TEMPUR PEDIC INTERNATIONAL INC
Form 10-K
March 14, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2005

Commission file number 001-31922

TEMPUR-PEDIC INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

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

1713 Jaggie Fox Way

Lexington, Kentucky 40511

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

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.01 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

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

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

The aggregate market value of the common equity held by non-affiliates of the registrant on June 30, 2005, computed by reference to the closing price for such stock on the New York Stock Exchange on such date, was approximately $1,449,997,760.

The number of shares outstanding of the registrant s common stock as of February 28, 2006 was 88,286,400 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement for the 2006 Annual Meeting of Stockholders, which is to be filed subsequent to the date hereof, are incorporated by reference into Part III of this Form 10-K.

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Special Note Regarding Forward-Looking Statements

This annual report on Form 10-K, including the information incorporated by reference herein, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which include information concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, the impact of the adoption of recently issued accounting pronouncements, the Company s intention to repurchase shares of its common stock under its share repurchase program, the putative securities class action lawsuits and related lawsuits recently filed, the rollout and market acceptance of new products, plans to increase sales and reduce costs, the impact of increases in raw materials costs, the construction of our new manufacturing facility in New Mexico, and other information that is not historical information. Many of these statements appear, in particular, under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations in ITEM 7 of Part II of this report. When used in this report, the words estimates, expects, anticipates, projects, plans, intends, believes and variations of such words or similar expres intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct.

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

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

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

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PART I

ITEM 1. BUSINESS

General

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

We sell our premium mattresses and pillows through four distribution channels: Retail (furniture and specialty stores, as well as department stores internationally); Direct (direct response and internet); Healthcare (chiropractors, medical retailers, hospitals and other healthcare markets); and Third party distributors in countries where we do not sell directly through our own subsidiaries. In the United States, we sell a majority of our mattresses and pillows through the Retail channel. For the year ended December 31, 2005, International sales accounted for approximately 36% of our Net sales. In Asia, our Net sales consist primarily of pillows. Internationally, in addition to sales through our Retail channel, we sell a significant amount of our products through the Healthcare channel and Third party distributors. In the four years ended December 31, 2005, our total Net sales grew at a compound annual rate of approximately 39%. We had Net sales of $836.7 million for the year ended December 31, 2005, which represented a 22% growth rate from 2004.

Our principal executive office is located at 1713 Jaggie Fox Way, Lexington, Kentucky 40511 and our telephone number is (800) 878-8889. We were incorporated under the laws of the State of Delaware in September 2002. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to such reports filed with or furnished to the Securities and Exchange Commission (SEC) pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are available free of charge on our website at www.tempurpedic.com as soon as reasonably practicable after such reports are electronically filed with the SEC.

Market Opportunity

Global Mattress Market

According to the International Sleep Products Association (ISPA), from 1991 to 2005, mattress unit sales grew in the U.S. at an average of approximately 500,000 units annually, with approximately 22.0 million mattress units sold in the U.S. in 2005. We believe a similar number of mattress units were sold outside the U.S. in 2005. Most standard mattresses are made using innersprings, and most innerspring mattresses are sold for under $1,000, primarily through retail furniture and bedding stores. Alternatives to standard and premium innerspring mattresses include viscoelastic and foam mattresses, airbeds and waterbeds.

The medical community is also a large consumer of mattresses to furnish hospitals and nursing homes. In the U.S., there are approximately 15,400 nursing homes and 5,000 hospitals with a collective bed count in excess of 2.7 million. Medical facilities typically purchase twin size mattresses with standard operating functions such as adjustable height and mechanisms to turn patients to prevent pressure ulcers, or bed sores. We believe demographic trends suggest that as the population ages, the healthcare market for mattresses will continue to grow.

Global Pillow Market

The U.S. pillow market has a traditional and a specialty segment. Traditional pillows are generally made of low cost foam or feathers, other than down. Specialty pillows include all alternatives to traditional pillows, including viscoelastic, foam, sponge rubber and down. We believe the international pillow market is generally the same size as the domestic pillow market, which we estimate to be approximately $1.1 billion.

Our Market Position

We are the leading global manufacturer, marketer and distributor of premium mattresses and pillows. We believe consumer demand for our premium products in the U.S. is being driven primarily by increased housing and home furnishing purchases by the baby boom generation; significant growth in our core demographic market as the baby boom generation ages; increased awareness of the health benefits of a better quality mattress; and the shifting consumer preference from firmness to comfort. As consumers continue to prefer alternatives to standard innerspring mattresses, our products become more widely available and as our brand gains broader consumer recognition, we expect that our premium products will continue to attract sales from the standard mattress market.

Competitive Strengths

We believe we are well-positioned for continued growth in our target markets, and that the following competitive strengths differentiate us from our competitors:

Superior Product Offering

Our proprietary TEMPUR® mattresses and pillows conform to the body more naturally and provide better spinal alignment, reduced pressure points, greater relief of lower back and neck pain, and a better quality sleep than traditional bedding products. We believe the benefits of our products have become widely recognized, as evidenced by the more than 25,000 healthcare professionals worldwide who recommend our products and the approval of one or more of our products for purchase or reimbursement by the government healthcare agencies in several European countries. In addition, we continue to leverage our unique and proprietary manufacturing process to develop new products and refine existing products to meet the changing demands and preferences of consumers. Continuing our commitment to innovation, we have recently unveiled our latest TEMPUR® proprietary formula, named TEMPUR-HD. Our innovative products distinguish us from the major manufacturers of standard innerspring mattresses and traditional pillows in the U.S., which we believe offer generally similar products and must compete primarily on price.

