NATURAL ALTERNATIVES INTERNATIONAL INC
Form 10-Q
February 08, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT

pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2007

000-15701

(Commission file number)

NATURAL ALTERNATIVES INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State of incorporation)**	**84-1007839** **(IRS Employer Identification No.)**
1185 Linda Vista Drive	
San Marcos, California 92078 **(Address of principal executive offices)**	**(760) 744-7340** **(Registrant s telephone number)**

Indicate by check mark whether Natural Alternatives International, Inc. (NAI) (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that NAI was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

x Yes ¨ No

Indicate by check mark whether NAI is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

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

Indicate by check mark whether NAI is a shell company (as defined in Rule 12b-2 of the Exchange Act).

¨ Yes x No

As of February 7, 2008, 6,991,149 shares of NAI s common stock were outstanding, net of 180,941 treasury shares.

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SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

Certain statements in this report, including information incorporated by reference, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements reflect current views about future events and financial performance based on certain assumptions. They include opinions, forecasts, intentions, plans, goals, projections, guidance, expectations, beliefs or other statements that are not statements of historical fact. Words such as may, will, should, could, would, expects, plans, believes, anticipates, intends, estimates, ap projects, or the negative or other variation of such words, and similar expressions may identify a statement as a forward-looking statement. Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focus and plans, and other characterizations of future events or circumstances, including statements expressing general optimism about future operating results, are forward-looking statements. Forward-looking statements in this report may include statements about:

- future financial and operating results, including projections of net sales, revenue, income, net income per share, profit margins, expenditures, liquidity and other financial items;
- our ability to develop relationships with new customers and maintain or improve existing customer relationships;
- development of new products, brands and marketing strategies;
- the effect of the discontinuance of Dr. Cherry s television program and our ability to develop a new marketing plan for, and to sustain, our Pathway to Healing® product line;
- distribution channels, product sales and performance, and timing of product shipments;
- our ability to expand the customer base of the As We Change® catalog and achieve higher sales, profitability and cash flows as a result;
- inventories and the adequacy and intended use of our facilities;
- current or future customer orders;
- the impact on our business and results of operations and variations in quarterly net sales from seasonal and other factors;
- management s goals and plans for future operations;
- our ability to improve operational efficiencies, manage costs and business risks and improve or maintain profitability;
- growth, expansion, diversification and acquisition strategies, the success of such strategies, and the benefits we believe can be derived from such strategies;

- personnel;
- the outcome of regulatory, tax and litigation matters;
- sources and availability of raw materials;
- operations outside the United States;
- the adequacy of reserves and allowances;
- overall industry and market performance;
- competition;
- current and future economic and political conditions;
- the impact of accounting pronouncements; and
- other assumptions described in this report underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements. Forward-looking statements are subject to certain events, risks, and uncertainties that may be outside of our control. When considering forward-looking statements, you should carefully review the risks, uncertainties and other cautionary statements in this report as they identify

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certain important factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. These factors include, among others, the risks described under Item 1A of Part II and elsewhere in this report, as well as in other reports and documents we file with the United States Securities and Exchange Commission (SEC).

Unless the context requires otherwise, all references in this report to the Company, NAI, we, our, and us refer to Natural Alternatives International, Inc. and, as applicable, Natural Alternatives International Europe S.A. (NAIE), Real Health Laboratories, Inc. (RHL) and our other wholly owned subsidiaries.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NATURAL ALTERNATIVES INTERNATIONAL, INC.

