

TEMPUR SEALY INTERNATIONAL, INC.  
Form 10-Q  
November 04, 2016

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, 2016

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

33-1022198

(State or other jurisdiction of incorporation or organization) (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  Smaller reporting company   
(Do not check if a 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 October 31, 2016 was 57,900,644 shares.



Table of Contents

Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q, including the information incorporated by reference herein, contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which includes information concerning one or more of our plans; objectives; goals; strategies; future events; future revenues or performance; our implementation of our key strategic priorities and anticipated resulting growth in our sales, earnings and cash flow in both the U.S. and internationally on our business segments; uncertainties arising from global events; general economic, financial and industry conditions, particularly in the retail sector, as well as consumer confidence and the availability of consumer financing; competition in our industry; consumer acceptance of our products; the ability to continuously improve and expand our product line, maintain efficient, timely and cost-effective production and delivery of products, and manage growth; the ability to expand brand awareness, distribution and new products; the efficiency and effectiveness of our advertising campaigns and other marketing programs; the ability to increase sales productivity within existing retail accounts and to further penetrate the retail channel, including the timing of opening or expanding within large retail accounts and the timing and success of product launches; the effects of consolidation of retailers on revenues and costs; changes in demand for the Company's products by significant retailer customers; the effects of strategic investments on our operations, including our efforts to expand our global market share; changing commodity costs; changes in product and channel mix and the impact on the Company's gross margin; initiatives to improve gross margin and operating margin; our capital structure and increased debt level, including our ability to meet financial obligations and continue to comply with the terms and financial ratio covenants of our credit facilities; changes in interest rates; changes in foreign tax rates and changes in tax laws generally, including the ability to utilize tax loss carry forwards; effects of changes in foreign exchange rates on our reported earnings; the outcome of pending tax audits or other tax, regulatory or litigation proceedings and similar issues; the effect of future legislative or regulatory changes; financial flexibility; our expected sources of cash flow; our expected level of capital expenditures for 2016 and changes in capital expenditures; expectations regarding the impact of costs from headcount reductions and international store closures; and our ability to effectively manage cash. 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," "guidance," "anticipates," "proposed," "projects," "plans," "intends," "believes" and variations of such words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct.

There are a number of risks, uncertainties and other 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 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2015 and the risks identified in ITEM 1A of this Report. 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.



TABLE OF CONTENTS

	Page
<u>Special Note Regarding Forward-Looking Statements</u>	<u>2</u>
 <u>PART I. FINANCIAL INFORMATION</u>	
<u>ITEM 1. Financial Statements</u>	
<u>Condensed Consolidated Statements of Income</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Income</u>	<u>5</u>
<u>Condensed Consolidated Balance Sheets</u>	<u>6</u>
<u>Condensed Consolidated Statements of Cash Flows</u>	<u>7</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>8</u>
 <u>ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	 <u>32</u>
 <u>ITEM 3. Quantitative and Qualitative Disclosures About Market Risk</u>	 <u>51</u>
 <u>ITEM 4. Controls and Procedures</u>	 <u>52</u>
 <u>PART II. OTHER INFORMATION</u>	
 <u>ITEM 1. Legal Proceedings</u>	 <u>52</u>
 <u>ITEM 1A. Risk Factors</u>	 <u>52</u>
 <u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	 <u>52</u>
 <u>ITEM 3. Defaults upon Senior Securities</u>	 <u>53</u>
 <u>ITEM 4. Mine Safety Disclosures</u>	 <u>53</u>
 <u>ITEM 5. Other Information</u>	 <u>53</u>
 <u>ITEM 6. Exhibits</u>	 <u>54</u>
 <u>Signatures</u>	 <u>55</u>

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Table of Contents

## 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, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net sales	\$832.4	\$880.0	\$2,357.8	\$2,383.9
Cost of sales	470.3	520.4	1,367.8	1,448.1
Gross profit	362.1	359.6	990.0	935.8
Selling and marketing expenses	175.2	175.6	498.1	498.0
General, administrative and other expenses	64.0	79.8	207.6	242.6
Equity income in earnings of unconsolidated affiliates	(2.4 )	(2.0 )	(8.6 )	(8.4 )
Royalty income, net of royalty expense	(5.8 )	(4.7 )	(15.1 )	(13.7 )
Operating income	131.1	110.9	308.0	217.3
Other expense, net:				
Interest expense, net	20.5	33.2	65.0	74.1
Loss on extinguishment of debt	—	—	47.2	—
Other expense, net	0.3	11.8	—	12.7
Total other expense, net	20.8	45.0	112.2	86.8
Income before income taxes	110.3	65.9	195.8	130.5
Income tax provision	(33.7 )	(25.0 )	(60.2 )	(43.6 )
Net income before non-controlling interest	76.6	40.9	135.6	86.9
Less: Net (loss) income attributable to non-controlling interest <sup>(1),(2)</sup>	(1.2 )	0.7	(3.1 )	2.1
Net income attributable to Tempur Sealy International, Inc.	\$77.8	\$40.2	\$138.7	\$84.8
Earnings per common share:				
Basic	\$1.34	\$0.65	\$2.31	\$1.38
Diluted	\$1.32	\$0.64	\$2.28	\$1.36
Weighted average common shares outstanding:				
Basic	58.2	62.1	60.1	61.4
Diluted	58.8	62.9	60.8	62.5

Net (loss) income attributable to the Company's redeemable non-controlling interest in Comfort Revolution, LLC for the three months ended September 30, 2016 and 2015 represented \$(1.2) million and \$0.5 million, respectively.

(1) Net (loss) income attributable to the Company's redeemable non-controlling interest in Comfort Revolution, LLC for the nine months ended September 30, 2016 and 2015 represented \$(3.1) million and \$1.0 million, respectively.

(2) As of September 30, 2015, the redemption value exceeded the accumulated earnings of the Company's redeemable non-controlling interest in Comfort Revolution, LLC. Accordingly, for the three and nine months ended September 30, 2015, the Company recorded a \$0.2 million and \$1.1 million adjustment, net of tax, respectively, to adjust the carrying value of redeemable non-controlling interest to its redemption value. As of September 30, 2016, the

accumulated earnings exceeded the redemption value and, accordingly, a redemption value adjustment was not necessary for the three or nine months ended September 30, 2016.

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(\$ in millions)

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net income before non-controlling interest	\$76.6	\$40.9	\$135.6	\$86.9
Other comprehensive (loss) income before tax, net of tax				
Foreign currency translation adjustments	(5.0 )	(19.0 )	11.8	(49.4 )
Net change in unrecognized gain on interest rate swap, net of tax	—	0.2	—	0.5
Pension expense, net of tax	—	—	—	(0.1 )
Unrealized (loss) gain on cash flow hedging derivatives, net of tax	(0.2 )	3.2	(6.1 )	4.4
Other comprehensive (loss) income, net of tax	(5.2 )	(15.6 )	5.7	(44.6 )
Comprehensive income	71.4	25.3	141.3	42.3
Less: Comprehensive (loss) income attributable to non-controlling interest <sup>(1),(2)</sup>	(1.2 )	0.7	(3.1 )	2.1
Comprehensive income attributable to Tempur Sealy International, Inc.	\$72.6	\$24.6	\$144.4	\$40.2

- Net (loss) income attributable to the Company's redeemable non-controlling interest in Comfort Revolution, LLC for the three months ended September 30, 2016 and 2015 represented \$(1.2) million and \$0.5 million, respectively.
- (1) Net (loss) income attributable to the Company's redeemable non-controlling interest in Comfort Revolution, LLC for the nine months ended September 30, 2016 and 2015 represented \$(3.1) million and \$1.0 million, respectively. As of September 30, 2015, the redemption value exceeded the accumulated earnings of the Company's redeemable non-controlling interest in Comfort Revolution, LLC. Accordingly, for the three and nine months ended September 30, 2015, the Company recorded a \$0.2 million and \$1.1 million adjustment, net of tax, respectively, to adjust the carrying value of redeemable non-controlling interest to its redemption value.
- (2) As of September 30, 2016, the accumulated earnings exceeded the redemption value and, accordingly, a redemption value adjustment was not necessary for the three or nine months ended September 30, 2016.

See accompanying Notes to Condensed Consolidated Financial Statements.



Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(\$ in millions)

	September 30, 2016	December 31, 2015
	(Unaudited)	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 89.0	\$ 153.9
Accounts receivable, net	404.3	379.4
Inventories, net	214.3	199.2
Prepaid expenses and other current assets	61.7	76.6
Total Current Assets	769.3	809.1
Property, plant and equipment, net	365.1	361.7
Goodwill	719.7	709.4
Other intangible assets, net	686.3	695.4
Deferred income taxes	25.4	12.2
Other non-current assets	180.4	67.7
Total Assets	\$ 2,746.2	\$ 2,655.5
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 237.9	\$ 266.3
Accrued expenses and other current liabilities	285.1	254.0
Income taxes payable	23.1	11.2
Current portion of long-term debt	66.1	181.5
Total Current Liabilities	612.2	713.0
Long-term debt, net	1,619.0	1,273.3
Deferred income taxes	192.2	195.4
Other non-current liabilities	162.2	171.2
Total Liabilities	2,585.6	2,352.9
Commitments and contingencies—see Note 8		
Redeemable non-controlling interest	9.3	12.4
Total Stockholders' Equity	151.3	290.2
Total Liabilities, Redeemable Non-Controlling Interest and Stockholders' Equity	\$ 2,746.2	\$ 2,655.5

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(\$ in millions)

(unaudited)

	Nine Months Ended September 30,	
	2016	2015
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income before non-controlling interest	\$135.6	\$86.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	54.3	54.9
Amortization of stock-based compensation	15.3	16.4
Amortization of deferred financing costs	3.0	18.7
Bad debt expense	3.2	4.4
Deferred income taxes	(15.7 )	(21.4 )
Dividends received from unconsolidated affiliates	7.3	3.0
Equity income in earnings of unconsolidated affiliates	(8.6 )	(8.4 )
Non-cash interest expense on 8.0% Sealy Notes	4.0	4.5
Loss on extinguishment of debt	47.2	—
Loss on sale of assets	0.8	1.2
Foreign currency adjustments and other	(1.5 )	4.7
Changes in operating assets and liabilities	(135.1 )	(31.7 )
Net cash provided by operating activities	109.8	133.2
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment	(41.9 )	(51.1 )
Proceeds from disposition of business and other	—	6.9
Net cash used in investing activities	(41.9 )	(44.2 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from borrowings under long-term debt obligations	1,871.5	855.4
Repayments of borrowings under long-term debt obligations	(1,659.3)	(974.4)
Proceeds from exercise of stock options	15.2	16.7
Excess tax benefit from stock-based compensation	6.0	19.7
Treasury stock repurchased	(319.7 )	(1.3 )
Payment of deferred financing costs	(6.6 )	(6.4 )
Fees paid to lenders	(7.8 )	—
Call premium on 2020 Senior Notes	(23.6 )	—
Proceeds from purchase of treasury shares by CEO	—	5.0
Other	0.1	(2.1 )
Net cash used in financing activities	(124.2 )	(87.4 )
<b>NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>	<b>(8.6 )</b>	<b>7.7</b>
(Decrease) increase in cash and cash equivalents	(64.9 )	9.3
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	<b>153.9</b>	<b>62.5</b>
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<b>\$89.0</b>	<b>\$71.8</b>

Supplemental cash flow information:

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Cash paid during the period for:

Interest	\$41.0	\$41.6
Income taxes, net of refunds	57.2	64.6

See accompanying Notes to Condensed Consolidated Financial Statements.

