 0.65		\$ (0.03)		\$ 0.83		\$ 1.31	
Weighted average common shares outstanding:								
Basic	60.5		59.6		60.3		62.1	
Diluted	61.6		59.6		61.6		63.6	

**Three Months Ended September 30, 2013 Compared with Three Months Ended September 30, 2012**

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

(in millions)	CONSOLIDATED		TEMPUR NORTH AMERICA		TEMPUR INTERNATIONAL		SEALY	
	Three Months Ended September 30,		Three Months Ended September 30,		Three Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Retail	\$ 669.7	\$ 306.4	\$ 226.5	\$ 221.2	\$ 79.7	\$ 85.2	\$ 363.5	\$ —
Direct	31.5	27.1	11.6	16.7	12.5	10.4	7.4	—
Other	34.3	14.4	4.3	3.0	11.0	11.4	19.0	—
	<u>\$ 735.5</u>	<u>\$ 347.9</u>	<u>\$ 242.4</u>	<u>\$ 240.9</u>	<u>\$ 103.2</u>	<u>\$ 107.0</u>	<u>\$ 389.9</u>	<u>\$ —</u>

Retail includes sales to furniture, bedding and department stores. Direct includes direct response and e-commerce sales as well as sales through company-owned stores. Other includes sales to third party distributors, health care and hospitality institutions.

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

(in millions)	CONSOLIDATED		TEMPUR NORTH AMERICA		TEMPUR INTERNATIONAL		SEALY	
	Three Months Ended September 30,		Three Months Ended September 30,		Three Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Bedding	\$ 662.3	\$ 300.4	\$ 220.6	\$ 220.1	\$ 76.5	\$ 80.3	\$ 365.2	\$ —
Other products	73.2	47.5	21.8	20.8	26.7	26.7	24.7	—
	<u>\$ 735.5</u>	<u>\$ 347.9</u>	<u>\$ 242.4</u>	<u>\$ 240.9</u>	<u>\$ 103.2</u>	<u>\$ 107.0</u>	<u>\$ 389.9</u>	<u>\$ —</u>

Bedding includes mattresses, foundations and adjustable foundations and Other products includes pillows and various other comfort products and components.

**Net sales.** Net sales for the three months ended September 30, 2013 increased to \$735.5 million from \$347.9 million for the same period in 2012, an increase of \$387.6 million, or 111.4%. Net sales for the three months ended September 30, 2013 increased across all product and channel categories over the same period in 2012, due primarily to the Sealy Acquisition. For the three months ended September 30, 2013, Bedding net sales increased 120.5%, Retail channel net sales increased 118.6% and Other channel net sales increased 138.2%. The principal factors impacting net sales for each segment are discussed below.

**Tempur North America.** Tempur North America net sales for the three months ended September 30, 2013 increased to \$242.4 million from \$240.9 million for the same period in 2012. Our Tempur North America Retail channel net sales increased 2.4%, compared to the same period in 2012. Tempur North America Retail channel net sales increased primarily due to various strategic initiatives implemented to drive growth in the Retail channel. These initiatives included new product introductions, increased advertising investments and improving how we serve our Retail channel customers. Each of these initiatives contributed to the improved Retail channel performance during the third quarter of 2013. We will continue to focus on these strategic initiatives to drive future growth in our Tempur North America segment. Tempur North America Direct net sales decreased \$5.1 million, or 30.5% compared to the same period in 2012. Tempur North American Direct channel net sales continue to be impacted by the advertising spend decreases in the first and second quarters of 2013 as compared to the prior year.

*Tempur International.* Tempur International net sales for the three months ended September 30, 2013 decreased to \$103.2 million from \$107.0 million for the same period in 2012, a decrease of \$3.8 million, or 3.6%. On a constant currency basis<sup>1</sup>, our Tempur International net sales decreased approximately 3.1%. Tempur International net sales decreased primarily due to macroeconomic pressure in Europe which was partially offset by growth in our Asia-Pacific and Latin American businesses. Tempur International bedding net sales decreased 4.7% compared to the third quarter of 2012, consistent with the decrease in net sales in our Tempur International Retail channel. The Tempur International Direct channel net sales increased \$2.1 million, or 20.2% compared to the same period in 2012, due to our expanding our points of distribution through an increase in the number of company-owned stores and e-commerce.

*Sealy.* Sealy net sales for the three months ended September 30, 2013 were \$389.9 million, with \$363.5 million in the Retail channel. Net sales for our Sealy Other channel were \$19.0 million, and Direct channel net sales were \$7.4 million for the three months ended September 30, 2013. For the three months ended September 30, 2013, Sealy bedding net sales were \$365.2 million and other products net sales were \$24.7 million.

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<sup>1</sup> The references to “constant currency basis” in this Management’s Discussion & Analysis section do not include operational impacts that could result from fluctuations in foreign currency rates. Certain financial results are adjusted based on a simple mathematical model that translates current period results in local currency using the comparable prior year period’s currency conversion rate. This approach is used for countries where the functional currency is the local country currency. This information is provided so that certain financial results can be viewed without the impact of fluctuations in foreign currency rates, thereby facilitating period-to-period comparisons of business performance. Refer to ITEM 3 under Part I of this report.

**Gross profit.** Gross profit for the three months ended September 30, 2013 increased to \$298.7 million from \$171.1 million for the same period in 2012, an increase of \$127.6 million, or 74.6%. The increase in gross profit for the three months ended September 30, 2013 as compared to the same period in 2012 was due primarily to the Sealy Acquisition. The gross profit margin for the three months ended September 30, 2013 was 40.6% as compared to 49.2% for the same period in 2012. The decrease in our gross profit margin for the three months ended September 30, 2013 as compared to the same period in 2012 was due primarily to the Sealy Acquisition.

Our gross profit margin is impacted by the relative amount of net sales between our three business segments. Our Sealy segment operates at a lower gross profit margin than our Tempur North America and Tempur International segments. As Sealy's net sales have increased as a percentage of Consolidated net sales, our gross profit margin has been negatively impacted. Additionally, our Tempur North America gross profit margin has been lower than that of our Tempur International segment, due in part to the royalty paid by the Tempur North America segment. This intercompany royalty expense was \$1.6 million and \$3.0 million for the three months ended September 30, 2013 and 2012, respectively. These changes in segment mix and other factors related to each business segment resulted in an 8.6% decrease in our gross profit margin for the three months ended September 30, 2013. The principal factors that impacted gross profit margin during the year are identified and discussed below in the respective segment discussions.

Costs associated with net sales are recorded in cost of sales. Cost of sales includes the costs of producing, shipping, warehousing, receiving and inspecting goods during the period, as well as depreciation and amortization of long-lived assets used in this process.

**Tempur North America.** Tempur North America gross profit for the three months ended September 30, 2013 decreased to \$102.1 million from \$105.1 million for the same period in 2012, a decrease of \$3.0 million, or 2.9%. The gross profit margin in our Tempur North America segment was 42.1% and 43.6% for the three months ended September 30, 2013 and 2012, respectively. Our Tempur North America segment gross profit margin was impacted by a 2.8% decrease due to unfavorable product and channel mix. Additionally, gross profit margin was impacted by a manufacturing change associated with our new Tempur-Up adjustable base, which accounted for a decrease of 1.5% in the gross profit margin for the period. These items were partially offset by a 2.0% increase due to reduced sourcing costs, and a 1.1% increase due to lower floor model discounts related to new product introductions.