Condensed Consolidated Balance Sheets

(In thousands, except share and per share data)

	December 31, 2007 (Unaudited)	June 30, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 5,000	$ 4,876
Accounts receivable - less allowance for doubtful accounts of $21 at December 31, 2007 and $20 at June 30, 2007	5,839	5,264
Inventories, net	12,890	14,099
Deferred income taxes	1,441	1,441
Other current assets	1,949	2,204
Total current assets	27,119	27,884
Property and equipment, net	14,084	15,059
Goodwill and purchased intangibles, net	4,141	4,268
Other noncurrent assets, net	169	169
Total assets	$ 45,513	$ 47,380
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 5,413	$ 6,330
Accrued liabilities	1,739	1,840
Accrued compensation and employee benefits	1,492	1,403
Line of credit		
Income taxes payable		270
Current portion of long-term debt	1,639	1,825
Total current liabilities	10,283	11,668
Long-term debt, less current portion	2,050	2,756
Deferred income taxes	1,620	1,620
Deferred rent	1,205	1,238
Long-term pension liability	101	76
Total liabilities	15,259	17,358
Commitments and contingencies		
Stockholders equity:		
Preferred stock; $0.01 par value; 500,000 shares authorized; none issued or outstanding		
	71	69

Common stock; $0.01 par value; 20,000,000 shares authorized; issued and outstanding 7,172,090 at December 31, 2007 and 7,001,230 at June 30, 2007			
Additional paid-in capital		18,024	17,335
Accumulated other comprehensive loss		(162)	(184)
Retained earnings		13,420	13,177
Treasury stock, at cost, 180,941 shares at December 31, 2007 and 70,000 at June 30, 2007		(1,099)	(375)
Total stockholders equity		30,254	30,022
Total liabilities and stockholders equity	$	45,513	$ 47,380

See accompanying notes to condensed consolidated financial statements.

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NATURAL ALTERNATIVES INTERNATIONAL, INC.

Condensed Consolidated Statements of Operations and Comprehensive (Loss) Income

(In thousands, except share and per share data)

(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	**2006**	**2007**	**2006**
Net sales	$ 20,410	$ 24,049	$ 45,929	$ 49,210
Cost of goods sold	16,158	18,347	36,383	37,993
Gross profit	4,252	5,702	9,546	11,217
Selling, general & administrative expenses	4,524	4,737	9,149	9,420
(Loss) income from operations	(272)	965	397	1,797
Other income (expense):				
Interest income	11	4	13	5
Interest expense	(80)	(167)	(213)	(397)
Foreign exchange gain	48	48	150	56
Other, net	(6)	(4)	(5)	(13)
	(27)	(119)	(55)	(349)
(Loss) income before income taxes	(299)	846	342	1,448
(Benefit) provision for income taxes	(119)	292	99	507
Net (loss) income	$ (180)	$ 554	$ 243	$ 941
Unrealized gain resulting from change in fair value of derivative instruments, net of tax	14	21	22	14
Comprehensive (loss) income	$ (166)	$ 575	$ 265	$ 955
Net (loss) income per common share:				
Basic	$ (0.03)	$ 0.08	$ 0.03	$ 0.14
Diluted	$ (0.03)	$ 0.08	$ 0.03	$ 0.13
Weighted average common shares outstanding:				
Basic	6,980,195	6,840,314	6,947,155	6,780,240
Diluted	6,980,195	7,184,910	7,044,402	7,189,213

See accompanying notes to condensed consolidated financial statements.

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NATURAL ALTERNATIVES INTERNATIONAL, INC.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended December 31, 2007	2006
Cash flows from operating activities		
Net income	$ 243	$ 941
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in allowance for uncollectible accounts receivable	1	(60)
Depreciation and amortization	1,628	1,687
Amortization of purchased intangibles	127	126
Non-cash equipment impairment charge	69	
Non-cash compensation	195	96
Tax benefit from exercise of stock options	(64)	(442)
Pension expense, net of contributions	24	29
Loss on disposal of assets		11
Changes in operating assets and liabilities:		
Accounts receivable	(576)	8,210
Inventories, net	1,209	(467)
Other assets	11	118
Accounts payable and accrued liabilities	(1,050)	13
Accrued compensation and employee benefits	89	(625)
Income taxes payable	62	
Net cash provided by operating activities	1,968	9,637
Cash flows from investing activities		
Capital expenditures	(723)	(1,412)
Proceeds from sale of equipment		30
Net cash used in investing activities	(723)	(1,382)
Cash flows from financing activities		
Payments on long-term debt	(893)	(824)
Net payments on line of credit		(7,574)
Tax benefit from exercise of stock options	64	442
Repurchase of common stock	(724)	(82)
Proceeds from issuance of common stock	432	838
Net cash used in financing activities	(1,121)	(7,200)
Net increase in cash and cash equivalents	124	1,055
Cash and cash equivalents at beginning of period	4,876	2,157
Cash and cash equivalents at end of period	$ 5,000	$ 3,212

