

---

---

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

---

**FORM 10-Q**

---

(Mark One)

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

For the quarterly period ended August 2, 2016

OR

- 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 001-35354

---

**MATTRESS FIRM HOLDING CORP.**

(Exact Name of Registrant as Specified in Its Charter)

---

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**20-8185960**  
(I.R.S. Employer  
Identification No.)

**5815 Gulf Freeway**  
**Houston, Texas 77023**  
(Address of Principal Executive Offices) (Zip Code)

**(713) 923-1090**  
(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report.)

---

Indicate by check mark whether the registrant has (1) 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 (§232.405 of this chapter) 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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of September 8, 2016, 37,255,048 shares of common stock, par value \$0.01 per share, of the registrant were outstanding.

---

---

## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of federal securities laws that relate to future events or our future financial performance. In many cases, you can identify forward-looking statements by terminology such as “may,” “would,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “intend,” “potential” or “continue” or the negative of these terms or other comparable terminology. These forward-looking statements are made based on our management’s expectations and beliefs concerning future events affecting us and are subject to uncertainties and factors relating to our operations and business environment, all of which are difficult to predict and many of which are beyond our control. These uncertainties and other factors could cause our actual results to differ materially from those matters expressed or implied by these forward-looking statements.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Important factors that may cause actual results to differ materially from the results expressed or implied by these forward-looking statements are set forth under “*Item 1A. Risk Factors*” of Part I of the Company’s Annual Report on Form 10-K for the fiscal year ended February 2, 2016 filed with the Securities and Exchange Commission (the “SEC”) on April 4, 2016 (the “Fiscal 2015 Annual Report”) and any additional risk factors identified in our other filings with the SEC. All forward-looking statements in this Quarterly Report on Form 10-Q are based on information available to us on the date of this report. 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.

Some of the important factors that could cause our actual results, performance or financial condition to differ materially from expectations are:

- a reduction in discretionary spending by consumers;
- our ability to profitably open and operate new stores;
- our relationship with certain mattress manufacturers as our primary suppliers;
- our dependence on a few key employees;
- the failure of our acquired businesses to achieve the results we expect;
- the possible impairment of our goodwill or other acquired intangible assets;
- the effect of our planned growth and the integration of our acquisitions on our business infrastructure;
- the impact of seasonality on our financial results and comparable-store sales;
- fluctuations in our comparable-store sales from quarter to quarter;
- the effectiveness and efficiency of our advertising expenditures;
- our success in keeping warranty claims and exchange return rates within acceptable levels;
- our ability to deliver our products in a timely manner;
- our status as a holding company with no business operations;
- our ability to anticipate consumer trends;
- heightened competition;
- the impact of significant weather events;
- changes in applicable regulations;

- risks related to our franchises, including our lack of control over their operations, their ability to finance and open new stores and our liabilities if they default on note or lease obligations;
- risks related to our stock; and
- risks related to our franchises, including our lack of control over their operations, their ability to finance and open new stores and our liabilities if they default on note or lease obligations;
- risks related to our stock; and
- other factors discussed in “*Item 1A. Risk Factors*” of Part I of the Fiscal 2015 Annual Report, elsewhere in this report and in our other filings with the SEC.

**MATTRESS FIRM HOLDING CORP.**  
**Table of Contents**

	<u>Page</u>
PART I. FINANCIAL INFORMATION	4
Item 1. Financial Statements (unaudited).	4
Condensed Consolidated Balance Sheets as of February 2, 2016 and August 2, 2016.	4
Condensed Consolidated Statements of Operations for the Thirteen Weeks ended August 4, 2015 and August 2, 2016 and Twenty-Six Weeks ended August 4, 2015 and August 2, 2016.	5
Condensed Consolidated Statements of Comprehensive Income for the Thirteen Weeks ended August 4, 2015 and August 2, 2016 and Twenty-Six weeks ended August 4, 2015 and August 2, 2016.	6
Condensed Consolidated Statement of Equity for the Twenty-Six Weeks ended August 2, 2016.	7
Condensed Consolidated Statements of Cash Flows for the Twenty-Six Weeks ended August 4, 2015 and August 2, 2016.	8
Notes to Condensed Consolidated Financial Statements.	9
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.	28
Item 3. Quantitative and Qualitative Disclosures About Market Risk.	42
Item 4. Controls and Procedures.	42
PART II. OTHER INFORMATION	44
Item 1A. Risk Factors.	44
Item 6. Exhibits.	44
Signatures.	45

**PART I  
FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**MATTRESS FIRM HOLDING CORP.  
Condensed Consolidated Balance Sheets  
(In thousands, except share amounts)  
(unaudited)**

	February 2, 2016	August 2, 2016
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 1,778	\$ 13,587
Accounts receivable, net	64,923	78,673
Inventories	161,190	253,105
Prepaid expenses and other current assets	55,176	126,738
Total current assets	<u>283,067</u>	<u>472,103</u>
Property and equipment, net	317,451	455,863
Intangible assets, net	214,942	99,038
Goodwill	826,728	1,490,167
Other noncurrent assets, net	16,496	22,291
Total assets	<u>\$ 1,658,684</u>	<u>\$ 2,539,462</u>
<b>Liabilities</b>		
Current liabilities:		
Notes payable and current maturities of long-term debt	\$ 8,664	\$ 16,284
Accounts payable	164,686	274,325
Accrued liabilities	83,869	179,592
Customer deposits	20,028	43,084
Total current liabilities	<u>277,247</u>	<u>513,285</u>
Long-term debt, net of current maturities	675,033	1,340,286
Deferred income tax liability	52,299	47,196
Other noncurrent liabilities	142,623	161,478
Total liabilities	<u>1,147,202</u>	<u>2,062,245</u>
Commitments and contingencies (Note 13)		
<b>Equity</b>		
Common stock, \$0.01 par value; 120,000,000 shares authorized; 35,356,859 and 35,294,568 shares issued and outstanding at February 2, 2016; and 37,297,201 and 37,228,002 shares issued and outstanding at August 2, 2016, respectively	353	372
Additional paid-in capital	447,357	516,004
Accumulated retained earnings (deficit)	63,772	(57,590)
Total Mattress Firm Holding Corp. equity	<u>511,482</u>	<u>458,786</u>
Noncontrolling interest	—	18,431
Total equity	<u>511,482</u>	<u>477,217</u>
Total liabilities and equity	<u>\$ 1,658,684</u>	<u>\$ 2,539,462</u>

The accompanying Notes to the Unaudited Condensed Consolidated Financial Statements are an integral part of these interim financial statements.

**MATTRESS FIRM HOLDING CORP.**  
**Condensed Consolidated Statements of Operations**  
(In thousands, except share and per share amounts)  
(unaudited)

	<u>Thirteen Weeks Ended</u>		<u>Twenty-Six Weeks Ended</u>	
	<u>August 4, 2015</u>	<u>August 2, 2016</u>	<u>August 4, 2015</u>	<u>August 2, 2016</u>
Net sales	\$ 661,064	\$ 980,011	\$ 1,223,618	\$ 1,819,403
Cost of sales	403,557	625,495	764,840	1,199,112
Gross profit from retail operations	257,507	354,516	458,778	620,291
Franchise fees and royalty income	1,285	1,076	2,400	2,198
Total gross profit	258,792	355,592	461,178	622,489
<b>Operating expenses:</b>				
Sales and marketing expenses	169,121	246,367	301,017	450,404
General and administrative expenses	42,893	79,664	94,257	161,905
Intangible asset impairment charge	—	—	—	138,726
Loss on store closings and impairment of store assets	1,173	7,066	1,468	16,659
Total operating expenses	213,187	333,097	396,742	767,694
Income (loss) from operations	45,605	22,495	64,436	(145,205)
<b>Other expense:</b>				
Interest expense, net	10,046	24,670	20,299	48,437
Income (loss) before income taxes	35,559	(2,175)	44,137	(193,642)
Income tax expense (benefit)	13,678	(408)	16,778	(73,207)
Net income (loss)	21,881	(1,767)	27,359	(120,435)
Net income attributable to noncontrolling interest	—	432	—	927
Net income (loss) attributable to Mattress Firm Holding Corp.	\$ 21,881	\$ (2,199)	\$ 27,359	\$ (121,362)
Basic net income (loss) per common share	\$ 0.62	\$ (0.06)	\$ 0.78	\$ (3.27)
Diluted net income (loss) per common share	\$ 0.61	\$ (0.06)	\$ 0.77	\$ (3.27)
Basic weighted average shares outstanding	35,188,368	37,201,842	35,167,565	37,126,890
Diluted weighted average shares outstanding	35,600,295	37,201,842	35,584,024	37,126,890

The accompanying Notes to the Unaudited Condensed Consolidated Financial Statements are an integral part of these interim financial statements.

**MATTRESS FIRM HOLDING CORP.**  
**Condensed Consolidated Statements of Comprehensive Income**  
**(In thousands)**  
**(unaudited)**

	<u>Thirteen Weeks Ended</u>		<u>Twenty-Six Weeks Ended</u>	
	<u>August 4, 2015</u>	<u>August 2, 2016</u>	<u>August 4, 2015</u>	<u>August 2, 2016</u>
Net income (loss)	\$ 21,881	\$ (1,767)	\$ 27,359	\$ (120,435)
Unrealized loss on cash flow hedge, net of tax benefit of \$0, \$44, \$0 and \$0, respectively	—	(71)	—	—
Other comprehensive income (loss), net of tax	21,881	(1,838)	27,359	(120,435)
Comprehensive income attributable to noncontrolling interest	—	432	—	927
Comprehensive income (loss) attributable to Mattress Firm Holding Corp	<u>\$ 21,881</u>	<u>\$ (2,270)</u>	<u>\$ 27,359</u>	<u>\$ (121,362)</u>

The accompanying Notes to the Unaudited Condensed Consolidated Financial Statements are an integral part of these interim financial statements.

**MATTRESS FIRM HOLDING CORP.**  
**Condensed Consolidated Statement of Equity**  
(In thousands, except share amount)  
(unaudited)

<b>Mattress Firm Holding Corp. Stockholders' Equity</b>							
	<u>Common Stock</u>		<u>Additional Paid-In Capital</u>	<u>Accumulated Retained Earnings (Deficit)</u>	<u>Total Stockholders' Equity</u>	<u>Noncontrolling Interest</u>	<u>Total Equity</u>
	<u>Shares</u>	<u>Par Value</u>					
<b>Balances at February 2, 2016</b>	35,294,568	\$ 353	\$ 447,357	\$ 63,772	\$ 511,482	\$ —	\$ 511,482
Acquisition-related noncontrolling interest	—	—	—	—	—	18,354	18,354
Net loss	—	—	—	(121,362)	(121,362)	—	(121,362)
Net income attributable to noncontrolling interest	—	—	—	—	—	927	927
Issuance of common stock	699,300	7	24,993	—	25,000	—	25,000
Sleepy's equity consideration	1,062,936	11	36,820	—	36,831	—	36,831
Exercise of common stock options	146,829	1	2,858	—	2,859	—	2,859
Excess tax benefits associated with stock -based awards	—	—	162	—	162	—	162
Vesting of restricted stock	31,277	—	—	—	—	—	—
Purchase of vested stock -based awards	(6,908)	—	(284)	—	(284)	—	(284)
Stock -based compensation	—	—	4,098	—	4,098	—	4,098
Distributions to noncontrolling interest partner	—	—	—	—	—	(850)	(850)
<b>Balances at August 2, 2016</b>	<u>37,228,002</u>	<u>\$ 372</u>	<u>\$ 516,004</u>	<u>\$ (57,590)</u>	<u>\$ 458,786</u>	<u>\$ 18,431</u>	<u>\$ 477,217</u>

The accompanying Notes to the Unaudited Condensed Consolidated Financial Statements are an integral part of these interim financial statements.



**MATTRESS FIRM HOLDING CORP.**  
**Condensed Consolidated Statements of Cash Flows**  
(In thousands)  
(unaudited)

	<b>Twenty-Six Weeks Ended</b>	
	<b>August 4, 2015</b>	<b>August 2, 2016</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 27,359	\$ (120,435)
Adjustments to reconcile net income to cash flows provided by operating activities:		
Depreciation	28,746	43,373
Loan fee and other amortization	3,797	14,023
(Gain) loss from disposals of property and equipment	(14)	1,088
Deferred income tax expense (benefit)	3,766	(32,500)
Stock-based compensation	4,352	4,098
Intangible asset impairment	—	138,726
Loss on store closings and impairment of store assets	1,468	16,659
Construction allowances from landlords	5,913	6,803
Excess tax benefits associated with stock-based awards	(915)	(162)
Effects of changes in operating assets and liabilities, excluding business acquisitions:		
Accounts receivable	(3,515)	(12,909)
Inventories	4,400	(7,351)
Prepaid expenses and other current assets	(5,952)	(48,266)
Other assets	(2,307)	(1,112)
Accounts payable	11,310	40,643
Accrued liabilities	9,455	29,339
Customer deposits	6,664	6,426
Other noncurrent liabilities	24,628	2,646
Net cash provided by operating activities	<u>119,155</u>	<u>81,089</u>
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(68,480)	(55,825)
Sales of property and equipment, net	—	74,262
Business acquisitions, net of cash acquired	119	(725,031)
Net cash used in investing activities	<u>(68,361)</u>	<u>(706,594)</u>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of debt	58,000	799,100
Principal payments of debt	(114,302)	(160,607)
Debt issuance costs	—	(28,066)
Proceeds from issuance of common stock	—	25,000
Proceeds from exercise of common stock options	1,755	2,859
Excess tax benefits associated with stock-based awards	915	162
Purchase of vested stock-based awards	—	(284)
Distributions to noncontrolling interest partner	—	(850)
Net cash (used in) provided by financing activities	<u>(53,632)</u>	<u>637,314</u>
Net (decrease) increase in cash and cash equivalents	(2,838)	11,809
Cash and cash equivalents, beginning of period	13,475	1,778
Cash and cash equivalents, end of period	<u>\$ 10,637</u>	<u>\$ 13,587</u>
<b>Cash paid for:</b>		
Interest	\$ 20,070	\$ 42,026
Income taxes	<u>\$ 6,038</u>	<u>\$ 2,423</u>
<b>Supplemental disclosure of noncash investing and financing activity:</b>		
Capital expenditures included in accounts payable and accruals at end of period	\$ 6,933	\$ 5,450
Capital leases	<u>\$ —</u>	<u>\$ 9,546</u>
Equity issued in acquisition	<u>\$ —</u>	<u>\$ 36,831</u>

The accompanying Notes to the Unaudited Condensed Consolidated Financial Statements are an integral part of these interim financial statements.

**MATTRESS FIRM HOLDING CORP.**  
**Notes to the Unaudited Condensed Consolidated Financial Statements**

**1. Business and Basis of Presentation**

Mattress Firm Holding Corp., through its direct and indirect subsidiaries, is engaged in the retail sale of mattresses and bedding-related products in the United States through over 3,600 company-operated and franchisee-owned mattress specialty stores in 49 states that operate primarily under the brand names *Mattress Firm*,<sup>®</sup> *Sleepy's*<sup>®</sup> and *Sleep Train*<sup>®</sup>, as well as through the Company's eCommerce sites and special events. Mattress Firm Holding Corp. and its subsidiaries are referred to collectively as the "Company" or "Mattress Firm."

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X of the U.S. Securities and Exchange Commission ("SEC"), and they reflect, in the opinion of management, all normal recurring adjustments necessary to present fairly the Company's financial position as of August 2, 2016, and the results of operations, other comprehensive income and cash flows for the periods presented. The Company's historical and quarterly results of operations may not be indicative of the results that may be achieved for the full year or any future period.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the Company's most recent audited consolidated financial statements and related notes for the fiscal year ended February 2, 2016, which are included in the Company's Annual Report on Form 10-K filed with the SEC on April 4, 2016 (the "Fiscal 2015 Annual Financial Statements").

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of (i) assets and liabilities, (ii) disclosure of contingent assets and liabilities at the date of the financial statements and (iii) the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Estimates that are more susceptible to change in the near term are the accruals for sales returns and exchanges, product warranty costs, asset impairments, vendor incentives, self-insured liabilities, store closing costs and acquisition accounting fair values.

