TEMPUR PEDIC INTERNATIONAL INC
Form 10-Q
July 30, 2012

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

FORM 10-Q

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

For the quarterly period ended June 30, 2012

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

For the transition period from

to

Commission file number 001-31922

TEMPUR-PEDIC INTERNATIONAL INC.
(Exact name of registrant as specified in its charter)

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

1713 Jaggie Fox 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 x No o

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). x Yes o 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 x	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares outstanding of the registrant’s common stock as of July 27, 2012 was 59,545,817 shares.

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Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q, including the information incorporated by reference herein, contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which includes information concerning our plans; objectives; goals; strategies; future events; future revenues or performance; the impact of the macroeconomic environment in both the U.S. and internationally on sales and our business segments; strategic long-term investments; changes in capital expenditures; the impact of consumer confidence; litigation and similar issues; pending tax assessments; financial flexibility; the impact of initiatives to respond to increased levels of competition in our industry; the impact of initiatives to accelerate growth, expand market share and attract sales from the standard mattress market; efforts to expand business within established accounts, improve account productivity, reduce costs and operating expenses and improve manufacturing productivity; initiatives to improve gross margin; the vertical integration of our business; the development, rollout and market acceptance of new products; our ability to further invest in the business and in brand awareness; our ability to meet financial obligations and continue to comply with the terms of our Senior Credit Facility, including its financial ratio covenants; effects of changes in foreign exchange rates on our reported earnings; our expected sources of cash flow; our ability to effectively manage cash; our ability to align costs with sales expectations; and other information that is not historical information. Many of these statements appear, in particular, under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" in ITEM 2 of Part I of this report. When used in this report, the words "estimates," "expects," "anticipates," "projects," "plans," "intends," "believes" and variations of such words or similar expressions are intended to identify forward-looking statements. These forward-looking statements are based upon our current expectations and various assumptions. There can be no assurance that we will realize our expectations or that our beliefs will prove correct.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this report. There are important factors, many of which are beyond the Company's control, that could cause our actual results to differ materially from those expressed as forward-looking statements are set forth in this report, including under the heading "Risk Factors" under ITEM IA of Part II of this report and under the heading "Risk Factors" under ITEM 1A of Part 1 of our Annual Report on Form 10-K for the year ended December 31, 2011. 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-Pedic International" refers to Tempur-Pedic International Inc. only, and the terms "Company," "we," "our," "ours" and "us" refer to Tempur-Pedic International Inc. and its consolidated subsidiaries.

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PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per common share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net sales	$ 329,461	$ 342,212	$ 713,854	$ 668,050
Cost of sales	162,578	161,194	340,985	316,722
Gross profit	166,883	181,018	372,869	351,328
Selling and marketing expenses	83,672	67,980	166,971	132,350
General, administrative and other expenses	35,662	30,208	72,284	60,868
Operating income	47,549	82,830	133,614	158,110
Other expense, net				
Interest expense, net	(4,167)	(2,646)	(8,233)	(5,185)
Other income (expense), net	486	(118)	45	(721)
Total other expense	(3,681)	(2,764)	(8,188)	(5,906)
Income before income taxes	43,868	80,066	125,426	152,204
Income tax provision	14,745	26,982	40,085	50,860
Net income	$ 29,123	$ 53,084	$ 85,341	$ 101,344
Earnings per common share:				
Basic	$ 0.46	$ 0.78	$ 1.35	$ 1.48
Diluted	$ 0.45	$ 0.76	$ 1.31	$ 1.44
Weighted average common shares outstanding:				
Basic	62,851	67,959	63,366	68,257
Diluted	64,337	70,018	65,019	70,469

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net income	$ 29,123	$ 53,084	$ 85,341	$ 101,344
Other comprehensive (loss) income before tax:				
Foreign currency translation adjustments	(10,138)	3,996	(4,547)	11,486
Derivative instruments accounted for as hedges, net of reclassification adjustments	(1,025)	582	(1,474)	1,430
Other comprehensive (loss) income, before tax	(11,163)	4,578	(6,021)	12,916
Income tax benefit (provision) related to other comprehensive income items	399	(227)	575	(558)
Other comprehensive (loss) income, net of tax	(10,764)	4,351	(5,446)	12,358
Comprehensive income	$ 18,359	$ 57,435	$ 79,895	$ 113,702