Supplemental disclosures of cash flow information

Cash paid during the period for:		
Interest	$ 211	$ 375
Taxes	$ 419	$ 671

See accompanying notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

A. Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

The accompanying interim unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and applicable rules and regulations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In management s opinion, all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows have been included and are of a normal, recurring nature. The results of operations for the three and six months ended December 31, 2007 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

You should read the financial statements and these notes, which are an integral part of the financial statements, together with our audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007 (2007 Annual Report). The accounting policies used to prepare the financial statements included in this report are the same as those described in the notes to the consolidated financial statements in our 2007 Annual Report unless otherwise noted below.

Net (Loss) Income per Common Share

We compute net (loss) income per common share in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, Earnings Per Share. This statement requires the presentation of basic (loss) income per common share, using the weighted average number of common shares outstanding during the period, and diluted net (loss) income per common share, using the additional dilutive effect of all dilutive securities. The dilutive impact of stock options account for the additional weighted average shares of common stock outstanding for our diluted net (loss) income per common share computation. We calculated basic and diluted net income per common share as follows (amounts in thousands, except per share data):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	2006	2007	2006
Numerator				
Net (loss) income	$ (180)	$ 554	$ 243	$ 941
Denominator				
Basic weighted average common shares outstanding	6,980	6,840	6,947	6,780
Dilutive effect of stock options		345	97	409
Diluted weighted average common shares outstanding	6,980	7,185	7,044	7,189
Basic net (loss) income per common share	$ (0.03)	$ 0.08	$ 0.03	$ 0.14
Diluted net (loss) income per common share	$ (0.03)	$ 0.08	$ 0.03	$ 0.13

Shares related to stock options of 1,114,900 for the three months ended December 31, 2007, and 552,000 for the six months ended December 31, 2007, were excluded from the calculation of diluted net (loss) income per common share, as the effect of their inclusion would have been anti-dilutive.

Shares related to stock options of 219,000 for the three months ended December 31, 2006, and 122,000 for the six months ended December 31, 2006, were excluded from the calculation of diluted net income per common share, as the effect of their inclusion would have been anti-dilutive.

Stock-Based Compensation

We have an equity incentive plan under which we have granted nonqualified and incentive stock options to employees, non-employee directors and consultants. We also have an employee stock purchase plan. These plans are accounted for under the provisions of SFAS No. 123R, Share Based Payment (SFAS 123R).

We estimated the fair value of the stock option awards at the date of grant and employee stock purchase plan shares at the beginning of the offering period using the Black-Scholes option valuation model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions. Black-Scholes uses assumptions related to volatility, the risk-free interest rate, the dividend yield (which is assumed to be zero, as we have not paid any cash dividends) and employee exercise behavior. Expected volatilities used in the model are based mainly on the historical volatility of our stock price. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect in the period of grant. The expected life of stock option grants is derived from historical experience.

Our net loss for the three months ended December 31, 2007 includes stock based compensation expense of approximately $100,000. Our net income for the three months ended December 31, 2006 has been reduced by stock based compensation expense of approximately $58,000. Our net income has been reduced by stock-based compensation expense of approximately $195,000 for the six months ended December 31, 2007 and $96,000 for the six months ended December 31, 2006.