**Tempur International.** Tempur International gross profit for the three months ended September 30, 2013 decreased to \$61.9 million from \$66.0 million for the same period in 2012, a decrease of \$4.1 million, or 6.2%. The gross profit margin in our International segment was 60.0% and 61.7% for the three months ended September 30, 2013 and 2012, respectively. Our Tempur International gross profit margin was impacted by a 1.5% decrease related to floor model discounts for new product introductions in our Tempur International segment, and a 1.1% decrease related to manufacturing inefficiencies. These items were partially offset due to favorable product and channel mix and reduced sourcing costs.

**Sealy.** Sealy gross profit for the three months ended September 30, 2013 was \$134.7 million. Sealy gross profit margin was 34.5% for the three months ended September 30, 2013.

**Selling and marketing expenses.** Selling and marketing expenses include advertising and other selling and marketing expenses. Advertising expenses include national and cooperative advertising. Other selling and marketing expenses include media production, marketing materials such as catalogs, brochures, videos, product samples, direct customer mailings, point of purchase materials, sales force compensation, and new product development costs, such as market research and new product testing.

Selling and marketing expenses increased to \$150.9 million for the three months ended September 30, 2013 as compared to \$76.2 million for the three months ended September 30, 2012, an increase of \$74.7 million, or 98.0%. The increase in selling and marketing expenses was primarily due to the Sealy Acquisition. Sealy's selling and marketing expenses were \$65.5 million for the three months ended September 30, 2013. Selling and marketing expenses as a percentage of net sales were 20.5% and 21.9% for the three months ended September 30, 2013 and 2012, respectively. The principal factors that impacted selling and marketing expenses during the period are identified and discussed below.

Our advertising expenses for the three months ended September 30, 2013 were \$88.4 million compared to \$38.4 million in 2012, an increase of \$50.0 million, or 130.2%. Advertising expenses as a percentage of net sales were 12.0% and 11.0% for the three months ended September 30, 2013 and 2012, respectively. The primary driver of the increase in advertising expenses was due to the inclusion of Sealy's advertising expenses of \$45.5 million for the three months ended September 30, 2013. During the second quarter of 2013, we completed a review of the effectiveness of the new Tempur North America advertising campaign and made certain adjustments. During the third quarter of 2013, we reintroduced the "Ask Me" campaign, along with making certain media mix adjustments, which resulted in a \$5.0 million increase in our Tempur North America advertising expense for the period. We expect to continue to increase advertising as a percentage of net sales in the fourth quarter of 2013.

All other selling and marketing expenses as a percentage of net sales were approximately 8.5% and 10.9% for the three months ended September 30, 2013 and 2012, respectively. All other selling and marketing expenses increased \$24.7 million, or 65.3%. The increase is primarily related to the addition of \$20.0 million in expenses related to our Sealy segment.

**General, administrative and other expenses.** General, administrative and other expenses include salaries and related expenses, information technology, professional fees, depreciation of buildings, furniture and fixtures, machinery, leasehold improvements and computer equipment, expenses for administrative functions and research and development costs.

General, administrative and other expenses as a percentage of net sales were 9.9% and 9.1% for the three months ended September 30, 2013 and 2012, respectively. General, administrative and other expenses increased to \$71.9 million for the three months ended September 30, 2013 as compared to \$31.5 million for the same period in 2012 for an increase of \$40.4 million or 128.3%. The primary driver of the increase was \$34.1 million in general, administrative and other expenses related to the addition of our Sealy segment for the three months ended September 30, 2013. In the third quarter of 2012, we recorded a \$6.1 million benefit for PRSUs granted in 2011 and 2012 following our re-evaluation of the probability of meeting certain required financial metrics related to the grants. General, administrative and other expenses increased \$8.1 million due to an increase in stock based compensation expense in the third quarter of 2013, which did not include a similar benefit.

Research and development expenses, a component of general, administrative and other expenses, for the three months ended September 30, 2013 were \$5.4 million compared to \$3.9 million for the same period in 2012, an increase of \$1.5 million, or 38.5%. We plan to continue to invest in research and development to leverage the combined technologies of our portfolio to remain innovators in the industry.

**Interest expense, net.** Interest expense, net, includes the interest costs associated with our borrowings and the amortization of deferred financing costs. Interest expense, net, increased to \$24.6 million for the three months ended September 30, 2013 as compared to \$4.8 million for the same period in 2012, an increase of \$19.8 million, or 412.5%. The increase in interest expense is primarily a result of interest on our Senior Notes and increased debt under our 2012 Credit Agreement, which are related to the funding of the Sealy Acquisition.

**Income before income taxes.** Income before income taxes for the quarter ended September 30, 2013 decreased to \$55.7 million from \$59.0 million for the same period in 2012, a decrease of 5.6%. Tempur North America loss before income taxes for the quarter ended September 30, 2013 was \$3.3 million, compared to income before income taxes of \$30.4 million for the same period in 2012, a decrease of 110.9%. Tempur International income before income taxes for the quarter ended September 30, 2013 decreased to \$22.3 million from \$28.6 million for the same period in 2012, a decrease of 22.0%. Sealy income before income taxes for the quarter ended September 30, 2013 was \$36.7 million. The decrease in income before income taxes was a result of the items discussed above.

**Income tax provision.** 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 tax rate for the three months ended September 30, 2013 and 2012 was 27.8% and 103.4%, respectively. During the three months ended September 30, 2012, we recorded \$41.9 million of additional income tax expense related to our undistributed earnings from non-U.S. operations based on estimates of 2013 earnings and our preliminary estimate of the value of Sealy's foreign subsidiaries used in the preliminary purchase price allocation. During the three months ended September 30, 2013, no adjustments were made to our income tax provision related to the repatriation of foreign earnings. However due to adjustments made in prior periods, the cumulative amount of income tax expense related to our undistributed earnings from non-U.S. operations is \$42.6 million. Throughout the remainder of 2013, we anticipate a tax rate of approximately 31.5%.

**Nine Months Ended September 30, 2013 Compared with Nine Months Ended September 30, 2012**

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

(in millions)	CONSOLIDATED		TEMPUR NORTH AMERICA		TEMPUR INTERNATIONAL		SEALY	
	Nine Months Ended September 30,		Nine Months Ended September 30,		Nine Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Retail	\$ 1,617.5	\$ 932.3	\$ 635.7	\$ 668.7	\$ 252.3	\$ 263.6	\$ 729.5	\$ —
Direct	88.8	83.4	36.6	58.7	35.2	24.7	17.0	—
Other	79.9	46.1	11.5	9.1	33.7	37.0	34.7	—
	<u>\$ 1,786.2</u>	<u>\$ 1,061.8</u>	<u>\$ 683.8</u>	<u>\$ 736.5</u>	<u>\$ 321.2</u>	<u>\$ 325.3</u>	<u>\$ 781.2</u>	<u>\$ —</u>

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

(in millions)	CONSOLIDATED		TEMPUR NORTH AMERICA		TEMPUR INTERNATIONAL		SEALY	
	Nine Months Ended September 30,		Nine Months Ended September 30,		Nine Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Bedding	\$ 1,599.4	\$ 923.3	\$ 624.7	\$ 675.1	\$ 239.7	\$ 248.2	\$ 735.0	\$ —
Other products	186.8	138.5	59.1	61.4	81.5	77.1	46.2	—
	<u>\$ 1,786.2</u>	<u>\$ 1,061.8</u>	<u>\$ 683.8</u>	<u>\$ 736.5</u>	<u>\$ 321.2</u>	<u>\$ 325.3</u>	<u>\$ 781.2</u>	<u>\$ —</u>

**Net sales.** Net sales for the nine months ended September 30, 2013 increased to \$1,786.2 million from \$1,061.8 million for the same period in 2012, an increase of 68.2%. Bedding net sales increased 73.2%. Other product net sales increased 34.9%. Retail net sales increased 73.5%. Other channel net sales increased \$33.8 million, or 73.3%. Net sales for the nine months ended September 30, 2013 increased across all product and channel categories over the same period in 2012, due primarily to the Sealy Acquisition. The increase in net sales was partially offset by decreases in our Tempur North America segment in bedding net sales, driven by decreases in net sales in our Retail and Direct channels. The principal factors impacting net sales for each segment are discussed below.