Certain reclassifications have been made to the prior year condensed consolidated statements of cash flows to segregate the gain (loss) from disposals of property and equipment from the previously reported activity that was included as a component of the change in noncurrent liabilities to conform to the current period financial statement presentation with no effect on the Company's previously reported net cash provided by operating activities.

The Company's fiscal year consists of 52 or 53 weeks ending on the Tuesday closest to January 31. The fiscal year ended February 2, 2016 ("Fiscal 2015") consisted of 52 weeks. The fiscal year ending January 31, 2017 ("Fiscal 2016") consists of 52 weeks.

The Company acquired The Sleep Train, Inc. ("Sleep Train") in October 2014 and HMK Mattress Holdings LLC, the holding company of Sleepy's LLC and related entities (collectively, "Sleepy's") in February 2016. Both the Sleep Train and Sleepy's legacy systems utilize the First-In, First-Out cost flow method ("FIFO") of inventory costing. As a result, inventory of \$44.1 million and \$134.6 million as of February 2, 2016 and August 2, 2016, respectively, is valued at FIFO. The Company, as a whole, uses the Weighted Average costing method for inventory. The Company determined the difference between Weighted Average and FIFO costs was not material at February 2, 2016 and August 2, 2016, therefore the carrying value of all inventory is essentially at Weighted Average. Steps are in process to convert the acquired legacy inventory systems to the Company's current ERP system; however, this is not expected to be completed until fiscal 2017. The Company will continue to assess and confirm that the carrying value of the FIFO inventory and the Weighted Average inventory is not materially different.

The Company acquired from Sleepy's an interest rate swap derivative used for the purpose of hedging exposure to changes of interest rates. This instrument has a notional amount of \$39 million. The interest rate swap, carried at fair value, matures on October 10, 2019. The derivative is an economic hedge and changes in fair value of the derivative instrument are recognized as interest expense in the Company's condensed consolidated statements of operations. In the

twenty-six weeks ended August 2, 2016, the Company has recognized a gain of less than \$0.1 million on the interest rate swap.

A subsidiary of Sleepy's entered into an arrangement in 2006 with an unrelated third party to purchase land as tenants in common and build office and warehouse space (the "Project") that would be leased to Sleepy's for its corporate headquarters. The Project is owned by a limited liability company ("LLC"), which is 50% owned by Sleepy's. As a result of the Sleepy's acquisition, this 50% interest is now owned by the Company. Pursuant to Accounting Standard Codification ("ASC") 810-10, the LLC is considered a variable interest entity and the Company is considered the primary beneficiary. As a result, the Company accounts for the Project utilizing the consolidation method of accounting and all operating results and the balance sheet of the LLC is consolidated with a corresponding noncontrolling interest presented in the Company's condensed consolidated financial statements. At August 2, 2016, the Company had \$18.4 million of equity in the noncontrolling interest recorded on its condensed consolidated balance sheets. At August 2, 2016, the LLC had land and buildings with a net book value of \$73.5 million, which are classified in property and equipment, net in the condensed consolidated balance sheets and \$35.5 million of mortgage debt that is classified in long-term debt, net of current maturities in our condensed consolidated balance sheets. Although the mortgage debt is collateralized by the land and buildings, Sleepy's is jointly and severally liable for the outstanding mortgage principal and interest payments on the mortgage debt. Only 50% of these assets and liabilities are attributable to the Company.

## 2. Recently Issued Accounting Standards

**Adopted in this Report**—In April 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-03, *Interest- Imputation of Interest- Simplifying the Presentation of Debt Issuance Costs*, which requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. This ASU is effective on a retrospective basis for annual reporting periods beginning after December 15, 2015, however early adoption is permitted. The Company has retrospectively applied the change in accounting principle as of May 3, 2016. As such, the prior year amounts of debt issuance costs previously reported as a component of other long-term assets were recast and resulted in a decrease of \$7.2 million in other long-term assets and long-term debt, net of current maturities, respectively, in the Company's condensed consolidated balance sheet as of February 2, 2016. The adoption of this ASU did not have an impact on the Company's results of operations, cash flows or equity.

In September 2015, the FASB issued ASU No. 2015-16, *Business Combinations- Simplifying the Accounting for Measurement-Period Adjustments*, which requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. This ASU is effective on a prospective basis for annual reporting periods beginning after December 15, 2015, however early adoption is permitted. The Company has adopted this ASU on a prospective basis beginning on February 3, 2016. The adoption of this ASU impacted the Company's adjustment to provisional amounts recorded in the 2016 acquisition discussed in Note 3.

**Not Yet Adopted in this Report**—In May 2014, the FASB issued 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. The 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. In March 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers: Principal versus Agent Considerations*, as an amendment to ASU 2014-09. The amendment clarifies how to identify the unit of accounting for the principal versus agent evaluation, how to apply the control principle to certain types of arrangements, such as service transaction, and reframed the indicators in the guidance to focus on evidence that an entity is acting as a principal rather than as an agent. In April 2016, the FASB issued ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*,

which also amends certain aspects of ASU 2014-09, specifically the standard's guidance on identifying performance obligations and the implementation guidance on licensing. The amendments clarify when promised goods or services are separately identifiable (i.e., distinct within the context of a contract), an important step in determining whether goods and services should be accounted for as separate performance obligations. In addition, the amendments allow entities to disregard goods or services that are immaterial in the context of a contract and provide an accounting policy election for accounting for certain shipping and handling activities. The amendments also clarify how an entity should evaluate the nature of its promise in granting a license of intellectual property (IP), which will determine whether the entity recognizes revenue over time or at a point in time. The amendments revise the guidance to address how entities should apply the exception for sales- and usage-based royalties to licenses of IP, recognize revenue for licenses that are not separate performance obligations and evaluate different types of license restrictions (e.g., time-based, geography-based). In May 2016, the FASB issued ASU 2016-12, "*Revenue from Contracts with Customers - Narrow Scope Improvements and Practical Expedients*", to reduce the risk of diversity in practice for certain aspects in ASU 2014-09, including collectability, noncash consideration, presentation of sales tax and transition. The new guidance's effective date and transition provisions are aligned with the requirements in the new revenue standard, which is not yet effective. The Company is currently evaluating the guidance, including the amendments, to determine the Company's adoption method and the effect it will have on the Company's condensed consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*, which requires any organization that lease assets to recognize the rights and obligations created by those leases on the balance sheet. This ASU is effective for fiscal years beginning after December 15, 2018 including interim periods within that reporting period, however early adoption is permitted. The Company will apply this ASU on a retrospective basis beginning in fiscal year 2019. The Company is currently evaluating the guidance to determine the effect it will have on the Company's condensed consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation-Stock Compensation- Improvements to Employee Share-Based Payment Accounting*, which involves several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Under the new standard, income tax benefits and deficiencies are to be recognized as income tax expense or benefit in the income statement and the tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity should also recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. Excess tax benefits should be classified along with other income tax cash flows as an operating activity. In regards to forfeitures, the entity may make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or account for forfeitures when they occur. This ASU is effective for fiscal years beginning after December 15, 2016 including interim periods within that reporting period, however early adoption is permitted. The Company is currently evaluating the guidance to determine the Company's adoption method and the effect it will have on the Company's condensed consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230) Classification of Certain Cash Receipts and Cash Payments*, which will make eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2017, and will require adoption on a retrospective basis. The Company is currently evaluating the impact the application of ASU 2016-15 will have on the Company's condensed consolidated financial statements.

### **3. Acquisitions**

On February 5, 2016, the Company completed the purchase of all of the outstanding equity interests in HMK Mattress Holdings LLC, the holding company of Sleepy's LLC and related entities (collectively, "Sleepy's"), for an aggregate purchase price of approximately \$796.3 million, subject to working capital adjustments. At the time of the acquisition, Sleepy's operated 1,065 specialty mattress retail stores located in 17 states in the Northeast, New England, the Mid-Atlantic and Illinois and employed approximately 3,300 people. The Sleepy's acquisition allowed the Company to achieve immediate scale and presence in New England and in the Northeast where it previously had little to no presence.

The Company expects to receive future annual cash income tax benefits of approximately \$11.5 million over the next 15 years from deductible tax basis goodwill generated from the acquisition, subject to the Company's ability to generate future taxable income. The purchase price consisted of cash of \$725.0 million (net of \$34.5 million of cash acquired), of which \$20.0 million was placed in escrow, and \$36.8 million delivered in the form of 1,062,936 shares of common stock, par value \$0.01 per share, of Mattress Firm Holding Corp. ("common stock") as calculated in accordance with the terms of the purchase agreement. The common stock was issued to certain affiliates of Adam Blank, the chief operating officer and general counsel of Sleepy's immediately prior to the closing of the acquisition, and Calera Capital Partners IV, L.P. in exchange for the aggregate equity value that each of them held in HMK Mattress Holdings LLC.

The purchase price payable to the selling equityholders of HMK Mattress Holdings LLC was reduced by certain payment obligations of Sleepy's, including the repayment of certain indebtedness of Sleepy's. The Company funded a portion of the cash purchase price for the Sleepy's acquisition by borrowing approximately \$749.2 million under its Senior Credit Facility. A portion of the cash purchase price was funded by capital that the Company raised by selling an aggregate of 699,300 shares of its common stock at \$35.75 per share to certain investment funds affiliated with J.W. Childs Associates, L.P., an existing stockholder ("J.W. Childs"), and to Steve Stagner, its chief executive officer at the time, and now the executive chairman and chairman of the board.

The allocation of the preliminary purchase price to the acquired assets and liabilities, based on management's estimate of their fair values on the acquisition date, is as follows (in thousands):

	<b>Sleepy's</b>
Cash	\$ 34,436
Accounts receivable	3,482
Inventories	84,564
Prepaid expenses and other current assets	23,296
Property and equipment	192,355
Intangible assets	31,500
Goodwill	663,436
Net favorable lease rights	7,449
Other assets	5,796
Notes payable and current maturities of long-term debt	(2,972)
Accounts payable	(71,122)
Accrued liabilities	(65,951)
Customer deposits	(16,630)
Long-term debt, net of current maturities	(45,687)
Deferred income tax liability	(27,559)
Other noncurrent liabilities	(1,744)
Noncontrolling interest	(18,354)
Fair value of assets and liabilities acquired	796,295
Reconciliation to cash used in acquisition:	
Fair value of equity consideration transferred	(36,831)
Cash of acquired business	(34,436)
Cash used in acquisition, net of cash acquired	\$ 725,028

The Sleepy's acquisition resulted in \$663.4 million of goodwill based on management's estimate on the acquisition closing date, of which approximately \$460.5 million will be deductible for income tax purposes over 15 years.

Intangible assets acquired in relation to the Sleepy's acquisition consist primarily of \$26.8 million in acquired tradenames and \$4.7 million related to a non-compete agreement. The tradenames were valued as defensive assets and have useful lives ranging from one to ten years. The weighted average amortization period remaining for these tradename intangible assets is three years. The non-compete agreement is being amortized over a period of five years.

The noncontrolling interest relates to the 50% interest in the LLC not owned by the Company and was adjusted to fair value at the date of acquisition based on the net fair value of the fixed assets and mortgage liability held by the LLC.

The net sales included in the Company's consolidated statement of operations which were generated by the Sleepy's business from the acquisition closing date of February 5, 2016 through August 2, 2016 was \$528.2 million. The earnings included in the Company's consolidated statement of operations derived from the Sleepy's business from the acquisition closing date to August 2, 2016 were \$17.4 million.

Acquisition-related costs for U.S. GAAP purposes are costs the acquirer incurs to effect a business combination, including advisory, legal, accounting, valuation, and other professional or consulting fees. The Company incurred a total of approximately \$0.4 million and \$6.8 million of acquisition-related costs charged to general and administrative expenses during the thirteen and twenty-six weeks ended August 2, 2016, respectively.

The allocation of the purchase price is preliminary and is not finalized and may be adjusted during the remainder of fiscal 2016. The items still under review include the fair value of inventories, accrued liabilities, and deferred income taxes. In addition, as the Company continues to integrate the Sleepy's accounting processes other items may require adjustment. During the thirteen weeks ended August 2, 2016, the Company made adjustments to provisional amounts recorded during the first quarter of fiscal 2016 of a net increase of \$11.5 million to various reserves and accruals, a net increase of \$3.1 million in the value assigned to property and equipment, net decrease of \$1.8 million in the value assigned to intangible assets, and a net adjustment of \$0.8 million in the purchase price, resulting in a net increase in goodwill of \$11.0 million. The impact to net income from these provisional adjustments in the first quarter of fiscal 2016 would have been less than a \$0.1 million decrease.

In the twenty-six weeks ended August 2, 2016, the Company recorded a working capital adjustment related to its November 2015 acquisition of the retail assets and operations of Double J-RD, LLC which increased goodwill and cash used in acquisitions by less than \$0.1 million.

The following table presents the selected consolidated financial information of the Company on a pro forma basis, assuming the Sleepy's acquisition occurred as of February 4, 2015, the first day of the Company's 2015 fiscal year. The historical financial information has been adjusted to give effect to the pro forma items that are directly attributable to the acquisition and are expected to have a continuing impact on the consolidated results.

The unaudited financial information set forth below has been compiled from the historical financial statements and other information, but is not necessarily indicative of the results that actually would have been achieved had the transactions occurred on the dates indicated or that may be achieved in the future (amounts in thousands, except per share amounts):

	<u>Thirteen Weeks Ended August 4, 2015</u>			<u>Twenty-Six Weeks Ended August 4, 2015</u>		
	<u>As Reported</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma</u>	<u>As Reported</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma</u>
Net sales	\$ 661,064	\$ 312,137	\$ 973,201	\$ 1,223,618	\$ 560,969	\$ 1,784,587
Net income (loss)	21,881	5,337	27,218	27,359	(4,696)	22,663
Diluted net income (loss) per common share	\$ 0.61	\$ 0.15	\$ 0.76	\$ 0.77	\$ (0.13)	\$ 0.64

For the thirteen and twenty-six weeks ended August 2, 2016 no pro-forma adjustments are required to be presented as the acquisition of Sleepy's occurred within three days of the beginning of the fiscal year. As such the three days of activity were not considered significant.

#### 4. Fair Value of Financial Instruments

The amounts reported in the condensed consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their respective fair values due to the short-term maturity of these instruments.

The FASB has issued guidance on the definition of fair value, the framework for using fair value to measure assets and liabilities, and disclosure regarding fair value measurements. The guidance establishes a three-tier fair value hierarchy, which prioritizes the inputs used to measure fair value. These tiers include:

- Level 1: Defined as observable inputs such as quoted prices in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2: Defined as pricing inputs other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors and current market and contractual prices for the underlying instruments, as well as other relevant economic measures.
- Level 3: Defined as pricing inputs that are unobservable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

The Company measures the fair value of its nonqualified deferred compensation plan on a recurring basis. The plan's assets are valued based on the marketable securities tied to the plan. Additionally, the Company measures the fair values of goodwill, intangible assets, and property and equipment on a nonrecurring basis if required by impairment tests applicable to these assets.

Assets requiring recurring or non-recurring fair value measurements consisted of the following (in thousands):

	Net Book Value as of February 2, 2016	Fair Value Measurements			Fiscal 2015 Impairments
		Level 1	Level 2	Level 3	
		Nonqualified deferred compensation plan	\$ 1,698	\$ —	
Property and equipment requiring impairment review	\$ 727	\$ —	\$ —	\$ 727	\$ 1,525
Senior Credit Facility term loans	\$ 685,113	\$ —	\$ 670,270	\$ —	\$ —

	Net Book Value as of August 2, 2016	Fair Value Measurements			Fiscal 2016 Impairments
		Level 1	Level 2	Level 3	
		Nonqualified deferred compensation plan	\$ 1,885	\$ —	
Intangible assets requiring impairment review	\$ 14,579	\$ —	\$ —	\$ 14,579	\$ 138,726
Interest rate swap liability	\$ 1,200	\$ —	\$ 1,200	\$ —	\$ —
Property and equipment requiring impairment review	\$ 1,780	\$ —	\$ —	\$ 1,780	\$ 14,438
Senior Credit Facility term loans	\$ 1,282,713	\$ —	\$ 1,296,279	\$ —	\$ —

The significant Level 3 unobservable input used in the fair value measurement of the Company's property and equipment was the weighted average cost of capital ("WACC"). Increases (decreases) in WACC inputs in isolation would result in a lower (higher) fair value measurement.