7

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Table of Contents

TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (unaudited)

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation and Description 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® and Stearns & Foster® brands, technology and trademarks to other manufacturers. The Company sells its products through two sales channels: Retail and Other.

The Company's Condensed Consolidated Financial Statements include the results of Comfort Revolution, LLC ("Comfort Revolution"), a 45.0% owned joint venture. Comfort Revolution constitutes a variable interest entity ("VIE") 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. The operations of Comfort Revolution are not material to the Company's Condensed Consolidated Financial Statements.

The Company also has ownership interests in a group of Asia-Pacific joint ventures to develop markets for Sealy® branded products in those regions. The Company's ownership interest in these joint ventures is 50.0%. The equity method of accounting is used for these joint ventures, over which the Company has significant influence but does not have control, and consolidation is not otherwise required. The Company's carrying value in its equity method investments of \$14.9 million and \$13.6 million at September 30, 2016 and December 31, 2015, respectively, are recorded in other non-current assets within the accompanying Condensed Consolidated Balance Sheets. The Company's share of earnings is recorded as equity income in earnings of unconsolidated affiliates in the accompanying Condensed Consolidated Statements of Income.

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, 2015, included in the Company's Annual Report on Form 10-K filed on February 12, 2016.

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

	September	December
	30,	31,
(in millions)	2016	2015
Finished goods	\$ 137.3	\$ 126.7
Work-in-process	12.4	14.0

Raw materials and supplies	64.6	58.5
	\$ 214.3	\$ 199.2

(c) 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.

8

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Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

The Company had the following activity for sales returns from December 31, 2015 to September 30, 2016:  
(in millions)

Balance as of December 31, 2015	\$28.5
Amounts accrued	100.6
Returns charged to accrual	(96.2 )
Balance as of September 30, 2016	\$32.9

(d) Warranties. The Company provides warranties on certain products, which vary by segment, product and brand. Estimates of warranty expenses are based primarily on historical claims experience and product testing. Estimated future obligations related to these products are charged to cost of sales in the period in which the related revenue is recognized. In estimating its warranty obligations, the Company considers the impact of recoverable salvage value on warranty costs in determining its estimate of future warranty obligations.

The Company provides warranties on mattresses with varying warranty terms. Tempur mattresses sold in the North America segment and all Sealy mattresses have warranty terms ranging from 10 to 25 years, generally non-prorated for the first 10 to 15 years and then prorated for the balance of the warranty term. Tempur mattresses sold in the International segment have warranty terms ranging from 5 to 15 years, non-prorated for the first 5 years and then prorated on a straight-line basis for the last 10 years of the warranty term. Tempur pillows have a warranty term of 3 years, non-prorated.

The Company had the following activity for its accrued warranty expense from December 31, 2015 to September 30, 2016:

(in millions)

Balance as of December 31, 2015	\$29.6
Amounts accrued	29.2
Warranties charged to accrual	(25.5 )
Balance as of September 30, 2016	\$33.3

As of September 30, 2016 and December 31, 2015, \$17.8 million and \$14.9 million of accrued warranty expense is included as a component of accrued expenses and other current liabilities and \$15.5 million and \$14.7 million of accrued warranty expense is included in other non-current liabilities on the Company's accompanying Condensed Consolidated Balance Sheets, respectively.

(e) Revenue Recognition. Sales of products are recognized when persuasive evidence of an arrangement exists, 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 at the time revenue is recognized based on historical experience. 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.

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's 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 and 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 customer 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 \$22.8 million and \$23.3 million as of September 30, 2016 and December 31, 2015, respectively.

Table of Contents

TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

(f) Cooperative Advertising, Rebate and Other Promotional Programs. The Company enters into agreements with customers to provide funds for advertising and promotions. The Company also enters into volume and other rebate programs with customers. When sales are made to these customers, the Company records liabilities pursuant to these agreements. The Company periodically assesses these liabilities based on actual sales and claims to determine whether all of the cooperative advertising earned will be used by the customer or whether the customer will meet the requirements to receive rebate funds. The Company generally negotiates these agreements on a customer-by-customer basis. Some of these agreements extend over several years. Significant estimates are required at any point in time with regard to the ultimate reimbursement to be claimed by the customers. Subsequent revisions to these estimates are recorded and charged to earnings in the period in which they are identified. Rebates and cooperative advertising are classified as a reduction of revenue and presented within net sales on the accompanying Condensed Consolidated Statements of Income. Certain cooperative advertising expenses are reported as components of selling and marketing expenses in the accompanying Condensed Consolidated Statements of Income because the Company receives an identifiable benefit and the fair value of the advertising benefit can be reasonably estimated.

(g) Derivative Financial Instruments. Derivative financial instruments are used in the normal course of business to manage interest rate and foreign currency exchange risks. 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. For all transactions designated as hedges, the hedging relationships are formally documented at the inception and on an ongoing basis in offsetting changes in cash flows of the hedged transaction.

The Company records derivative financial instruments on the Condensed Consolidated Balance Sheets as either an asset or liability measured at its fair value. Changes in a derivative's fair value (i.e. unrealized gains or losses) are recorded each period in earnings or other comprehensive income ("OCI"), depending on whether the derivative is designated and is effective as a hedged transaction, and on the type of hedging relationship.

For derivative financial instruments that are designated as a hedge, unrealized gains and losses related to the effective portion are either recognized in income immediately to offset the realized gain or loss on the hedged item, or are deferred and reported as a component of accumulated other comprehensive loss ("AOCL") in stockholders' equity and subsequently recognized in net income when the hedged item affects net income. The change in fair value of the ineffective portion of a derivative financial instrument is recognized in net income immediately. For derivative instruments that are not designated as hedges, the gain or loss related to the change in fair value is also recorded to net income immediately.

The Company manages a portion of the risk associated with fluctuations in foreign currencies related to intercompany and third party inventory purchases denominated in foreign currencies through foreign exchange forward contracts designated as cash flow hedges. As of September 30, 2016, the Company had foreign exchange forward contracts designated as cash flow hedges to buy U.S. dollars and to sell Canadian dollars with a notional amount outstanding of \$42.1 million. These foreign exchange forward contracts have maturities ranging from October 2016 to September 2017. The effectiveness of the cash flow hedge contracts, including time value, is assessed prospectively and retrospectively on a monthly basis using regression analysis, as well as other timing and probability criteria. The effective portion of the cash flow hedge contracts' gains or losses resulting from changes in the fair value of these hedges is initially reported, net of tax, as a component of AOCL until the underlying hedged item is reflected in the Company's accompanying Condensed Consolidated Statements of Income, at which time the effective amount in AOCL is reclassified to cost of sales in the accompanying Condensed Consolidated Statements of Income. The



Company expects to reclassify a gain of approximately \$0.5 million, net of tax, over the next 12 months based on September 30, 2016 exchange rates.

The Company is also exposed to foreign currency risk related to intercompany debt and associated interest payments and certain intercompany accounts receivable and accounts payable. To manage the risk associated with fluctuations in foreign currencies related to these assets and liabilities, the Company enters into foreign exchange forward contracts. The Company considers these contracts to be economic hedges. Accordingly, changes in the fair value of these instruments affect earnings during the current period. These foreign exchange forward contracts protect against the reduction in value of forecasted foreign currency cash flows resulting from payments in foreign currencies.

(h) Income Taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Deferred tax assets are also recognized for the estimated future effects of tax loss carry forwards. The effect of changes in tax rates on deferred taxes is recognized in the period in which any such

Table of Contents

TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

change is enacted. Valuation allowances are established when necessary on a jurisdictional basis to reduce deferred tax assets to the amounts expected to be realized. The Company accounts for uncertain foreign and domestic tax positions utilizing a proscribed recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

(i) Pensions. The Company contributed \$10.0 million to its U.S. defined benefit pension plan in the second quarter of 2016.

(j) German Regulatory Investigation. For the three and nine months ended September 30, 2015, the Company recognized expense of \$17.4 million (€15.5 million) related to the settlement of the antitrust investigation by the German Federal Cartel Office ("FCO") regarding vertical price fixing, which is presented within other expense, net in the accompanying Condensed Consolidated Statements of Income. This matter is fully resolved and all amounts were paid to the FCO in 2015.

(k) Subsequent Events. During October 2016, the Company initiated certain restructuring activities, including moving to a more centralized structure and store closures, primarily in the Company's International segment. During the three months ending December 31, 2016, the Company expects to incur approximately \$7.0 million of expense related to these restructuring activities.

(2) Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue From Contracts With Customers, that outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. This ASU is based on the core principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This ASU also requires disclosures sufficient to enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative disclosures about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. Entities have the option of using either a full retrospective or a modified retrospective approach for the adoption of the new standard. This ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period. The Company is currently evaluating this ASU to determine the Company's adoption method and the impact it will have on the Company's Condensed Consolidated Financial Statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases, that requires lessees to recognize most leases on the balance sheet and provides for expanded disclosures on key information about leasing arrangements. This ASU is effective for interim and annual periods beginning after December 15, 2018, however early adoption is permitted. In transition, entities are required to use a modified retrospective approach for the adoption of this ASU. The Company is currently evaluating this ASU to determine the impact it will have on the Company's Condensed Consolidated Financial Statements.