Income Taxes

On July 1, 2007 we adopted the provisions of the Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods.

As of June 30, 2007 and December 31, 2007, we had unrecognized tax liabilities of $47,000. The total amount of unrecognized tax liabilities, if recognized, would not materially affect the effective tax rate.

Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense. Upon adoption of FIN 48 on July 1, 2007, we did not record any interest or penalties.

We are subject to taxation in the United States and various state jurisdictions. Our tax years for the fiscal year ended June 30, 2006 and forward are subject to examination by the United States and state tax authorities.

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B. Goodwill and Purchased Intangibles

Goodwill and other acquisition-related intangibles as of December 31, 2007 were as follows (dollars in thousands):

	Amortization Life in Years	Gross Amount	Accumulated Amortization	Net Amount
Goodwill [1]	N/A	$ 458	$	$ 458
Distributor relationships	13	500	(80)	420
Direct consumer relationships	9	400	(92)	308
Tradenames	20	3,300	(346)	2,954
Non-compete agreements	2	10	(9)	1
		$ 4,668	$ (527)	$ 4,141

1 On June 30, 2007, as a result of our annual goodwill impairment testing in accordance with SFAS No. 142, Goodwill and Other Intangible Assets, we recorded a non-cash goodwill impairment charge of $7.0 million.

The estimated future amortization expense of purchased intangible assets as of December 31, 2007 was as follows (dollars in thousands):

Six months ending June 30, 2008	$ 121
Fiscal year 2009	247
Fiscal year 2010	247
Fiscal year 2011	247
Fiscal year 2012	247
Thereafter	2,574
	$ 3,683

C. Inventories

Inventories, net consisted of the following (dollars in thousands):

	December 31, 2007	June 30, 2007
Raw materials	$ 8,247	$ 6,997
Work in progress	2,455	3,410
Finished goods	2,188	3,692
	$ 12,890	$ 14,099

D. Property and Equipment

Property and equipment consisted of the following (dollars in thousands):

	Depreciable Life In Years	December 31, 2007	June 30, 2007
Land	N/A	$ 393	$ 393
Building and building improvements	7 39	2,732	2,726
Machinery and equipment	3 12	19,976	19,514
Office equipment and furniture	3 5	4,592	4,470
Vehicles	3	204	204
Leasehold improvements	1 15	10,388	10,325
Total property and equipment		38,285	37,632
Less: accumulated depreciation and amortization		(24,201)	(22,573)
Property and equipment, net		$ 14,084	$ 15,059

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E. Debt

We amended our credit facility on December 1, 2005 and again on March 29, 2006 to increase our working capital line of credit from $8.0 million to $12.0 million, extend the maturity date from November 1, 2006 to November 1, 2007 and modify certain financial covenants. We also obtained an additional $3.8 million term loan on December 5, 2005, to fund, in part, the cash purchase price of the RHL acquisition.

On January 24, 2007, we further amended our credit facility to extend the maturity date for the working capital line of credit from November 1, 2007 to November 1, 2008, and maintain the ratio of total liabilities/tangible net worth covenant at 1.25/1.0 for the remainder of the term of the credit facility.

On December 18, 2007, we again amended our credit facility to (i) extend the maturity date for the working capital line of credit from November 1, 2008 to November 1, 2009; (ii) reduce the maximum principal amount available under the working capital line of credit from $12.0 million to $7.5 million; (iii) reduce the maximum borrowings against inventory from $6.0 million to $3.75 million, provided any such borrowings do not at any time exceed eligible accounts receivable; and (iv) extend the availability of the Foreign Exchange Facility from November 1, 2007 to November 1, 2008 and the allowable contract term thereunder from November 1, 2008 to November 1, 2009.