The following tables are not intended to be all-inclusive, but rather provide a summary of the significant unobservable inputs used in the fair value measurement of the Company's Level 3 assets in which impairment testing was performed.

### Impairment testing performed as of February 2, 2016

Valuation Technique	Significant Unobservable Inputs	Unobservable Input Range
<b>Property and Equipment Impairment Testing</b>		
Income approach	WACC	13.5%

### Impairment testing performed as of August 2 2016

Valuation Technique	Significant Unobservable Inputs	Unobservable Input Range
<b>Intangible Asset Impairment Testing</b>		
Income approach	WACC	7.5% to 11.5%
	Royalty rate	1.0% to 2.0%
<b>Property and Equipment Impairment Testing</b>		
Income approach	WACC	13.5%

The fair value of the Senior Credit Facility term loans was estimated based on the ask and bid prices quoted from an external source. The fair value of the interest rate swap liability was estimated based on prices quoted from an external source.

## 5. Property and Equipment

Property and equipment consists of the following (in thousands):

	February 2, 2016	August 2, 2016
Land	\$ —	\$ 19,429
Building	—	62,816
Leasehold improvements	340,029	392,444
Equipment, computers and software	83,879	116,826
Store signs	56,149	65,318
Furniture and fixtures	36,730	34,765
Vehicles	1,738	1,479
Property and equipment	518,525	693,077
Accumulated depreciation	(201,074)	(237,214)
Property and equipment, net	<u>\$ 317,451</u>	<u>\$ 455,863</u>

Depreciation expense was \$14.7 million and \$22.6 million for the thirteen weeks ended August 4, 2015 and August 2, 2016, respectively. Depreciation expense was \$28.7 million and \$43.4 million for the twenty-six weeks ended August 4, 2015 and August 2, 2016, respectively. Based upon the review of the performance of individual stores, including a decline in performance of certain stores, impairment losses of approximately \$0.7 million and \$4.5 million were recognized during the thirteen and twenty-six weeks ended August 4, 2015 and August 2, 2016, respectively. The impairment loss amounts were determined as the excess of the carrying value of property and equipment of those stores with potential impairment in excess of the estimated fair value based on estimated cash flows. Estimated cash flows are primarily based on projected revenues, operating costs and maintenance capital expenditures of individual stores and are discounted based on comparable industry average rates for weighted average cost of capital. The Company also recorded an impairment charge related to store assets of approximately \$6.9 million in the thirteen weeks ended May 3, 2016, primarily related to our plan to close certain stores near the end of their lease term. An additional \$1.0 million and \$3.0 million of impairment losses were recorded during the thirteen and twenty-six weeks ended August 2, 2016, respectively, related to other fixed assets. Impairment losses related to fixed assets are reported as a component of “Loss on store closing and impairment of store assets” in the condensed consolidated statements of operations.



On June 20, 2016, the Company completed the sale and leaseback of two warehouses to an unrelated third party and on July 11, 2016, the Company completed the sale and leaseback of 15 store properties to an unrelated third party. The Company received aggregate gross proceeds from the transactions of \$70.9 million (\$68.5 million, net of closing costs). Mortgage debt of \$9.4 million related to these properties was paid off as part of the transaction and \$2.6 million of the proceeds, recorded as a component of accounts receivable, net, was placed in escrow with the state of New Jersey and will be released during fiscal 2017. In connection with the transactions the Company has entered into agreements under which the Company leases these properties. The Company accounted for the transactions as sale-leasebacks and determined the transactions qualified for sales recognition and sale-leaseback accounting. The Company recognized any loss on sale immediately and any gain was deferred and will be recognized over the lease term. Accordingly, during the second quarter of fiscal 2016, the Company recognized net losses of \$1.7 million. The gains of \$14.7 million were deferred and will be recognized over the respective lease terms.

## 6. Goodwill and Intangible Assets

The Company's goodwill is attributable to the retail segment. A summary of the changes in the carrying amounts of goodwill and non-amortizable assets for the twenty-six weeks ended August 2, 2016 is as follows (in thousands):

	<b>Goodwill</b>	<b>Nonamortizable Intangibles</b>
Balance at February 2, 2016	\$ 826,728	\$ 178,358
Prior year business acquisition adjustment (See Note 3)	3	—
Current period business acquisitions (see Note 3)	663,436	—
Impairment of tradenames	—	(97,759)
Reclassification of tradenames to definite lived intangible assets	—	(8,953)
Balance at August 2, 2016	<u>\$ 1,490,167</u>	<u>\$ 71,646</u>

A summary of the changes in the carrying amounts of amortizable intangible assets for the twenty-six weeks ended August 2, 2016 is as follows (in thousands):

	<b>Gross Cost</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Value</b>
Balance at February 2, 2016	\$ 44,936	\$ (8,352)	\$ 36,584
Current period business acquisitions (See Note 3)	31,500	—	31,500
Reclassification of tradenames to definite lived intangible assets	8,953	—	8,953
Impairment of tradenames	(45,694)	4,727	(40,967)
Trademarks defense	129	—	129
Amortization expense	—	(8,807)	(8,807)
Balance at August 2, 2016	<u>\$ 39,824</u>	<u>\$ (12,432)</u>	<u>\$ 27,392</u>

The components of intangible assets were as follows (dollar amounts in thousands):

	Useful Life (Years)	February 2, 2016			August 2, 2016		
		Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Nonamortizing:							
Trade names and trademarks		\$ 178,358	\$ —	\$ 178,358	\$ 71,646	\$ —	\$ 71,646
Amortizing:							
Franchise agreement rights	20	5,907	1,266	4,641	5,907	1,490	4,417
Acquired trade names and trademarks	1 - 10	34,972	5,518	29,454	25,160	8,689	16,471
Software technology	15	1,573	275	1,298	1,573	328	1,245
Non-compete agreements	3 - 5	2,484	1,293	1,191	7,184	1,925	5,259
Intangible assets, net		<u>\$ 223,294</u>	<u>\$ 8,352</u>	<u>\$ 214,942</u>	<u>\$ 111,470</u>	<u>\$ 12,432</u>	<u>\$ 99,038</u>

Expense included in general and administrative expense related to the amortization of intangible assets was \$0.7 million and \$4.1 million for the thirteen weeks ended August 4, 2015 and August 2, 2016, respectively. Expense included in general and administrative expense related to the amortization of intangible assets was \$1.4 million and \$8.8 million for the twenty-six weeks ended August 4, 2015 and August 2, 2016, respectively.

The weighted average amortization period remaining for intangible assets is five years. As of August 2, 2016, amortization expense for intangible assets is expected to be as follows (in thousands):

Fiscal Year	
Remainder of 2016	\$ 9,928
2017	\$ 4,352
2018	\$ 2,434
2019	\$ 2,386
2020	\$ 2,372
Thereafter	\$ 5,920

No goodwill impairment charges were recognized in the thirteen and twenty-six weeks ended August 4, 2015 and August 2, 2016.

The Company made the decision in late April 2016 to rebrand all stores to the *Mattress Firm* brand name. This rebranding is expected to be complete in the first quarter of fiscal 2017. In connection with this decision, the Company revalued all tradename intangible assets held by the Company using the relief of royalty method and recorded the corresponding non-cash impairment charge of \$138.7 million in the thirteen weeks ended May 3, 2016 to write down these intangible assets to fair value. (See Note 4).

## 7. Notes Payable and Long-term Debt

Notes payable and long-term debt consists of the following (in thousands):

	February 2, 2016	August 2, 2016
Senior Credit Facility - term loans	\$ 691,000	\$ 1,306,075
Less: Senior Credit Facility - term loans discount	(5,887)	(23,362)
Senior Credit Facility - revolver borrowings	—	40,000
Capital leases	—	9,458
Equipment financing and other notes payable	5,808	37,951
Total long-term debt	690,921	1,370,122
Less: deferred financing costs	(7,224)	(13,552)
Total debt, net	683,697	1,356,570
Less: current maturities of long-term debt	8,664	16,284
Long-term debt, net of current maturities	<u>\$ 675,033</u>	<u>\$ 1,340,286</u>

**Senior Credit Facility**— Effective October 20, 2014, Mattress Holding Corp. (“MHC”), a Delaware corporation and indirect subsidiary of Mattress Firm Holding Corp., entered into a \$125 million asset-backed loan credit agreement dated October 20, 2014, among MHC, as borrower, Mattress Holdco, Inc., the lenders party thereto, and Barclays Bank PLC, as administrative agent, collateral agent and issuer (the “ABL Credit Agreement”). Effective February 5, 2016, MHC entered into Amendment No. 1 to the ABL Credit Agreement, which amended the ABL Credit Agreement to, among other things, increase the available revolving credit commitments thereunder by \$75.0 million, to up to \$200 million total.

The ABL Credit Agreement is a committed senior revolving credit facility, secured by the assets of the borrower and the guarantors, that permits aggregate borrowings of up to \$200 million, and contains a letter of credit facility that, at any time outstanding, is limited to \$60 million and a swing line facility that, at any time outstanding, is limited to \$20 million. Subject to customary conditions, the Company may request that the lenders’ aggregate commitments with respect to the revolving credit facility be increased by up to \$50 million. The maturity date under the ABL Credit Agreement was extended under Amendment No. 1 to February 5, 2021.

Loans under the ABL Credit Agreement bear interest by reference, at MHC’s election, to the LIBOR rate or base rate, provided, that swing line loans bear interest by reference only to the base rate. The applicable margin for LIBOR rate loans varies from 1.25% to 1.50% and the applicable margin for base rate loans varies from 0.25% to 0.50%. The interest rate for loans under the ABL Credit Agreement, whether tied to LIBOR or the base rate, is determined based upon the Company’s average excess available borrowing capacity for the prior three month period. A letter of credit issuance fee is payable by the Company equal to 0.125% per annum multiplied by the average daily amount available to be drawn under the applicable letter of credit, as well as an additional fee equal to the applicable margin for LIBOR rate loans times the daily amount available to be drawn under all outstanding letters of credit. The commitment fee rate payable to the lenders for each of the revolving facility and term facility is 0.25% per annum.

Mattress Holdco, Inc., the parent company of the borrower, and each domestic subsidiary of MHC other than immaterial subsidiaries, as determined by certain ratios in the credit agreement, has unconditionally guaranteed all existing and future indebtedness and liabilities of the other guarantors and the borrower arising under the ABL Credit Agreement and other loan documents. Mattress Holdco, Inc. and subsidiaries own all assets and liabilities of the Company, with the exception of a minimal cash balance.

The ABL Credit Agreement requires compliance with one financial covenant. The Company cannot permit its fixed charge coverage ratio to fall below 1.0. The ABL Credit Agreement generally defines the fixed charge coverage ratio as the ratio of (a) adjusted EBITDA, less capital expenditures, less all taxes paid or payable in cash by the borrower and guarantors to (b) the sum of fixed charges, in each case, determined as of the most recently ended four fiscal quarter period. As of August 2, 2016, the fixed charge coverage ratio was 2.53 to 1.0. The ABL Credit Agreement also contains customary representations, warranties and affirmative and negative covenants.

Events of default under the ABL Credit Agreement include failure to pay principal or interest when due, failure to comply with the financial and operational covenants, as well as a cross default event, Loan Document (as defined in the ABL Credit Agreement) enforceability event, change of control event and bankruptcy and other insolvency events. If an event of default occurs and is continuing, then the lenders holding the majority of the outstanding loans have the right, among others, to (i) terminate the commitments under the ABL Credit Agreement, (ii) accelerate and require the Company to repay all the outstanding amounts owed under any Loan Document (provided that in limited circumstances with respect to insolvency and bankruptcy of the Company, such acceleration is automatic), and (iii) require the Company to cash collateralize any outstanding letters of credit.

There were \$40.0 million in outstanding ABL Credit Agreement borrowings at August 2, 2016. Outstanding letters of credit on the revolving facility were \$12.3 million at August 2, 2016, resulting in \$114.4 million of availability for revolving borrowings.

Effective October 20, 2014, MHC entered into a \$720 million term loan credit agreement dated October 20, 2014, among MHC, as borrower, Mattress Holdco, Inc., the lenders party thereto, and Barclays Bank PLC, as administrative agent and collateral agent (the "Term Loan Credit Agreement"). Effective February 5, 2016, MHC entered into Amendment No. 1 to the Term Loan Credit Agreement, which amended the Term Loan Credit Agreement to, among other things, add a \$665 million incremental term loan facility thereunder. The Term Loan Credit Agreement and the ABL Credit Agreement are collectively referred to as the "Senior Credit Facility".

Two term loans in the aggregate principal amounts of \$720 million and \$665 million were issued under the Term Loan Credit Agreement on October 20, 2014 and February 5, 2016, respectively. The maturity date under the Term Loan Credit Agreement is October 20, 2021. Loans under the Term Loan Credit Agreement bear interest by reference, at MHC's election, to (i) the LIBOR rate, which is 5.25%, or (ii) the base rate, which is 4.25%. The interest rate for loans under the Term Loan Credit Agreement, whether tied to LIBOR or the base rate, is determined based upon the Company's total net leverage ratio. The weighted average interest rate applicable to outstanding borrowings under the Term Loan Credit Agreement was the 1.0% LIBOR rate plus 5.25% as of August 2, 2016.

Mattress Holdco, Inc., the parent company of the borrower, and each domestic subsidiary of MHC other than immaterial subsidiaries, as determined by certain ratios in the Term Loan Credit Agreement, has unconditionally guaranteed all existing and future indebtedness and liabilities of the other guarantors and MHC arising under the Term Loan Credit Agreement and other loan documents.

The Term Loan Credit Agreement requires compliance with one financial covenant. Commencing with the fiscal quarter ending as of August 2, 2016, MHC must not exceed a total net leverage coverage ratio subject to specified stepdowns. The financial covenant starts at 5.5 times and steps down annually. As of August 2, 2016 the total net leverage coverage ratio was 3.9 times. The Term Loan Credit Agreement generally defines the total net leverage coverage ratio as the ratio of (a) consolidated net debt to (b) adjusted EBITDA of MHC, in each case, determined as of the last day of the four fiscal quarter period ending on such test date. The Term Loan Credit Agreement contains customary representations, warranties and affirmative and negative covenants. Mattress Holdco, Inc. and subsidiaries own all assets and liabilities of the Company, with the exception of a minimal cash balance.

Events of default under the Term Loan Credit Agreement include failure to pay principal or interest when due, failure to comply with the covenants, as well as a cross default event, Loan Document (as defined in the Term Loan Credit Agreement) enforceability event, change of control event and bankruptcy and other insolvency events. If an event of default occurs and is continuing, then the lenders holding a majority of the outstanding loans have the right, among others, to (i) terminate the commitments under the Term Loan Credit Agreement, and (ii) accelerate and require the Company to repay all the outstanding amounts owed under any Loan Document (provided that in limited circumstances with respect to insolvency and bankruptcy of the Company, such acceleration is automatic).

**Capital Leases**— The Company has an outstanding capital lease in the amount of \$8.0 million for its new corporate office headquarters. The Company expects to move to its new headquarters in the third fiscal quarter of 2016. The capital lease will be amortized through fiscal 2023, at an interest rate of 4.1%.

The Company has outstanding capital leases for information technology and warehouse equipment as of August 2, 2016 in the amount of \$1.5 million. The capital leases will be amortized through fiscal 2018.