**Tempur North America.** Tempur North America net sales for the nine months ended September 30, 2013 decreased to \$683.8 million from \$736.5 million for the same period in 2012, a decrease of 7.2%. During the three months ended March 31, 2013, we experienced a decrease in Tempur North America net sales of 16.0%, and a decrease during the three months ended June 30, 2013 of 4.9%. However, during the third quarter of 2013, Tempur North America net sales increased 0.6% compared to the third quarter of 2012. Tempur North America bedding net sales decreased \$50.4 million, over the same period in 2012, primarily due to decreases in the Retail and Direct channels net sales. Our Tempur North America Retail channel net sales decreased \$33.0 million, or 4.9%, compared to the same period in 2012. Direct channel net sales decreased \$22.1 million, or 37.6%, compared to the same period in 2012.

To drive growth in our Tempur North America segment, we implemented various strategic initiatives, which included new product introductions, increased advertising investments, and improving how we serve our Retail customers. During the first half of 2013, Tempur North America decreased advertising expenses to better align with net sales expectations. However, this reduction in advertising has negatively impacted the Retail and Direct channels net sales. During the third quarter of 2013, we increased our advertising investment, which we believe has contributed to the improved performance in our Tempur North America segment.



*Tempur International.* Tempur International net sales for the nine months ended September 30, 2013 decreased to \$321.2 million from \$325.3 million for the same period in 2012, a decrease of 1.3%. On a constant currency basis<sup>2</sup>, our Tempur International net sales decreased approximately 0.2%. Tempur International Retail channel net sales decreased primarily due to macroeconomic pressure in Europe which was partially offset by growth in our Asia-Pacific and Latin American businesses. Tempur International bedding net sales decreased 3.4% compared to the nine months ended 2012. The Tempur International Direct channel net sales increased 42.5% compared to the same period in 2012, due to expanding our points of distribution through an increase in the number of company-owned stores and e-commerce.

*Sealy.* Sealy net sales for the period March 18, 2013 through September 30, 2013 were \$781.2 million, with \$729.5 million in the Retail channel. Net sales in the Other channel were \$34.7 million, and Direct channel net sales were \$17.0 million for the period March 18, 2013 through September 30, 2013. Bedding products net sales were \$735.0 million for the period ended September 30, 2013.

**Gross profit.** Gross profit for the nine months ended September 30, 2013 increased to \$742.0 million from \$544.0 million for the same period in 2012, an increase of \$198.0 million, or 36.4%. The gross profit margin for the nine months ended September 30, 2013 was 41.5% as compared to 51.2% for the same period in 2012.

Our gross profit margin is impacted by the relative amount of net sales between our business segments. The Sealy segment operates at a lower gross profit margin than the Tempur North America and Tempur International segments. As Sealy's net sales have increased as a percentage of Consolidated net sales, our gross profit margin has been negatively impacted. Additionally, our Tempur North America gross profit margin has been lower than that of our Tempur International segment, due in part to the royalty paid by the Tempur North America segment. This intercompany royalty expense was \$4.3 million and \$9.4 million for the nine months ended September 30, 2013 and 2012, respectively. These changes in segment mix and other factors related to each business segment resulted in a 9.7% decrease in our gross profit margin for the nine months ended September 30, 2013. The principal factors that impacted gross profit margin during the year are identified and discussed below in the respective segment discussions.

Costs associated with net sales are recorded in cost of sales. Cost of sales includes the costs of producing, shipping, warehousing, receiving and inspecting goods during the period, as well as depreciation and amortization of long-lived assets used in this process.

*Tempur North America.* Tempur North America gross profit for the nine months ended September 30, 2013 decreased to \$294.0 million from \$348.5 million for the same period in 2012, a decrease of \$54.5 million, or 15.6%. The gross profit margin in our Tempur North America segment was 43.0% and 47.3% for the nine months ended September 30, 2013 and 2012, respectively. Our Tempur North America segment gross profit margin decreased by 4.3% due to a 5.8% unfavorable product and channel mix, which includes the impact of initiatives implemented to drive net sales growth and the decrease in Direct channel net sales. Unfavorable product mix was partially offset by a 2.5% increase as a result of sourcing initiatives following the Sealy Acquisition.

*Tempur International.* Tempur International gross profit for the nine months ended September 30, 2013 increased to \$198.7 million from \$195.5 million for the same period in 2012, an increase of \$3.2 million, or 1.6%. The gross profit margin in our Tempur International segment was 61.9% and 60.1% for the nine months ended September 30, 2013 and 2012, respectively. Our Tempur International gross profit margin was impacted by a 2.3% increase related to favorable product and channel mix and a 0.6% decrease related to floor model discounts for new product introductions.

*Sealy.* Sealy gross profit from March 18, 2013 to the period ended September 30, 2013 was \$249.3 million. Sealy gross profit margin was 31.9% for the period ended September 30, 2013. The Sealy gross profit margin includes an incremental cost of \$7.7 million associated with the revaluation of finished goods inventory related to the purchase price allocation of the Sealy Acquisition, which had an unfavorable gross profit margin impact of 1.0%.

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<sup>2</sup> The references to "constant currency basis" in this Management's Discussion & Analysis section do not include operational impacts that could result from fluctuations in foreign currency rates. Certain financial results are adjusted based on a simple mathematical model that translates current period results in local currency using the comparable prior year period's currency conversion rate. This approach is used for countries where the functional currency is the local country currency. This information is provided so that certain financial results can be viewed without the impact of fluctuations in foreign currency rates, thereby facilitating period-to-period comparisons of business performance. Refer to ITEM 3 under Part I of this report.

**Selling and marketing expenses.** Selling and marketing expenses include advertising and other selling and marketing expenses. Advertising expenses include national and cooperative advertising. Other selling and marketing expenses include media production, marketing materials such as catalogs, brochures, videos, product samples, direct customer mailings, point of purchase materials, sales force compensation, and new product development costs, such as market research and new product testing.

Selling and marketing expenses increased to \$377.1 million for the nine months ended September 30, 2013, as compared to \$243.2 million for the nine months ended September 30, 2012, an increase of \$133.9 million, or 55.1%. Selling and marketing expenses increased primarily due to the addition of \$137.6 million for our Sealy segment from March 18, 2013 to September 30, 2013 following the completion of the Sealy Acquisition. Selling and marketing expenses as a percentage of net sales were 21.1% and 22.9% for the nine months ended September 30, 2013 and 2012, respectively. The principal factors that impacted selling and marketing expenses during the period are identified and discussed below.

Our advertising expenses for the nine months ended September 30, 2013 were \$202.8 million compared to \$131.3 million in 2012, an increase of \$71.5 million, or 54.5%. Advertising expenses as a percentage of net sales were 11.4% and 12.4% for the nine months ended September 30, 2013 and 2012, respectively. Our advertising expenses increased primarily due to the addition of our Sealy segment expenses of \$90.8 million for the period ended September 30, 2013. However, this increase was offset by decreased advertising expenses in our Tempur North America and Tempur International segments. During the first and second quarter of 2013, we reduced our Tempur North America advertising expense to align with reduced Tempur North America net sales. Throughout the third quarter of 2013 we increased Tempur North America advertising expense and reintroduced the "Ask Me" campaign. We expect to continue to increase advertising as a percentage of net sales in the fourth quarter of 2013.