In March 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, that simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and the classification on the statement of cash

flows. Entities should use a modified retrospective approach when adopting amendments related to the timing of excess tax benefit recognition, minimum statutory withholding requirements and forfeitures, and a retrospective approach when adopting amendments related to recognition of excess tax benefits and tax deficiencies in the income statement; and entities have the option of using a prospective or a retrospective transition approach when adopting amendments related to the presentation of excess tax benefits on the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2016, including interim periods within that reporting period. The Company is currently evaluating this ASU to determine the Company's adoption method and the impact it will have on the Company's Condensed Consolidated Financial Statements.

(3) Goodwill

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

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

(in millions)	North America	International	Consolidated
Balance as of December 31, 2015	\$ 562.8	\$ 146.6	\$ 709.4
Foreign currency translation	3.4	6.9	10.3
Balance as of September 30, 2016	\$ 566.2	\$ 153.5	\$ 719.7

## (4) Debt

Debt for the Company consists of the following:

(in millions, except percentages)	September 30, 2016		December 31, 2015		Maturity Date
Debt:	Amount	Rate	Amount	Rate	
2016 Credit Agreement					
Term A Facility	\$592.5	(1)	\$—	N/A	April 6, 2021
2012 Credit Agreement					
Term A Facility	—	N/A	409.4	(2)	
Term B Facility	—	N/A	100.1	(3)	
2026 Senior Notes	600.0	5.500%	—	N/A	June 15, 2026
2023 Senior Notes	450.0	5.625%	450.0	5.625%	October 15, 2023
2020 Senior Notes	—	N/A	375.0	6.875%	
8.0% Sealy Notes	—	8.0%	111.1	8.0%	
Capital lease obligations and other	53.5		34.0		Various
Total debt	1,696.0		1,479.6		
Less: deferred financing costs	(10.9 )		(24.8 )		
Total debt, net	1,685.1		1,454.8		
Less: current portion	(66.1 )		(181.5 )		
Total long-term debt, net	\$1,619.0		\$1,273.3		

(1)Interest at LIBOR plus applicable margin of 1.50% as of September 30, 2016.

(2)Interest at LIBOR plus applicable margin of 2.00% as of December 31, 2015.

(3)Interest at LIBOR, subject to a 0.75% floor plus applicable margin of 2.75% as of December 31, 2015.

The Company is in compliance with all applicable covenants as of September 30, 2016.

## 2016 Credit Agreement

On April 6, 2016, the Company entered into a senior secured credit agreement ("2016 Credit Agreement") with a syndicate of banks. The 2016 Credit Agreement replaced the Company's 2012 Senior Secured Credit Agreement ("2012 Credit Agreement"). The 2016 Credit Agreement provides for a \$500.0 million revolving credit facility, a \$500.0 million initial term loan facility and a \$100.0 million delayed draw term loan facility. At any time, the Company may also elect to request the establishment of one or more incremental term loan facilities and/or increase commitments under the revolving credit facility in an aggregate amount of up to \$500.0 million. A portion of the revolving credit facility of up to \$250.0 million is available in Canadian Dollars, Pounds Sterling, the Euro and any additional currencies determined by mutual agreement of the Company, the Agent and the lenders under the revolving credit facility. A portion of the revolving credit facility of up to \$100.0 million is available for the issuance of letters of credit for the account of the Company and a portion of the revolving credit facility of up to \$50.0 million is available for swing line loans to the Company.

Borrowings under the 2016 Credit Agreement will generally bear interest, at the election of Tempur Sealy International and the other subsidiary borrowers, at either (i) LIBOR plus the applicable margin or (ii) Base Rate plus the applicable margin. The applicable margins are determined by a pricing grid based on the consolidated total net leverage ratio of the Company following

12

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Table of Contents

TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

the delivery of the consolidated financial statements of the Company for the most recent quarter. The delayed draw term loan facility has identical pricing to the revolving credit facility and initial term loan facility. For the period ended September 30, 2016, the margin was either (i) LIBOR plus 1.50% per annum (ii) Base Rate plus 0.50%.

Obligations under the 2016 Credit Agreement are guaranteed by the Company's existing and future direct and indirect wholly-owned domestic subsidiaries, subject to certain exceptions. The 2016 Credit Agreement is secured by a security interest in substantially all of Tempur Sealy International's and the other subsidiary 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 2016 Credit Agreement requires compliance with certain financial covenants providing for maintenance of a minimum consolidated interest coverage ratio, maintenance of a maximum consolidated total net leverage ratio, and maintenance of a maximum consolidated secured 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 other short-term debt. The Company is allowed to subtract from consolidated funded debt an amount equal to 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, 2016, domestic qualified cash was \$33.8 million and foreign qualified cash was \$33.1 million.

The 2016 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 2016 Credit Agreement also contains certain customary affirmative covenants and events of default, including upon a change of control.

The Company is required to pay a commitment fee on the unused portion of the revolving credit facility. The commitment fee rate is determined by a pricing grid based on the consolidated total net leverage ratio of the Company. The commitment fee is payable quarterly in arrears following the delivery of consolidated financial statements for the most recent quarter and on the date of termination or expiration of the commitments under the revolving credit facility. The Company and the other borrowers also pay customary letter of credit issuance and other fees under the 2016 Credit Agreement. For the period ended September 30, 2016, the Company's commitment fee rate was 0.25%.

As a result of the Company's 2016 Credit Agreement, \$3.6 million of deferred financing costs were capitalized in the second quarter of 2016 and will be amortized as interest expense over the respective debt instrument period, 5 years, using the effective interest method. In addition, the Company expensed \$1.9 million of lender fees associated with this transaction in the second quarter of 2016, which is included in loss on extinguishment of debt in the Condensed Consolidated Statement of Income.

#### 2012 Credit Agreement

The Company used the proceeds from the 2016 Credit Agreement to repay in full and terminate the 2012 Credit Agreement. The 2012 Credit Agreement initially provided for (i) a revolving credit facility of \$350.0 million, (ii) a term A facility of \$550.0 million and (iii) a term B facility of \$870.0 million.

In conjunction with the repayment of all outstanding borrowings on the 2012 Credit Agreement, the Company wrote off approximately \$11.0 million of deferred financing costs in the second quarter of 2016, which is included in loss on extinguishment of debt in the Condensed Consolidated Statement of Income.

#### Senior Notes

##### 2026 Senior Notes

On May 24, 2016, Tempur Sealy International issued \$600.0 million aggregate principal amount of 5.500% senior notes due 2026 (the "2026 Senior Notes") in a private offering 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 2026 Senior Notes were issued pursuant to an indenture, dated as of May 24, 2016 (the "2026 Indenture"), among Tempur Sealy International, certain subsidiaries of Tempur Sealy International as guarantors (the "Combined Guarantor Subsidiaries"),

Table of Contents

TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

and The Bank of New York Mellon Trust Company, N.A., as trustee. The 2026 Senior Notes are general unsecured senior obligations of Tempur Sealy International and are guaranteed on a senior unsecured basis by the Combined Guarantor Subsidiaries. The 2026 Senior Notes mature on June 15, 2026, and interest is payable semi-annually in arrears on each June 15 and December 15, beginning on December 15, 2016. The gross proceeds from the 2026 Senior Notes were used to refinance the \$375.0 million aggregate principal amount of 6.875% senior notes due 2020 (the "2020 Senior Notes") and to pay related fees and expenses, and the remaining funds were used for share repurchase and general corporate purposes.

Tempur Sealy International has the option to redeem all or a portion of the 2026 Senior Notes at any time on or after June 15, 2021. The initial redemption price is 102.750% of the principal amount, plus accrued and unpaid interest, if any. The redemption price will decline each year after 2021 until it becomes 100.0% of the principal amount beginning on June 15, 2024. In addition, Tempur Sealy International has the option at any time prior to June 15, 2021 to redeem some or all of the 2026 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 2026 Senior Notes prior to June 15, 2019, under certain circumstances with the net cash proceeds from certain equity offerings, at 105.500% of the principal amount plus accrued and unpaid interest, if any. Tempur Sealy International may make such redemptions as described in the preceding sentence only if, after any such redemption, at least 65.0% of the original aggregate principal amount of the 2026 Senior Notes issued remains outstanding.

The 2026 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.

In conjunction with the issuance and sale of the 2026 Senior Notes, Tempur Sealy International and the Combined Guarantor Subsidiaries agreed through a Registration Rights Agreement to exchange the 2026 Senior Notes for a new issue of substantially identical senior notes registered under the Securities Act (the "Exchange Offer"). On October 18, 2016, Tempur Sealy International completed the Exchange Offer, with 100% of the outstanding notes tendered and received for new 2026 Senior Notes registered under the Securities Act.

As a result of the issuance of the 2026 Senior Notes, \$3.1 million of deferred financing costs were capitalized in the second quarter of 2016 and will be amortized as interest expense over the respective debt instrument period, 10 years, using the effective interest method. In addition, the Company expensed \$5.9 million of lender fees associated with this transaction in the second quarter of 2016, which is included in loss on extinguishment of debt in the Condensed Consolidated Statement of Income.

2020 Senior Notes

The Company used the proceeds from the 2026 Senior Notes to refinance the 2020 Senior Notes and to pay related fees and expenses. The 2020 Senior Notes were redeemed at a price equal to the principal amount thereof and the applicable "make-whole" premium, \$23.6 million, which is included in loss on extinguishment of debt in the



Condensed Consolidated Statement of Income. In conjunction with the refinancing of the 2020 Senior Notes, the Company wrote off approximately \$4.8 million of deferred financing costs in the second quarter of 2016, which is included in loss on extinguishment of debt in the Condensed Consolidated Statement of Income.

#### Repayment of 8.0% Sealy Notes

In July 2016, the Company paid a total of approximately \$115.0 million in cash to holders of the 8.0% Senior Secured Third Lien Convertible Notes issued by Sealy Corporation and Sealy Mattress Company (the "8.0% Sealy Notes") who properly converted their 8.0% Sealy Notes in advance of the maturity date, pursuant to the terms of the 8.0% Sealy Notes.

In connection with the repayment of the 8.0% Sealy Notes, on July 14, 2016, the Company also borrowed \$100.0 million using the delayed draw term loan facility under the Company's 2016 Credit Agreement. The commitment to provide the delayed draw term loan facility terminated with its funding.

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## (5) Fair Value Measurements

The fair value of the foreign exchange forward contracts is calculated using standard industry models based on observable forward points and discount curves. The fair values of all derivative instruments are adjusted for credit risk and restrictions and other terms specific to the contracts.