**Equipment Financing and Other Notes Payable**—In connection with the acquisition of Sleepy’s the Company acquired mortgages payable with a remaining balance of \$37.9 million as of August 2, 2016 payable through fiscal 2019 at interest rates ranging from 3.6% to 5.6%. The mortgages are collateralized by their respective properties. At August 2, 2016, \$35.5 million of this mortgage debt related to the Project that is fully reflected in our condensed consolidated balance sheets but is only 50% attributable to the Company due to the noncontrolling interest. (See Note 1).

**Covenant Compliance**—The Company was in compliance with all of the financial covenants required under the Senior Credit Facility and our other indebtedness as of August 2, 2016.

**Future Maturities of Notes Payable and Long-Term Debt**—The aggregate maturities of notes payable and long-term debt at August 2, 2016 were as follows (in thousands):

<b>Fiscal Year</b>	
Remainder of 2016	\$ 5,754
2017	10,737
2018	10,716
2019	40,593
2020	8,221
Thereafter	1,280,549
<b>Total</b>	<b>\$ 1,356,570</b>

## 8. Income Taxes

Income tax expense during the interim periods is based on the estimated annual effective income tax rate plus any discrete items which are recorded in the period in which they occur. Discrete items include such events as changes in estimates due to the finalization of tax returns, tax audit settlements, tax law changes, and increases or decreases in valuation allowances related to prior year estimates. The determination of the consolidated provision for income taxes, deferred tax assets and liabilities and related valuation allowance requires management to make judgments and estimates. Although management believes that its tax estimates are reasonable, the ultimate tax determination involves significant judgments that could become subject to audit by tax authorities in the ordinary course of business, as well as the generation of sufficient future taxable income.

The Company recognized \$73.2 million of income tax benefit for the twenty-six weeks ended August 2, 2016, compared to \$16.8 million of income tax expense for the twenty-six weeks ended August 4, 2015. The effective tax rate was 37.8% for the twenty-six weeks ended August 2, 2016, compared to 38.0% for the twenty-six weeks ended August 4, 2015. The effective tax rate of 37.8% for the current period differs from the federal statutory rate of 35.0% primarily due to state income taxes. The prior year rate also varied from the federal statutory rate, primarily due to state income taxes but were offset by the release of \$0.4 million in liabilities for unrecognized tax benefits as a result of settling an audit, which lowered the effective tax rate.

The Company and its subsidiaries are included in a consolidated income tax return in the U.S. federal jurisdiction and some states, and file separate income tax returns in several other states. As of August 2, 2016, the federal return is open to audit for tax years after 2012 and some state jurisdictions are open for tax years after 2009.

As of February 3, 2015, the Company had approximately \$3.5 million of net operating loss carryforwards that begin expiring in fiscal 2029, if not utilized to offset future taxable income. These net operating loss carryforwards arose from the acquisition of MGHC Holding Corporation (“Mattress Giant”) during fiscal 2012 are limited to \$2.8 million in fiscal 2016 and \$0.7 million in fiscal 2017.

## 9. Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of the following (in thousands):

	February 2, 2016	August 2, 2016
Prepaid rent	\$ 32,098	\$ 51,941
Prepaid income taxes	2,722	45,091
Prepaid insurance	5,752	10,686
Prepaid computer software and hardware services	3,317	9,802
Prepaid special event space rental	1,924	3,203
Prepaid point-of-purchase inventory	2,032	1,837
Prepaid advertising	1,903	671
Other	5,428	3,507
Total	<u>\$ 55,176</u>	<u>\$ 126,738</u>

## 10. Accrued Liabilities and Other Noncurrent Liabilities

The Company estimates certain liabilities in an effort to recognize those expenses in the period incurred. The most significant estimates relate to employee wages, payroll taxes and withholdings, product warranty returns and insurance-related expenses, significant portions of which are self-insured related to workers' compensation and employee health insurance.

Accrued liabilities consist of the following (in thousands):

	February 2, 2016	August 2, 2016
Unbilled advertising	\$ 22,452	\$ 46,661
Insurance	8,837	36,520
Employee wages, payroll taxes and withholdings	13,537	25,072
Sales and property tax	10,642	21,265
Closed store lease reserve	630	6,875
Product warranty returns	4,830	5,267
Utilities	2,391	4,846
Accrued employee compensated absences	4,756	4,756
Accrued rent	3,526	4,393
Accrued construction in-progress costs	3,274	3,877
Sales returns and exchanges	2,353	3,785
Accrued interest	843	3,124
Other	5,798	13,151
Total	<u>\$ 83,869</u>	<u>\$ 179,592</u>

Other noncurrent liabilities consist of the following (in thousands):

	February 2, 2016	August 2, 2016
Deferred lease liabilities	\$ 95,047	\$ 114,404
Deferred vendor incentives	35,026	32,304
Product warranty returns, less current portion	8,784	9,946
Other	3,766	4,824
Total	<u>\$ 142,623</u>	<u>\$ 161,478</u>

## 11. Earnings Per Share

Basic net income (loss) per common share is computed by dividing the net income (loss) applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period, adjusted to reflect potentially dilutive securities using the treasury stock method for stock option awards. Diluted net income (loss) per common share adjusts basic net income (loss) per common share for the effects of stock options and other potentially dilutive financial instruments only in the periods in which such effect is dilutive.

The following table presents a reconciliation of the weighted average shares outstanding used in the earnings per share calculations:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 4, 2015	August 2, 2016	August 4, 2015	August 2, 2016
Basic weighted average shares outstanding	35,188,368	37,201,842	35,167,565	37,126,890
Effect of dilutive securities:				
Stock options	319,819	—	332,038	—
Restricted shares	92,108	—	84,421	—
Diluted weighted average shares outstanding	<u>35,600,295</u>	<u>37,201,842</u>	<u>35,584,024</u>	<u>37,126,890</u>

Diluted net income per common share for the thirteen and twenty-six weeks ended August 4, 2015, excludes stock options for the purchase of 49,631 shares of common stock as their inclusion would be anti-dilutive.

Certain stock option and restricted stock awards contain vesting conditions based on specified stock price targets for the Company's common stock as measured at each of the annual vesting dates ("market-based awards"). The Company includes such market-based awards in the determination of dilutive weighted average shares outstanding under the treasury stock method when, as of the date of determination, the specified stock price targets are met and the common stock shares pursuant to those awards become contingently issuable. Accordingly, the determination of diluted weighted average shares outstanding excludes, as of the date of determination, stock options for the purchase of 15,388 shares of common stock for the thirteen and twenty-six weeks ended August 4, 2015, and excludes 136,832 shares of non-vested restricted stock for the thirteen and twenty-six weeks ended August 4, 2015, as the specified stock price targets were not met as of the determination date.

For the thirteen and twenty-six weeks ended August 2, 2016, there were no reconciling items to the weighted average common shares outstanding in the calculation of diluted loss per common share. The thirteen and twenty-six weeks ended August 2, 2016 excludes stock options for the purchase of 589,160 shares of common stock and excludes 483,094 shares of non-vested restricted stock as their inclusion would be anti-dilutive due to the net loss position of the Company in the thirteen and twenty-six weeks ended August 2, 2016.

## 12. Stock-Based Compensation

**2011 Omnibus Incentive Plan**—On November 3, 2011, the Company's board of directors and shareholders adopted the Mattress Firm Holding Corp. 2011 Omnibus Incentive Plan to provide for the grant of equity-based awards to Company employees, directors and other service providers. A total of 4,206,000 shares of the Company's common stock were reserved for grants under the 2011 Omnibus Incentive Plan. There were 2,080,432 shares available for future grants under the stock incentive plan as of August 2, 2016.

**Stock Options**—A portion of the stock options granted to the Company's employees are subject to time-based vesting schedules, while the remaining portion of the stock options are subject to market-based vesting schedules, with such vesting based on specified stock price targets. The exercise price of the options is based upon the closing market price per share of the Company's common stock on the date of grant, and the options have a term of 10 years.

The following table summarizes the stock option grants, exercises, and forfeitures for the twenty-six weeks ended August 2, 2016 (in thousands, except per share amounts):

	Stock Options	Weighted Average Exercise Price Per Share
Outstanding, as of February 2, 2016	750	\$ 26.78
Granted (a)	28	\$ 44.50
Exercised (b)	(147)	\$ 19.47
Forfeited	(42)	\$ 36.38
Outstanding, as of August 2, 2016 (c)	589	\$ 28.77
Exercisable, as of August 2, 2016 (d)	370	\$ 23.13

- (a) The weighted average grant date fair value of stock options granted during the twenty-six weeks ended August 2, 2016 was \$21.86.
- (b) The aggregate intrinsic value of stock options exercised during the twenty-six weeks ended August 2, 2016 was \$2.5 million. The weighted average market price of shares exercised during the twenty-six weeks ended August 2, 2016 was \$36.69.
- (c) Stock options outstanding as of August 2, 2016 have a weighted average remaining contractual term of 6.18 years and an aggregate intrinsic value of \$3.7 million based on the market value of the Company's common stock on August 2, 2016.
- (d) Stock options exercisable as of August 2, 2016 have a weighted average remaining contractual term of 5.68 years and an aggregate intrinsic value of \$3.0 million based on the market value of the Company's common stock on August 2, 2016.

Future vesting dates on the stock options range from August 13, 2016 to March 21, 2020, and expiration dates range from November 17, 2021 to March 21, 2026 at exercise prices and average contractual lives as follows:

Range of Exercise Prices	Outstanding as of August 2, 2016 (in thousands)	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Exercisable as of August 2, 2016 (in thousands)	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price
<b>Time Based</b>						
\$19.00 - \$29.26	247	5.34	\$ 19.78	165	5.31	\$ 19.51
\$34.65 - \$57.05	134	7.80	\$ 45.58	45	7.23	\$ 43.80
\$60.74 - \$60.74	37	9.11	\$ 60.74	—	—	\$ —
<b>Market Based</b>						
\$19.00 - \$29.26	153	5.37	\$ 19.97	147	5.34	\$ 19.55
\$34.65 - \$57.05	18	6.73	\$ 36.84	13	6.73	\$ 36.84

The Company accounts for employee stock options under the fair value method of accounting using a Black Scholes methodology to measure time-based option fair value at the date of grant and a Monte Carlo Simulation approach to measure market-based option fair value at the date of grant. The fair value of the stock options at the date of grant is recognized as expense over the vesting term, which represents the requisite service period.



The following assumptions were used to calculate the fair value of the Company's time-based stock options on the date of grant utilizing the Black-Scholes option pricing model:

	<b>Twenty-Six Weeks Ended August 2, 2016</b>
Weighted average expected life (in years)	6.25
Volatility factor	50 %
Dividend yield	0 %
Risk-free interest rate	1.23 to 1.35 %

The Company bases its expected option life on the expected exercise and termination behavior of the option holders and an appropriate model of the Company's future stock price. The expected volatility assumption is derived from the historical volatility of similar companies' common stock over the most recent period commensurate with the estimated expected life of the Company's stock options, combined with other relevant factors.

For the thirteen and twenty-six weeks ended August 2, 2016, the Company recognized \$0.4 million and \$0.7 million, respectively, of compensation expense associated with stock option awards in general and administrative expenses in the condensed consolidated statement of operations compared to \$0.6 million and \$1.2 million, respectively, for the thirteen and twenty-six weeks ended August 4, 2015. The Company did not capitalize any equity-based compensation costs related to stock options during the thirteen and twenty-six weeks ended August 2, 2016 and August 4, 2015

As of August 2, 2016, the Company estimates that a total of approximately \$2.9 million of currently unrecognized forfeiture adjusted compensation expense will be recognized over a weighted average period of 2.09 years for unvested stock option awards issued and outstanding.

**Restricted Stock**—The Company grants restricted stock to certain employees and to non-employee independent directors. A portion of the restricted stock granted to the Company's employees is subject to time-based vesting schedules, while the remaining portion of the restricted stock is subject to market-based vesting schedules, with such vesting based on specified stock price targets.

The following table summarizes the restricted stock grants, vesting, and forfeitures for the twenty-six weeks ended August 2, 2016 (in thousands, except per share amounts):

	<b>Restricted Shares</b>	<b>Weighted Average Fair Value</b>
Outstanding, as of February 2, 2016	496	\$ 42.53
Granted (a)	80	\$ 36.80
Vested (b)	(31)	\$ 59.67
Forfeited	(62)	\$ 42.20
Unvested, as of August 2, 2016	<u>483</u>	<u>\$ 40.51</u>

(a) The total grant-date fair value of restricted stock awards granted during the twenty-six weeks ended August 2, 2016 was \$3.0 million.

(b) The total fair value of awards vested during the twenty-six weeks ended August 2, 2016 was \$1.3 million.

The Company accounts for restricted stock under the fair value method of accounting using the closing market price per share of the Company's stock to measure time-based restricted stock fair value at the date of grant and a Monte Carlo Simulation approach to measure market-based restricted stock fair value at the date of grant. The fair value of the restricted stock at the date of grant is recognized as expense over the vesting term, which represents the requisite service period.

The following assumptions were used to calculate the fair value of the Company's market-based restricted stock on the grant date utilizing a Monte Carlo Simulation approach:

	<b>Twenty-Six Weeks Ended August 2, 2016</b>
Weighted average expected life (in years)	4
Volatility factor	45 %
Dividend yield	0 %
Risk-free interest rate	1.05 to 1.22 %

For the thirteen and twenty-six weeks ended August 2, 2016, the Company recognized \$1.0 million and \$3.4 million, respectively, of compensation expense associated with restricted stock awards in general and administrative expenses in the condensed consolidated statement of operations compared to \$1.8 million and \$3.3 million, respectively, for the thirteen and twenty-six weeks ended August 4, 2015. The Company did not capitalize any equity-based compensation costs related to restricted stock awards during the thirteen and twenty-six weeks ended August 2, 2016 and August 4, 2015.

As of August 2, 2016, the Company estimates that a total of approximately \$12.4 million of currently unrecognized forfeiture adjusted compensation expense will be recognized over a weighted average period of 2.59 years for unvested restricted stock awards.

### 13. Commitments and Contingencies

The Company conducts the majority of its operations from leased store and warehouse facilities pursuant to non-cancellable operating lease agreements with initial terms generally ranging from five to ten years. Certain leases include renewal options generally ranging from one to five years and contain certain rent escalation clauses. Most leases require the Company to pay its proportionate share of the property tax, insurance and maintenance expenses of the property. Certain leases provide for contingent rentals based on sales volume; however, incremental rent expense resulting from such arrangements are accrued for those stores expected to surpass the sales threshold subject to their respective lease agreements.

Future minimum lease payments under operating leases as of August 2, 2016, related to properties operated by the Company is as follows (in thousands):

<b>Fiscal Year</b>	
Remainder of 2016	\$ 219,797
2017	445,397
2018	388,289
2019	336,839
2020	295,486
Thereafter	1,030,361
<b>Total</b>	<b>\$ 2,716,169</b>

The Company remains directly and contingently obligated under lease agreements related to leased properties no longer operated by the Company. In certain instances, the Company has entered into assignment and sublease agreements with third parties, although the Company remains contingently liable with respect to future lease obligations for such leased properties.

Future minimum lease payments under operating leases as of August 2, 2016, associated with properties no longer operated by the Company, and the related future sublease rentals is as follows (in thousands):

Fiscal Year	Company's Commitment	Sublease Rentals
Remainder of 2016	\$ 5,212	\$ 280
2017	2,599	1,551
2018	1,810	1,118
2019	1,285	1,104
2020	390	368
Thereafter	—	—
<b>Total</b>	<b>\$ 11,296</b>	<b>\$ 4,421</b>

The Company has contracts related to sponsorships and space rentals at special event venues, with future minimum commitments as of August 2, 2016 of \$1.9 million, \$3.5 million, \$2.1 million, and \$1.2 million for the remainder of fiscal 2016, fiscal 2017, fiscal 2018, and fiscal 2019, respectively.

The Company is subject to legal proceedings and claims that arise in the ordinary course of business. Management does not believe that the outcome of any of those matters will have a material adverse effect on the Company's financial position, results of operations or cash flows.