See accompanying Notes to Condensed Consolidated Financial Statements

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	June 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 134,198	$ 111,367
Accounts receivable, net	131,192	142,412
Inventories	106,056	91,212
Prepaid expenses and other current assets	24,148	20,088
Deferred income taxes	17,161	14,391
Total Current Assets	412,755	379,470
Property, plant and equipment, net	166,310	160,502
Goodwill	213,150	213,273
Other intangible assets, net	64,959	66,491
Other non-current assets	8,366	8,904
Total Assets	$ 865,540	$ 828,640
LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY		
Current Liabilities:		
Accounts payable	$ 69,179	$ 69,936
Accrued expenses and other current liabilities	76,009	76,636
Income taxes payable	8,632	20,506
Total Current Liabilities	153,820	167,078
Long-term debt	681,500	585,000
Deferred income taxes	19,568	24,227
Other non-current liabilities	22,792	21,544
Total Liabilities	877,680	797,849
Commitments and contingencies — see Note 10		
Total Stockholders' (Deficit) Equity	(12,140)	30,791
Total Liabilities and Stockholders' (Deficit) Equity	$ 865,540	$ 828,640

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 85,341	$ 101,344
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	17,648	16,590
Amortization of stock-based compensation	7,410	7,719
Amortization of deferred financing costs	700	346
Bad debt expense	1,260	1,137
Deferred income taxes	(7,150)	(1,133)
Foreign currency adjustments and other	779	826
Changes in operating assets and liabilities	(19,447)	(22,879)
Net cash provided by operating activities	86,541	103,950
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(20,664)	(12,098)
Other	(1,669)	(1,970)
Net cash used by investing activities	(22,333)	(14,068)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term revolving credit facility	245,500	572,500
Repayments of long-term revolving credit facility	(149,000)	(504,500)
Proceeds from issuance of common stock	10,077	22,386
Excess tax benefit from stock based compensation	9,678	14,133
Treasury shares repurchased	(152,565)	(160,010)
Payments of deferred financing costs	—	(6,109)
Other	(2,321)	—
Net cash used by financing activities	(38,631)	(61,600)
NET EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(2,746)	4,834
Increase in cash and cash equivalents	22,831	33,116
CASH AND CASH EQUIVALENTS, beginning of period	111,367	53,623
CASH AND CASH EQUIVALENTS, end of period	$ 134,198	$ 86,739
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	$ 7,490	$ 4,973
Income taxes, net of refunds	$ 48,052	$ 32,721

See accompanying Notes to Condensed Consolidated Financial Statements.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per common share amounts)

(1) Summary of Significant Accounting Policies

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

The Company manufactures, markets and sells products including pillows, mattresses and other related products. The Company manufactures essentially all its pressure-relieving TEMPUR® products at three manufacturing facilities, with one located in Denmark and two in the U.S. The Company has sales distribution subsidiaries operating in North America, Europe, Asia Pacific, and South America and has third party distribution arrangements in certain other countries where it does not have subsidiaries. The Company sells its products through four sales channels: Retail, Direct, Healthcare and Third party.

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) 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, 2011, included in the Company’s Annual Report on Form 10-K.

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

(b) Reclassifications. The Company reclassified certain Accrued expenses and other current liabilities to Other non-current liabilities to conform to the 2012 presentation of Condensed Consolidated Financial Statements. This change does not materially impact previously reported subtotals within the Condensed Consolidated Financial Statements for any previous period presented.

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

	June 30, 2012	December 31, 2011
Finished goods	$ 77,382	$ 65,391
Work-in-process	8,790	9,088
Raw materials and supplies	19,884	16,733
	$ 106,056	$ 91,212

(d) Accrued Sales Returns. The Company allows product returns up to 90 days following a sale 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. The level of sales returns differs by channel with the Direct channel typically experiencing the highest rate of return. Estimated future obligations related to these products are provided by a reduction of sales in the period in which the revenue is recognized. Accrued sales returns are included in Accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheets.

The Company had the following activity for sales returns from December 31, 2011 to June 30, 2012:

Balance as of December 31, 2011	$	5,285
Amounts accrued		21,389
Returns charged to accrual		(21,318)
Balance as of June 30, 2012	$	5,356

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) - (Continued)
(In thousands, except per common share amounts)

(e) Warranties. The Company provides a 20-year warranty for North American sales and a 15-year warranty for International sales on mattresses, each prorated for the last 10 years. The Company also provides a 2-year to 3-year warranty on pillows. Estimated future obligations related to these products are charged to cost of sales in the period in which the related revenue is recognized. Estimates of warranty expenses are based primarily on historical claim experience and product testing. Warranties are included in Accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheets.