All other selling and marketing expenses as a percentage of net sales were approximately 9.8% and 10.5% for the nine months ended September 30, 2013 and 2012, respectively. All other selling and marketing expenses increased \$62.4 million, or 55.8%. The increase is primarily related to the addition of \$46.7 million of expenses related to our Sealy segment. The additional increase is related to a \$7.2 million increase related to promotional activities and the support of Tempur North America's new product introductions and a \$6.2 million increase due to costs associated with the growth in Tempur International company-owned stores and e-commerce.

**General, administrative and other expenses.** General, administrative and other expenses include salaries and related expenses, information technology, professional fees, depreciation of buildings, furniture and fixtures, machinery, leasehold improvements and computer equipment, expenses for administrative functions and research and development costs.

General, administrative and other expenses as a percentage of net sales were 11.5% and 9.8% for the nine months ended September 30, 2013 and 2012, respectively. General, administrative and other expenses increased to \$206.9 million for the nine months ended September 30, 2013, as compared to \$103.8 million for the same period in 2012. General, administrative and other expenses increased compared to the nine months ended September 30, 2012 primarily due to the addition of our Sealy segment from March 18, 2013 to September 30, 2013, which increased general, administrative and other expenses by \$75.8 million. General administrative and other expenses were also impacted by a \$14.0 million increase in professional fees related to the Sealy Acquisition and integration of the business. Additionally, salaries and related expenses increased \$11.5 million, with the majority of the increase driven by increased stock-based compensation expense. However, this increase was offset by a \$7.3 million benefit recorded during the nine months ended September 30, 2012 for the PRSUs granted in 2011 and 2012 following the re-evaluation of the probability of meeting certain required financial metrics related to the grants.

Research and development expenses, a component of general and administrative expenses, for the nine months ended September 30, 2013 were \$14.8 million compared to \$11.1 million for the same period in 2012, an increase of \$3.7 million, or 33.3%. We plan to continue to invest in research and development to leverage the combined technologies of our portfolio to deliver innovative products.

**Interest expense, net.** Interest expense, net, includes the interest costs associated with our borrowings and the amortization of deferred financing costs. Interest expense, net, increased to \$88.2 million for the nine months ended September 30, 2013, as compared to \$13.0 million for the same period in 2012, an increase of \$75.2 million, or 578.5%. The Company incurred \$19.9 million of incremental interest expense for the nine months ended September 30, 2013, which includes interest and fees on the Senior Notes and 2012 Credit Agreement for the period prior to March 18, 2013, commitment fees associated with financing for the closing of the Sealy Acquisition, and write off of deferred financing costs associated with the 2011 Credit Facility. In addition, we incurred \$8.7 million in prepayment fees related to the refinancing of our Term B Facility in the second quarter of 2013. The remaining increase is due to higher debt levels as a result of the Sealy Acquisition.

**Income before income taxes.** Income before income taxes for the nine months ended September 30, 2013 decreased to \$77.5 million from \$184.4 million for the same period in 2012, a decrease of \$106.9 million, or 58.0%. Tempur North America loss before income taxes for the nine months ended September 30, 2013 decreased to \$37.9 million from income before income taxes of \$107.8 million for the same period in 2012, a decrease of \$145.7 million, or 135.2%. Tempur International income before income taxes for the nine months ended September 30, 2013 decreased to \$75.0 million from \$76.6 million for the same period in 2012, a decrease of \$1.6 million, or 2.1%. Sealy income before income taxes for the nine months ended September 30, 2013 was \$40.4 million. The decrease in income before income taxes was a result of the items discussed above.

**Income tax provision.** 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 tax rate for the nine months ended September 30, 2013 and 2012 was 34.7% and 54.8%, respectively. During the nine months ended September 30, 2012, we recorded \$41.9 million of additional income tax expense related to our undistributed earnings from non-U.S. operations based on estimates of 2013 earnings and our preliminary estimate of the value of Sealy's foreign subsidiaries used in the preliminary purchase price allocation. During the three months ended September 30, 2013, no adjustments were made to our income tax provision related to the repatriation of foreign earnings. However due to adjustments made in prior periods, the cumulative amount of income tax expense related to our undistributed earnings from non-U.S. operations is \$42.6 million. Throughout the remainder of 2013, we anticipate a tax rate of approximately 31.5%.

## **Liquidity and Capital Resources**

### *Liquidity*

Our principal sources of funds are cash flows from operations, borrowings made pursuant to our credit facilities and cash and cash equivalents on hand. Principal uses of funds consist of payments of principal and interest on our debt facilities, business combinations, capital expenditures and working capital needs. At September 30, 2013, we had working capital of \$275.3 million including cash and cash equivalents of \$126.6 million compared to working capital of \$611.9 million including \$179.3 million in cash and cash equivalents as of December 31, 2012. Working capital as of December 31, 2012 included a \$375.0 million receivable from escrow account that was funded with the issuance of proceeds of the Senior Notes. This escrow was released at the closing of the Sealy Acquisition and was used to fund a portion of the purchase price cash consideration. This decrease was primarily offset by the assumption of working capital due to the Sealy Acquisition.

Our net cash provided by operating activities was \$104.8 million for the nine months ended September 30, 2013 compared to \$153.6 million provided by operating activities for the nine months ended September 30, 2012. The decrease in operating cash flow was primarily due to a \$32.7 million decrease in net income, which was primarily impacted in the current period by transaction, integration and other expenses related to the Sealy Acquisition and partially offset by Sealy net income. Our cash flow provided by operating activities was also impacted by decreases due to deferred income taxes resulting from the Sealy Acquisition, offset by working capital improvements during the nine months ended September 30, 2013.

Net cash used by investing activities increased to \$1,200.4 million for the nine months ended September 30, 2013, compared to \$42.3 million for the nine months ended September 30, 2012. This increase is due to the Sealy Acquisition. Refer to Note 2, "Business Combination", in our Condensed Consolidated Financial Statements included in Part I, ITEM I for further discussion of the Sealy Acquisition.

Cash flow provided by financing activities was \$1,040.5 million for the nine months ended September 30, 2013, compared to cash flow used of \$70.4 million for the same period in 2012. This increase is primarily due to new debt facilities put in place in December 2012 in anticipation of the Sealy Acquisition, which provided \$375.0 million from our Senior Notes and \$1,525.0 million from our 2012 Credit Agreement and was funded in connection with the closing of the Sealy Acquisition on March 18, 2013. Proceeds from the Senior Notes and 2012 Credit Agreement were used for the Sealy Acquisition and to repay the 2011 Credit Facility outstanding balance of \$696.5 million. In the current period, we also repriced certain portions of the 2012 Credit Agreement. On May 16, 2013, we completed a repricing of our Term B Facility under the 2012 Credit Agreement, and this repricing was effected through a full repayment of \$867.8 million and new borrowing of \$742.8 million at the new lower interest rate. On July 11, 2013, we completed a repricing of our Term A Facility under the 2012 Credit Agreement, and this repricing was effected through a full repayment of \$536.3 million and new borrowing of \$536.3 million at the new lower interest rate. Additional borrowings made pursuant to the 2012 Credit Agreement in the nine months ended September 30, 2013 also provided \$113.5 million and were used primarily to fund capital expenditures and our working capital needs. Additional repayments made pursuant to the 2012 Credit Agreement in the current period were \$155.0 million and were funded by operating activities. Refer to Note 4, "Debt", in our Condensed Consolidated Financial Statements included in Part I, ITEM I for further discussion of our debt.

## Capital Expenditures

Capital expenditures totaled \$28.4 million for the nine months ended September 30, 2013 and \$38.4 million for the nine months ended September 30, 2012. We currently expect our 2013 capital expenditures to be approximately \$50.0 million, and relate to continued strategic investments that we believe will support our future plans.