The Company has conducted an internal investigation, with the assistance of outside counsel and forensic consultants, of potential related party transactions involving contracts and leases entered into by the Company. While no related party transactions were identified, in the course of the investigation, the Company discovered that two employees of the Company's real estate group had conflicts of interest involving business relationships with certain of the Company's real estate vendors that were not disclosed to the Company in accordance with policy. The two employees were terminated for violating Company policy. As a further step, the Company, with the assistance of outside counsel, is conducting a more detailed investigation into its real estate and leasing practices. In the course of this second investigation, the Company has reason to believe that there may have been improper gifts made to certain of its employees from vendors. However, this second investigation is still ongoing and, as of the date of the filing of these financial statements, the Company is unable to determine whether other matters will be uncovered, the quantitative impact of any such matters, or what the ultimate impact will be on the Company. No provision with respect to these investigations and actions taken or to be taken by the Company has been made in the Company's financial statements or cash flows.

#### 14. Subsequent Event

On August 6, 2016, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Steinhoff International Holdings N.V., a company incorporated under the laws of the Netherlands ("Steinhoff"), Stripes US Holding, Inc., a Delaware corporation and direct, wholly-owned subsidiary of Steinhoff, and Stripes Acquisition Corp., a Delaware corporation and indirect, wholly-owned subsidiary, of Steinhoff ("Purchaser"), pursuant to which the Company will be, subject to the satisfaction of certain conditions precedent including, among others, the successful completion of a cash tender offer, acquired by Steinhoff (collectively, the "Potential Acquisition").

On August 16, 2016, Purchaser commenced the tender offer to purchase any and all of the issued and outstanding shares of the Company's Common Stock (the "Shares") at a purchase price of \$64.00 per Share (the "Offer Price") in cash, without interest. Unless the Offer is extended or earlier terminated pursuant to the Merger Agreement, the Offer will expire at midnight, New York City time, on September 13, 2016. If the applicable conditions set forth in the Merger Agreement are satisfied and the Offer closes, Purchaser will be merged with and into the Company (the "Merger") pursuant to Section 251(h) of the General Corporation Law of the State of Delaware (the "DGCL"), with the Company surviving the Merger and becoming a wholly-owned, indirect subsidiary of Steinhoff.

At the effective time of the Merger, each Share (other than (i) Shares held in the treasury of the Company, (ii) Shares owned by the Company, Steinhoff or any of Steinhoff's direct or indirect wholly-owned subsidiaries and (iii) Shares held by stockholders who have properly demanded appraisal of such Shares in accordance with the DGCL) will be cancelled and converted into the right to receive an amount in cash equal to the Offer Price, without interest.

The Merger Agreement includes customary representations, warranties and covenants of the Company, Steinhoff, Stripes US Holding, Inc. and Purchaser. The Company has agreed to operate its business in the ordinary course until the effective time of the Merger. The Company has also agreed not to solicit or initiate discussions with third parties regarding other proposals to acquire the Company and to certain restrictions on its ability to respond to any such proposals. Steinhoff and the Company have agreed to take actions that may be required in order to obtain antitrust approval of the proposed transaction.

The Merger Agreement also includes customary termination provisions for both the Company and Steinhoff, subject, in certain circumstances, to the payment by the Company of a termination fee of \$73.2 million. The Company must pay Steinhoff the \$73.2 million termination fee in the event the Merger Agreement is terminated (i) by Steinhoff following a change of recommendation by the Board, (ii) by the Company in order to enter into an agreement with respect to a third party proposal that the Board determines to be superior to Steinhoff's or (iii) by Steinhoff as a result of certain breaches of the Merger Agreement provided that there is a third party proposal pending at the time of termination and, within 12 months of such termination, the Company enters into a business combination transaction of the type described in the relevant provision of the Merger Agreement and such transaction is, at any time thereafter, subsequently consummated, in each case, as is more particularly described in the Merger Agreement. The parties to the Merger Agreement are also entitled to an injunction or injunctions to prevent breaches of the Merger Agreement, and to specifically enforce the terms and provisions of the Merger Agreement.

As of the date of this filing, the Company has incurred approximately \$1.1 million of costs directly relating to the Potential Acquisition.

On August 26, 2016, the Company received early termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act") with respect to the proposed acquisition of the Company by Steinhoff.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

*The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q. The discussion in this section contains forward-looking statements that involve risks and uncertainties. See "Cautionary Note Regarding Forward-Looking Statements" included elsewhere in this report for a discussion of important factors that could cause actual results to differ materially from those described or implied by the forward-looking statements contained herein.*

*Unless the context otherwise requires, the terms "Mattress Firm®," "our company," "the Company," "we," "us," "our" and the like refer to Mattress Firm Holding Corp. and its consolidated subsidiaries. Unless otherwise indicated, (i) the term "our stores" refers to our company-operated stores and our franchised stores and (ii) when used in relation to our company, the terms "market" and "markets" refer to the metropolitan statistical area or an aggregation of the metropolitan statistical areas in which we or our franchisees operate.*

*In this report, we refer to earnings before interest, taxes, depreciation and amortization and other adjustments (such as goodwill impairment charges, loss on store closings and acquisition expenses), or "Adjusted EBITDA." Adjusted EBITDA is not a performance measure under accounting principles generally accepted in the United States, or "U.S. GAAP." See "Adjusted EBITDA to Net Income Reconciliation" on pages 39 and 40 for a definition of Adjusted EBITDA and a reconciliation of Adjusted EBITDA to net income.*

*We report on the basis of a 52- or 53-week fiscal year, which ends on the Tuesday closest to January 31. Each fiscal year is described by the period of the calendar year that comprises the majority of the fiscal year period. For example, the fiscal year ending January 31, 2017 is described as "fiscal 2016." Fiscal 2015 and 2016 contain 52 weeks.*

### Executive Summary

Key results for the thirteen and twenty-six weeks ended August 2, 2016 include:

- Net sales increased \$318.9 million, or 48.2%, to \$980.0 million for the thirteen weeks ended August 2, 2016, compared to \$661.1 million for the comparable prior year period primarily as the result of the acquisitions of Double J-RD in the fourth quarter of 2015 and Sleepy's on February 5, 2016 and an increase in the number of stores we operated, partially offset by a decrease in comparable-store sales. Comparable-store sales decreased 1.1% during the thirteen weeks ended August 2, 2016, compared to a 2.8% increase in the prior year period. Net sales increased \$595.8 million, or 48.7%, to \$1,819.4 million for the twenty-six weeks ended August 2, 2016, compared to \$1,223.6 million for the comparable prior year period primarily as the result of the acquisitions of Double J-RD in the fourth quarter of 2015 and Sleepy's on February 5, 2016 and an increase in the number of stores we operated, partially offset by a decrease in comparable-store sales. Comparable-store sales decreased 1.1% during the twenty-six weeks ended August 2, 2016, compared to a 2.1% increase in the prior year period.
- Income from operations for the thirteen weeks ended August 2, 2016 was \$22.5 million, or 2.3% of sales. Excluding \$33.1 million of acquisition-related expenses, fixed asset impairment charges, ERP system implementation training costs, loss on disposals of property and severance charges, adjusted income from operations was \$55.6 million. Adjusted operating margin during the thirteen weeks ended August 2, 2016 decreased 170 basis-points from 7.4% of sales during the thirteen weeks ended August 4, 2015 to 5.7% of sales during the thirteen weeks ended August 2, 2016. This operating margin decrease on an adjusted basis (excluding acquisition-related expenses, fixed asset impairment charges, ERP system implementation training costs, loss on disposals of property and severance charges) is comprised of a 260 basis-point decline in gross margin, a 50 basis-point improvement in general and administrative expense leverage and a 40 basis-point increase from sales and marketing expense leverage. Loss from operations for the twenty-six weeks ended August 2, 2016 was \$145.2 million, or (8.0)% of sales. Excluding \$214.5 million of intangible asset impairment charges, acquisition-related expenses, fixed asset impairment charges, ERP system implementation training costs, loss on disposals of property and severance charges, adjusted income from operations was \$69.3 million. Adjusted operating margin during the twenty-six weeks ended August 2, 2016 decreased 250 basis-points from 6.3% of sales during the twenty-six weeks ended August 4, 2015 to 3.8% of

sales during the twenty-six weeks ended August 2, 2016. This operating margin decrease on an adjusted basis (excluding intangible asset impairment charges, acquisition-related expenses, fixed asset impairment charges, ERP system implementation training costs, loss on disposals of property and severance charges) is comprised of a 260 basis-point decline in gross margin, a 20 basis-point decrease from sales and marketing expense deleverage, a 10 basis-point decline in franchise fees and royalty income, partially offset by a 40 basis-point improvement in general and administrative expense leverage. (Adjusted income from operations is not a performance measure under U.S. GAAP. See “Reconciliation of Reported (U.S. GAAP) to Adjusted Statements of Operations Data” on pages 41 and 42 for a reconciliation of net income as reported to adjusted net income.)

- Adjusted EBITDA increased \$14.6 million to \$82.1 million for the thirteen weeks ended August 2, 2016, compared with \$67.5 million for the comparable prior year period. Adjusted EBITDA as a percentage of net sales decreased to 8.4% during the thirteen weeks ended August 2, 2016, compared with 10.2% for the comparable prior year period. Adjusted EBITDA increased \$9.8 million to \$124.1 million for the twenty-six weeks ended August 2, 2016, compared with \$114.3 million for the comparable prior year period. Adjusted EBITDA as a percentage of net sales decreased to 6.8% during the twenty-six weeks ended August 2, 2016, compared with 9.3% for the comparable prior year period. (See “Adjusted EBITDA to Net Income Reconciliation” on pages 39 and 40 for a definition of Adjusted EBITDA and a reconciliation of Adjusted EBITDA to net income.)

On February 5, 2016, we completed the purchase of all of the outstanding equity interests in HMK Mattress Holdings LLC, the holding company of Sleepy’s LLC and related entities for an aggregate purchase price of approximately \$796.3 million, subject to working capital adjustments. At the time of the acquisition, Sleepy’s operated 1,065 specialty mattress retail stores located in 17 states in the Northeast, New England, the Mid-Atlantic and Illinois and employed approximately 3,300 persons. The Sleepy’s acquisition allows us to achieve immediate scale and presence in New England and in the Northeast where we previously had little to no presence.

## Results of Operations

The following table presents the consolidated historical financial operating data for each period indicated (amounts in thousands). The historical results are not necessarily indicative of results to be expected for any future period.

	Thirteen Weeks Ended				Twenty-Six Weeks Ended			
	August 4, 2015	% of Sales	August 2, 2016	% of Sales	August 4, 2015	% of Sales	August 2, 2016	% of Sales
Net sales	\$ 661,064	100.0 %	\$ 980,011	100.0 %	\$ 1,223,618	100.0 %	\$ 1,819,403	100.0 %
Costs of sales	403,557	61.0 %	625,495	63.8 %	764,840	62.5 %	1,199,112	65.9 %
Gross profit from retail operations	257,507	39.0 %	354,516	36.2 %	458,778	37.5 %	620,291	34.1 %
Franchise fees and royalty income	1,285	0.1 %	1,076	0.1 %	2,400	0.2 %	2,198	0.1 %
Total gross profit	258,792	39.1 %	355,592	36.3 %	461,178	37.7 %	622,489	34.2 %
Sales and marketing expenses	169,121	25.5 %	246,367	25.1 %	301,017	24.6 %	450,404	24.8 %
General and administrative expenses	42,893	6.5 %	79,664	8.2 %	94,257	7.7 %	161,905	8.9 %
Intangible asset impairment charge	—	— %	—	— %	—	— %	138,726	7.6 %
Loss on store closings and impairment of store assets	1,173	0.2 %	7,066	0.7 %	1,468	0.1 %	16,659	0.9 %
Income (loss) from operations	45,605	6.9 %	22,495	2.3 %	64,436	5.3 %	(145,205)	(8.0)%
Other expense, net	10,046	1.5 %	24,670	2.5 %	20,299	1.7 %	48,437	2.6 %
Income (loss) before income taxes	35,559	5.4 %	(2,175)	(0.2) %	44,137	3.6 %	(193,642)	(10.6)%
Income tax expense (benefit)	13,678	2.1 %	(408)	— %	16,778	1.4 %	(73,207)	(4.0)%
Net income (loss)	21,881	3.3 %	(1,767)	(0.2) %	\$ 27,359	2.2 %	(120,435)	(6.6)%
Net income attributable to noncontrolling interest	—	— %	432	— %	—	— %	927	(0.1)%
Net income (loss) attributable to Mattress Firm Holding Corp	\$ 21,881	3.3 %	\$ (2,199)	(0.2) %	27,359	2.2 %	\$ (121,362)	(6.7)%

### Thirteen Weeks Ended August 2, 2016 Compared to Thirteen Weeks Ended August 4, 2015

**Net sales.** Net sales are recognized upon delivery and acceptance of mattresses and bedding products by our customers and include fees collected for delivery services, and are recorded net of estimated returns and net of sales tax collected from customers and remitted to various taxing jurisdictions. Net sales increased \$318.9 million, or 48.2%, to \$980.0 million during the thirteen weeks ended August 2, 2016, compared to \$661.1 million during the thirteen weeks ended August 4, 2015 primarily as a result of the Sleepy's acquisition and an increase in the number of stores we operated, partially offset by a decrease in comparable-store sales. The components of the net sales increase for the thirteen weeks ended August 2, 2016 as compared to the thirteen weeks ended August 4, 2015 were as follows (in millions):

	<b>Progression in Net Sales</b>	
	<b>Thirteen Weeks Ended August 2, 2016</b>	
Net sales for prior year period	\$	661.1
Increase (decrease) in net sales:		
Comparable-store sales		(6.9)
New stores		70.1
Acquired stores		268.7
Closed stores		(13.0)
Increase in net sales		318.9
Net sales for current year period	\$	980.0
<i>% increase</i>		48.2%

Comparable-store net sales decreased 1.1%, which was primarily the result of a decrease in the average ticket for mattress sales, partially offset by an increase in mattress units sold. The increase in our net sales from new stores was the result of 305 new stores opened at various times during the fifty-two week period ended August 2, 2016, including 59 stores opened during the thirteen week period ended August 2, 2016, prior to their inclusion in the comparable-store sales calculation which begins with the thirteenth full fiscal period of operations. The increase in net sales from acquired stores was the result of our acquisition of nine formerly franchised stores from Double J-RD, LLC in November 2015 and 1,065 Sleepy's stores in February 2016. We closed 120 stores during the fifty-two week period ended August 2, 2016, including 49 stores during the thirteen week period ended August 2, 2016.

The activity with respect to the number of company-operated store units was as follows:

	<b>Thirteen Weeks Ended August 2, 2016</b>
Store units, beginning of period	3,472
New stores	59
Closed stores	(49)
Store units, end of period	3,482

**Cost of sales.** Cost of sales consists of the following:

- Costs associated with purchasing and delivering our products to our stores and customers, net of vendor incentives earned on the purchase of products subsequently sold;
- Physical inventory losses;
- Store and warehouse occupancy and depreciation expense of related facilities and equipment;
- Store and warehouse operating costs, including warehouse (i) labor costs, (ii) utilities, (iii) repairs and maintenance, (iv) supplies and (v) store facilities; and
- Estimated costs to provide for customer returns and exchanges and to service customer warranty claims.

Cost of sales increased \$221.9 million, or 55.0%, to \$625.5 million during the thirteen weeks ended August 2, 2016, compared to \$403.6 million during the thirteen weeks ended August 4, 2015. The major components of the increase

in cost of sales are discussed below. Cost of sales as a percentage of net sales increased to 63.8% during the thirteen weeks ended August 2, 2016, as compared to 61.0% for the comparable prior year period.

Product costs increased \$122.8 million, or 49.5%, to \$370.7 million during the thirteen weeks ended August 2, 2016, compared with \$247.9 million during the thirteen weeks ended August 4, 2015. The increase in the amount of product costs is primarily the result of the corresponding increase in net sales. Product costs as a percentage of net sales increased to 37.8% during the thirteen weeks ended August 2, 2016, as compared to 37.5% for the comparable prior year period. Product costs for the thirteen weeks ended August 2, 2016 included \$2.5 million of acquisition-related costs related to the flow through of the Sleepy's inventory step-up valued in the purchase accounting allocation.