As a result of the most recent amendments, our bank credit facility decreased to a total of $16.4 million, comprised of a $7.5 million working capital line of credit and $8.9 million in term loans. The working capital line of credit is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has an interest rate of Prime Rate or LIBOR plus 1.75%, as elected by NAI from time to time, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. The term loans consist of a $1.1 million, fifteen year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a $700,000, ten year term loan with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; a $1.8 million, four year term loan, secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, at an interest rate of LIBOR plus 2.10%; a $1.5 million, five year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%; and a $3.8 million, four year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%. As of December 31, 2007, there was no amount outstanding on the working capital line of credit and the amount outstanding on the term loans was $3.7 million. Monthly payments on the term loans are approximately $143,000 plus interest. As of December 31, 2007, we had $7.5 million available under the line of credit.

As of December 31, 2007, we were not in compliance with our quarterly net after-tax income covenant under our credit facility, which requires us to have at least $1.00 of after-tax net income for each quarter. Our lender agreed to waive its default rights as a result of this covenant violation as of December 31, 2007.

On September 22, 2006, NAIE, our wholly owned subsidiary, entered into a credit facility to provide it with a credit line of up to CHF 1,300,000, or approximately $1.2 million, which was the initial maximum aggregate amount that could be outstanding at any one time under the credit facility. This maximum amount was reduced by CHF 160,000, or approximately $142,000, as of December 31, 2007 and will be reduced by an additional CHF 160,000 at the end of each succeeding calendar year. On February 19, 2007, NAIE amended its credit facility to provide that the maximum aggregate amount that may be outstanding under the facility cannot be reduced below CHF 500,000, or approximately $444,000. As of December 31, 2007, there was no outstanding balance under the credit facility.

The composite interest rate on all of our outstanding debt was 8.23% at December 31, 2007, and 7.84% at December 31, 2006.

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F. Defined Benefit Pension Plan

We sponsor a defined benefit pension plan that provides retirement benefits to employees based generally on years of service and compensation during the last five years before retirement. Effective June 20, 1999, our Board of Directors amended the plan to freeze the accrued benefit of each plan member at its then current amount and to no longer allow inactive plan members or other employees to become active members of the plan. We contribute an amount not less than the minimum funding requirements of the Employee Retirement Income Security Act of 1974 nor more than the maximum tax-deductible amount.

The components included in the net periodic benefit for the periods ended December 31 were as follows (dollars in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	2006	2007	2006
Interest cost	$ 21	$ 21	$ 42	$ 42
Expected return on plan assets	(9)	(27)	(17)	(54)
Net periodic expense (benefit)	$ 12	$ (6)	$ 25	$ (12)

G. Economic Dependency

We had substantial net sales to certain customers during the periods shown in the following table. The loss of either of these customers, or a significant decline in net sales or the growth rate of sales to these customers could have a material adverse impact on our net sales and net income. Net sales to any one customer representing 10% or more of the respective period s total net sales were as follows (dollars in thousands):

	Three Months Ended December 31,				Six Months Ended December 31,			
	2007		2006		2007		2006	
	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales
Customer 1	$ 10,730	53%	$ 10,095	42%	$ 19,462	42%	$ 20,051	41%
Customer 2	4,640	23	7,341	31	13,814	30	14,870	30
	$ 15,370	76%	$ 17,436	73%	$ 33,276	72%	$ 34,921	71%

We buy certain products from a limited number of raw material suppliers. The loss of any of these suppliers could have a material adverse impact on our net sales and net income. Raw material purchases from any one supplier representing 10% or more of the respective period s total raw material purchases were as follows (dollars in thousands):

	Three Months Ended December 31,				Six Months Ended December 31,			
	2007		2006		2007		2006	
	Raw Material Purchases by Supplier	% of Total Raw Material Purchases	Raw Material Purchases by Supplier	% of Total Raw Material Purchases	Raw Material Purchases by Supplier	% of Total Raw Material Purchases	Raw Material Purchases by Supplier	% of Total Raw Material Purchases
Supplier 1	$ (a)	(a)	$ 1,112	11%	$ 3,730	20%	$ 2,993	14%
Supplier 2	$ 586	11%	1,630	16	2,708	15	2,388	11
Supplier 3	(a)	(a)	1,276	12	(a)	(a)	2,341	11
	$ 586	11%	$ 4,018	39%	$ 6,438	35%	$ 7,722	36%

(a) Purchases were less than 10% of the respective period s total raw material purchases.