Increasing Global Brand Awareness

We believe consumers in the U.S. and internationally increasingly associate our brand name with premium quality products that enable better overall sleep. We sell our products in 60 countries primarily under the TEMPUR® and Tempur-Pedic® brands. Our TEMPUR® brand has been in existence since 1991 and its global awareness is reinforced by our high level of customer satisfaction. As of January 2006, The OriginalBed *by* Tempur-Pedic , The ClassicBed *by* Tempur-Pedic, The DeluxeBed *by* Tempur-Pedic, The CelebrityBed *by* Tempur-Pedic and The EuroBed *by* Tempur-Pedic have been awarded the Arthritis Foundations Ease of Use Commendation. In December 2004, The ComfortPillow *by* Tempur-Pedic was awarded best buy status in the premium pillow category by *Consumers Digest*. In September 2004, we were added to the list of approved products by *Good Housekeeping* magazine, which earned us the privilege to display the Good Housekeeping Seal across our entire line of mattresses. In April 2003, *Consumers Digest* named one of our mattresses among the eight best buys of the mattress industry in the applicable price range. Furthermore, we believe our direct response business and associated multi-channel advertising in our domestic and international markets have enhanced awareness of our brand.

Diversified Product Offerings Sold Globally Through Multiple Distribution Channels

Our diversified product offerings include mattresses, pillows and other products, primarily foundations and adjustable beds, which we sell through all of our channels and represented 68%, 15% and 17%, respectively, of our Net sales for 2005. For the year ended December 31, 2005, our Retail channel represented 76% of Net sales, with our Direct, Healthcare and Third party distributor channels representing 12%, 6% and 6%, respectively. Domestic and International operations generated 64% and 36%, respectively, of Net sales for the year ended December 31, 2005.

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A graphic depiction of our Net sales for the year ended December 31, 2005 is as follows:

Vertically Integrated Manufacturing and Supply Chain

We produce all of our proprietary Tempur® material in our own manufacturing facilities in the U.S. and Europe in order to precisely control the key product specifications that go into our products. We believe that our vertical integration, from the manufacture of the Tempur ® material and fabrication and construction of our products through to the marketing, sale and delivery of our products, ensures a high level of quality and performance that is not matched by our competition.

Strong Financial Performance

Our business generates significant free cash flow due to the combination of our growing revenues, strong gross and operating margins, low maintenance capital expenditures and working capital requirements, and limited corporate overhead. Further, our vertically-integrated operations generated an average of approximately $0.6 million in Net sales per employee in 2005. For the year ended December 31, 2005, our Gross profit margin and Net income margin were 51% and 12%, respectively, on Net sales of $836.7 million. In addition, capital expenditures were $84.9 million for the year ended December 31, 2005, of which approximately $73.0 million was related to our New Mexico manufacturing facility. Our strong financial performance gives us the flexibility to invest in our manufacturing operations, enhance our sales force and marketing, invest in information systems and recruit experienced management and other personnel.

Significant Growth Opportunities

We believe we have significant growth opportunities primarily because we can further expand our distribution into our addressable market, and because we expect consumers will continue to shift away from standard innerspring mattresses to non-innerspring premium products such as ours. As of December 31, 2005, our products were sold in approximately 5,310 furniture and bedding retail stores in the U.S., out of a total of approximately 10,000 stores we have identified as appropriate targets. Within this addressable market of approximately 10,000 stores, our plan is to increase our total penetration to a total of 7,000 to 8,000 stores over time. As we deepen our penetration of the furniture retail market, our strategy is to focus our sales force and retail trainers to concentrate more on expanding our business within our established accounts. While we will continue to expand our distribution our focus has shifted to expanding those regions where demographic and buying power metrics indicate that we are under penetrated. Similarly, our products are available in approximately 4,100 furniture retail and department stores internationally, out of a total of approximately 7,000 stores we have identified as appropriate targets. In addition, we currently supply only a small percentage of the approximately 15,400 nursing homes and 5,000 hospitals in the U.S., with an estimated collective bed count in excess of 2.7 million. As consumers continue their shift toward the purchase of non-innerspring mattress products and sleep surfaces we believe we are well positioned to capitalize on this growth opportunity.

Our Products

Our high-quality, high-density, temperature-sensitive TEMPUR® material distinguishes our products from other products in the marketplace. Viscoelastic pressure-relieving material was originally developed by NASA in 1971 in an effort to relieve astronauts of the g-forces experienced during lift-off, and NASA subsequently made

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this formula publicly available. The NASA viscoelastic pressure-relieving material originally proved unstable for commercial use. However, after several years of research and development, we succeeded in developing a proprietary formulation and proprietary process to manufacture a stable, durable and commercially viable product. The key feature of our pressure-relieving TEMPUR® material is its temperature sensitivity. It conforms to the body, becoming softer in warmer areas where the body is making the most contact with the pressure-relieving TEMPUR® material and remaining firmer in cooler areas where less body contact is being made. As the material molds to the body s shape, the body is supported in the correct anatomical position with the neck and spine in complete therapeutic alignment. Our pressure-relieving TEMPUR® material also has higher density than other viscoelastic materials, resulting in improved durability and enhanced comfort. In addition, clinical evidence indicates that our products are both effective and cost efficient for the prevention and treatment of pressure ulcers or bed sores, a major problem for elderly and bed-ridden patients.

Mattresses

Our mattresses represented 68% of our worldwide Net sales in 2005 and are our leading product category in growth in recent years. Our mattresses are composed of proprietary multi-layer, heat sensitive, pressure-relieving TEMPUR® material. We offer several mattress models, some of which are covered by one or more patents and/or patent applications. Our two newest mattress offerings, The GrandBed *by* Tempur-Pedic and The RhapsodyBed *by* Tempur-Pedic , were introduced at The World Market in Las Vegas in January 2006 and will be shipping to retailers in the first half of 2006.

Pillows

Our premium pillow offerings represented 15% of worldwide sales in 2005 and provide plush and pressure-relieving comfort as the temperature sensitive material molds to the body in a variety of styles. Our pillow offerings include The ComfortPillow *by* Tempur-Pedic , which contains micro-cushions of TEMPUR® fill material in a specially designed cover, our classic cervical shaped pillow designed for neck and spine alignment, the Millennium pillow with its unique patented design, and the BodyPillow *by* Tempur-Pedic and Supreme line of premium pillows introduced in the U.S. in 2004 and 2005.