Store and warehouse occupancy costs, consisting primarily of lease related costs of rented facilities, increased \$64.3 million, or 70.6%, to \$155.5 million during the thirteen weeks ended August 2, 2016, compared to \$91.2 million for the corresponding prior year period. The increase in the amount of store and warehouse occupancy costs during the thirteen weeks ended August 2, 2016 was mainly attributable to the increase in the number of stores we operated and the warehouse operations in a number of new markets opened or acquired. Store and warehouse occupancy costs as a percentage of net sales increased to 15.9% during the thirteen weeks ended August 2, 2016, as compared to 13.8% during the thirteen weeks ended August 4, 2015. The increase in store and warehouse occupancy costs as a percentage of net sales during the thirteen weeks ended August 2, 2016 was mostly attributable to our entrance into new markets that resulted in less scale and cost leverage relative to established markets.

Depreciation expense related to leasehold improvements and other fixed assets used in stores and warehouse operations increased \$5.4 million, or 42.6%, to \$18.0 million, during the thirteen weeks ended August 2, 2016, compared to \$12.6 million during the thirteen weeks ended August 4, 2015. The increase in depreciation expense was primarily attributable to the increase in the number of stores we operated during the thirteen weeks ended August 2, 2016, as compared with the comparable prior year period.

Other cost of sales, consisting of store and warehouse operating and delivery costs, increased \$29.4 million, or 56.7%, to \$81.3 million during the thirteen weeks ended August 2, 2016, compared to \$51.9 million during the thirteen weeks ended August 4, 2015, primarily as a result of the increase in net sales and in the increased number of stores we operated during the thirteen weeks ended August 2, 2016, as compared with the corresponding prior year period.

**Gross profit from retail operations.** As a result of the above, gross profit from retail operations increased \$97.0 million, or 37.7%, to \$354.5 million during the thirteen weeks ended August 2, 2016, compared with \$257.5 million during the thirteen weeks ended August 4, 2015. Gross profit from retail operations as a percentage of net sales decreased to 36.2% during the thirteen weeks ended August 2, 2016, as compared to 39.0% during the thirteen weeks ended August 4, 2015, for the reasons discussed above.

**Franchise fees and royalty income.** Franchise fees and royalty income represents initial franchise fees earned upon the opening of new franchisee stores and ongoing royalties based on a percentage of gross franchisee sales. Franchise fees and royalty income decreased \$0.2 million, or 16.2%, to \$1.1 million during the thirteen weeks ended August 2, 2016, compared with \$1.3 million during the thirteen weeks ended August 4, 2015. Our franchisees operated 121 stores at August 2, 2016.

**Sales and marketing expenses.** Sales and marketing expenses consist of the following:

- Advertising and media production;
- Payroll and benefits for sales associates; and
- Merchant service fees for customer credit and debit card payments, check guarantee fees and promotional financing expense.

Sales and marketing expenses increased \$77.3 million, or 45.7%, to \$246.4 million during the thirteen weeks ended August 2, 2016, compared to \$169.1 million during the thirteen weeks ended August 4, 2015. Sales and marketing expenses as a percentage of net sales decreased to 25.1% during the thirteen weeks ended August 2, 2016, compared to 25.5% during the thirteen weeks ended August 4, 2015. The components of sales and marketing expenses are explained below.



Advertising expense increased \$29.7 million, or 46.4%, to \$93.7 million during the thirteen weeks ended August 2, 2016, from \$64.0 million during the thirteen weeks ended August 4, 2015. The increase in the amount of advertising spend was a result of our expansion into new markets from acquisitions and new store additions. Advertising expense as a percentage of net sales decreased to 9.6% during the thirteen weeks ended August 2, 2016, compared to 9.7% during the thirteen weeks ended August 4, 2015. We receive funds from time to time from certain vendors for the advertisement of their products, and we recognize these funds as a direct reduction of advertising expense. The amount of vendor advertising funds that were recognized as a reduction of advertising expense totaled \$4.7 million during the thirteen weeks ended August 2, 2016, compared with \$3.7 million during the thirteen weeks ended August 4, 2015.

Other sales and marketing expenses, consisting mainly of salesman compensation costs, but also including costs incurred to accept payments from our customers, such as credit card and third party finance fees, increased \$47.6 million, or 45.3%, to \$152.7 million during the thirteen weeks ended August 2, 2016, compared to \$105.1 million during the thirteen weeks ended August 4, 2015, primarily as a result of the increase in net sales during the period. Other sales and marketing expenses as a percentage of net sales decreased to 15.6% during the thirteen weeks ended August 2, 2016, as compared to 15.9% during the thirteen weeks ended August 4, 2015.

***General and administrative expenses.*** General and administrative expenses consist of the following:

- Payroll and benefit costs for corporate office and regional management employees;
- Stock-based compensation costs;
- Occupancy costs of corporate facilities;
- Information systems hardware, software and maintenance;
- Depreciation related to corporate assets;
- Insurance; and
- Other overhead costs.

General and administrative expenses increased \$36.8 million, or 85.7%, to \$79.7 million for the thirteen weeks ended August 2, 2016, compared to \$42.9 million for the thirteen weeks ended August 4, 2015. The increase in general and administrative expenses was primarily a result of our growth, including a \$17.7 million increase in acquisition-related costs, a \$13.1 million increase in wages, benefits and stock-based compensation resulting from employee additions to our corporate office, a \$3.2 million increase in amortization expense primarily related to our accelerated tradename amortization due to us adopting one national brand, a \$2.5 million increase in depreciation related to property and equipment and an increase in loss from asset disposals of \$1.7 million, partially offset by a \$1.4 million decrease in various other general and administrative expense categories. General and administrative expenses as a percentage of net sales increased to 8.2% during the thirteen weeks ended August 2, 2016, compared to 6.5% for the comparable prior year period. The increase in general and administrative expense as a percentage of net sales is primarily due to the increase in acquisition-related costs and the loss from asset disposals, partially offset by a decrease in the cost of administrative labor as a percentage of net sales. General and administrative expenses for the thirteen weeks ended August 2, 2016 and August 4, 2015 included \$25.1 million and \$2.3 million, respectively, of primarily acquisition-related costs, ERP system implementation training costs, secondary offering costs and severance charges. We expect to continue making investments in our corporate infrastructure commensurate with our growth strategy.

***Loss on store closings and impairment of store assets.*** Loss on store closings and impairment of store assets consists of the following:

- Estimated future costs to close locations at the time of closing including, as applicable, the difference between future lease obligations and anticipated sublease rentals;
- The write-off of unamortized fixed assets related to store leasehold costs on closed stores; and
- Non-cash charges recognized for long-lived assets generally consisting of leasehold costs and related equipment resulting in a reduction of the carrying value to estimated fair value, based on our periodic assessment of whether projected future cash flows of individual stores are sufficient to recover the carrying value of the related assets.

Loss on store closings and impairment of store assets increased \$5.9 million to \$7.1 million for the thirteen weeks ended August 2, 2016, compared to \$1.2 million for the thirteen weeks ended August 4, 2015, primarily the result of an

increase of \$4.8 million in store-level fixed asset impairment charges and an increase of \$1.1 million in other costs related to closed stores.

The Company continues to review its real estate portfolio as part of the real estate optimization strategy announced on March 21, 2016. This store optimization effort is expected to drive a more efficient deployment of capital under one national banner going forward.

**Other expense, net.** Other expense, net includes interest income and interest expense. Interest expense includes interest on outstanding debt, amortization of debt discounts, and amortization of financing costs. Other expense, net, for both periods consisted primarily of interest expense. Interest expense, net increased \$14.7 million to \$24.7 million for the thirteen weeks ended August 2, 2016, compared to \$10.0 million for the thirteen weeks ended August 4, 2015, primarily as a result of an increase in term and revolver borrowings to fund the Sleepy's acquisition.

**Income tax expense (benefit).** We recognized \$0.4 million of income tax benefit during the thirteen weeks ended August 2, 2016, compared to \$13.7 million of income tax expense during the thirteen weeks ended August 4, 2015. The effective tax rate was 18.8% during the thirteen weeks ended August 2, 2016 and 38.5% during the thirteen weeks ended August 4, 2015.

**Net income (loss).** As a result of the above, net loss was \$1.8 million during the thirteen weeks ended August 2, 2016 compared to net income of \$21.9 million during the thirteen weeks ended August 4, 2015.

#### Twenty-Six Weeks Ended August 2, 2016 Compared to Twenty-Six Weeks Ended August 4, 2015

**Net sales.** Net sales increased \$595.8 million, or 48.7%, to \$1,819.4 million during the twenty-six weeks ended August 2, 2016, compared to \$1,223.6 million during the twenty-six weeks ended August 4, 2015, primarily as a result of the Sleepy's acquisition and an increase in the number of stores we operated, partially offset by a decrease in comparable-store sales. The components of the net sales increase for the twenty-six weeks ended August 2, 2016 as compared to the twenty-six weeks ended August 4, 2015 were as follows (in millions):

	<u>Progression in Net Sales</u>	
	<u>Twenty-Six Weeks Ended August 2, 2016</u>	
Net sales for prior year period	\$	1,223.6
Increase (decrease) in net sales:		
Comparable-store sales		(13.0)
New stores		129.8
Acquired stores		500.0
Closed stores		(21.0)
Increase in net sales		595.8
Net sales for current year period	\$	1,819.4
<i>% increase</i>		48.7%

Comparable-store net sales decreased 1.1%, which was primarily the result of a decrease in average ticket for mattress sales and to a lesser extent a decrease in mattress units sold. The increase in our net sales from new stores was the result of 305 new stores opened at various times during the fifty-two week period ended August 2, 2016, including 144 stores opened during the twenty-six week period ended August 2, 2016, prior to their inclusion in the comparable-store sales calculation which begins with the thirteenth full fiscal period of operations. The increase in net sales from acquired stores was the result of our acquisition of nine formerly franchised stores from Double J-RD, LLC in November 2015 and 1,065 Sleepy's stores in February 2016. We closed 120 stores during the fifty-two week period ended August 2, 2016, including 86 stores during the twenty-six week period ended August 2, 2016.

The activity with respect to the number of company-operated store units was as follows:

	<b>Twenty-Six Weeks Ended August 2, 2016</b>
Store units, beginning of period	2,359
New stores	144
Acquired stores	1,065
Closed stores	(86)
Store units, end of period	<u>3,482</u>

**Cost of sales.** Cost of sales increased \$434.3 million, or 56.8%, to \$1,199.1 million during the twenty-six weeks ended August 2, 2016, compared to \$764.8 million during the twenty-six weeks ended August 4, 2015. The major components of the increase in cost of sales are discussed below. Cost of sales as a percentage of net sales increased to 65.9% during the twenty-six weeks ended August 2, 2016, as compared to 62.5% for the comparable prior year period.

Product costs increased \$236.3 million, or 51.3%, to \$697.3 million during the twenty-six weeks ended August 2, 2016, compared with \$461.0 million during the twenty-six weeks ended August 4, 2015. The increase in the amount of product costs is primarily the result of the corresponding increase in net sales. Product costs as a percentage of net sales increased to 38.3% during the twenty-six weeks ended August 2, 2016 from 37.7% during the twenty-six weeks ended August 4, 2015. Product costs for the twenty-six weeks ended August 2, 2016 included \$14.0 million of acquisition-related costs related to the flow through of the Sleepy's inventory step-up valued in the purchase accounting allocation.

Store and warehouse occupancy costs, consisting primarily of lease related costs of rented facilities, increased \$128.9 million, or 72.0%, to \$307.9 million during the twenty-six weeks ended August 2, 2016, compared to \$179.0 million for the corresponding prior year period. The increase in the amount of store and warehouse occupancy costs during the twenty-six weeks ended August 2, 2016 was mainly attributable to the increase in the number of stores we operated and the warehouse operations in a number of new markets opened or acquired. Store and warehouse occupancy costs as a percentage of net sales increased to 16.9% during the twenty-six weeks ended August 2, 2016, compared to 14.6% during the twenty-six weeks ended August 4, 2015. The increase in store and warehouse occupancy costs as a percentage of net sales during the twenty-six weeks ended August 2, 2016 was mostly attributable to our entrance into new markets that resulted in less scale and cost leverage relative to established markets.

Depreciation expense related to leasehold improvements and other fixed assets used in stores and warehouse operations increased \$10.0 million, or 40.4%, to \$34.7 million, during the twenty-six weeks ended August 2, 2016, compared to \$24.7 increase in the number of stores we operated during the twenty-six weeks ended August 2, 2016, as compared with the comparable prior year period.

Other cost of sales, consisting of store and warehouse operating and delivery costs, increased \$59.1 million, or 59.1%, to \$159.2 million during the twenty-six weeks ended August 2, 2016, compared to \$100.1 million during the twenty-six weeks ended August 4, 2015, primarily as a result of the increase in net sales and in the increased number of stores we operated during the twenty-six weeks ended August 2, 2016, as compared with the corresponding prior year period.

**Gross profit from retail operations.** As a result of the above, gross profit from retail operations increased \$161.5 million, or 35.2%, to \$620.3 million during the twenty-six weeks ended August 2, 2016, compared with \$458.8 million during the twenty-six weeks ended August 4, 2015. Gross profit from retail operations as a percentage of net sales decreased to 34.1% during the twenty-six weeks ended August 2, 2016, as compared to 37.5% during the twenty-six weeks ended August 4, 2015, for the reasons discussed above.

**Franchise fees and royalty income.** Franchise fees and royalty income decreased \$0.2 million, or 8.4%, to \$2.2 million during the twenty-six weeks ended August 2, 2016, compared to \$2.4 million during the twenty-six weeks ended August 4, 2015.

**Sales and marketing expenses.** Sales and marketing expenses increased \$149.4 million, or 49.6%, to \$450.4 million during the twenty-six weeks ended August 2, 2016, compared to \$301.0 million during the twenty-six weeks ended August 4, 2015. Sales and marketing expenses as a percentage of net sales increased to 24.8% during the twenty-six weeks ended August 2, 2016, compared to 24.6% during the twenty-six weeks ended August 4, 2015. The components of sales and marketing expenses are explained below.

Advertising expense increased \$52.3 million, or 49.4%, to \$158.2 million during the twenty-six weeks ended August 2, 2016, from \$105.9 million during the twenty-six weeks ended August 4, 2015. The increase in the amount of advertising spend was a result of our expansion into new markets from acquisitions and new store additions. Advertising expense as a percentage of net sales remained flat at 8.7% during both the twenty-six weeks ended August 2, 2016 and the twenty-six weeks ended August 4, 2015. We receive funds from time to time from certain vendors for the advertisement of their products, and we recognize these funds as a direct reduction of advertising expense. The amount of vendor advertising funds that were recognized as a reduction of advertising expense totaled \$9.7 million during the twenty-six weeks ended August 2, 2016, compared with \$7.1 million during the twenty-six weeks ended August 4, 2015.

Other sales and marketing expenses, consisting mainly of salesman compensation costs, but also including costs incurred to accept payments from our customers, such as credit card and third party finance fees, increased \$97.1 million, or 49.8%, to \$292.2 million during the twenty-six weeks ended August 2, 2016, compared to \$195.1 million during the twenty-six weeks ended August 4, 2015, primarily as a result of the increase in net sales during the period. Other sales and marketing expenses as a percentage of net sales increased to 16.1% during the twenty-six weeks ended August 2, 2016, compared to 15.9% during the twenty-six weeks ended August 4, 2015.