The Company had the following activity for warranties from December 31, 2011 to June 30, 2012:

Balance as of December 31, 2011	$	4,280
Amounts accrued		3,160
Warranties charged to accrual		(2,779)
Balance as of June 30, 2012	$	4,661

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

The allowance for doubtful accounts is the Company’s best estimate of the amount of probable credit losses in the Company’s existing accounts receivable. The Company regularly reviews the adequacy of its allowance for doubtful accounts. The Company determines the allowance based on historical write-off experience and current economic conditions. It also considers factors such as customer credit, past transaction history with the customer and changes in customer payment terms when determining whether the collection of a receivable is reasonably assured. Account balances are charged off against the allowance after all reasonable means of collection have been exhausted and the potential for recovery is considered remote. The allowance for doubtful accounts included in Accounts receivable, net in the accompanying Condensed Consolidated Balance Sheets was $7,510 and $6,801 as of June 30, 2012 and December 31, 2011, respectively.

(g) Research and Development Expenses. Research and development expenses for new products are expensed as they are incurred and included in General, administrative and other expenses in the accompanying Condensed Consolidated Statements of Income. Research and development costs charged to expense were $3,805 and $2,566 for the three months ended June 30, 2012 and 2011, respectively. Research and development costs charged to expense were $7,247 and $4,900 for the six months ended June 30, 2012 and 2011, respectively.

(h) Subsequent Event. On July 5, 2012, the Company acquired its third party distributor in Brazil. The Company paid approximately $2,200 in cash to acquire this entity with additional future payments due to the former owners if certain operational targets are met.

(2) Goodwill and Other intangible assets

The following summarizes changes to the Company’s Goodwill, by reportable business segment:

	North America	International	Total
Balance as of December 31, 2011	$ 108,504	$ 104,769	$ 213,273
Foreign currency translation adjustments	(32)	(91)	(123)
Balance as of June 30, 2012	$ 108,472	$ 104,678	$ 213,150

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) - (Continued)
(In thousands, except per common share amounts)

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

		June 30, 2012			December 31, 2011		
	Useful Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Unamortized indefinite life intangible assets:							
Trademarks		$ 55,000	$ —	$ 55,000	$ 55,000	$ —	$ 55,000
Amortized intangible assets:							
Technology	10	$ 16,000	$ 15,467	$ 533	$ 16,000	$ 14,667	$ 1,333
Patents & other Trademarks	5-20	12,559	9,498	3,061	12,546	9,180	3,366
Customer database	5	5,184	5,184	—	4,928	4,928	—
Foam formula	10	3,700	3,577	123	3,700	3,392	308
Reacquired rights	3	5,628	4,220	1,408	5,638	3,289	2,349
Customer relationships	5	5,963	1,129	4,834	4,989	854	4,135
Total		$ 104,034	$ 39,075	$ 64,959	$ 102,801	$ 36,310	$ 66,491

Amortization expense relating to intangible assets for the Company was $1,434 and $1,283 for the three months ended June 30, 2012 and 2011, respectively. For the six months ended June 30, 2012 and 2011, amortization expense relating to intangible assets for the Company was $2,815 and $2,549, respectively. No impairments of goodwill or other intangible assets have adjusted the gross carrying amount of these assets in any historical period.

(3) Acquisition

On April 2, 2012, the Company acquired its third party distributor in Poland. The Company paid $1,669 in cash to acquire this entity, with future payments due to the former owners if certain operational targets are met. Assets acquired include certain Intangible assets, Inventories and Prepaids and other current assets.

(4) Long-term Debt

(a) Long-term Debt. Long-term debt for the Company consists of the following:

	June 30, 2012	December 31, 2011
Senior Credit Facility:		
Domestic Long-Term Revolving Credit Facility payable to lenders, interest at Base Rate	$ 681,500	$ 585,000

or LIBOR plus applicable margin (1.99% and 2.05% as of June 30, 2012 and December 31, 2011, respectively), commitment through and due June 28, 2016.				
Long-term Debt	$	681,500	$	585,000

(b) Secured Credit Financing. On October 18, 2005, the Company entered into a credit agreement (Senior Credit Facility) with a syndicate of banks. On June 28, 2011, the Company amended and restated its Senior Credit Facility, as amended, which increased the total availability under the Senior Credit Facility to an aggregate of $770,000, added an option to increase domestic availability by an additional $250,000, extended the maturity date to June 28, 2016, and increased the applicable margins and certain fees to current market conditions.

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) - (Continued)
(In thousands, except per common share amounts)

The Senior Credit Facility consists of domestic and foreign credit facilities (Revolvers) that provide for the incurrence of indebtedness up to an aggregate principal amount of $770,000. The domestic credit facility is a five-year, $745,000 revolving credit facility. The foreign credit facility is a five-year, $25,000 revolving credit facility. The Revolvers provide for the issuance of letters of credit and bank guarantees (Contingent Liabilities) which, when issued, constitute usage and reduce availability under the Revolvers. The aggregate amount of Contingent Liabilities outstanding under the Revolvers was $1,025 at June 30, 2012. After giving effect to Contingent Liabilities and $681,500 in borrowings under the Revolvers, total availability under the Revolvers was $87,475 as of June 30, 2012. Both credit facilities bear interest at a rate equal to the applicable margin, as determined in accordance with a performance pricing grid set forth in the Senior Credit Facility, plus one of the following indexes: London Inter-Bank Offering Rate (LIBOR) and for U.S. dollar-denominated loans only, a base rate. The base rate of U.S. dollar-denominated loans is defined as the higher of the Bank of America prime rate or the Federal Funds rate plus .50%. The Company also pays an annual commitment fee on the unused amount of the Senior Credit Facility. The commitment fee is calculated based on the consolidated leverage ratio and ranges from .375% to .50%.