Other Products

Our other products represented 17% of our worldwide sales in 2005. This category includes foundations used to support our mattress products, adjustable beds, and many other types of offerings including a variety of cushions and other comfort products. In addition, we believe our adjustable beds are the highest quality and most advanced adjustable beds available. Our mattress easily molds to the shape of the base to stay in place and perform better than other mattresses.

Marketing and Sales

While primarily a wholesaler, we market directly to consumers in the U.S. and the United Kingdom. Our marketing strategy is to increase consumer awareness of the benefits of our products and to further associate our brand name with better overall sleep and premium quality products.

Retail

This channel is our fastest growing sales channel and is driven by a sales team dedicated to introducing our products to traditional furniture and bedding retailers. We work with and target furniture retailers, sleep shops, specialty back and gift stores, home stores and international department stores.

We are currently positioned in approximately 9,410 furniture stores worldwide. In the U.S., our retail sales channel is our largest channel, and we currently sell to approximately 5,310 furniture stores and 1,500 specialty retail stores. Our products are now offered in approximately 4,100 furniture stores in Europe and Asia. We plan to build and maintain our channel of specialty retail stores.

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Direct

This channel sells products directly to consumers through our call center operations and the internet in the U.S. and the United Kingdom. Our direct response program targets customers in these markets through television, radio, magazine and newspaper product offering advertisements. Most direct response sales orders are taken through responding to in-bound telephone calls, although some orders are also accepted through the internet.

Healthcare

We sell to chiropractors, physical therapists, massage therapists, various other health professionals, as well as medical retailers, sleep clinics and other medical institutions that utilize our products to treat patients or recommend and/or sell them to their clients. Within our healthcare channel, approximately 25,000 healthcare professionals worldwide recommend and/or sell our products to their patients, medical retailers (including pharmacists), and hospitals and nursing homes. In addition, we work closely with hospitals, nursing homes, and medical equipment providers to place our products in facilities where they will be positioned for general public use.

Our Healthcare division in the U.S., which we refer to as Tempur-Pedic Medical, began primarily through indirect sales of our mattresses and pillows through a network of medical professionals, and has grown to include sales to hospitals, nursing homes and medical retailers. Sales to these market segments are now being generated by leading distributors and manufacturers who represent our product lines through their respective sales forces.

Third Party

We have successfully expanded distribution into international markets by utilizing third party distributors. Our approach to these developing markets has allowed us to build sales, marketing and brand awareness with minimal capital risk.

We have entered into written and verbal arrangements with third party distributors located in Eastern Europe, Asia/Pacific, the Middle East, Central and South America and Canada and Mexico. We utilize third party distributors to serve markets that are currently outside the range of our wholly-owned subsidiaries. We have recently made investments in personnel to manage and grow this important form of product distribution, and have restructured our organization to better track and manage our third party distribution arrangements.

Seasonality

A significant portion of our growth in Net sales is attributable to growth in sales in our Domestic retail channel, particularly sales to furniture stores. We believe that our sales of mattresses and pillows to furniture stores are subject to modest seasonality inherent in the bedding industry with sales expected to be generally lower in the second and fourth quarters and higher in the first and third quarters.

Operations

Manufacturing and Related Technology

Our products are currently manufactured at facilities located in Aarup, Denmark and Duffield, Virginia, both of which we own. Much of the sewing and production of mattress and pillow covers is outsourced to third party suppliers.

Our Danish plant has undergone several major plant expansions in the past five years, including an $18.4 million facility expansion in 2004. As a result of this expansion, the Danish plant is now approximately 517,000 square feet. In February 2004, we completed the $21.0 million expansion of our Virginia plant, which is now approximately 540,000 square feet.

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In order to continue to increase productivity and expand our manufacturing capacity, we began construction in September 2004 of a third manufacturing facility located in Albuquerque, New Mexico, for which we estimate total construction costs to be approximately $90.0 million. This 750,000 square foot state-of-the-art manufacturing plant will meet demand for our products primarily within the western U.S. as well as well as certain third party distributors. We expect this facility to be completed in the fourth quarter of 2006.

Suppliers

We currently obtain the raw materials used to produce our pressure-relieving TEMPUR® material from outside sources. We currently acquire chemicals and proprietary additives from a number of suppliers with manufacturing locations around the world. We expect to continue these supplier relationships for the foreseeable future. We do not consider ourselves dependent upon any single outside vendor as a source of raw materials and believe that sufficient alternative sources of supply for the same or similar raw materials are available.

During 2005 we were negatively impacted by a rise in certain raw material prices and fuel surcharges for the transportation and delivery of our products that impacted our industry. We have taken steps to mitigate the impact of price increases through productivity and efficiency initiatives, including negotiated discounts for many of our chemical purchases, reverse auctions on certain material purchases, purchasing leverage on consolidated global buying, and implementation of warehousing and shipping efficiencies.

Research and Development

We have invested more than $2.0 million over the past 3 years in a new research and development center located in Duffield, Virginia designed to facilitate detailed product testing and analysis utilizing state-of-the-art technology. In addition to our research and development efforts, we also devote significant efforts to product development as part of our sales and marketing operations. Research and development expenses, excluding product development, were $2.7 million, $2.3 million and $1.5 million in 2005, 2004 and 2003, respectively. In 2006, we plan to increase our spending on research and development efforts in order to continue providing superior and innovative mattress and pillow products to our target markets.

Competition

The mattress and pillow industries are highly competitive. Participants in the mattress and pillow industries have traditionally competed primarily based on price. Our premium mattresses compete with a number of different types of premium and standard mattress alternatives, including innerspring mattresses, foam mattresses, waterbeds, futons, air beds and other air-supported mattresses that are sold through a variety of channels, including furniture stores, specialty bedding stores, department stores, mass merchants, wholesale clubs, telemarketing programs, television infomercials and catalogs. The pillow industry is characterized by a large number of competitors, none of which is dominant.