**General and administrative expenses.** General and administrative expenses increased \$67.7 million, or 71.2%, to \$161.9 million for the twenty-six weeks ended August 2, 2016, compared to \$94.2 million for the twenty-six weeks ended August 4, 2015. The increase in general and administrative expenses was primarily a result of our growth, including a \$28.8 million increase in acquisition-related costs, a \$25.8 million increase in wages, benefits and stock-based compensation resulting from employee additions to our corporate office, a \$7.1 million increase in amortization expense primarily related to our accelerated tradename amortization due to us adopting one national brand, a \$4.6 million increase in depreciation related to property and equipment, an increase from loss from asset disposals of \$1.1 million and a \$0.3 million increase in various other general and administrative expense categories. General and administrative expenses as a percentage of net sales increased to 8.9% during the twenty-six weeks ended August 2, 2016, compared to 7.7% for the comparable prior year period. The increase in general and administrative expense as a percentage of net sales is primarily due to the increase in acquisition-related costs and the loss from asset disposals, partially offset by a decrease in the cost of administrative labor as a percentage of net sales. General and administrative expenses for the twenty-six weeks ended August 2, 2016 and August 4, 2015 included \$47.3 million and \$12.5 million, respectively, of primarily acquisition-related costs, ERP system implementation training costs, secondary offering costs and severance charges.

**Intangible asset impairment charge.** We decided in late April 2016 to rebrand all of our stores operating under different brand names to the *Mattress Firm* brand name. We expect to complete this rebranding in the first quarter of fiscal 2017. In connection with this decision a triggering event was identified related to the recoverability of our tradename intangible assets. We revalued our tradename intangible assets and recorded a corresponding non-cash impairment charge of \$138.7 million in the twenty-six weeks ended August 2, 2016 to write down these intangible assets to fair value. The Sleep Train asset was previously held as a definite lived intangible, however with the decision to move to one national brand this tradename was revalued and reclassified as a definite lived intangible asset with the remaining value to be amortized over a period of less than two years.

**Loss on store closings and impairment of store assets.** Loss on store closings and impairment of store assets increased \$15.2 million to \$16.7 million for the twenty-six weeks ended August 2, 2016, compared to \$1.5 million for the twenty-six weeks ended August 4, 2015, primarily the result of an increase of \$13.7 million in store-level fixed asset impairment charges and an increase of \$1.5 million in other costs related to closed stores. The increase in store-level fixed asset impairment charges is primarily related to our plan to close certain stores near the end of their lease term. We recorded an impairment charge related to the assets in these stores of approximately \$6.9 million. In addition, store-level fixed asset impairment charges related to underperforming stores increased \$3.8 million over the comparable prior-year period. An additional \$3.0 million related to other fixed assets was also recorded in the twenty-six weeks ended August 2, 2016.

**Other expense, net.** Other expense, net, for both periods consisted primarily of interest expense. Interest expense, net increased \$28.1 million to \$48.4 million for the twenty-six weeks ended August 2, 2016, compared to \$20.3 million for the twenty-six weeks ended August 4, 2015, primarily as a result of an increase in term and revolver borrowings to fund the Sleepy's acquisition.

**Income tax expense (benefit).** We recognized \$73.2 million of income tax benefit during the twenty-six weeks ended August 2, 2016, compared to \$16.8 million of income tax expense during the twenty-six weeks ended August 4, 2015. The effective tax rate was 37.8% during the twenty-six weeks ended August 2, 2016 and 38.0% during the twenty-six weeks ended August 4, 2015. The effective tax rate of 37.8% for the current period differs from the federal statutory rate of 35.0% primarily due to state income taxes.

Our estimated full year effective tax rate for fiscal 2016 is 37.6%, which is above the federal statutory rate of 35.0% primarily due to state income taxes.

**Net income (loss).** As a result of the above, net loss was \$120.4 million during the twenty-six weeks ended August 2, 2016 compared to net income of \$27.4 million during the twenty-six weeks ended August 4, 2015.

## Liquidity and Capital Resources

The following table summarizes the principal elements of our cash flows (in thousands):

	<b>Twenty-Six Weeks Ended</b>	
	<b>August 4, 2015</b>	<b>August 2, 2016</b>
<b>Total cash provided by (used in):</b>		
Operating activities	\$ 119,155	\$ 81,089
Investing activities	(68,361)	(706,594)
Financing activities	(53,632)	637,314
Net decrease in cash and cash equivalents	(2,838)	11,809
Cash and cash equivalents, beginning of period	13,475	1,778
Cash and cash equivalents, end of period	<u>\$ 10,637</u>	<u>\$ 13,587</u>

**Operating cash flows.** Net cash provided by operating activities was \$81.1 million for the twenty-six weeks ended August 2, 2016, compared to net cash provided of \$119.2 million for the twenty-six weeks ended August 4, 2015. The \$38.1 million decrease in cash flows from operating activities as compared to the prior year period was primarily due to a decrease in net income of \$147.8 million from the twenty-six weeks ended August 2, 2016 compared to the twenty-six weeks ended August 4, 2015, however the increase in the add-back of non-cash charges such as intangible asset impairment, deferred taxes and depreciation expense of \$142.9 million resulted in a \$4.9 million decrease in cash compared to the twenty-six weeks ended August 4, 2015. Additionally, the changes in operating assets and liabilities related to normal fluctuations in the timing of cash collections and cash requirements used an additional \$34.1 million in cash. Cash provided by construction allowances from landlords increased \$0.9 million for the twenty-six weeks ended August 2, 2016 as compared to the twenty-six weeks ended August 4, 2015.

**Investing cash flows.** Net cash used in investing activities was \$706.6 million for the twenty-six weeks ended August 2, 2016, compared to net cash used of \$68.4 million for the twenty-six weeks ended August 4, 2015. The \$638.2 million increase was primarily due to a \$725.2 million increase in cash used for the Sleepy's acquisition during the twenty-six weeks ended August 2, 2016, partially offset by a decrease in capital expenditures of \$12.7 million and the cash inflow from sales of property and equipment in the amount \$74.3 million in the twenty-six weeks ended August 2, 2016. We opened 144 new stores during the twenty-six weeks ended August 2, 2016, compared to 149 new stores in the twenty-six weeks ended August 4, 2015.

**Financing cash flows.** Net cash provided by financing activities was \$637.3 million for the twenty-six weeks ended August 2, 2016, compared to net cash used of \$53.6 million for the twenty-six weeks ended August 4, 2015. The \$690.9 million increase in cash provided by financing activities was primarily the result of net increased borrowings of \$694.8 million which were used to finance the Sleepy's acquisition in the current year period and the inflow of \$25.0 million in cash from the issuance of common stock, a \$1.1 million increase in cash provided by the exercise of common stock options, offset by a \$28.1 million increase in debt issuance costs associated with the current fiscal year borrowings increase, a \$0.9 million decrease due to distributions to the noncontrolling interest partner, a decrease of \$0.7 million of excess tax benefits associated with stock-based awards and a \$0.3 million decrease due to higher cash paid to purchase vested stock-based awards.

Our primary source of liquidity is cash flows generated by operations, supported by other sources, included but not limited to our Senior Credit Facility, proceeds from sales of property and equipment and equity offerings. During the second quarter of fiscal 2016 we closed on the sale leasebacks of certain Sleepy's retail and warehouse locations for net proceeds of \$68.5 million, which we used to repay associated mortgages and additional long-term debt.

### **Covenant Compliance**

The Senior Credit Facility requires us to comply on a quarterly basis with one financial covenant, which is a minimum fixed charge coverage ratio. This financial covenant is measured using, among other things, Adjusted EBITDA of MHC and its subsidiaries, as adjusted to include pro forma results of new stores. Commencing with the fiscal quarter ending as of August 2, 2016, MHC must not exceed a total net leverage ratio subject to specified stepdowns.

At August 2, 2016, there was \$40.0 million in outstanding revolver borrowings under the Senior Credit Facility. There were standby letters of credit outstanding in the amount of \$12.3 million and additional borrowing capacity of \$114.4 million.

For more information about the restrictive covenants imposed on us by the Senior Credit Facility, please see "Risk Factors" in the Fiscal 2015 Annual Report.

We were in compliance with the financial covenants required under the Senior Credit Facility as of August 2, 2016. We believe that we will be able to maintain compliance with the covenants required under our debt facilities for the next 12 months without amending the credit facility or requesting waivers from the lenders that are party to the agreement.

### **Seasonality**

Our business is subject to seasonal fluctuations. We generally have experienced more sales and a greater portion of income during the second and third quarters of our fiscal year due to a concentration of summer season holidays, including Memorial Day, the Fourth of July and Labor Day, and other seasonal factors.

Sleepy's quarterly sales mix is similar to that of Mattress Firm's legacy businesses. However, the expected profitability of the Sleepy's business differs dramatically by quarter, with an approximately breakeven first quarter and 80% to 85% of profitability generated during the second and third quarters.

## Summary Disclosures about Contractual Obligations and Commercial Commitments

The following summarizes certain of our contractual obligations at August 2, 2016 and the effect such obligations are expected to have on our liquidity and cash flows in future periods (*in thousands*):

	Payments Due by Period						Total
	Remainder of Fiscal 2016	Fiscal 2017	Fiscal 2018	Fiscal 2019	Fiscal 2020	Thereafter	
Long-term debt, including principal and interest(1)	\$ 89,177	\$ 94,342	\$ 93,310	\$ 121,814	\$ 87,706	\$ 1,359,122	\$ 1,845,471
Operating leases(2)	219,797	445,397	388,289	336,839	295,486	1,030,361	2,716,169
Operating contracts(3)	1,938	3,446	2,138	1,193	—	—	8,715
Letters of credit(4)	25	125	—	—	—	—	150
Interest rate swap liability	—	—	—	1,200	—	—	1,200
Severance liabilities	1,608	3,065	—	—	—	—	4,673
<b>Total</b>	<b>\$ 312,545</b>	<b>\$ 546,375</b>	<b>\$ 483,737</b>	<b>\$ 461,046</b>	<b>\$ 383,192</b>	<b>\$ 2,389,483</b>	<b>\$ 4,576,378</b>

- (1) Future contractual obligations on the Senior Credit Facility reflect the Company's current interest rate, which is based on a 1.0% LIBOR rate plus 5.25% on the Term Loan and a 0.48% LIBOR rate plus 1.25% on the Revolver. Also includes capital leases, equipment financing and other notes payable.
- (2) Does not include certain other expenses required to be paid by the Company under such operating leases, comprised primarily of the Company's proportionate share of common area maintenance, property taxes and insurance. These other expenses have typically amounted to approximately 25% of the base rent expense during recent fiscal years.
- (3) We have certain operating contracts related to sponsorships and space rentals at special event venues.
- (4) We have outstanding letters of credit at August 2, 2016, which expire at varying times through 2017, including \$12.1 million that are subject to automatic renewal for an additional one-year period on the anniversary date of the agreement, unless we receive notice from the counterparty that the letter of credit agreement has been terminated at least 30 to 60 days prior to the automatic renewal date.

### Off-Balance Sheet Arrangements

We do not have any "off-balance sheet arrangements" (as such term is defined in Item 303 of Regulation S-K), other than the operating leases, operating contracts and letters of credit shown above in the Contractual Obligations and Commercial Commitments table, that are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

## Adjusted EBITDA to Net Income (Loss) Reconciliation

Adjusted EBITDA is defined as net income (loss) before income tax expense (benefit), interest income, interest expense, depreciation and amortization (“EBITDA”), without giving effect to non-cash goodwill and intangible asset impairment charges, gains or losses on store closings and impairment of store assets, gains or losses related to the early extinguishment of debt, financial sponsor fees and expenses, non-cash charges related to stock-based awards and other items that are excluded by management in reviewing the results of operations. We have presented Adjusted EBITDA because we believe that the exclusion of these items is appropriate to provide additional information to investors about our ongoing operating performance excluding certain non-cash and other items and to provide additional information with respect to our ability to comply with various covenants in documents governing our indebtedness and as a means to evaluate our period-to-period results. In evaluating Adjusted EBITDA, you should be aware that in the future we may incur expenses that are the same as or similar to some of the adjustments in this presentation. Our presentation of Adjusted EBITDA should not be construed to imply that our future results will be unaffected by any such adjustments. We have provided this information to analysts, investors and other third parties to enable them to perform more meaningful comparisons of past, present and future operating results and as a means to evaluate the results of our ongoing operations. Management also uses Adjusted EBITDA to determine executive incentive compensation payment levels. In addition, our compliance with certain covenants under our Senior Credit Facility that are calculated based on similar measures and differ from Adjusted EBITDA primarily by the inclusion of pro forma results for acquired businesses in those similar measures. Other companies in our industry may calculate Adjusted EBITDA differently than we do. Adjusted EBITDA is not a measure of performance under U.S. GAAP and should not be considered as a substitute for net income prepared in accordance with U.S. GAAP. Adjusted EBITDA has significant limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results as reported under U.S. GAAP. Some of the additional limitations to the use of Adjusted EBITDA are:

- Adjusted EBITDA does not reflect our cash expenditures, or future requirements, for capital expenditures or contractual commitments;
- Adjusted EBITDA does not reflect interest expense or the cash requirements necessary to service interest or principal payments on our debt;
- Adjusted EBITDA does not reflect tax expense or the cash requirements necessary to pay for tax obligations;
- Although depreciation and amortization are non-cash charges, the asset being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements;
- Adjusted EBITDA does not reflect the cash requirements of closing underperforming stores; and
- Adjusted EBITDA does not reflect certain other costs that may recur in future periods.



We compensate for these limitations by relying primarily on our U.S. GAAP results and using Adjusted EBITDA only as a supplemental measure. The following table contains a reconciliation of our net income (loss) determined in accordance with U.S. GAAP to EBITDA and Adjusted EBITDA for the periods indicated (in thousands):

	<b>Thirteen Weeks Ended</b>		<b>Twenty-Six Weeks Ended</b>	
	<b>August 4, 2015</b>	<b>August 2, 2016</b>	<b>August 4, 2015</b>	<b>August 2, 2016</b>
Net income (loss)	\$ 21,881	\$ (1,767)	\$ 27,359	\$ (120,435)
Income tax expense (benefit)	13,678	(408)	16,778	(73,207)
Interest expense, net	10,046	24,670	20,299	48,437
Depreciation	14,752	22,615	28,746	43,373
Intangible assets and other amortization	1,366	4,567	2,703	9,791
<b>EBITDA</b>	<b>61,723</b>	<b>49,677</b>	<b>95,885</b>	<b>(92,041)</b>
Intangible asset impairment charge	—	—	—	138,726
Loss on store closings and impairment of store assets	1,173	7,066	1,468	16,659
Loss (gain) from disposals of property and equipment	30	1,676	(14)	1,088
Stock-based compensation	2,050	1,392	3,880	2,923
Secondary offering costs	169	—	480	—
Vendor new store funds(a)	223	(564)	611	(19)
Acquisition-related expenses(b)	2,021	23,265	11,195	54,834
Other(c)	121	(421)	784	1,892
<b>Adjusted EBITDA</b>	<b>\$ 67,510</b>	<b>\$ 82,091</b>	<b>\$ 114,289</b>	<b>\$ 124,062</b>

- (a) We receive cash payments from certain vendors for each new incremental store that we open (“new store funds”). New store funds are initially recorded in other noncurrent liabilities when received and are then amortized as a reduction of cost of sales over 36 months in our financial statements. Historically, we have considered new store funds as a component of Adjusted EBITDA when received since new store funds are included in cash provided from operations. The adjustment includes the amount of new store funds received during the period presented and eliminates the non-cash reduction in cost of sales included in our results of operations.
- (b) Reflects both non-cash effects included in net income related to acquisition accounting adjustments made to inventories and other acquisition-related cash costs included in net income (loss), such as direct acquisition costs and costs related to integration of acquired businesses.
- (c) Consists of various items that management excludes in reviewing the results of operations, including \$0.1 million and \$2.2 million of reduction of workforce severance expense incurred during the thirteen and twenty-six weeks ended August 2, 2016, \$0.7 million of ERP system implementation training costs incurred during the twenty-six weeks ended August 4, 2015 and \$0.5 million of ERP system implementation training costs incurred during the thirteen and twenty-six weeks ended August 2, 2016.

## Reconciliation of Reported (U.S. GAAP) to Adjusted Statements of Operations Data (In thousands, except share and per share amounts)

The following table provides a reconciliation of our “As Adjusted” statements of operations data for the thirteen and twenty-six weeks ended August 4, 2015 and August 2, 2016 with the most directly comparable financial measures in our “As Reported”, or U.S. GAAP, statements of operations data. Our “As Adjusted” data is considered a non-U.S. GAAP financial measure and is not in accordance with, or preferable to, “As Reported,” or U.S. GAAP, financial data. However, we are providing this information as we believe it may enhance year-over-year comparisons for investors and financial analysts.