## Non-GAAP Financial Information

We provide information regarding earnings before interest, taxes, depreciation and amortization ("EBITDA"), adjusted EBITDA, consolidated funded debt less qualified cash, adjusted net income and adjusted earnings per share, which are not recognized terms under U.S. GAAP and do not purport to be alternatives to net income as a measure of operating performance or total debt. Because not all companies use identical calculations, these presentations may not be comparable to other similarly titled measures of other companies. A reconciliation of our adjusted earnings per share is provided below. We believe that the use of this non-GAAP financial measure provides investors with additional useful information with respect to the impact of transaction and integration costs, and interest expense incurred related to the Sealy Acquisition. A reconciliation of our net income to EBITDA and adjusted EBITDA and a reconciliation of total debt to consolidated funded debt are also provided below. We believe the use of these non-GAAP financial measures provides investors with additional useful information with respect to our debt agreements and our compliance with the related debt covenants.

### Reconciliation of GAAP net income (loss) to adjusted net income

The following table sets forth the reconciliation of our reported GAAP net income (loss) for the three months ended September 30, 2013 and 2012 to the calculation of adjusted net income for the three months ended September 30, 2013 and 2012:

(in millions, except per share amounts)

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012
<b>GAAP net income (loss)</b>	\$ 40.2	\$ (2.0)
Plus:		
Transaction costs, net of tax <sup>(1)</sup>	1.0	2.4
Integration costs, net of tax <sup>(1)</sup>	5.1	—
Long term debt refinance, net of tax <sup>(2)</sup>	0.5	—
Adjustment of taxes to normalized rate <sup>(3)</sup>	(1.9)	—
Tax provision related to repatriation of foreign earnings <sup>(4)</sup>	—	41.9
Adjusted net income	\$ 44.9	\$ 42.3
<b>GAAP earnings (loss) per share, diluted</b>	\$ 0.65	\$ (0.03)
Transaction costs, net of tax <sup>(1)</sup>	0.02	0.04
Integration costs, net of tax <sup>(1)</sup>	0.08	—
Long term debt refinance, net of tax <sup>(2)</sup>	0.01	—
Adjustment of taxes to normalize rate <sup>(4)</sup>	(0.03)	—
Tax provision related to repatriation of foreign earnings <sup>(4)</sup>	—	0.69
Adjusted earnings per share, diluted	\$ 0.73	\$ 0.70
Diluted shares outstanding	61.6	60.8

- (1) Transaction and integration represent costs, including legal fees, professional fees and other charges to align the businesses related to the Sealy Acquisition.
- (2) Refinance costs represent the interest fees incurred in connection with the refinancing of the Term A Facility which occurred in July 2013.
- (3) Adjustment of taxes to normalize rate represents adjustments associated with the tax impacts of transaction costs.
- (4) Represents tax provision recorded in connection with the repatriation of foreign earnings related to the Sealy Acquisition.

*Debt Service*

Our debt increased to \$1,860.1 million as of September 30, 2013 from \$1,025.0 million as of December 31, 2012. Our debt as of December 31, 2012 included \$375.0 million of Senior Notes issued in December 2012 to finance a portion of the cost of the Sealy Acquisition. The increase in debt is due to funding of the 2012 Credit Agreement in conjunction with the closing of the Sealy Acquisition, partially offset by the payoff of the remaining balance under the 2011 Credit Facility. After giving effect to \$90.0 million in borrowings under the revolver portion of the 2012 Credit Agreement and letters of credit outstanding of \$22.4 million, total availability under the revolver was \$237.6 million as of September 30, 2013. Refer to Note 4, "Debt", in our Condensed Consolidated Financial Statements included in Part I, ITEM I for further discussion of our debt.

As of September 30, 2013, we are in compliance with all the financial covenants in our debt agreements. The table below sets forth the calculation of our compliance with the covenant in the 2012 Credit Agreement that requires that we maintain a ratio of less than 5.5 times of consolidated funded debt less qualified cash to adjusted EBITDA through September 30, 2013. From October 1, 2013 through December 31, 2013 the covenant in the 2012 Credit Agreement requires that we maintain a ratio not greater than 5.25 times for consolidated funded debt less qualified cash to adjusted EBITDA. Both consolidated funded debt and adjusted EBITDA are terms that are not recognized under U.S. GAAP and do not purport to be alternatives to net income as a measure of operating performance or total debt.

*Reconciliation of GAAP net income to EBITDA and adjusted EBITDA*

The following table sets forth a mathematical combination related to the calculation of adjusted EBITDA in accordance with the 2012 Credit Agreement. The following table provides useful information about how the 2012 Credit Agreement treats adjusted EBITDA for the period prior to the completion of the Sealy Acquisition, and sets forth a calculation of the Company's reported GAAP net income to the calculation of EBITDA and adjusted EBITDA for the twelve months ended September 30, 2013:

(in millions)	<b>Combined <sup>(A)</sup></b>
<b>EBITDA</b>	
GAAP net income	\$ 67.7
Interest expense	140.1
Income taxes	35.9
Depreciation & amortization	92.5
<b>EBITDA</b>	<b>\$ 336.2</b>
<b>Adjustments for financial covenant purposes:</b>	
Transaction costs <sup>(1)</sup>	33.9
Integration costs <sup>(1)</sup>	14.4
Refinancing charges <sup>(2)</sup>	2.8
Non-cash compensation <sup>(3)</sup>	3.1
Restructuring and impairment related charges <sup>(4)</sup>	8.5
Discontinued operations <sup>(5)</sup>	3.6
Other <sup>(6)</sup>	11.7
<b>Adjusted EBITDA</b>	<b>\$ 414.2</b>

- (1) Transaction and integration represent costs related to the Sealy Acquisition, including legal fees, professional fees and costs to align the businesses.
- (2) Refinancing charges represent costs associated with debt refinanced by Sealy prior to the Sealy Acquisition.
- (3) Non-cash compensation represents costs associated with various share-based awards.
- (4) Restructuring and impairment represent costs related to restructuring the Tempur Sealy business and asset impairment costs recognized by Sealy prior to the Sealy Acquisition.
- (5) Discontinued operations represent losses from Sealy's divested operations prior to the Sealy Acquisition.
- (6) Other represents \$7.7 million in cost of sales associated with the revaluation of finished goods inventory related to the purchase price allocation and various immaterial costs.

This information is presented solely for the purpose of providing information to investors regarding our compliance with certain financial covenants in our 2012 Credit Agreement that are based on adjusted EBITDA. This information does not include the pro forma adjustments that would be required under Regulation S-X for pro forma financial information, and does not reflect future events that may occur after September 30, 2013 or any operating efficiencies or inefficiencies that may result from the Sealy Acquisition and related financing. Therefore, the information is not necessarily indicative of results that would have been achieved had the businesses been combined during the periods presented or the results that we will experience going forward.

(A) Combined includes the mathematical combination of our historical financial results for the twelve months ended September 30, 2013 and Sealy's historical financial results for the pre-acquisition period from August 27, 2012 through March 3, 2013. Results for Sealy for periods prior to the Sealy Acquisition do not give effect to any purchase accounting considerations.

*Reconciliation of debt to consolidated funded debt less qualified cash*

The following table sets forth the reconciliation of our reported debt to the calculation of consolidated funded debt and ratio of the consolidated funded debt less qualified cash to adjusted EBITDA as of September 30, 2013:

<i>(in millions)</i>	<b>As of September 30, 2013</b>
GAAP basis debt	\$ 1,860.1
Plus:	
Letters of credit outstanding	22.4
Consolidated funded debt	1,882.5
Less:	
Domestic qualified cash	62.0
Foreign qualified cash	38.8
Consolidated funded debt less qualified cash <sup>(1)</sup>	\$ 1,781.7

(1) Qualified cash as defined in the credit agreement equals 100.0% unrestricted domestic cash plus 60.0% of unrestricted foreign cash. For purposes of calculating leverage ratios, qualified cash is capped at \$150.0 million.