The standard mattress market in the U.S. is dominated by three large manufacturers of innerspring mattresses with nationally recognized brand names, Sealy, Serta, and Simmons. These three competitors also offer premium innerspring mattresses and collectively have a significant share of the premium mattress market in the U.S. Select Comfort Corporation competes in the specialty mattress market and focuses on the air mattress market segment. The balance of the mattress market in the U.S. is served by a large number of other manufacturers, primarily operating on a regional basis. Many of these competitors and, in particular, the three largest manufacturers of innerspring mattresses named above, have significant financial, marketing and manufacturing resources, strong brand name recognition, and sell their products through broader and more established distribution channels. During the past several years, a number of our competitors, including Sealy, Serta and Simmons, have offered viscoelastic mattress and pillow products.

The international market for mattresses and pillows is generally served by a large number of manufacturers, primarily operating on a regional basis. Some of these manufacturers also offer viscoelastic mattress and pillow products.

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Intellectual Property

We hold various U.S. and foreign patents and patent applications regarding certain elements of the design and function of many of our mattress and pillow products. As of December 31, 2005, we had 11 issued U.S. patents, expiring at various points between 2013 and 2021, and 14 U.S. patent applications pending. We also held 45 foreign patents and had 28 foreign patent applications pending.

As of December 31, 2005, we held approximately 200 trademark registrations worldwide, which we believe have significant value and are important to the marketing of our products to retailers. TEMPUR® and Tempur-Pedic® are trademarks registered with the United States Patent and Trademark Office. We have a number of other trademarks, including The Celebritybed *by* Tempur-Pedic and our other key product models, Swedish Sleep System® and Tempur-Med®, and our Tempur-Pedic logo is registered. In addition, we have U.S. applications pending for additional marks. Several of our trademarks have been registered, or are the subject of pending applications, in various foreign countries. Each U.S. trademark registration is renewable indefinitely as long as the mark remains in use.

Governmental Regulation

Our operations are subject to state, local and foreign consumer protection and other regulations relating to the mattress and pillow industry. These regulations vary among the states and countries in which we do business. The regulations generally impose requirements as to the proper labeling of bedding merchandise, restrictions regarding the identification of merchandise as new or otherwise, controls as to hygiene and other aspects of product handling and sale and penalties for violations. The U.S. Consumer Product Safety Commission recently voted in favor of a new federal fire-resistant standard for mattresses that mirrors the standard set forth in California Technical Bulletin 603. We have developed and implemented product modifications that allow us to meet these new standards. Many foreign jurisdictions also regulate fire retardancy standards, and changes to these standards and changes in our products that require compliance with additional standards would raise similar risks. We are also subject to environmental and health and safety requirements with regards to the manufacture of our products. We have made and will continue to make capital and other expenditures necessary to comply with all these requirements. We believe that we are in substantial compliance with the applicable federal, state, local, and foreign rules and regulations governing our business.

Employees

As of December 31, 2005, we have approximately 1,300 employees, with approximately 600 in the U.S., 300 in Denmark and 400 in the rest of the world. Our employees in Denmark are under a government labor union contract as is normal practice. None of our U.S. employees are covered by a collective bargaining agreement. We believe our relations with our employees are generally good.

ITEM 1A. RISK FACTORS

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

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

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

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Our largest competitors have significant financial, marketing and manufacturing resources and strong brand name recognition, and sell their products through broad and well established distribution channels. As a result of the significant growth in the sale of viscoelastic mattresses over the last several years, a large number of competitors are aggressively pursuing the viscoelastic mattress market through a variety of channels and a wide range of price points. These competitors include Sealy, Serta and Simmons, who all offer premium priced viscoelastic products claimed to be similar to our products. Any such competition by established manufacturers or new entrants into the market could have a material adverse effect on our business, financial condition and operating results by causing our products to lose market share or causing us to reduce the prices we charge for our products, which would reduce our profitability. The pillow industry is characterized by a large number of competitors, none of which is dominant.

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

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

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

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

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

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

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This change in our consumer base makes our business more susceptible to general economic factors that impact disposable income or consumer confidence.

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

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

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

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

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

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

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

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

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

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

Approximately 36% of our Net sales were denominated in foreign currency for the year ended December 31, 2005. As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. We use foreign exchange forward contracts to manage a portion of the exposure to the risk of the eventual net cash inflows and outflows resulting from foreign currency denominated transactions between Tempur-Pedic subsidiaries and their customers and suppliers, as well as between Tempur-Pedic subsidiaries themselves from time to time. The hedging transactions may not succeed in managing our foreign currency exchange rate risk. See ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exposures under Part II of this report.

Foreign currency exchange rate movements also create a degree of risk by affecting the U.S. dollar value of sales made and costs incurred in foreign currencies. We do not enter into hedging transactions to hedge this risk. Consequently, our reported earnings and financial position could fluctuate materially as a result of foreign exchange gains or losses. Our outlook assumes no significant changes in currency values from current rates. Should currency rates change sharply, our results could be negatively impacted. See ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exposures under Part II of this report.

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

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

Our marketing and advertising practices could also become the subject of proceedings before regulatory authorities or the subject of claims by other parties. In addition, we are subject to federal, state and local laws and regulations relating to pollution, environmental protection and occupational health and safety. We may not be in complete compliance with all such requirements at all times. We have made and will continue to make capital and other expenditures to comply with environmental and health and safety requirements. If a release of hazardous substances occurs on or from our properties or any associated offsite disposal location, or if contamination from prior activities is discovered at any of our properties, we may be held liable and the amount of such liability could be material.