	Thirteen Weeks Ended									
	August 4, 2015					August 2, 2016				
	Income From Operations	Income Before Income Taxes	Net Income Attributable to Mattress Firm Holding Corp.	Diluted Weighted Shares	Diluted EPS*	Income From Operations	Income Before Income Taxes	Net (Loss) Income Attributable to Mattress Firm Holding Corp.	Diluted Weighted Shares	Diluted EPS*
As Reported	\$ 45,605	\$ 35,559	\$ 21,881	35,600,295	\$ 0.61	\$ 22,495	\$ (2,175)	\$ (2,199)	37,201,842	\$ (0.06)
% of sales	6.9 %	5.4 %	3.3 %			2.3 %	(0.2)%	(0.2)%		
<b>Adjustments</b>										
Acquisition-related costs(2)	2,021	2,021	1,246	—	0.03	23,265	23,265	15,038	—	0.40
Fixed asset impairment charges(3)	735	735	452	—	0.01	5,524	5,524	3,476	—	0.09
ERP system implementation training costs(4)	—	—	—	—	—	547	547	342	—	0.01
Secondary offering costs(5)	169	169	169	—	0.01	—	—	—	—	—
Other expenses(6)	116	116	71	—	0.01	3,781	3,781	2,367	—	0.07
Diluted share count adjustment(7)	—	—	—	—	—	—	—	—	154,924	—
Total adjustments	3,041	3,041	1,938	—	0.06	33,117	33,117	21,223	154,924	0.57
As Adjusted	\$ 48,646	\$ 38,600	\$ 23,819	35,600,295	\$ 0.67	\$ 55,612	\$ 30,942	\$ 19,024	37,356,766	\$ 0.51
% of sales	7.4 %	5.8 %	3.6 %			5.7 %	3.2 %	1.9 %		
	Twenty-Six Weeks Ended									
	August 4, 2015					August 2, 2016				
	Income From Operations	Income Before Income Taxes	Net Income Attributable to Mattress Firm Holding Corp.	Diluted Weighted Shares	Diluted EPS*	(Loss) Income From Operations	(Loss) Income Before Income Taxes	Net (Loss) Income Attributable to Mattress Firm Holding Corp.	Diluted Weighted Shares	Diluted EPS*
As Reported	\$ 64,436	\$ 44,137	\$ 27,359	35,584,024	\$ 0.77	\$ (145,205)	\$ (193,642)	\$ (121,362)	37,126,890	\$ (3.27)
% of sales	5.3 %	3.6 %	2.2 %			(8.0)%	(10.6)%	(6.7)%		
<b>Adjustments</b>										
Intangible asset impairment charge (1)	—	—	—	—	—	138,726	138,726	86,621	—	2.32
Acquisition-related costs (2)	11,195	11,195	6,885	—	0.19	54,834	54,834	34,238	—	0.92
Fixed asset impairment charges (3)	735	735	452	—	0.01	14,438	14,438	9,015	—	0.24
ERP system implementation training costs (4)	666	666	409	—	0.01	547	547	342	—	0.01
Secondary offering costs (5)	480	480	480	—	0.01	—	—	—	—	—
Other expenses (6)	116	116	71	—	0.01	5,927	5,927	3,701	—	0.10
Diluted share count adjustment(7)	—	—	—	—	—	—	—	—	189,360	—
Total adjustments	13,192	13,192	8,297	—	0.23	214,472	214,472	133,917	189,360	3.59
As Adjusted	\$ 77,628	\$ 57,329	\$ 35,656	35,584,024	\$ 1.00	\$ 69,267	\$ 20,830	\$ 12,555	37,316,250	\$ 0.34
% of sales	6.3 %	4.7 %	2.9 %			3.8 %	1.1 %	0.7 %		

\*Due to rounding to the nearest cent, totals may not equal the sum of the lines in the table above.

The adjustments for the twenty-six weeks ended August 4, 2015 and August 2, 2016 were tax effected using our annualized effective tax rates as of August 4, 2015 and August 2, 2016 of 38.5% and 37.6%, respectively.

- Reflects approximately \$138.7 million of non-cash impairment of tradenames recorded in the twenty-six weeks ended August 2, 2016. We decided in late April 2016 to rebrand all of our stores operating under different brand names to the Mattress Firm brand name. In conjunction with this decision, we revalued all of our tradename intangible assets and recorded a corresponding non-cash impairment charge to write down these assets to fair value.
- On October 20, 2014, we acquired 100% of the outstanding equity interests in The Sleep Train, Inc., related to the operations of 314 mattress specialty retail stores in California, Oregon, Washington, Nevada, Idaho and Hawaii. On January 6, 2015, we acquired substantially all of the mattress specialty retail assets and operations of Sleep America LLC (“Sleep America”), which operated approximately 45 *Sleep America* retail stores in Arizona. On January 13, 2015 we acquired substantially all of the mattress specialty retail assets and operations of Mattress World, Inc. (“Mattress World”), related to the operation of 4 mattress specialty retail stores under the brand *Mattress World* in Pennsylvania. On November 17, 2015, we acquired the assets and operations of Double J-RD, LLC, including nine mattress specialty retail stores located primarily in East Texas. On February 5, 2016, we acquired 100% of the outstanding equity interests in HMK Mattress Holdings LLC, the holding company of Sleepy’s LLC and related entities, related to the operation of 1,065 mattress specialty retail stores in 17 states in the Northeast, New England, the Mid-Atlantic and Illinois. Acquisition-related costs, which are included in the “As Reported” results of operations, consist of acquisition-related costs as defined under U.S. GAAP, including advisory, legal, accounting, valuation, and other professional or consulting fees and, in addition, costs of integrating store and warehouse operations and corporate functions that are not expected to recur as acquisitions are absorbed. Acquisition-related costs,

consisting of direct transaction costs and integration costs, are included in the results of operations as incurred. We incurred approximately \$2.0 million and \$23.3 million of acquisition-related costs during the thirteen weeks ended August 4, 2015 and August 2, 2016, respectively. We incurred approximately \$11.2 million and \$54.8 million of acquisition-related costs during the twenty-six weeks ended August 4, 2015 and August 2, 2016, respectively.

- (3) Reflects approximately \$0.7 million and \$5.5 million of impairment of store and other fixed assets recorded in the thirteen weeks ended August 4, 2015 and August 2, 2016, respectively. Reflects approximately \$0.7 million and \$14.4 million of impairment of store and other fixed assets recorded in the twenty-six weeks ended August 4, 2015 and August 2, 2016, respectively.
- (4) Reflects implementation costs included in the results of operations as incurred, consisting primarily of incremental training-related costs, related to the roll-out of the Microsoft Dynamics AX for Retail ERP system. During the thirteen weeks ended August 2, 2016, we incurred approximately \$0.5 million of ERP system implementation training costs. We incurred approximately \$0.7 million and \$0.5 million of ERP system implementation training costs during the twenty-six weeks ended August 4, 2015 and August 2, 2016, respectively.
- (5) Reflects approximately \$0.2 million and \$0.5 million for the thirteen and twenty-six weeks ended August 4, 2015, respectively, of costs borne by us in connection with a secondary offering of common stock by certain of our selling shareholders which was completed in April 2015. No offering proceeds were received by the Company.
- (6) Reflects severance expense recorded in the thirteen and twenty-six weeks ended August 4, 2015. Reflects \$0.1 million and \$2.1 million of severance expense resulting from the beginning of our integration of the Sleepy's and Mattress Firm's management structure recorded in the thirteen and twenty-six weeks ended August 2, 2016, respectively. Reflects \$2.1 million of early lease termination fees related to the store optimization project recorded in the thirteen and twenty-six weeks ended August 2, 2016, respectively. Reflects \$1.5 million of net loss on asset disposals related to the sale-leaseback of certain stores and warehouses acquired in the Sleepy's acquisition recorded in the thirteen and twenty-six weeks ended August 2, 2016, respectively.
- (7) Reflects diluted share count adjustment related to the positive position of As Adjusted net income attributable to Mattress Firm Holding Corp.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

***Interest Rate Risk.*** Our earnings are affected by changes in interest rates due to the impact those changes have on our interest expense on borrowings under the Senior Credit Facility and mortgages payable with interest rates that vary in direct relationship to changes in the prime interest rate or LIBOR. Our floating rate indebtedness was approximately \$1,346.1 million at August 2, 2016. If short-term floating interest rates increase by 100 basis points over the next twelve months, our interest expense will increase by approximately \$14.2 million during that period. This amount is determined by considering the impact of the hypothetical change in interest rates on our average amount of floating rate indebtedness outstanding in the twenty-six weeks ended August 2, 2016.

### **Item 4. Controls and Procedures.**

#### ***Evaluation of Disclosure Controls and Procedures***

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

During the first quarter, we identified a material weakness in our controls relating to accounting for significant transactions, as described below. Based on the evaluation of our disclosure controls and procedures as of the end of the period covered by this report and upon that discovery, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective at a level that provides reasonable assurance as of the last day of the period covered by this report.

### ***Changes in Internal Control***

We acquired all of the outstanding equity interests in HMK Mattress Holdings LLC, the holding company of Sleepy's LLC and related entities, on February 5, 2016 and management has excluded the Sleepy's business from its assessment of the effectiveness of disclosure controls and processes as of August 2, 2016.

As permitted by the guidelines established by the SEC, companies are allowed to exclude certain acquisitions from their assessment of internal controls over financial reporting during the first year of an acquisition while integrating the acquired company. As plans to integrate Sleepy's processes and systems into the Company's structure are developed and accomplished, management will continue to update its assessment at each reporting period.

A material weakness is a control deficiency, or a combination of control deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.

Even though management did not perform the evaluation of Sleepy's internal controls over financial reporting, we became aware of the following material weaknesses that existed at the end of Sleepy's fiscal year 2015 and are still unremediated:

- Sleepy's does not adequately document its vendor agreements relating to incentives offered by vendors and does not document changes to its vendor agreements.
- Sleepy's does not adequately document its agreed upon firm prices for, and does not timely bill for the sale of, damaged, clearance, outlet and obsolete inventory to third parties.

The Company has begun converting Sleepy's markets to Mattress Firm's processes and systems which will address these material weaknesses. We expect the conversions will be substantially complete by the end of fiscal 2016, but the material weaknesses remain unremediated at August 2, 2016.

During the first quarter of 2016, we identified a material weakness in our controls over financial reporting related to the accounting for significant transactions that occurred during the quarter. Specifically, we did not design and maintain effective controls related to the recording of the expense for the flow through of the inventory step up fair value adjustment in the Sleepy's acquisition. The financial statements included herein properly reflect the correct amount and proper classification of the flow through of the Sleepy's inventory step-up adjustment.

In order to remediate this material weakness, we have begun implementing the following steps to improve the overall processes of identifying and reviewing purchase accounting considerations beyond the recording of the initial purchase price:

- Adjusted our standard calculations to incorporate the acquired company's recent inventory turnover as a basis for the flow through of the fair value adjustment;
- Added additional considerations to our processes to address the accounting for and financial statement presentation of activities that occur beyond the initial purchase accounting and subsequent adjustments to purchase accounting; and
- Performed additional internal review processes to ensure the appropriate accounting and disclosure of significant transactions.

Based on these measures, management believes that the control deficiencies will be remediated by the end of the fiscal year as the revised controls will need to operate for a sufficient period of time for management to test that they are designed and operating effectively before the material weakness will be considered remediated. Should additional changes to the remediation plan be warranted, management will modify the planned measures accordingly.

Other than the steps taken to begin remediating the material weakness and the converting of Sleepy's processes and systems to Mattress Firm, there were no changes in the Company's internal controls over financial reporting that materially affected or are reasonably likely to materially affect the Company's internal controls over financial reporting during the period ended August 2, 2016.

**Part II.**  
**OTHER INFORMATION**

**Item 1A. Risk Factors**

We described the most significant risk factors applicable to us in Part I, Item 1A. “Risk Factors” of our Fiscal 2015 Annual Report. We believe there have been no material changes from the risk factors disclosed in our Fiscal 2015 Annual Report except as stated below:

*Our re-branding efforts to a single, national brand in markets where historically we have had little or no presence may not resonate with consumers and could adversely affect our financial condition and results of operations.*

In April 2016 we announced our intention to operate under a single brand name nationwide and to re-brand all of our stores which currently operate under different brand names to the *Mattress Firm*® brand name. The majority of the stores that will be re-branded are located in markets where the *Mattress Firm* brand-name has little or no previous presence and that have operated under other brand names – primarily *Sleepy’s*® and *Sleep Train*® – for many decades. We have engaged in extensive research to determine the appropriate single brand name for our operations going forward and believe that building a national chain under the *Mattress Firm* brand name is the appropriate long-term strategy. As a result of this decision we have incurred a corresponding impairment to the identifiable intangible tradename assets associated with our affected brand names. Although historically we have experienced limited, if any, long-term sales declines with respect to re-branded stores in our prior acquisition markets, the intended brand conversions may have both short-term and long-term impact on sales given the strong regional brand awareness built over decades of consumer advertising in our recently acquired markets. If customers decline to shop at the stores that we ultimately re-brand to *Mattress Firm*®, we may experience a material decline in sales that could adversely affect our financial condition and results of operations.

*A material weakness in our internal control over financial reporting existed as of August 2, 2016. If we do not maintain effective internal control over financial reporting, our operating results could require material modification and our financial reports may not be reliable.*

As described in Part I, Item 4. “Controls and Procedures” of this report, a material weakness in our controls over financial reporting related to the recording of the expense for the flow through of the inventory step up fair value adjustment in the *Sleepy’s* acquisition existed as of May, 3, 2016. As of the end of the period covered by this report, our management, with the participation of our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation and because of the material weakness noted above, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were not effective as of August 2, 2016. The Company has identified and has begun implementing steps to remediate the deficiency.

Although we are committed to continuing to improve our internal control processes to ensure the adequacy of the internal controls over financial reporting, any control system, regardless of how well designed, operated and evaluated, can provide only reasonable, not absolute, assurance that its objectives will be met. Therefore, we cannot be certain that, in the future, additional material weaknesses or significant deficiencies will not exist or otherwise be discovered. If our efforts to address the material weakness identified are not successful, or if other deficiencies occur, these weaknesses or deficiencies could result in misstatements of our results of operations, a restatement of our financial statements for one or more prior periods, a decline in our stock price and investor confidence or other material effects on our business, reputation, results of operations, financial condition or liquidity periods, a decline in our stock price and investor confidence or other material effects on our business, reputation, results of operations, financial condition or liquidity.

**Item 6. Exhibits.**

- (a) Exhibits: Reference is made to the Exhibit List filed as a part of this report beginning on page E-1. Each of such exhibits is incorporated by reference herein.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**MATTRESS FIRM HOLDING CORP.**

Date: September 12, 2016

By: /s/ Kenneth E. Murphy III  
Kenneth E. Murphy III  
President and Chief Executive Officer  
(principal executive officer)

Date: September 12, 2016

By: /s/ Alexander S. Weiss  
Alexander S. Weiss  
Chief Financial Officer  
(principal financial officer)

Date: September 12, 2016

By: /s/ Cathy Hauslein  
Cathy Hauslein  
Senior Vice President and Chief Accounting  
Officer  
(principal accounting officer)

## EXHIBIT LIST

<b>Exhibit Number</b>	<b>Exhibit Title</b>
2.1	Agreement and Plan of Merger, dated August 6, 2016, by and among Steinhoff International Holdings N.V., Stripes US Holding, Inc., Stripes Acquisition Corp., and Mattress Firm Holding Corp. (incorporated by reference to Exhibit 2.1 to Mattress Firm Holding Corp.'s Current Report on Form 8-K (File No. 001-35354) filed August 8, 2016).
31.1	Principal Executive Officer Certification Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to the Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Principal Financial Officer Certification Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14 as Adopted Pursuant to the Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Principal Executive Officer Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Principal Financial Officer Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document