*Calculation of consolidated funded debt less qualified cash to adjusted EBITDA*

The following table calculates our consolidated funded debt less qualified cash to adjusted EBITDA as of September 30, 2013:

<i>(\$ in millions)</i>	<b>As of September 30, 2013</b>
Consolidated funded debt less qualified cash	\$ 1,781.7
Adjusted EBITDA	414.2
	4.3 times

(1) The ratio of consolidated debt to adjusted EBITDA was 4.3 times, within our covenant, which requires this ratio be less than 5.5 times from March 18, 2013 through September 30, 2013, and less than 5.25 times from October 1, 2013 through December 31, 2013.

## *Future Liquidity Sources and Requirements*

Our primary sources of liquidity are cash flow from operations and borrowings under our debt facilities. We expect that ongoing requirements for debt service and capital expenditures will be funded from these sources. As of September 30, 2013, we had \$1,860.1 in total debt outstanding, and our stockholders' equity was \$82.5 million. Our debt service obligations could, under certain circumstances, have material consequences to our security holders. Total cash interest payments related to our borrowings is expected to be approximately \$92.3 million in 2013. Interest expense in the periods presented also includes non-cash amortization of deferred financing costs and accretion on the 8.0% Sealy Notes.

During the fourth quarter of 2013 we expect to make required U.S. federal and state income tax payments of approximately \$35.0 million in connection with the repatriation of foreign earnings and certain foreign income tax payments of approximately \$25.0 million. Refer to Note 13, "Income Taxes" in our Condensed Consolidated Financial Statements included elsewhere in this report for further discussion of the repatriation of foreign earnings.

In connection with the income tax assessments from the Danish Tax Authority ("SKAT") with respect to the tax years 2001 through 2007 relating to the royalty paid by one of Tempur Sealy International's U.S. Subsidiaries, we were notified that SKAT has granted the deferral to 2017 of the requirement to post a cash deposit or other form of security for taxes that have been assessed for the period 2001 through 2007. The cumulative total tax assessment for all years is approximately \$200.3 million including interest and penalties. We are currently contesting the matter through the Danish National Tax Tribunal. Refer to Note 13, "Income Taxes" in our Condensed Consolidated Financial Statements included elsewhere in this report for further discussion of the matter.

As of September 30, 2013, the fair value of the 8.0% Sealy Notes was \$98.6 million, which includes \$2.4 million of accreted discount. As of September 30, 2013, the 8.0% Sealy Notes had a carrying value of \$98.4 million, which includes \$2.4 million of accreted discount less conversion payments made to holders of certain 8.0% Sealy Notes that were tendered for conversion. Holders of the 8.0% Sealy Notes may choose to convert to cash the amount outstanding at their discretion prior to maturity. Upon conversion prior to maturity, we would be required to pay the holders within 3 business days after the receipt of the notice of conversion. The conversion of the 8.0% Sealy Notes prior to maturity could have a significant impact on our liquidity.

During the second quarter of 2013, we received \$92.7 million in funds from an escrow receivable related to that portion of the 8.0% Sealy Notes which were not converted during the Make-Whole Period, which ended April 12, 2013. We used these funds to reduce our outstanding debt under the 2012 Credit Agreement.

We improved our capital structure in the second quarter of 2013 by repricing the Term B Facility of our 2012 Credit Agreement. Additionally, we made a prepayment of \$125.0 million on the Term B Facility. Because a smaller amount of 8.0% Sealy Notes were converted than originally anticipated, we require less debt under our 2012 Credit Agreement than we had originally anticipated when we arranged the financing for the Sealy Acquisition. During the third quarter of 2013, the favorable interest rate environment provided us with an attractive opportunity to reprice the Term A Facility of our 2012 Credit Agreement. As a result of the repricing, current interest rates on the Term A Facility have been reduced by 75 basis points. We believe that these repricings and the lower debt levels will reduce our estimated annual interest expense. We expect that the fees associated with these repricings will have a payback period of less than one year.

Based upon the current level of operations, we believe that cash generated from operations and amounts available under our 2012 Credit Agreement will be adequate to meet our anticipated debt service requirements, capital expenditures, share repurchases, and working capital needs for the foreseeable future. There can be no assurance, however, that our business will generate sufficient cash flow from operations or that future borrowings will be available under facilities or otherwise enable us to service our indebtedness or to make anticipated capital expenditures.

At September 30, 2013, total cash and cash equivalents were \$126.6 million, of which \$62.0 million was held in the U.S. and \$64.6 million was held by subsidiaries outside of the U.S. The Company repatriated \$130.0 million of foreign cash during the three months ended March 31, 2013. The amount of cash and cash equivalents held by subsidiaries outside of the U.S. and not readily convertible into other major foreign currencies, or the U.S. Dollar, is not material to our overall liquidity or financial position. At September 30, 2013, the tax basis of the Company's investment in its foreign subsidiaries exceeds the Company's book basis. Accordingly, no deferred taxes have been recorded related to this basis difference as it is not apparent that the difference will reverse in the foreseeable future.

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

For a discussion of our critical accounting policies and estimates, see "ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2012. There have been no material changes to our critical accounting policies and estimates in 2013.

### **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. Should currency rates change sharply, our results could be 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 September 30, 2013, resulting from



a hypothetical 10.0% adverse change in all foreign currency exchange rates against the U.S. dollar, is approximately \$0.1 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 2012 Credit Agreement has a variable rate component. On August 8, 2011, we entered into a new four-year interest rate swap agreement to manage interest costs and the risk of changing interest rates associated with a portion of the borrowings outstanding under our credit facilities. Under this swap, we pay at a fixed rate and receive payments at a variable rate. The swap effectively fixes the floating LIBOR-based interest rate to 1.25% on \$250.0 million of the outstanding balance as of September 30, 2013 under our 2012 Credit Agreement, with the outstanding balance declining over time. The interest rate swap expires on December 30, 2015. The Company selects the LIBOR-based rate on the hedged portion of our 2012 Credit Agreement during the term of the swap. The effective portion of the change in value of the swap is reflected as a component of comprehensive income and recognized as interest expense, net as payments are paid or accrued. The remaining gain or loss in excess of the cumulative change in the present value of the future cash flows of the hedged item, if any (i.e., the ineffective portion) or hedge components excluded from the assessment of effectiveness are recognized as interest expense, net during the current period.

Interest rate changes impact the amount of our interest payments and therefore, our future earnings and cash flows, assuming other factors are held constant. On September 30, 2013, after giving effect to our interest rate swap agreement, we had variable-rate debt of approximately \$1,195.4 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 \$12.0 million.

#### **ITEM 4. CONTROLS AND PROCEDURES**

An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), of the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act), as of the end of the period covered by this report. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of September 30, 2013 and designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that was conducted during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

#### **PART II OTHER INFORMATION**

##### **ITEM 1. LEGAL PROCEEDINGS**

See Note 12, "Commitments and Contingencies", in the "Notes to Condensed Consolidated Financial Statements," in ITEM 1 under Part I of this report for a full description of our legal proceedings.

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

##### **ITEM 1A. RISK FACTORS**

None.

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



(a) Not applicable.

(b) Not applicable.