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

Part of our Domestic marketing and advertising strategy in certain Domestic channels focuses on providing up to a 120-day money back guarantee under which customers may return their mattress and obtain a refund of the purchase price. For the year ended December 31, 2005, in the U.S. we had approximately $36.5 million in returns for a return rate of approximately 7% of our Net sales in the U.S. As we expand our sales, our return rates may not remain within our historical levels. An increase in return rates could significantly impair our liquidity and profitability. We also currently provide our customers with a limited, pro-rata 20-year warranty on mattresses sold in the U.S. and a limited 15-year warranty on mattresses sold outside of the U.S. However, as we have only been selling mattresses in significant quantities since 1992, and have released new products in recent years, many are fairly early in their product life cycles. We also provide 2-year to 3-year warranties on pillows.

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

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

We currently conduct international operations in 14 countries directly and in 46 additional countries through distributors, and we may pursue additional international opportunities. We generated approximately 36% of our Net sales from non-U.S. operations during the year ended December 31, 2005, and international suppliers provided a significant portion of our manufacturing material during this period. Our international operations are subject to the customary risks of operating in an international environment, including complying with foreign laws and regulations and the potential imposition of trade or foreign exchange restrictions, tariff and other tax increases, fluctuations in exchange rates, inflation and unstable political situations, the potential unavailability of intellectual property protection and labor issues.

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

We rely on trade secrets to protect the design, technology and function of our TEMPUR® material and our products. To date, we have not sought U.S. or international patent protection for our principal product formula and manufacturing processes. Accordingly, we may not be able to prevent others from developing viscoelastic material and products that are similar to or competitive with our products. Our ability to compete effectively with other companies also depends, to a significant extent, on our ability to maintain the proprietary nature of our owned and licensed intellectual property. We own several patents on aspects of our products and have patent applications pending on aspects of our manufacturing processes. However, the principal product formula and manufacturing processes for our TEMPUR® material and our products are not patented and we must maintain these as trade secrets in order to protect this intellectual property. We own 11 U.S. patents, and we have 14 U.S. patent applications pending. Further, we own 45 foreign patents, and we have 28 foreign patent applications pending. In addition, we hold approximately 200 trademark registrations worldwide. We own U.S. and foreign registered trade names and service marks and have applications for the registration of trade names and service marks pending domestically and abroad. We also license certain intellectual property rights from third parties.

Although our trademarks are currently registered in the U.S. and registered or pending in 56 foreign countries, they could be circumvented, or violate the proprietary rights of others, or we could be prevented from using them if challenged. A challenge to our use of our trademarks could result in a negative ruling regarding our use of our trademarks, their validity or their enforceability, or could prove expensive and time consuming in terms of legal costs and time spent defending against it. Any loss of trademark protection could result in a decrease in sales or cause us to spend additional amounts on marketing, either of which could decrease our liquidity and profitability. In addition, if we incur significant costs defending our trademarks that could also decrease our liquidity and profitability. In addition, we may not have the financial resources necessary to enforce or defend our trademarks. Furthermore, our patents may not provide meaningful protection and patents may never be issued for our pending patent applications. It is also possible that others could bring claims of infringement against us, as our principal product formula and manufacturing processes are not patented, and that any licenses protecting our intellectual property could be terminated. If we were unable to maintain the proprietary nature of our intellectual property and our significant current or proposed products, this loss of a competitive advantage could result in decreased sales or increased operating costs, either of which would decrease our liquidity and profitability.

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

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

Our top five customers, collectively, accounted for 12% of our Net sales for the year ended December 31, 2005. Many of our customer arrangements are by purchase order or are terminable at will at the option of either party. A substantial decrease or interruption in business from our significant customers could result in write-offs or in the loss of future business and could reduce our liquidity and profitability.

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

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

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

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

As of December 31, 2005, we had approximately 1,300 full-time employees, with approximately 600 in the U.S., 300 in Denmark and 400 in the rest of the world. The employees in Denmark are under a government labor union contract, but those in the U.S. are not. Any significant increase in our labor costs could decrease our liquidity and profitability and any deterioration of employee relations, slowdowns or work stoppages at any of our locations, whether due to union activities, employee turnover or otherwise, could result in a decrease in our Net sales or an increase in our costs, either of which could decrease our liquidity and profitability.

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

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

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

As of December 31, 2005, we had $344.5 million in total Long-term debt outstanding. In addition, as of December 31, 2005, our Stockholders Equity was $226.3 million. In October 2005, we announced an $80.0 million share repurchase program. In January 2006, our Board of Directors amended the share repurchase program to increase the total authorized purchase by $100.0 million resulting in a total authorization of $180.0 million, of which $76.0 million had been spent as of December 31, 2005. Additionally, we spent $42.8 million on share repurchases through February 24, 2006. We intend to fund the repurchase in part through borrowings under our 2005 Senior Credit Facility, which will increase leverage. Our degree of leverage could have important consequences to our investors, such as:

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

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

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

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

We are subject to interest rate risk in connection with our issuance of variable rate debt under our 2005 Senior Credit Facility. Interest rate changes could increase the amount of our interest payments and thus, negatively impact our future earnings and cash flows. We estimate that our annual interest expense on our floating rate indebtedness would increase by $2.5 million for each 1% increase in interest rates until IBOR reaches 5%. After IBOR reaches 5% our annual interest expense on the unhedged portion of our floating rate indebtedness would increase by $1.9 million for each 1% increase in interest rates. See ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk under Part II of this report.

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

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

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

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

actual or anticipated variations in our quarterly operating results, including those resulting from seasonal variations in our business;

introductions or announcements of technological innovations or new products by us or our competitors;

disputes or other developments relating to proprietary rights, including patents, litigation matters, and our ability to patent our products and technologies;

changes in estimates by securities analysts of our financial performance;

Equity Universe Minimum Size Requirement: this investability screen is applied at the company level. In order to be included in a market investable equity universe, a company must have the required minimum full market capitalization.