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 measurements. There were no transfers between levels for the nine months ended September 30, 2016 or the year ended December 31, 2015. The fair value of the Company's financial instruments which are recorded on a recurring basis at fair value are not material.

Financial instruments, although not recorded at fair value on a recurring basis, include cash and cash equivalents, accounts receivable, accounts payable, and the Company's debt obligations. 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 and 2016 Credit Agreement are at variable interest rates and accordingly their carrying amounts approximate fair value. The fair values of the following material financial instruments were based on Level 2 inputs estimated using discounted cash flows and market-based expectations for interest rates, credit risk, and the contractual terms of the debt instruments. The fair values of material financial instruments are as follows:

	Fair Value	
(in millions)	September 30, 2016	December 31, 2015
2020 Senior Notes	\$ —	\$ 393.8
2023 Senior Notes	477.4	53.4
2026 Senior Notes	618.0	—
8.0% Sealy Notes	—	112.7

## (6) Stockholder's Equity

(a) Common Stock. Tempur Sealy International has 300.0 million authorized shares of common stock with \$0.01 per share par value 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.

(b) Treasury Stock. On February 1, 2016, the Board authorized a new share repurchase authorization of up to \$200.0 million of Tempur Sealy International's common stock. On both June 7, 2016 and July 27, 2016, the Board increased the authorization under the Company's share repurchase program by an additional \$200.0 million. As of September 30, 2016, the Company had repurchased 5.2 million shares for approximately \$317.7 million under the share repurchase authorization. As of September 30, 2016, the Company had approximately \$280 million remaining under the existing share repurchase authorization.

In addition, the Company acquired 0.1 million shares upon the vesting of certain performance restricted stock units ("PRSUs"), which were withheld to satisfy tax withholding obligations during the nine months ended September 30, 2016 and 2015, respectively. The shares withheld were valued at the closing price of the common stock on the New York Stock Exchange on the vesting date or first business day thereafter, resulting in approximately \$2.0 million and

\$1.3 million in treasury stock acquired during the nine months ended September 30, 2016 and 2015, respectively.

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

(c) Accumulated Other Comprehensive Loss. AOCL consisted of the following:

(in millions)	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
Foreign Currency Translation				
Balance at beginning of period	\$(98.6 )	\$(84.4 )	\$(115.4)	\$(54.0 )
Other comprehensive (loss) income:				
Foreign currency translation adjustments <sup>(1)</sup>	(5.0 )	(19.0 )	11.8	(49.4 )
Balance at end of period	\$(103.6)	\$(103.4)	\$(103.6)	\$(103.4)
Interest Rate Swap Agreement				
Balance at beginning of period	\$—	\$(0.4 )	\$—	\$(0.7 )
Other comprehensive income (loss):				
Net change from period revaluations	—	0.8	—	2.3
Tax expense <sup>(2)</sup>	—	(0.3 )	—	(0.9 )
Total other comprehensive income before reclassifications, net of tax	\$—	\$0.5	\$—	\$1.4
Net amount reclassified to earnings <sup>(3)</sup>	—	(0.5 )	—	(1.5 )
Tax benefit <sup>(2)</sup>	—	0.2	—	0.6
Total amount reclassified from AOCL, net of tax	\$—	\$(0.3 )	\$—	\$(0.9 )
Total other comprehensive income, net of tax	—	0.2	—	0.5
Balance at end of period	\$—	\$(0.2 )	\$—	\$(0.2 )
Pensions				
Balance at beginning of period	\$(1.4 )	\$(2.5 )	\$(1.4 )	\$(2.4 )
Other comprehensive loss:				
Net change from period revaluations, net of tax	—	—	—	(0.1 )
Balance at end of period	\$(1.4 )	\$(2.5 )	\$(1.4 )	\$(2.5 )
Foreign Exchange Forward Contracts				
Balance at beginning of period	\$0.7	\$2.5	\$6.6	\$1.3
Other comprehensive income (loss):				
Net change from period revaluations	0.8	6.6	(4.5 )	11.4
Tax (expense) benefit <sup>(2)</sup>	(0.2 )	(1.7 )	1.2	(2.9 )
Total other comprehensive income (loss) before reclassifications, net of tax	\$0.6	\$4.9	\$(3.3 )	\$8.5
Net amount reclassified to earnings <sup>(4)</sup>	(1.1 )	(2.3 )	(3.8 )	(5.5 )
Tax benefit <sup>(2)</sup>	0.3	0.6	1.0	1.4
Total amount reclassified from AOCL, net of tax	\$(0.8 )	\$(1.7 )	\$(2.8 )	\$(4.1 )
Total other comprehensive (loss) income	(0.2 )	3.2	(6.1 )	4.4
Balance at end of period	\$0.5	\$5.7	\$0.5	\$5.7

(1) In 2016 and 2015, 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.

(4) This amount was included in cost of sales on the accompanying Condensed Consolidated Statements of Income.

(7) Stock-Based Compensation

The Company's stock-based compensation expense for the three and nine months ended September 30, 2016 and 2015 included PRSUs, non-qualified stock options, restricted stock units ("RSUs") and deferred stock units ("DSUs"). A summary of the Company's stock-based compensation expense is presented in the following table.

16

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Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

	Three		Nine	
	Months		Months	
	Ended		Ended	
	September		September	
	30,		30,	
(in millions)	2016	2015	2016	2015
PRSU expense	\$ 1.8	\$ 3.0	\$ 6.0	\$ 10.4
Option expense	1.2	1.4	4.0	4.8
RSU/DSU expense	1.7	0.5	5.3	1.2
Total stock-based compensation expense	\$ 4.7	\$ 4.9	\$ 15.3	\$ 16.4

In the nine months ended September 30, 2016, the Company recorded \$2.0 million of accelerated amortization associated with executive management transition. The Company recorded \$0.9 million and \$4.9 million of accelerated amortization associated with executive management transition for the three and nine months ended September 30, 2015.

The Company has 1.3 million PRSUs outstanding that will vest if the Company achieves more than \$650 million of Adjusted earnings before interest, tax, depreciation and amortization ("EBITDA") for 2017 (the "2017 Aspirational Plan PRSUs"). All of the 2017 Aspirational Plan PRSUs will vest in full if the Company achieves Adjusted EBITDA in 2017 greater than \$650 million. In addition, if this target is not met in 2017 but the Company achieves more than \$650 million in Adjusted EBITDA for 2018, then one-third of the total 2017 Aspirational Plan PRSUs will vest, and the remaining 2017 Aspirational Plan PRSUs will be forfeited. If the Company does not achieve more than \$650 million of Adjusted EBITDA in either 2017 or 2018, then all of the 2017 Aspirational Plan PRSUs will be forfeited. Adjusted EBITDA is defined as the Company's "Consolidated EBITDA" as such term is defined in the Company's 2012 Credit Agreement.

The Company did not record any stock-based compensation expense related to the 2017 Aspirational Plan PRSUs during the three or nine months ended September 30, 2016 or 2015, as it is not considered probable that the Company will achieve the specified performance target as of December 31, 2017 or December 31, 2018. The Company will continue to evaluate the probability of achieving the performance condition in future periods and record the appropriate expense if necessary. Based on the price of the Company's common stock on the grant date, the total unrecognized compensation expense related to this award if the performance target is met for 2017 is \$92.4 million, which would be expensed over the remaining service period if achieving the performance condition becomes probable.

## (8) Commitments and Contingencies

(a) 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. On November 19, 2013, the Company was served for the first time in the case but with an amended petition adding additional class representatives for additional states. The purported classes seek certification of claims under applicable state laws.

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 state laws, interest, attorneys' fees and costs. The purported classes do not seek damages for physical injuries. The Company believes the case lacks merit and intends to defend against the claims vigorously. The Court was scheduled to consider class certification motions in the fourth quarter of 2015; however, the plaintiffs filed a Motion to Amend the Complaint, at which time the Company filed a Motion to Dismiss the Amended Complaint. A hearing on the Motion to Dismiss was held January 28, 2016 and the Court denied in part and granted in part the Company's Motion to Dismiss, allowing certain claims to proceed. The Court considered class certification motions on August 18, 2016, and on September 30, 2016, denied the Plaintiffs' motion for class certification. The plaintiffs have indicated that they will appeal the ruling.

Table of Contents

TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

(b) 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 New Jersey Department of Environmental Protection approval, and the Company 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 does not believe this matter is material to the Company's financial statements.

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. 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 Company is continuing to work with the Connecticut DEEP and is performing additional testing to obtain closure for the lower portion of the site. The Company does not believe the contamination on this site is attributable to the Company's operations, or that it will have a material effect on the Company's financial statements.

In 1998, the Company sold an inactive facility located in Putnam, Connecticut. In 2012, 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 this matter, but intends to vigorously defend the claim of the current owner against the Company.

The Company cannot predict the ultimate timing or costs of the South Brunswick, Oakville and Putnam 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.

(c) Income Tax Assessments. The Company received income tax assessments from the Danish Tax Authority ("SKAT") with respect to the tax years 2001 through 2008 relating to the royalty paid by a U.S. subsidiary of Tempur Sealy International to a Danish subsidiary. For more information please refer to Note 9, "Income Taxes."

(d) Other. 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.

(9) Income Taxes



The Company's effective tax rate for the three months ended September 30, 2016 and 2015 was 30.6% and 37.9%, respectively. The Company's effective tax rate for the nine months ended September 30, 2016 and 2015 was 30.7% and 33.4%, respectively. The Company's income tax rate for the three and nine months ended September 30, 2016 and 2015 differed from the U.S. federal statutory rate of 35.0% principally due to certain foreign income tax rate differentials, state and local income taxes, the production activities deduction, the non-deductibility of the settlement costs related to the antitrust investigation by the German FCO, certain other permanent differences, and changes in the Company's uncertain tax positions.

The Company has received income tax assessments from SKAT with respect to the tax years 2001 through 2008 relating to the royalty paid by a U.S. subsidiary of Tempur Sealy International to a Danish subsidiary. The royalty is paid by the U.S. subsidiary for the right to utilize certain intangible assets owned by the Danish subsidiary in the U.S. production processes. In its assessment, SKAT asserts that the amount of royalty rate paid by the U.S. subsidiary to the Danish subsidiary is not reflective of an arms-length transaction. Accordingly, the tax assessment received from SKAT is based, in part, on a 20% royalty rate, which is substantially higher than that historically used or deemed appropriate by the Company.