(c) Issuer Purchases of Equity Securities

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

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. 3, dated as of July 11, 2013, to that certain Credit Agreement, dated as of December 12, 2012, as amended (filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K as filed on July 12, 2013) (1).
10.2	Tempur Sealy International, Inc. Amended and Restated Non-Employee Director Deferred Compensation Plan, which includes as Exhibit A the Form of Acknowledgement and Award Agreement and as Exhibit B the Election Form under such Plan. (2)
10.3	Form of Stock Option Agreement under the Tempur Sealy International, Inc. 2013 Equity Incentive Plan (Director) (2)
10.4	Tempur Sealy International, Inc. Long-Term Incentive Plan (filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K as filed on October 23, 2013) (1) (2)
10.5	Tempur Sealy International, Inc. Severance and Retention Plan (filed as Exhibit 10.2 to Registrant's Current Report on Form 8-K as filed on October 23, 2013) (1) (2)
10.6	Employment and Retention Agreement entered into July 2, 2013 between Sealy Corporation and Lawrence J. Rogers and, for certain purposes, Tempur-Pedic International Inc., with and Effective Date of March 18, 2013 (filed as Exhibit 10.4 to the Registrant's Quarterly Report on Form 10-Q for the Quarter ended June 30, 2013) (1) (2)
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.
32.2	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.
101	The following materials from Tempur Sealy International, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statements of Operations, (ii) the Condensed Consolidated Statement of Comprehensive Income (iii) the Condensed Consolidated Balance Sheets, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) the Notes to Condensed Consolidated Financial Statements.

(1) Incorporated by reference.

(2) Represents management contract or compensatory plan or arrangement.

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



**TEMPUR SEALY INTERNATIONAL, INC.  
2013 EQUITY INCENTIVE PLAN**

**Stock Option Agreement**

[Insert Director]  
(Board of Directors)

This Stock Option Agreement dated as of [Insert Date], between Tempur Sealy International, Inc., a corporation organized under the laws of the State of Delaware (the “Company”), and the individual identified below, residing at the address there set out (the “Optionee”).

**1. Grant of Option.** Pursuant and subject to the Company’s 2013 Equity Incentive Plan (as the same may be amended from time to time, the “Plan”), the Company grants to the Optionee an option (the “Option”) to purchase from the Company all or any part of a total of [\_\_\_\_\_] shares (the “Option Shares”) of the Company’s common stock, par value \$0.01 per share (the “Stock”), at a price of \$[Exercise Price] per share (the “Exercise Price”). The Grant Date of this Option is [Date].

**2. Character of Option.** This Option is not to be treated as an “incentive stock option” within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended.

**3. Duration of Option.** Subject to the following sentence, this Option shall expire at 11:59 p.m. (Lexington, KY local time) on the date that is immediately preceding the tenth anniversary of the Grant Date. Subject to Section 5, if the Optionee’s membership with the Board of Directors of the Company ends before that date, this Option shall expire on the earlier date specified in whichever of the following applies:

(a) If the termination of the Optionee’s membership with the Board of Directors of the Company is on account of the optionee’s death or disability, the first anniversary of the date the Optionee’s membership ends; or

(b) If the termination of the Optionee’s membership with the Board of Directors of the Company is due to any other reason, three (3) months after the Optionee’s membership ends.

**4. Exercise of Option.**

(a) Until the expiration of this Option pursuant to Section 3 or Section 5 of this Agreement, the Optionee may exercise it as to the number of Option Shares identified in the table below, in full or in part, at any time on or after the applicable exercise date or dates identified in the table. However, subject to Section 5, during any period that this Option remains outstanding after the Optionee’s membership with the Company’s Board of Directors ends for any reason, the Optionee may exercise it only to the extent it was exercisable immediately prior to the end of the Optionee’s membership with the Company’s Board of Directors; *provided, however*, if the Optionee dies or the Optionee’s membership with the Board ends due to the Optionee’s long-term disability (within the meaning of Section 409A of the Code), all of the Option Shares that have not become vested pursuant this Section 4 as of the date of death or disability, shall immediately vest and become exercisable.

Number of Shares in Each Installment	Percentage of Option Shares	Initial Exercise Date for Shares in Installment
[Number]	[ ]%	[Date]
[Number]	[ ]%	[Date]
[Number]	[ ]%	[Date]
[Number]	[ ]%	[Date]

Section 7.1(e) of the Plan sets forth the procedure for exercising this Option by paying cash or a check made payable to the order of the Company in an amount equal to the aggregate Exercise Price of the Stock to be purchased, or by delivering other shares of Stock of equivalent Market Value, provided the Optionee has owned such shares of Stock for at least six (6) months. The Optionee may also exercise this Option pursuant to a formal cashless exercise program as referred to in Section 7.1(e) of the Plan, subject to the terms and conditions referred to in Section 7.1(e) of the Plan.

**5. Acceleration in Certain Cases.**

(a) The Option shall be subject to early termination prior to the tenth anniversary of the Grant Date and accelerated vesting in certain circumstances, as described below. Notwithstanding anything contained in this Section 5 to the contrary, however, in no event shall the Option become or remain exercisable to any extent after the expiration date set forth in Section 3.

**(b)** In lieu of the Change of Control provisions of Section 9 (a) and (b) of the Plan and notwithstanding anything herein to the contrary, if a Change of Control occurs this Agreement shall remain in full force and effect in accordance with its terms subject to the following. In the event of such Change of Control:

(i) if the Optionee's association with the Company and its Affiliates is terminated after the occurrence of a Change of Control and before all of the Option Shares have become vested pursuant this Section 4, all of the Optionee's Option Shares which have not become vested Option Shares pursuant to Section 4 as of the date of such termination shall immediately become vested Option Shares and the Option Shares shall remain outstanding and exercisable until the date that is the one (1) year anniversary of the date of such termination of employment; and

(ii) if the Option or the Option Shares are not assumed, converted or replaced by a successor organization following such Change of Control, all of the Optionee's Option Shares which have not become vested Option Shares pursuant to Section 4 as of the date of such Change of Control shall immediately become vested Option Shares and the Option Shares shall remain outstanding and exercisable until the date that is the one (1) year anniversary of the date of such Change of Control.

**(c)** For the purposes of this Agreement, "Change of Control" shall have the meaning set forth in the Plan, provided, that no event or transaction shall constitute a Change of Control for purposes of this Agreement unless it also qualifies as a change of control for purposes of Section 409A of the Code.

**6. Transfer of Option.** Except as provided in Section 6.4 of the Plan, neither this Option nor any Option Shares nor any rights hereunder to the underlying Stock may be transferred except by will or the laws of descent and distribution, and during the Optionee's lifetime, only the Optionee may exercise this Option.

**7. Incorporation of Plan Terms.** Except as otherwise provided herein in Section 5 above, this Option is granted subject to all of the applicable terms and provisions of the Plan, including but not limited to Section 8 of the Plan, "Adjustment Provisions", and the limitations on the Company's obligation to deliver Option Shares upon exercise set forth in Section 10 of the Plan, "Settlement of Awards". Capitalized terms used but not defined herein shall have the meaning assigned under the Plan.

**8. Miscellaneous.** This Agreement shall be construed and enforced in accordance with the laws of the State of Delaware, without regard to the conflict of laws principles thereof, and shall be binding upon and inure to the benefit of any successor or assign of the Company and any executor, administrator, trustee, guardian, or other legal representative of the Optionee. This Agreement may be executed in one or more counterparts all of which together shall constitute one instrument.

#### **9. Tax Consequences.**

**(a)** The Company makes no representation or warranty as to the tax treatment of this Option, including upon the exercise of this Option or upon the Optionee's sale or other disposition of the Option Shares. The Optionee should rely on his/her own tax advisors for such advice. Notwithstanding the foregoing, the Optionee and the Company hereby acknowledge that both the Optionee and the Company may be subject to certain obligations for tax withholdings, social security taxes and other applicable taxes associated with the vesting or exercise of the Options or the issuance of the Option Shares by the Optionee pursuant to this Agreement. The Optionee hereby affirmatively consents to the transfer to the Company of any and all personal information necessary for the Company to comply with its obligations.