- Equity Universe Minimum Free Float–Adjusted Market Capitalization Requirement: this investability screen is applied at the individual security level. To be eligible for inclusion in a market investable equity universe, a security must have a free float–adjusted market capitalization equal to or higher than 50% of the equity universe minimum size requirement.
- DM and EM Minimum Liquidity Requirement: This investability screen is applied at the individual security level. To be eligible for inclusion in a market investable equity universe, a security must have adequate liquidity. The twelve-month and three-month Annual Traded Value Ratio (“ATVR”), a measure that screens out extreme daily trading volumes and takes into account the free float–adjusted market capitalization size of securities, together with the three-month frequency of trading are used to measure liquidity. A minimum liquidity level of 20% of three- and twelve-month ATVR and 90% of three-month frequency of trading over the last four consecutive quarters are required for inclusion of a security in a market investable equity universe of a DM, and a minimum liquidity level of 15% of three- and twelve-month ATVR and 80% of three-month frequency of trading over the last four consecutive quarters are required for inclusion of a security in a market investable equity universe of an EM.
- Global Minimum Foreign Inclusion Factor Requirement: this investability screen is applied at the individual security level. To be eligible for inclusion in a market investable equity universe, a security’s Foreign Inclusion Factor (“FIF”) must reach a certain threshold. The FIF of a security is defined as the proportion of shares outstanding that is available for purchase in the public equity markets by international investors. This proportion accounts for the available free float of and/or the foreign ownership limits applicable to a specific security (or company). In general, a security must have an FIF equal to or larger than 0.15 to be eligible for inclusion in a market investable equity universe.
- Minimum Length of Trading Requirement: this investability screen is applied at the individual security level. For an initial public offering (“IPO”) to be eligible for inclusion in a market investable equity universe, the new issue must have started trading at least three months before the implementation of a semi–annual index review (as described below). This requirement is applicable to small new issues in all markets. Large IPOs are not subject to the minimum length of trading requirement and may be included in a market investable equity universe and the Standard Index

outside of a Quarterly or Semi−Annual Index Review.

- Minimum Foreign Room Requirement: this investability screen is applied at the individual security level. For a security that is subject to a foreign ownership limit to be eligible for inclusion in a market investable equity universe, the proportion of shares still available to foreign investors relative to the maximum allowed (referred to as "foreign room") must be at least 15%.

Defining Market Capitalization Size Segments for Each Market. Once a market investable equity universe is defined, it is segmented into the following size−based indices:

- Investable Market Index (Large + Mid + Small);
- Standard Index (Large + Mid);
- Large Cap Index;
- Mid Cap Index; or
- Small Cap Index.

Creating the size segment indices in each market involves the following steps:

- defining the market coverage target range for each size segment;
- determining the global minimum size range for each size segment;
- determining the market size segment cutoffs and associated segment number of companies;
- assigning companies to the size segments; and
- applying final size–segment investability requirements.

Index Continuity Rules for the Standard Indices. In order to achieve index continuity, as well as to provide some basic level of diversification within a market index, and notwithstanding the effect of other index construction rules described in this section, a minimum number of five constituents will be maintained for a DM Standard Index and a minimum number of three constituents will be maintained for an EM Standard Index.

Creating Style Indices within Each Size Segment. All securities in the investable equity universe are classified into value or growth segments using the MSCI Global Value and Growth methodology.

Classifying Securities under the Global Industry Classification Standard. All securities in the global investable equity universe are assigned to the industry that best describes their business activities. To this end, MSCI has designed, in conjunction with S&P Dow Jones Indexes, the GICS. Under the GICS, each company is assigned to one sub–industry according to its principal business activity. Therefore, a company can belong to only one industry grouping at each of the four levels of the GICS.

Index Maintenance

The MSCI Global Investable Market Indices are maintained with the objective of reflecting the evolution of the underlying equity markets and segments on a timely basis, while seeking to achieve index continuity, continuous investability of constituents and replicability of the indices, index stability and low index turnover. In particular, index maintenance involves:

(i) Semi–Annual Index Reviews ("SAIRs") in May and November of the Size Segment and Global Value and Growth Indices which include:

- updating the indices on the basis of a fully refreshed equity universe;
- taking buffer rules into consideration for migration of securities across size and style segments; and
- updating FIFs and Number of Shares ("NOS").

(ii) Quarterly Index Reviews in February and August of the Size Segment Indices aimed at:

- including significant new eligible securities (such as IPOs that were not eligible for earlier inclusion) in the index;
- allowing for significant moves of companies within the Size Segment Indices, using wider buffers than in the SAIR; and
- reflecting the impact of significant market events on FIFs and updating NOS.

(iii) Ongoing Event–Related Changes: changes of this type are generally implemented in the indices as they occur. Significantly large IPOs are included in the indices after the close of the company's tenth day of trading.

None of us, the dealer or any of our other affiliates accepts any responsibility for the calculation, maintenance, or publication of, or for any error, omission, or disruption in, the index or any successor to the index.

Barrier Enhanced Return Notes
Linked to a Basket of One Equity Index
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Due July 24, 2020

Historical Information for the MSCI Europe Index (“MXEU”)
The graph below sets forth the information relating to the historical performance of this Basket Component. In addition, below the graph is a table setting forth the intra-day high, intra-day low and period-end closing levels of this Basket Component. The information provided in this table is for the four calendar quarters of 2012 through 2016, the first two calendar quarters of 2017 and the period from July 1, 2017 through July 19, 2017.
We obtained the information regarding the historical performance of this Basket Component in the chart below from Bloomberg Financial Markets.
We have not independently verified the accuracy or completeness of the information obtained from Bloomberg Financial Markets. The historical performance of this Basket Component should not be taken as an indication of its future performance, and no assurance can be given as to the Final Level of the Basket Component. We cannot give you assurance that the performance of this Basket Component will result in any positive return on your initial investment.