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H. Segment Information

Effective July 1, 2006, we changed our reporting segments to reflect the structure of our internal organization after the integration of previously outsourced fulfillment and call center activities for our Dr. Cherry Pathway to Healing® product line into RHL s existing operations. The reportable segments are as follows:

Private label contract manufacturing, in which we primarily provide manufacturing services to companies that market and distribute nutritional supplements and other health care products; and

Branded products, in which we market and distribute branded nutritional supplements and other lifestyle products in the following distribution channels:

Direct-to-consumer marketing programs, under which we develop, manufacture and market our own products and work with nationally recognized physicians and others to develop brand name products that reflect their individual approaches to restoring, maintaining or improving health. These products are sold through a variety of distribution channels, including television programs, print media and the internet. The Dr. Cherry Pathway to Healing® product line is sold under a direct-to-consumer marketing program;

Food, Drug and Mass Market (FDM) retail channel in which we sell the Real Health® Laboratories nutritional supplement product line; and

As We Change® catalog, a lifestyle catalog geared towards women between the ages of 45 and 65, in which we sell our own branded products as well as third party products. The quarterly print catalog offers a variety of high quality nutritional, beauty, skin care, exercise, lifestyle and other personal care products.

We evaluate performance based on a number of factors. The primary performance measures for each segment are net sales and income or loss from operations before corporate allocations. Operating income or loss for each segment does not include corporate general and administrative expenses, interest expense and other miscellaneous income and expense items. Corporate general and administrative expenses include, but are not limited to: human resources, legal, finance, information technology, and other corporate level related expenses, which are not allocated to either segment. The accounting policies of our segments are the same as those described in the summary of significant accounting policies in Note A above and in the consolidated financial statements included in our 2007 Annual Report.

Our operating results by business segment were as follows (dollars in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	2006	2007	2006
Net Sales				
Private label contract manufacturing	$ 17,387	$ 20,147	$ 39,205	$ 41,117
Branded products	3,023	3,902	6,724	8,093
	$ 20,410	$ 24,049	$ 45,929	$ 49,210

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	2006	2007	2006
(Loss) income from Operations				

Private label contract manufacturing	$ 1,944	$ 3,004	$ 4,663	$ 5,722
Branded products	(243)	10	(476)	218
Income from operations of reportable segments	1,701	3,014	4,187	5,940
Corporate expenses not allocated to segments	(1,973)	(2,049)	(3,790)	(4,143)
	$ (272)	$ 965	$ 397	$ 1,797

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	December 31, 2007	June 30, 2007
Total Assets		
Private label contract manufacturing	$ 38,414	$ 39,583
Branded products	7,099	7,797
	$ 45,513	$ 47,380

Our private label contract manufacturing products are sold both in the United States and in markets outside the United States, including Europe, Australia and Japan. Our primary market outside the United States is Europe. Our branded products are sold only in the United States.

Net sales by geographic region, based on the customers location, were as follows (dollars in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2007	2006	2007	2006
United States	$ 15,302	$ 18,564	$ 34,541	$ 39,006
Markets outside the United States	5,108	5,485	11,388	10,204
Total net sales	$ 20,410	$ 24,049	$ 45,929	$ 49,210

Products manufactured by NAIE accounted for approximately 62% of net sales in markets outside the United States for the three months ended December 31, 2007, and 40% for the three months ended December 31, 2006. NAIE accounted for 49% of net sales in markets outside the United States for the six months ended December 31, 2007, and 45% for the six months ended December 31, 2006. No products manufactured by NAIE were sold in the United States during the six months ended December 31, 2007 and 2006.