Table of Contents

TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

The cumulative total tax assessment at September 30, 2016 for all years for which an assessment has been received (2001 - 2008) is approximately Danish Krone ("DKK") 1,524.5 million, including interest and penalties (\$229.6 million, based on the DKK to USD exchange rate on September 30, 2016). The cumulative total tax assessment at December 31, 2015 for all years for which an assessment had been received up through that date (2001 - 2008) including interest and penalties was approximately DKK 1,363.1 million (\$199.6 million, based on the DKK to USD exchange rate on December 31, 2015). If SKAT continues to issue assessments for each year not currently assessed, the Company expects the aggregate assessments for such years (2009 - 2015) to be in excess of the amounts described above.

The Company and SKAT continued negotiations with respect to this matter in the third quarter of 2016 and the Company expects such negotiations to continue into 2017. At September 30, 2016, the Company's Condensed Consolidated Balance Sheets reflect approximately \$84.7 million for the combined U.S. and Danish income tax impact related to this matter, which includes the foreign exchange impact and additional interest accrued during 2016. In July 2016, the Company put on deposit with SKAT substantially all the Company's estimate of the liability for Danish income tax and related interest (the "Tax Deposit") to mitigate additional interest and foreign exchange exposure related to this matter. The Tax Deposit is included within other non-current assets on the Condensed Consolidated Balance Sheets. The Condensed Consolidated Balance Sheets, including the uncertain income tax liability related to this matter, reflect the Company's evaluation and analysis of the facts, circumstances and information available through September 30, 2016.

If the Company is not successful in defending its position before the Danish National Tax Tribunal (the "Tribunal"), or in the Danish courts or in negotiating a mutually acceptable settlement, there is significant risk that the Company could be required to pay significant amounts to SKAT in excess of any related reserve or Tax Deposit. Such an outcome could have a material adverse impact on the Company's profitability and liquidity. In addition, prior to any ultimate resolution of this issue before the Tribunal or the Danish courts, based on a change in facts and circumstances, the Company may be required to further increase its uncertain tax liability associated with this matter, which could have a material impact on the Company's reported earnings.

From June 2012 through September 30, 2016, SKAT withheld Value Added Tax refunds otherwise owed to the Company, pending resolution of this matter. Total withheld refunds at September 30, 2016 and December 31, 2015 are approximately \$36.0 million and \$26.0 million, respectively, and are included within other non-current assets on the Condensed Consolidated Balance Sheets. Certain of these refunds may ultimately be applied by the Company in full or partial satisfaction of the liability for Danish tax and interest related to the royalty matter discussed herein.

Interest and penalties related to unrecognized tax benefits are recorded in income tax expense. It is reasonably possible that there could be material changes to the amount of uncertain tax positions due to activities of the taxing authorities, settlement of audit issues, reassessment of existing uncertain tax positions, including the Danish tax matter, or the expiration of applicable statute of limitations; however, the Company is not able to estimate the impact of these items at this time. There were no significant changes to the liability for unrecognized tax benefits during the three months ended September 30, 2016.

(10) Major Customers

Mattress Firm Holding Corp. ("Mattress Firm"), which was acquired by Steinhoff International Holdings N.V. in September 2016 and a customer within the North America segment, is our largest customer. In February 2016, Mattress Firm acquired all of the outstanding equity interests in HMK Mattress Holdings, LLC ("Sleepy's"). Sleepy's

has historically been one of the Company's top five customers and, as a result of this acquisition, the combined companies represented 20.6% and 24.0% of the Company's sales for the three months ended September 30, 2016 and 2015, respectively. Sales for the combined companies represented 21.8% and 24.0% of the Company's sales for the nine months ended September 30, 2016 and 2015, respectively.

The top five customers, including the impact of the Mattress Firm acquisition of Sleepy's and prior acquisitions, accounted for approximately 38.9% and 40.9% of the Company's sales for the three months ended September 30, 2016 and 2015, respectively. The top five customers, including the impact of the Mattress Firm acquisitions, accounted for approximately 39.5% and 41.2% of the Company's sales for the nine months ended September 30, 2016 and 2015, respectively. The top five customers, including the impact of the Mattress Firm acquisitions, accounted for approximately 40.6% and 37.7% of accounts receivable, net as of September 30, 2016, and December 31, 2015, respectively.

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## (11) Earnings Per Common Share

The following table sets forth the components of the numerator and denominator for the computation of basic and diluted earnings per share for net income attributable to Tempur Sealy International. As presented on the Company's Condensed Consolidated Statements of Income, the Company has included the effect of the \$0.2 million and \$1.1 million Comfort Revolution redemption value adjustment, net of tax, for the three and nine months ended September 30, 2015 in net income attributable to Tempur Sealy International, Inc. below. As of September 30, 2016, the accumulated earnings exceeded the redemption value and, accordingly, a redemption value adjustment was not necessary for the three or nine months ended September 30, 2016.

	Three Months Ended		Nine Months Ended	
	September 30, 2016	2015	2016	September 30, 2015
(in millions, except per common share amounts)				
Numerator:				
Net income attributable to Tempur Sealy International, Inc.	\$77.8	\$40.2	\$138.7	\$84.8
Denominator:				
Denominator for basic earnings per common share-weighted average shares	58.2	62.1	60.1	61.4
Effect of dilutive securities:				
Employee stock-based compensation	0.6	0.8	0.7	1.1
Denominator for diluted earnings per common share-adjusted weighted average shares	58.8	62.9	60.8	62.5
Basic earnings per common share	\$1.34	\$0.65	\$2.31	\$1.38
Diluted earnings per common share	\$1.32	\$0.64	\$2.28	\$1.36

The Company excluded 0.4 million and 0.0 million shares issuable upon exercise of outstanding stock options for the three months ended September 30, 2016 and 2015, respectively, from 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. The Company excluded 0.4 million and 0.1 million shares issuable upon exercise of outstanding stock options for the nine months ended September 30, 2016 and 2015, respectively, from 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.

## (12) Business Segment Information

The Company operates in two segments: North America and International. Corporate operating expenses are not included in either of the segments and are presented separately as a reconciling item to consolidated results. These segments are strategic business units that are managed separately based on geography. The North America segment consists of Tempur and Sealy manufacturing and distribution subsidiaries, joint ventures and licensees located in the U.S. and Canada. The International segment consists of Tempur and Sealy manufacturing and distribution subsidiaries, joint ventures and licensees located in Europe, Asia-Pacific and Latin America. The Company evaluates segment performance based on net sales, gross profit and operating income.

The Company's North America and International segment assets include investments in subsidiaries that are appropriately eliminated in the Company's accompanying Condensed Consolidated Financial Statements. The remaining inter-segment eliminations are comprised of intercompany accounts receivable and payable.

20

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Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

The following table summarizes total assets by segment:

	September 30, 2016	December 31, 2015
(in millions)		
North America	\$2,521.2	\$2,533.1
International	604.8	477.1
Corporate	665.6	775.0
Inter-segment eliminations	(1,045.4 )	(1,129.7 )
Total assets	\$2,746.2	\$2,655.5

The following table summarizes property, plant and equipment, net by segment:

	September 30, 2016	December 31, 2015
(in millions)		
North America	\$ 240.0	\$ 239.2
International	54.9	54.8
Corporate	70.2	67.7
Total property, plant and equipment, net	\$ 365.1	\$ 361.7

The following table summarizes segment information for the three months ended September 30, 2016:

(in millions)	North America	International	Corporate	Eliminations	Consolidated
Bedding sales	\$ 667.6	\$ 106.1	\$ —	\$ —	\$ 773.7
Other sales	30.9	27.8	—	—	58.7
Net sales	698.5	133.9	—	—	832.4
Inter-segment sales	\$ 1.0	\$ 0.2	\$ —	\$ (1.2 )	\$ —
Inter-segment royalty expense (income)	1.8	(1.8 )	—	—	—
Gross profit	290.1	72.0	—	—	362.1
Operating income (loss)	128.3	25.6	(22.8 )	—	131.1
Income (loss) before income taxes	127.1	23.6	(40.4 )	—	110.3
Depreciation and amortization <sup>(1)</sup>	\$ 10.8	\$ 4.0	\$ 8.2	\$ —	\$ 23.0
Capital expenditures	10.7	3.6	3.3	—	17.6

(1) Depreciation and amortization includes stock-based compensation amortization expense.

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

The following table summarizes segment information for the three months ended September 30, 2015:

(in millions)	North America	International	Corporate	Eliminations	Consolidated
Bedding sales	\$ 690.8	\$ 110.2	\$ —	\$ —	\$ 801.0
Other sales	50.4	28.6	—	—	79.0
Net sales	741.2	138.8	—	—	880.0
Inter-segment sales	\$ 1.0	\$ 0.2	\$ —	\$ (1.2 )	\$ —
Inter-segment royalty expense (income)	2.0	(2.0 )	—	—	—
Gross profit	287.7	71.9	—	—	359.6
Operating income (loss)	118.4	23.0	(30.5 )	—	110.9
Income (loss) before income taxes	114.4	1.7	(50.2 )	—	65.9
Depreciation and amortization <sup>(1)</sup>	\$ 11.3	\$ 4.0	\$ 7.7	\$ —	\$ 23.0
Capital expenditures	5.6	4.4	7.1	—	17.1

(1) Depreciation and amortization includes stock-based compensation amortization expense.

The following table summarizes segment information for the nine months ended September 30, 2016:

(in millions)	North America	International	Corporate	Eliminations	Consolidated
Bedding sales	\$ 1,858.2	\$ 327.8	\$ —	\$ —	\$ 2,186.0
Other sales	88.5	83.3	—	—	171.8
Net sales	1,946.7	411.1	—	—	2,357.8
Inter-segment sales	\$ 3.5	\$ 0.4	\$ —	\$ (3.9 )	\$ —
Inter-segment royalty expense (income)	5.6	(5.6 )	—	—	—
Gross profit	771.9	218.1	—	—	990.0
Operating income (loss)	308.9	76.1	(77.0 )	—	308.0
Income (loss) before income taxes	304.3	69.0	(177.5 )	—	195.8
Depreciation and amortization <sup>(1)</sup>	\$ 32.1	\$ 11.7	\$ 25.8	\$ —	\$ 69.6
Capital expenditures	22.0	8.3	11.6	—	41.9

(1) Depreciation and amortization includes stock-based compensation amortization expense.