**(b)** All amounts earned and paid pursuant to this Agreement are intended to be paid in compliance with, or on a basis exempt from, Section 409A of the Code. This Agreement, and all terms and conditions used herein, shall be interpreted and construed consistent with that intent. However, the Company does not warrant all such payments will be exempt from, or paid in compliance with, Section 409A. The Optionee bears the entire risk of any adverse federal, state or local tax consequences and penalty taxes which may result from payments made on a basis contrary to the provisions of Section 409A or comparable provisions of any applicable state or local income tax laws.

#### **10. Certain Remedies.**

**(a)** If at any time prior to the later of (y) the two (2) year period after termination of the Optionee's association with the Company and its Affiliates, and (z) the period that includes the date (after the termination of the Optionee's association with the Company and its Affiliates) on which all of the Option Shares granted hereunder and capable of becoming vested Option Shares so become vested Option Shares (the last day of such later period being the "Covenant Termination Date"), any of the following occur:

(i) the Optionee unreasonably refuses to comply with lawful requests for cooperation made by the Company, its board of directors, or its Affiliates;

(ii) the Optionee accepts employment or a consulting or advisory engagement with any Competitive Enterprise (as defined in Section 11(c) below) of the Company or its Affiliates or the Optionee otherwise engages in competition with the Company or its Affiliates;

(iii) the Optionee acts against the interests of the Company and its Affiliates, including recruiting or employing, or encouraging or assisting the Optionee's new employer to recruit or employ an employee of the Company or any Affiliate without the Company's written consent;

(iv) the Optionee fails to protect and safeguard while in his/her possession or control, or surrender to the Company upon termination of the Optionee's association with the Company or any Affiliate or such earlier time or times as the Company or its board of directors or any Affiliate may specify, all documents, records, tapes, disks and other media of every kind and description relating to the business, present or otherwise, of the Company and its Affiliates and any copies, in whole or in part thereof, whether or not prepared by the Optionee;

(v) the Optionee solicits or encourages any person or enterprise with which the Optionee has had business-related contact, who has been a customer of the Company or any of its Affiliates, to terminate its relationship with any of them;

(vi) the Optionee breaches any confidentiality obligations the Optionee has to the Company or an Affiliate, the Optionee fails to comply with the policies and procedures of the Company or its Affiliates for protecting confidential information, the Optionee uses confidential information of the Company or its Affiliates for his/her own benefit or gain, or the Optionee discloses or otherwise misuses confidential information or materials of the Company or its Affiliates (except as required by applicable law); or

(vii) the Optionee takes any action or makes any statement, written or oral, that disparages the business, products, services or management of Company or its Affiliates, or any of their respective directors, officers, agents, or employees, or the Optionee takes any action that is intended to, or that does in fact, damage the business or reputation of the Company or its Affiliates, or the personal or business reputations of any of their respective directors, officers, agents, or employees, or that interferes with, impairs or disrupts the normal operations of the Company or its Affiliates; then

(1) this Option shall terminate and be cancelled effective as of the date on which the Optionee entered into such activity, unless terminated or cancelled sooner by operation of another term or condition of this Agreement or the Plan;

(2) any stock acquired and held by the Optionee pursuant to the exercise of this Option during the Applicable Period (as defined in Section 11(b) below) may be repurchased by the Company at a purchase price equal to the Exercise Price per share; and

(3) any gain realized by the Optionee from the sale of stock acquired through the exercise of this Option during the Applicable Period shall be paid by the Optionee to the Company.

**(b)** The term "Applicable Period" shall mean the period commencing on the later of the date of this Agreement or the date which is one year prior to the Optionee's termination of association with the Company or any Affiliate and ending on the Covenant Termination Date.

**(c)** The term "Competitive Enterprise" shall mean a business enterprise that engages in, or owns or controls a significant interest in, any entity that engages in, the manufacture, sale or distribution of mattresses or pillows or other bedding products or other products competitive with the Company's products. Competitive Enterprise shall include, but not be limited to, the entities set forth on Appendix A hereto, which may be amended by the Company from time to time upon notice to the Optionee. At any time the Optionee may request in writing that the Company make a determination whether a particular enterprise is a Competitive Enterprise. Such determination will be made within fourteen (14) days after the receipt of sufficient information from the Optionee about the enterprise, and the determination will be valid for a period of ninety (90) days from the date of determination.

**11. Right of Set Off.** By executing this Agreement, the Optionee consents to a deduction from any amounts the Company or any Affiliate owes the Optionee from time to time, to the extent of the amounts the Optionee owes the Company under Section 10 above, provided that this set-off right may not be applied against wages, salary or other amounts payable to the Optionee to the extent that the exercise of such set-off right would violate any applicable law. If the Company does not recover by means of set-off the full amount the Optionee owes the Company, calculated as set forth above, the Optionee agrees to pay immediately the unpaid balance to the Company upon the Company's demand.

## **12. Nature of Remedies.**

**(a)** The remedies set forth in Sections 10 and 11 above are in addition to any remedies available to the Company and its Affiliates in any non-competition, employment, confidentiality or other agreement, and all such rights are cumulative. The exercise of any rights hereunder or under any such other agreement shall not constitute an election of remedies.

**(b)** The Company shall be entitled to place a legend on any certificate evidencing any stock acquired upon exercise of this Option referring to the repurchase right set forth in Section 10(a). The Company shall also be entitled to issue stop transfer instructions to the Company's stock transfer agent in the event the Company believes that any event referred to in Section 10(a) has occurred or is reasonably likely to occur.

In Witness Whereof, the parties have executed this Agreement as of the date first above written.

TEMPUR SEALY INTERNATIONAL, INC.

By: \_\_\_\_\_

Name: \_\_\_\_\_

OPTIONEE

\_\_\_\_\_

Name: [Insert Director]

Optionee's Address:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

#### Appendix A

#### Competitive Enterprises of the Company and its Affiliates

Ace  
AH Beard  
Auping  
Ashley Sleep  
Boyd  
Carpe Diem  
Carpenter  
Carolina Mattress  
Cauval Group  
Chaide & Chaide  
Classic Sleep Products  
Comforpedic  
Comfort Solutions  
COFEL group  
De Rucci  
Diamona  
Doremo Octaspring  
Dorelan  
Dunlopillo  
Duxiana  
Eastborne  
Eminflex  
Englander  
Flex Group of Companies  
Foamex  
France Bed  
Future Foam  
Harrisons

Hastens  
Hilding Anders Group  
Hypnos  
IBC  
KayMed  
King Koil  
Kingsdown  
Lady Americana  
Land and Sky  
Leggett & Platt  
Lo Monaco  
Magniflex  
Metzler  
Myers  
Optimo  
Ortobom  
Natura  
Natures Rest  
Park Place  
Permaflex  
Pikolin Group  
Recticel Group  
Relyon  
Restonic  
Rosen  
Rowe  
Sapsa Bedding  
Select Comfort  
Serta and any direct or indirect parent company  
Silentnight  
Simmons Company/Beautyrest and any direct or indirect parent company  
Sleepmaker  
Spring Air  
Sterling  
Stobel  
Swiss Comfort  
Swiss Sense  
Therapedic



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

I, Mark Sarvary, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended September 30, 2013, of Tempur-Pedic International Inc.;

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

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

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

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

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

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

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

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

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

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

Date: November 8, 2013

By: \_\_\_\_\_ /s/ MARK SARVARY

**Mark Sarvary**  
**President and Chief Executive Officer**