Period-Start Date	Period-End Date	High Intra-Day Level of this Basket Component	Low Intra-Day Level of this Basket Component	Period-End Closing Level of this Basket Component
1/1/2012	3/31/2012	94.33	84.93	91.00
4/1/2012	6/30/2012	92.50	80.63	86.79
7/1/2012	9/30/2012	95.38	86.37	92.57
10/1/2012	12/31/2012	97.16	90.55	96.31
1/1/2013	3/31/2013	102.73	96.17	100.92
4/1/2013	6/30/2013	106.73	94.28	97.69
7/1/2013	9/30/2013	108.48	96.85	106.16
10/1/2013	12/31/2013	112.18	104.01	112.13
1/1/2014	3/31/2014	115.44	107.72	113.81
4/1/2014	6/30/2014	119.28	111.09	116.74
7/1/2014	9/30/2014	119.92	110.34	117.21
10/1/2014	12/31/2014	119.70	103.30	116.72
1/1/2015	3/31/2015	137.73	112.60	135.26
4/1/2015	6/30/2015	141.31	128.25	129.19
7/1/2015	9/30/2015	138.52	112.23	117.25
10/1/2015	12/31/2015	130.67	115.70	123.11
1/1/2016	3/31/2016	123.11	101.98	113.62
4/1/2016	6/30/2016	118.68	104.17	111.62
7/1/2016	9/30/2016	118.68	107.49	115.82
10/1/2016	12/31/2016	122.60	110.72	122.50
1/1/2017	3/31/2017	129.16	121.95	128.93
4/1/2017	6/30/2017	133.90	127.03	128.08
7/1/2017	7/19/2017	130.95	127.78	130.07

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PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.
Historical Information for the iShares® MSCI Emerging Markets ETF ("EEM")
The graph below sets forth the information relating to the historical performance of this Basket Component. In addition, below the graph is a table setting forth the intra-day high, intra-day low and period-end closing share prices of this Basket Component. The information provided in this table is for the four calendar quarters of 2012 through 2016, the first two calendar quarters of 2017 and the period from July 1, 2017 through July 19, 2017.
We obtained the information regarding the historical performance of this Basket Component in the chart below from Bloomberg Financial Markets.
We have not independently verified the accuracy or completeness of the information obtained from Bloomberg Financial Markets. The historical performance of this Basket Component should not be taken as an indication of its future performance, and no assurance can be given as to the Final Level of the Basket Component. We cannot give you assurance that the performance of this Basket Component will result in any positive return on your initial investment.

Period-Start Date	Period-End Date	High Intra-Day Price of this Basket Component ($)	Low Intra-Day Price of this Basket Component ($)	Period-End Closing Price of this Basket Component ($)
1/1/2012	3/31/2012	44.91	38.21	42.94
4/1/2012	6/30/2012	43.75	36.58	39.19
7/1/2012	9/30/2012	42.83	37.15	41.32
10/1/2012	12/31/2012	44.42	39.93	44.35
1/1/2013	3/31/2013	45.28	41.72	42.78
4/1/2013	6/30/2013	44.26	36.16	38.57
7/1/2013	9/30/2013	43.32	36.98	40.77
10/1/2013	12/31/2013	43.91	40.15	41.77
1/1/2014	3/31/2014	41.25	37.06	40.99
4/1/2014	6/30/2014	43.98	40.55	43.23
7/1/2014	9/30/2014	45.85	41.36	41.56
10/1/2014	12/31/2014	42.46	37.23	39.29
1/1/2015	3/31/2015	41.11	37.72	40.13
4/1/2015	6/30/2015	44.18	39.03	39.62
7/1/2015	9/30/2015	40.02	30.00	32.78
10/1/2015	12/31/2015	36.42	31.51	32.19
1/1/2016	3/31/2016	34.58	27.62	34.25
4/1/2016	6/30/2016	35.34	31.71	34.36
7/1/2016	9/30/2016	38.31	33.33	37.45
10/1/2016	12/31/2016	38.19	33.95	35.01
1/1/2017	3/31/2017	40.23	35.30	39.39
4/1/2017	6/30/2017	42.04	38.72	41.39
7/1/2017	7/19/2017	43.79	40.96	43.71

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.
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USE OF PROCEEDS AND HEDGING

In anticipation of the sale of the Notes, we may have entered into hedging transactions with one or more of our affiliates, involving purchases of the securities represented by the MXEU, shares of the EEM and/or listed and/or over-the-counter derivative instruments related to any of those securities or the Basket Components prior to or on the Pricing Date. From time to time, including around the time of the Valuation Date and the Maturity Date, we, RBCCM, and our other affiliates may enter into additional hedging transactions or unwind those that we or they have entered into. In this regard, we, RBCCM, and our other affiliates may:

- acquire or dispose of investments relating to the Basket Components;
- acquire or dispose of long or short positions in listed or over-the-counter derivative instruments based on the Basket Components; or
- any combination of the above two.

We, RBCCM and our other affiliates may acquire a long or short position in securities similar to the Notes from time to time and may, in our or their sole discretion, hold or resell those similar securities.

We, RBCCM and our other affiliates may close out our or their hedges on or before the Valuation Date. That step may involve sales or purchases of the securities represented by the MXEU, shares of the EEM, or over-the-counter derivative instruments linked to the Basket Components.

SUPPLEMENTAL DISCUSSION OF
U.S. FEDERAL INCOME TAX CONSEQUENCES

The following disclosure supplements, and to the extent inconsistent supersedes, the discussion in the product prospectus supplement dated January 11, 2016 under "Supplemental Discussion of U.S. Federal Income Tax Consequences."