The following table summarizes segment information for the nine months ended September 30, 2015:

(in millions)	North America	International	Corporate	Eliminations	Consolidated
Bedding sales	\$ 1,854.2	\$ 333.9	\$ —	\$ —	\$ 2,188.1
Other sales	111.4	84.4	—	—	195.8
Net sales	1,965.6	418.3	—	—	2,383.9
Inter-segment sales	\$ 4.5	\$ 0.5	\$ —	\$ (5.0 )	\$ —
Inter-segment royalty expense (income)	5.3	(5.3 )	—	—	—
Gross profit	718.2	217.6	—	—	935.8
Operating income (loss)	240.9	72.0	(95.6 )	—	217.3
Income (loss) before income taxes	233.0	47.8	(150.3 )	—	130.5

Depreciation and amortization <sup>(1)</sup>	\$33.5	\$ 12.1	\$ 25.7	\$ —	\$ 71.3
Capital expenditures	23.7	9.8	17.6	—	51.1

(1) Depreciation and amortization includes stock-based compensation amortization expense.



Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

The following table summarizes property, plant and equipment, net by geographic region:

	September 30, 2016	December 31, 2015
(in millions)		
United States	\$ 303.2	\$ 300.1
Canada	7.0	6.8
Other International	54.9	54.8
Total property, plant and equipment, net	\$ 365.1	\$ 361.7
Total International	\$ 61.9	\$ 61.6

The following table summarizes net sales by geographic region:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2016	2015	2016	2015
United States	\$641.4	\$684.8	\$1,792.7	\$1,813.4
Canada	57.1	56.4	154.0	152.2
Other International	133.9	138.8	411.1	418.3
Total net sales	\$832.4	\$880.0	\$2,357.8	\$2,383.9
Total International	\$191.0	\$195.2	\$565.1	\$570.5

## (13) Guarantor/Non-Guarantor Financial Information

The \$450.0 million and \$600.0 million aggregate principal amount of 2023 Senior Notes and 2026 Senior Notes (collectively the "Senior Notes"), respectively, 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 \$375.0 million aggregate principal amount of 2020 Senior Notes were general unsecured senior obligations at December 31, 2015. 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 applicable 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 applicable 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 applicable 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 the Condensed Consolidated Statements of Income and Comprehensive Income for the three and nine months ended September 30, 2016 and 2015, the Supplemental Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015, and the Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015 for Tempur Sealy International, Combined Guarantor Subsidiaries and Combined Non-Guarantor Subsidiaries.



Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Statements of Income and Comprehensive Income

Three Months Ended September 30, 2016

(in millions)

	Tempur Sealy International Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	\$ —	\$ 656.0	\$ 191.5	\$ (15.1 )	\$ 832.4
Cost of sales	—	381.1	104.3	(15.1 )	470.3
Gross profit	—	274.9	87.2	—	362.1
Selling and marketing expenses	1.0	129.6	44.6	—	175.2
General, administrative and other expenses	4.0	44.5	15.5	—	64.0
Equity income in earnings of unconsolidated affiliates	—	—	(2.4 )	—	(2.4 )
Royalty income, net of royalty expense	—	(5.6 )	(0.2 )	—	(5.8 )
Operating (loss) income	(5.0 )	106.4	29.7	—	131.1
Other expense, net:					
Third party interest expense, net	15.0	4.7	0.8	—	20.5
Intercompany interest (income) expense, net	(1.0 )	—	1.0	—	—
Interest expense, net	14.0	4.7	1.8	—	20.5
Other expense, net	—	—	0.3	—	0.3
Total other expense, net	14.0	4.7	2.1	—	20.8
Income from equity investees	89.0	21.1	—	(110.1 )	—
Income before income taxes	70.0	122.8	27.6	(110.1 )	110.3
Income tax benefit (provision)	6.6	(33.8 )	(6.5 )	—	(33.7 )
Net income before non-controlling interest	76.6	89.0	21.1	(110.1 )	76.6
Less: Net loss attributable to non-controlling interest	(1.2 )	(1.2 )	—	1.2	(1.2 )
Net income attributable to Tempur Sealy International, Inc.	\$ 77.8	\$ 90.2	\$ 21.1	\$ (111.3 )	\$ 77.8
Comprehensive income attributable to Tempur Sealy International, Inc.	\$ 72.6	\$ 90.5	\$ 15.8	\$ (106.3 )	\$ 72.6

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Statements of Income and Comprehensive Income

Three Months Ended September 30, 2015

(in millions)

	Tempur Sealy International Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Elimination	Consolidated
Net sales	\$ —	\$ 697.8	\$ 195.6	\$ (13.4 )	\$ 880.0
Cost of sales	—	427.2	106.6	(13.4 )	520.4
Gross profit	—	270.6	89.0	—	359.6
Selling and marketing expenses	1.1	129.4	45.1	—	175.6
General, administrative and other expenses	4.2	59.1	16.5	—	79.8
Equity income in earnings of unconsolidated affiliates	—	—	(2.0 )	—	(2.0 )
Royalty income, net of royalty expense	—	(4.7 )	—	—	(4.7 )
Operating (loss) income	(5.3 )	86.8	29.4	—	110.9
Other expense, net:					
Third party interest expense, net	6.7	25.8	0.7	—	33.2
Intercompany interest expense (income), net	8.3	(8.9 )	0.6	—	—
Interest expense, net	15.0	16.9	1.3	—	33.2
Other (income) expense, net	—	(8.6 )	20.4	—	11.8
Total other expense, net	15.0	8.3	21.7	—	45.0
Income from equity investees	55.0	1.4	—	(56.4 )	—
Income before income taxes	34.7	79.9	7.7	(56.4 )	65.9
Income tax benefit (provision)	6.2	(24.9 )	(6.3 )	—	(25.0 )
Net income before non-controlling interest	40.9	55.0	1.4	(56.4 )	40.9
Less: Net income attributable to non-controlling interest	0.7	0.7	—	(0.7 )	0.7
Net income attributable to Tempur Sealy International, Inc.	\$ 40.2	\$ 54.3	\$ 1.4	\$ (55.7 )	\$ 40.2
Comprehensive income (loss) attributable to Tempur Sealy International, Inc.	\$ 24.6	\$ 53.9	\$ (21.3 )	\$ (32.6 )	\$ 24.6



Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Statements of Income and Comprehensive Income

Nine Months Ended September 30, 2016

(in millions)

	Tempur Sealy International, Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	\$ —	\$ 1,835.0	\$ 566.4	\$ (43.6 )	\$ 2,357.8
Cost of sales	—	1,106.3	305.1	(43.6 )	1,367.8
Gross profit	—	728.7	261.3	—	990.0
Selling and marketing expenses	3.7	358.0	136.4	—	498.1
General, administrative and other expenses	12.8	146.3	48.5	—	207.6
Equity income in earnings of unconsolidated affiliates	—	—	(8.6 )	—	(8.6 )
Royalty income, net of royalty expense	—	(15.1 )	—	—	(15.1 )
Operating (loss) income	(16.5 )	239.5	85.0	—	308.0
Other expense, net:					
Third party interest expense, net	51.1	11.7	2.2	—	65.0
Intercompany interest (income) expense, net	(3.1 )	(0.1 )	3.2	—	—
Interest expense, net	48.0	11.6	5.4	—	65.0
Loss on extinguishment of debt	34.3	12.9	—	—	47.2
Other (income) expense, net	—	(1.4 )	1.4	—	—
Total other expense, net	82.3	23.1	6.8	—	112.2
Income from equity investees	200.8	62.3	—	(263.1 )	—
Income before income taxes	102.0	278.7	78.2	(263.1 )	195.8
Income tax benefit (provision)	33.6	(77.9 )	(15.9 )	—	(60.2 )
Net income before non-controlling interest	135.6	200.8	62.3	(263.1 )	135.6
Less: Net loss attributable to non-controlling interest	(3.1 )	(3.1 )	—	3.1	(3.1 )
Net income attributable to Tempur Sealy International, Inc.	\$ 138.7	\$ 203.9	\$ 62.3	\$ (266.2 )	\$ 138.7
Comprehensive income attributable to Tempur Sealy International, Inc.	\$ 144.4	\$ 204.9	\$ 67.2	\$ (272.1 )	\$ 144.4

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Statements of Income and Comprehensive Income

Nine Months Ended September 30, 2015

(in millions)

	Tempur Sealy International Inc. (Ultimate Parent)	Combined Guarantor Subsidiaries	Combined Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	\$ —	\$ 1,849.2	\$ 572.7	\$ (38.0 )	\$ 2,383.9
Cost of sales	—	1,173.6	312.5	(38.0 )	1,448.1
Gross profit	—	675.6	260.2	—	935.8
Selling and marketing expenses	2.8	358.1	137.1	—	498.0
General, administrative and other expenses	15.3	177.5	49.8	—	242.6
Equity income in earnings of unconsolidated affiliates	—	—	(8.4 )	—	(8.4 )
Royalty income, net of royalty expense	—	(13.7 )	—	—	(13.7 )
Operating (loss) income	(18.1 )	153.7	81.7	—	217.3
Other expense, net:					
Third party interest expense, net	20.1	52.0	2.0	—	74.1
Intercompany interest expense (income), net	24.6	(26.5 )	1.9	—	—
Interest expense, net	44.7	25.5	3.9	—	74.1
Other (income) expense, net	—	(8.2 )	20.9	—	12.7
Total other expense, net	44.7	17.3	24.8	—	86.8
Income from equity investees	130.0	40.1	—	(170.1 )	—
Income before income taxes	67.2	176.5	56.9	(170.1 )	130.5
Income tax benefit (provision)	19.7	(46.5 )	(16.8 )	—	(43.6 )
Net income before non-controlling interest	86.9	130.0	40.1	(170.1 )	86.9
Less: Net income attributable to non-controlling interest	2.1	2.1	—	(2.1 )	2.1
Net income attributable to Tempur Sealy International, Inc.	\$ 84.8	\$ 127.9	\$ 40.1	\$ (168.0 )	\$ 84.8
Comprehensive income (loss) attributable to Tempur Sealy International, Inc.	\$ 40.2	\$ 127.5	\$ (14.0 )	\$ (113.5 )	\$ 40.2