The Senior Credit Facility is guaranteed by Tempur-Pedic International, as well as certain other subsidiaries of Tempur-Pedic International, and is secured by certain fixed and intangible assets of Dan-Foam ApS and substantially all the Company’s U.S. assets. The Senior Credit Facility contains certain financial covenants and requirements affecting the Company, including a consolidated interest coverage ratio and a consolidated leverage ratio. The Company was in compliance with all covenants as of June 30, 2012.

On August 8, 2011, the Company entered into a four-year interest rate swap agreement to manage interest costs and the risk associated with changing interest rates associated with the Senior Credit Facility. Refer to Note 6, “Derivative Financial Instruments” for additional information regarding the Company’s derivative instruments, including this interest rate swap.

(5) Fair Value Measurements

The classification of fair value measurements within the established three-level hierarchy is based upon the lowest level of input that is significant to the measurement. There were no transfers between levels for the three months ended June 30, 2012. At June 30, 2012, the Company had an interest rate swap and foreign exchange forward contracts recorded at fair value. Estimates of the fair value of foreign currency derivative instruments are determined using exchange traded prices and rates. The fair value of the interest rate swap is calculated using standard industry models based on observable forward yield curves. The fair values of all derivative instruments are adjusted for credit risk and restrictions and other terms specific to the contracts.

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

		Fair Value Measurements at June 30, 2012 Using:		
	June 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

Liabilities:								
Interest rate swap	$	4,090	$	—	$	4,090	$	—
Foreign exchange forward contracts	$	595	$	—	$	595	$	—

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TEMPUR-PEDIC INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) - (Continued)
(In thousands, except per common share amounts)

		Fair Value Measurements at December 31, 2011 Using:		
	December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:				
Interest rate swap	$ 2,616	$ —	$ 2,616	$ —
Foreign exchange forward contracts	$ 935	$ —	$ 935	$ —

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 Senior Credit Facility (as defined in Note 4(b)) are at variable interest rates and accordingly their carrying amounts approximate fair value.

(6) Derivative Financial Instruments

In the normal course of business, the Company is exposed to certain risks related to fluctuations in interest rates and foreign currency exchange rates. The Company uses various derivative contracts, primarily interest rate swaps and foreign exchange forward contracts, to manage risks from these market fluctuations. The financial instruments used by the Company are straight-forward, non-leveraged instruments. The counterparties to these financial instruments are financial institutions with strong credit ratings. The Company maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit ratings of these institutions.

Interest Rate Risk

The Company is exposed to changes in interest rates on its Senior Credit Facility. In order to manage this risk, on August 8, 2011, the Company entered into a four-year interest rate swap agreement to manage interest costs and the risk associated with changing interest rates. The Company designated this interest rate swap as a cash flow hedge of floating rate borrowings and expects the hedge to be highly effective in offsetting fluctuations in the designated interest payments resulting from changes in the benchmark interest rate. The gains and losses on the designated swap agreement will offset losses and gains on the transactions being hedged. The Company formally documented the effectiveness of this qualifying hedge instrument (both at the inception of the swap and on an ongoing basis) in offsetting changes in cash flows of the hedged transaction. The fair value of the interest rate swap is calculated as described in Note 5, “Fair Value Measurements,” taking into consideration current interest rates and the current creditworthiness of the counterparties or the Company, as applicable.

As a result of this swap, the Company pays interest at a fixed rate and receives payments at a variable rate which began on December 30, 2011. The swap effectively fixes the floating LIBOR-based interest rate to 1.25% on $250,000 of the outstanding balance under the Senior Credit Facility, with the outstanding balance subject to the swap declining over time. The interest rate swap expires on December 30, 2015. The Company has selected the LIBOR-based rate on the hedged portion of the Senior Credit Facility during the term of the swap. The effective portion of the change in value of the swap is reflected as a component of comprehensive income and recognized as Interest expense, net as payments are paid or accrued. The remaining gain or loss in excess of the cumulative change in the present value of the future cash flows of the hedged item, if any (i.e., the ineffective portion) or hedge components excluded from the assessment of effectivenes