Under Section 871(m) of the Code, a "dividend equivalent" payment is treated as a dividend from sources within the United States. Such payments generally would be subject to a 30% U.S. withholding tax if paid to a non-U.S. holder. Under U.S. Treasury Department regulations, payments (including deemed payments) with respect to equity-linked instruments ("ELIs") that are "specified ELIs" may be treated as dividend equivalents if such specified ELIs reference an interest in an "underlying security," which is generally any interest in an entity taxable as a corporation for U.S. federal income tax purposes if a payment with respect to such interest could give rise to a U.S. source dividend. However, U.S. Treasury Department regulations provide that withholding on dividend equivalent payments will not apply to specified ELIs that are not delta-one instruments and that are issued before January 1, 2018. Based on our determination that the Notes are not delta-one instruments, non-U.S. holders should not be subject to withholding on dividend equivalent payments, if any, under the Notes. However, it is possible that the Notes could be treated as deemed reissued for U.S. federal income tax purposes upon the occurrence of certain events affecting a Basket Component or the Notes, and following such occurrence the Notes could be treated as subject to withholding on dividend equivalent payments. Non-U.S. holders that enter, or have entered, into other transactions in respect of a Basket Component or the Notes should consult their tax advisors as to the application of the dividend equivalent withholding tax in the context of the Notes and their other transactions. If any payments are treated as dividend equivalents subject to withholding, we (or the applicable withholding agent) would be entitled to withhold taxes without being required to pay any additional amounts with respect to amounts so withheld.

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SUPPLEMENTAL PLAN OF DISTRIBUTION

Delivery of the Notes will be made against payment for the Notes on July 24, 2017, which is the third business day following the Pricing Date (this settlement cycle being referred to as "T+3"). See "Plan of Distribution" in the prospectus dated January 8, 2016. For additional information as to the relationship between us and RBC Capital Markets, LLC, please see the section "Plan of Distribution—Conflicts of Interest" in the prospectus dated January 8, 2016.

In the initial offering of the Notes, they will be offered to investors at a purchase price equal to par, except with respect to certain accounts as indicated on the cover page of this document.

The value of the Notes shown on your account statement may be based on RBCCM's estimate of the value of the Notes if RBCCM or another of our affiliates were to make a market in the Notes (which it is not obligated to do). That estimate will be based upon the price that RBCCM may pay for the Notes in light of then prevailing market conditions, our creditworthiness and transaction costs. For a period of approximately 6 months after the issue date of the Notes, the value of the Notes that may be shown on your account statement may be higher than RBCCM's estimated value of the Notes at that time. This is because the estimated value of the Notes will not include the underwriting discount and our hedging costs and profits; however, the value of the Notes shown on your account statement during that period may be a higher amount, reflecting the addition of RBCCM's underwriting discount and our estimated costs and profits from hedging the Notes. This excess is expected to decrease over time until the end of this period. After this period, if RBCCM repurchases your Notes, it expects to do so at prices that reflect their estimated value.

STRUCTURING THE NOTES

The Notes are our debt securities, the return on which is linked to the performance of the Basket Components. As is the case for all of our debt securities, including our structured notes, the economic terms of the Notes reflect our actual or perceived creditworthiness at the time of pricing. In addition, because structured notes result in increased operational, funding and liability management costs to us, we typically borrow the funds under these Notes at a rate that is more favorable to us than the rate that we might pay for a conventional fixed or floating rate debt security of comparable maturity. Using this relatively lower implied borrowing rate rather than the secondary market rate, is a factor that reduced the initial estimated value of the Notes at the time their terms were set. Unlike the estimated value included in this pricing supplement, any value of the Notes determined for purposes of a secondary market transaction may be based on a different funding rate, which may result in a lower value for the Notes than if our initial internal funding rate were used.

In order to satisfy our payment obligations under the Notes, we may choose to enter into certain hedging arrangements (which may include call options, put options or other derivatives) on the issue date with RBCCM or one of our other subsidiaries. The terms of these hedging arrangements take into account a number of factors, including our creditworthiness, interest rate movements, the volatility of the Basket Components, and the tenor of the Notes. The economic terms of the Notes and their initial estimated value depend in part on the terms of these hedging arrangements.

The lower implied borrowing rate is a factor that reduced the economic terms of the Notes to you. The initial offering price of the Notes also reflects the underwriting commission and our estimated hedging costs. These factors resulted in the initial estimated value for the Notes on the Pricing Date being less than their public offering price. See "Selected Risk Considerations—The Initial Estimated Value of the Notes Is Less than the Price to the Public" above.

Barrier Enhanced Return Notes
Linked to a Basket of One Equity Index
and One Exchange Traded Fund
Due July 24, 2020

VALIDITY OF THE NOTES

In the opinion of Norton Rose Fulbright Canada LLP, the issue and sale of the Notes has been duly authorized by all necessary corporate action of the Bank in conformity with the Indenture, and when the Notes have been duly executed, authenticated and issued in accordance with the Indenture and delivered against payment therefor, the Notes will be validly issued and, to the extent validity of the Notes is a matter governed by the laws of the Province of Ontario or Québec, or the laws of Canada applicable therein, and will be valid obligations of the Bank, subject to equitable remedies which may only be granted at the discretion of a court of competent authority, subject to applicable bankruptcy, to rights to indemnity and contribution under the Notes or the Indenture which may be limited by applicable law; to insolvency and other laws of general application affecting creditors' rights, to limitations under applicable limitations statutes, and to limitations as to the currency in which judgments in Canada may be rendered, as prescribed by the Currency Act (Canada). This opinion is given as of the date hereof and is limited to the laws of the Provinces of Ontario and Québec and the federal laws of Canada applicable thereto. In addition, this opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and certain factual matters, all as stated in the letter of such counsel dated January 8, 2016, which has been filed as Exhibit 5.1 to Royal Bank's Form 6-K filed with the SEC dated January 8, 2016.

In the opinion of Morrison & Foerster LLP, when the Notes have been duly completed in accordance with the Indenture and issued and sold as contemplated by the prospectus supplement and the prospectus, the Notes will be valid, binding and enforceable obligations of Royal Bank, entitled to the benefits of the Indenture, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith). This opinion is given as of the date hereof and is limited to the laws of the State of New York. This opinion is subject to customary assumptions about the Trustee's authorization, execution and delivery of the Indenture and the genuineness of signatures and to such counsel's reliance on the Bank and other sources as to certain factual matters, all as stated in the legal opinion dated January 8, 2016, which has been filed as Exhibit 5.2 to the Bank's Form 6-K dated January 8, 2016.