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Balance Sheets

September 30, 2016

(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	\$ —	\$ 33.6	\$ 55.4	\$ —	\$ 89.0
Accounts receivable, net	—	265.7	138.6	—	404.3
Inventories, net	—	154.5	59.8	—	214.3
Income taxes receivable	229.0	—	—	(229.0)	—
Prepaid expenses and other current assets	0.2	40.2	21.3	—	61.7
Total Current Assets	229.2	494.0	275.1	(229.0)	769.3
Property, plant and equipment, net	—	303.2	61.9	—	365.1
Goodwill	—	501.4	218.3	—	719.7
Other intangible assets, net	—	602.8	83.5	—	686.3
Deferred income taxes	19.6	—	25.4	(19.6)	25.4
Other non-current assets	—	31.9	148.5	—	180.4
Net investment in subsidiaries	2,164.3	48.9	—	(2,213.2)	—
Due from affiliates	414.7	1,632.5	4.0	(2,051.2)	—
Total Assets	\$ 2,827.8	\$ 3,614.7	\$ 816.7	\$ (4,513.0)	\$ 2,746.2
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current Liabilities:					
Accounts payable	\$ 1.6	\$ 185.3	\$ 51.0	\$ —	\$ 237.9
Accrued expenses and other current liabilities	23.3	190.2	71.6	—	285.1
Income taxes payable	—	242.2	9.9	(229.0)	23.1
Current portion of long-term debt	—	32.3	33.8	—	66.1
Total Current Liabilities	24.9	650.0	166.3	(229.0)	612.2
Long-term debt, net	1,040.1	578.9	—	—	1,619.0
Deferred income taxes	—	190.1	21.7	(19.6)	192.2
Other non-current liabilities	—	30.1	132.1	—	162.2
Due to affiliates	1,602.2	1.3	447.7	(2,051.2)	—
Total Liabilities	2,667.2	1,450.4	767.8	(2,299.8)	2,585.6
Redeemable non-controlling interest	9.3	9.3	—	(9.3)	9.3
Total Stockholders' Equity	151.3	2,155.0	48.9	(2,203.9)	151.3
Total Liabilities, Redeemable Non-Controlling Interest and Stockholders' Equity	\$ 2,827.8	\$ 3,614.7	\$ 816.7	\$ (4,513.0)	\$ 2,746.2





Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Balance Sheets

December 31, 2015

(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	\$ —	\$ 121.8	\$ 32.1	\$—	\$ 153.9
Accounts receivable, net	—	231.9	147.5	—	379.4
Inventories, net	—	145.3	53.9	—	199.2
Income taxes receivable	193.1	—	—	(193.1)	—
Prepaid expenses and other current assets	—	43.5	33.1	—	76.6
Total Current Assets	193.1	542.5	266.6	(193.1)	809.1
Property, plant and equipment, net	—	300.1	61.6	—	361.7
Goodwill	—	501.4	208.0	—	709.4
Other intangible assets, net	—	612.9	82.5	—	695.4
Deferred income taxes	16.0	—	12.2	(16.0)	12.2
Other non-current assets	—	23.3	44.4	—	67.7
Net investment in subsidiaries	1,960.5	—	—	(1,960.5)	—
Due from affiliates	548.1	1,655.3	4.8	(2,208.2)	—
Total Assets	\$ 2,717.7	\$ 3,635.5	\$ 680.1	\$ (4,377.8)	\$ 2,655.5
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>					
Current Liabilities:					
Accounts payable	\$ —	\$ 212.2	\$ 54.1	\$—	\$ 266.3
Accrued expenses and other current liabilities	1.4	183.8	68.8	—	254.0
Income taxes payable	—	196.0	8.3	(193.1)	11.2
Current portion of long-term debt	—	168.7	12.8	—	181.5
Total Current Liabilities	1.4	760.7	144.0	(193.1)	713.0
Long-term debt, net	811.9	461.4	—	—	1,273.3
Deferred income taxes	—	189.8	21.6	(16.0)	195.4
Other non-current liabilities	—	166.6	4.6	—	171.2
Due to affiliates	1,601.8	96.5	604.9	(2,303.2)	—
Total Liabilities	2,415.1	1,675.0	775.1	(2,512.3)	2,352.9
Redeemable non-controlling interest	12.4	12.4	—	(12.4)	12.4
Total Stockholders' Equity	290.2	1,948.1	(95.0)	(1,853.1)	290.2
Total Liabilities, Redeemable Non-Controlling Interest and Stockholders' Equity	\$ 2,717.7	\$ 3,635.5	\$ 680.1	\$ (4,377.8)	\$ 2,655.5



Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2016

(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	\$ (30.4 )	\$ 38.2	\$ 102.0	\$	—\$ 109.8
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>					
Purchases of property, plant and equipment	—	(33.2 )	(8.7 )	—	(41.9 )
Contributions (paid to) received from subsidiaries and affiliates	—	(76.8 )	76.8	—	—
Net cash (used in) provided by investing activities	—	(110.0 )	68.1	—	(41.9 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>					
Proceeds from borrowings under long-term debt obligations	600.0	1,214.6	56.9	—	1,871.5
Repayments of borrowings under long-term debt obligations	(375.0 )	(1,246.6 )	(37.7 )	—	(1,659.3 )
Net activity in investment in and advances from (to) subsidiaries and affiliates	136.5	22.6	(159.1 )	—	—
Proceeds from exercise of stock options	15.2	—	—	—	15.2
Excess tax benefit from stock-based compensation	6.0	—	—	—	6.0
Treasury stock repurchased	(319.7 )	—	—	—	(319.7 )
Payment of deferred financing costs	(3.0 )	(3.6 )	—	—	(6.6 )
Fees paid to lenders	(6.0 )	(1.8 )	—	—	(7.8 )
Call premium on 2020 Senior Notes	(23.6 )	—	—	—	(23.6 )
Other	—	(1.6 )	1.7	—	0.1
Net cash provided by (used in) financing activities	30.4	(16.4 )	(138.2 )	—	(124.2 )
<b>NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>					
(Decrease) increase in cash and cash equivalents	—	(88.2 )	23.3	—	(64.9 )
CASH AND CASH EQUIVALENTS, beginning of period	—	121.8	32.1	—	153.9
CASH AND CASH EQUIVALENTS, end of period	\$ —	\$ 33.6	\$ 55.4	\$	—\$ 89.0

Table of Contents

## TEMPUR SEALY INTERNATIONAL, INC. AND SUBSIDIARIES

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

## Supplemental Condensed Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2015

(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	\$ (63.3 )	\$ 158.5	\$ 38.0	\$	—\$ 133.2
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>					
Purchases of property, plant and equipment	—	(40.3 )	(10.8 )	—	(51.1 )
Proceeds from disposition of business and other	—	7.2	(0.3 )	—	6.9
Net cash used in investing activities	—	(33.1 )	(11.1 )	—	(44.2 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>					
Proceeds from borrowings under long-term debt obligations	—	852.9	2.5	—	855.4
Repayments of borrowings under long-term debt obligations	—	(974.4 )	—	—	(974.4 )
Net activity in investment in and advances from (to) subsidiaries and affiliates	22.8	19.5	(42.3 )	—	—
Proceeds from exercise of stock options	16.7	—	—	—	16.7
Excess tax benefit from stock-based compensation	19.7	—	—	—	19.7
Treasury stock repurchased	(1.3 )	—	—	—	(1.3 )
Payment of deferred financing costs	—	(6.4 )	—	—	(6.4 )
Proceeds from purchase of treasury shares by CEO	5.0	—	—	—	5.0
Other	—	(2.5 )	0.4	—	(2.1 )
Net cash provided by (used in) financing activities	62.9	(110.9 )	(39.4 )	—	(87.4 )
NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	—	—	7.7	—	7.7
(Decrease) increase in cash and cash equivalents	(0.4 )	14.5	(4.8 )	—	9.3
CASH AND CASH EQUIVALENTS, beginning of period	0.4	25.5	36.6	—	62.5
CASH AND CASH EQUIVALENTS, end of period	\$ —	\$ 40.0	\$ 31.8	\$	—\$ 71.8

## Table of Contents

### 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 our Annual Report on Form 10-K, including "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in ITEM 7 of Part II of the Annual Report, and 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 consolidated financial information for the Company. The forward-looking statements in this discussion regarding the mattress and pillow industries, our expectations regarding our strategy, our future performance, liquidity and capital resources and other non-historical statements in this discussion are subject to numerous risks and uncertainties. See "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, 2015. Our actual results may differ materially from those contained in any forward-looking statements.

In this discussion and analysis, we discuss and explain the consolidated financial condition and results of operations for the three and nine months ended September 30, 2016, including the following topics:

- an overview of our business;
- factors impacting results of operations;
- results of operations including our net sales and costs in the periods presented as well as changes between periods;
- expected sources of liquidity for future operations; and
- our use of certain non-GAAP financial measures.

#### Business Overview

##### General

We are the world's largest bedding provider. We develop, manufacture, market and distribute bedding products, which we sell globally in approximately 100 countries. Our brand portfolio includes many highly recognized brands in the industry, including TEMPUR®, Tempur-Pedic®, Sealy®, Sealy Posturepedic® and Stearns & Foster®. Our comprehensive suite of bedding products offers a variety of products to consumers across a broad range of channels.

##### Our Channels

We sell our products through two distribution channels in each segment: Retail (furniture and bedding retailers, department stores, specialty retailers and warehouse clubs); and Other (direct-to-consumer through e-commerce platforms, Company-owned stores and call centers, third party distributors, hospitality and healthcare customers).

##### Segments

We operate in two segments: North America and International. Corporate operating expenses are not included in either of the segments and are presented separately as a reconciling item to consolidated results. These segments are strategic business units that are managed separately based on geography. Our North America segment consists of Tempur and Sealy manufacturing and distribution subsidiaries, joint ventures and licensees located in the U.S. and Canada. Our International segment consists of Tempur and Sealy manufacturing and distribution subsidiaries, joint ventures and licensees located in Europe, Asia-Pacific and Latin America. We evaluate segment performance based on net sales, gross profit and operating income.

##### Factors That Could Impact Results of Operations

The factors outlined below could impact our future results of operations. For more extensive discussion of these and other risk factors that could impact our future results of operations, please refer to "Risk Factors", under ITEM 1A of Part II and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Factors That Could Impact Results of Operations" included in ITEM 7 of Part II of our Annual Report on Form 10-K for the year ended December 31, 2015.

#### General Business and Economic Conditions

Our business has been affected by general business and economic conditions, and these conditions could have an impact on future demand for our products. We believe the retail environment in the U.S. weakened in the third quarter of 2016 with respect to consumer durable goods companies. Our net sales declined 5.4% in the third quarter of 2016 as compared to the same period in the prior year, and we believe the retail environment in the U.S. will continue to be challenging for the remainder of

## Table of Contents

2016. We expect our net sales to decline in the fourth quarter of 2016 as compared to the same period in the prior year. Additionally, the global economic environment continues to be challenging, and we expect this uncertainty to continue.

### Customer Concentration

Mattress Firm Holding Corp. ("Mattress Firm"), which was acquired by Steinhoff International Holdings N.V. in September 2016 and a customer within the North America segment, is our largest customer. In February 2016, Mattress Firm acquired all of the outstanding equity interests in HMK Mattress Holdings, LLC (Sleepy's), another large customer. As a result of this acquisition, Mattress Firm and Sleepy's combined represented 20.6% and 24.0% of our sales for the three months ended September 30, 2016 and 2015, respectively. Sales for the combined companies represented 21.8% and 24.0% of our sales for the nine months ended September 30, 2016 and 2015, respectively. We experienced a decline in sales to Mattress Firm in the third quarter of 2016 as compared to the same period in the prior year, primarily due to the challenging U.S. retail environment, the impact of Mattress Firm's current program of rebranding and remerchandising its newly acquired stores, and because we did not have our Stearns & Foster® products in the Mattress Firm stores. In the fourth quarter, we will complete the Stearns & Foster® launch into the Mattress Firm stores. However, we expect our sales to Mattress Firm will also decline in the fourth quarter of 2016 as compared to the same period in the prior year.

The risks associated with our largest customers is further described in "Risk Factors," under ITEM 1A of Part II and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Factors That Could Impact Results of Operations" included in ITEM 7 of Part II of our Annual Report on Form 10-K for the year ended December 31, 2015.

### Financial Leverage and Liquidity

Our debt agreements contain certain covenants that limit restricted payments, including share repurchases and dividends. The 2016 Credit Agreement and 2023 Senior Notes contain similar limitations which, subject to other conditions, allow unlimited restricted payments at times when the ratio of consolidated funded debt less qualified cash to adjusted EBITDA remains below 3.5 times. In addition, both agreements permit limited restricted payments under certain conditions when the ratio of consolidated funded debt less qualified cash to adjusted EBITDA is above 3.5 times and less than 4.5 times. The limit on restricted payments under the 2016 Credit Agreement and 2023 Senior Notes is in part determined by a basket that grows at 50% of adjusted net income each quarter, reduced by restricted payments that are not otherwise permitted.

During the nine months ended September 30, 2016, we repurchased 5.2 million shares for approximately \$317.7 million under the current share repurchase authorization. As of September 30, 2016, we had approximately \$280.0 million remaining under the existing share repurchase authorization. We estimate the restricted payment basket under the 2016 Credit Agreement and 2023 Senior Notes will be approximately \$460.0 million after the filing of this Quarterly Report on Form 10-Q for the period ended September 30, 2016. We believe that repurchasing our shares creates value for our shareholders, and subject to market conditions, we expect that, in the fourth quarter of 2016, we will continue to repurchase shares opportunistically in accordance with our debt covenants under our current share repurchase authorization.

### New Product Development and Introduction

In the fourth quarter of 2016, we expect to incur significant costs associated with new product introductions. We typically do not introduce products in the fourth quarter. As a result, we expect our profitability in the fourth quarter of 2016 to be negatively impacted by incremental floor model discounts and product launch costs as compared to the



same period in the prior year.

Each year we invest significant time and resources in research and development to improve our product offerings. There are a number of risks inherent in our new product line introductions, including that the anticipated level of market acceptance may not be realized, which could negatively impact our sales. Also, product introduction costs, the speed of the rollout of the product and manufacturing inefficiencies may be greater than anticipated, which could impact profitability.

#### Restructuring

During October 2016, we initiated certain restructuring activities, including moving to a more centralized structure and store closures, primarily in our International segment. We expect to incur costs of approximately \$7.0 million related to these restructuring activities, which is also the approximate anticipated reduction of our annual operating costs as a result of the restructuring.

Table of Contents

Results of Operations

A summary of our results for the three months ended September 30, 2016 include:

Total net sales decreased 5.4% to \$832.4 million from \$880.0 million in the third quarter of 2015. On a constant currency basis, which is a non-GAAP financial measure, total net sales decreased 4.6%, with a decrease of 5.8% in the North America business segment and an increase of 1.8% in the International business segment.

Gross margin was 43.5% as compared to 40.9% in the third quarter of 2015.

Operating income increased 18.2% to \$131.1 million, or 15.7% of net sales, as compared to \$110.9 million, or 12.6% of net sales, in the third quarter of 2015. Operating income in the third quarter of 2015 included \$5.5 million of integration costs, \$5.2 million of additional costs related to executive management transition and retention compensation and \$2.4 million of restructuring costs.

Net income increased 93.5% to \$77.8 million as compared to \$40.2 million in the third quarter of 2015.

Earnings before interest, tax, depreciation and amortization ("EBITDA") increased 27.7% to \$155.0 million as compared to \$121.4 million for the third quarter of 2015. EBITDA increased 8.9% as compared to adjusted EBITDA, which is a non-GAAP financial measure, of \$142.3 million in the third quarter of 2015.

Earnings per diluted share ("EPS") increased 106.3% to \$1.32 as compared to \$0.64 in the third quarter of 2015.

A summary of our results for the nine months ended September 30, 2016 include:

Net sales decreased 1.1% to \$2,357.8 million from \$2,383.9 million in the nine months ended September 30, 2015.

On a constant currency basis, total net sales increased 0.4%.

Net income increased 63.6% to \$138.7 million from \$84.8 million in the nine months ended September 30, 2015.

EPS increased 67.6% to \$2.28 from \$1.36 in the nine months ended September 30, 2015.

For a discussion and reconciliation of non-GAAP financial measures as discussed above to the corresponding GAAP financial results, refer to the non-GAAP financial information set forth below under the heading "Non-GAAP Financial Information."

We may refer to net sales or earnings or other historical financial information on a "constant currency basis," which is a non-GAAP financial measure. These references to constant currency basis do not include operational impacts that could result from fluctuations in foreign currency rates. To provide information on a constant currency basis, the applicable 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. Constant currency information is not recognized under U.S. GAAP, and it is not intended as an alternative to U.S. GAAP measures. Refer to ITEM 3 under Part I of this Report for a discussion of our foreign currency disclosure.

Table of Contents

## THREE MONTHS ENDED SEPTEMBER 30, 2016 COMPARED TO THE THREE MONTHS ENDED SEPTEMBER 30, 2015

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

(in millions, except per share amounts)	Three Months Ended September 30,			
	2016		2015	
Net sales	\$832.4	100.0 %	\$880.0	100.0 %
Cost of sales	470.3	56.5	520.4	59.1
Gross profit	362.1	43.5	359.6	40.9
Selling and marketing expenses	175.2	21.0	175.6	20.0
General, administrative and other expenses	64.0	7.7	79.8	9.0
Equity income in earnings of unconsolidated affiliates	(2.4 )	(0.2 )	(2.0 )	(0.2 )
Royalty income, net of royalty expense	(5.8 )	(0.7 )	(4.7 )	(0.5 )
Operating income	131.1	15.7	110.9	12.6
Other expense, net:				
Interest expense, net	20.5	2.5	33.2	3.8
Other expense, net	0.3	—	11.8	1.3
Total other expense, net	20.8	2.5	45.0	5.1
Income before income taxes	110.3	13.3	65.9	7.5
Income tax provision	(33.7 )	(4.1 )	(25.0 )	(2.8 )
Net income before non-controlling interest	76.6	9.2	40.9	4.7
Less: Net (loss) income attributable to non-controlling interest <sup>(1)</sup>	(1.2 )	(0.1 )	0.7	0.1
Net income attributable to Tempur Sealy International, Inc.	\$77.8	9.3 %	\$40.2	4.6 %
Earnings per common share:				
Basic	\$1.34		\$0.65	
Diluted	\$1.32		\$0.64	
Weighted average common shares outstanding:				
Basic	58.2		62.1	
Diluted	58.8		62.9	

Net (loss) income attributable to the Company's redeemable non-controlling interest in Comfort Revolution, LLC for the three months ended September 30, 2016 and 2015 represented \$(1.2) million and \$0.5 million, respectively. As of September 30, 2015, the redemption value exceeded the accumulated earnings of the Company's redeemable non-controlling interest in Comfort Revolution, LLC. Accordingly, for the three months ended September 30, 2015, the Company recorded a \$0.2 million adjustment, net of tax, to adjust the carrying value of redeemable non-controlling interest to its redemption value. As of September 30, 2016, the accumulated earnings exceeded the redemption value and, accordingly, a redemption value adjustment was not necessary for the three months ended September 30, 2016.

Table of Contents

## NET SALES

(in millions)	Three Months Ended September 30,					
	2016	2015	2016	2015	2016	2015
	Consolidated		North America		International	
Net sales by channel						
Retail channel	\$753.7	\$800.3	\$663.1	\$703.3	\$90.6	\$97.0
Other channel	78.7	79.7	35.4	37.9	43.3	41.8
Total net sales	\$832.4	\$880.0	\$698.5	\$741.2	\$133.9	\$138.8
Net sales by product						
Bedding	\$773.7	\$801.0	\$667.6	\$690.8	\$106.1	\$110.2
Other products	58.7	79.0	30.9	50.4	27.8	28.6
Total net sales	\$832.4	\$880.0	\$698.5	\$741.2	\$133.9	\$138.8

Net sales decreased 5.4%, and on a constant currency basis decreased 4.6%. The decrease in net sales was driven by:

North America net sales decreased 5.8%. Net sales of Bedding products decreased \$23.2 million, or 3.4%, primarily due to a decrease in net sales of our Tempur products. Tempur product net sales were impacted by three primary factors. The retail environment in the U.S. in the third quarter was less robust than we had expected. We also experienced some significant weakness in our largest national account, which is in the process of rebranding and remerchandising certain stores. In addition, we believe our advertising campaign overemphasized our new product introductions and did not adequately support our legacy Tempur products. Net sales of Other products decreased \$19.5 million, or 38.7%, primarily as a result of a decline in net sales of pillows and products sold through Comfort Revolution.

International net sales decreased 3.5%. On a constant currency basis, International net sales increased approximately 1.8%, with growth across all major regions. The increase in net sales on a constant currency basis was primarily due to an increase in direct sales of our Tempur products in Asia-Pacific, and an increase in net sales of our Sealy products in Latin America. International Other channel sales increased 13.4% on a constant currency basis, primarily driven by increases in net sales through the Internet and our company-owned stores.

## GROSS PROFIT

(in millions, except percentages)	Three Months Ended			
	September 30,			
	2016	2015		
	Gross	Gross	Gross	Margin
	Profit	Profit	Margin	Change
North America				