Assets and capital expenditures by geographic region, based on the location of the company or subsidiary at which they were located or made, were as follows (dollars in thousands):

	Long-Lived Assets		Total Assets		Capital Expenditures Six Months Ended	
	December 31, 2007	June 30, 2007	December 31, 2007	June 30, 2007	December 31, 2007	December 31, 2006
United States	$ 16,320	$ 17,362	$ 38,783	$ 41,493	$ 613	$ 707
Europe	1,906	1,965	6,730	5,887	110	705
	$ 18,226	$ 19,327	$ 45,513	$ 47,380	$ 723	$ 1,412

I. Contingencies

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operations. However, a settlement payment or unfavorable outcome could adversely impact our results of operations. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

As of February 7, 2008, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis is intended to help you understand our financial condition and results of operations for the three and six months ended December 31, 2007. You should read the following discussion and analysis together with our unaudited condensed consolidated financial statements and the notes to the condensed consolidated financial statements included under Item 1 in this report, as well as the risk factors and other information included in our 2007 Annual Report and other reports and documents we file with the SEC. Our future financial condition and results of operations will vary from our historical financial condition and results of operations described below based on a variety of factors.

Executive Overview

The following overview does not address all of the matters covered in the other sections of this Item 2 or other items in this report or contain all of the information that may be important to our stockholders or the investing public. This overview should be read in conjunction with the other sections of this Item 2 and this report.

Our primary business activity is providing private label contract manufacturing services to companies that market and distribute vitamins, minerals, herbs and other nutritional supplements, as well as other health care products, to consumers both within and outside the United States. Historically, our revenue has been largely dependent on sales to one or two private label contract manufacturing customers and subject to variations in the timing of such customers orders, which in turn is impacted by such customers internal marketing programs, supply chain management, entry into new markets and new product introductions.

A cornerstone of our business strategy is to achieve long-term growth and diversify our sales. We have sought and expect to continue to seek to diversify our sales both by developing relationships with additional, quality-oriented, private label contract manufacturing customers, and developing and growing our own line of branded products through RHL, an integrated direct marketer of branded nutritional supplements and other lifestyle products that we acquired in fiscal 2006.

During the six months ended December 31, 2007, our net sales were 6.7% lower than in the comparable quarter last year. Private label contract manufacturing sales contributed five percent of the overall decrease primarily due to lower volumes of existing products in existing markets sold to one of our largest customers. We also experienced a decrease in branded products sales. The decrease in branded products sales was primarily attributed to the continued softening of our Dr. Cherry Pathway to Healing® product line.

In April 2007, Dr. Cherry ceased airing his weekly television program, which had served as the primary customer acquisition vehicle in marketing the Pathway to Healing® product line. While sales of the product line have been primarily generated by continuity orders from long-standing repeat customers, the loss of the television program has had a negative impact on our ability to acquire new customers. We have continued to work with Dr. Cherry to evaluate alternative marketing programs and revise marketing plans to support the product line.

During the remainder of fiscal 2008, we plan to continue to focus on:

- Leveraging our state of the art, certified facilities to increase the value of the goods and services we provide to our highly valued private label contract manufacturing customers, and assist us in developing relationships with additional quality oriented customers;
- Implementing focused initiatives to grow our branded product lines and to sustain our Pathway to Healing® product line;
- Improving operational efficiencies and managing costs and business risks to improve profitability; and
- Identifying and evaluating additional acquisition opportunities that could increase product lines, expand distribution channels, enhance manufacturing capabilities or reduce risk associated with a variety of factors.

As we previously anticipated, our second quarter sales and profits were significantly impacted by the reduction in volume from one of our largest private label customers. Looking forward, during the second half of fiscal 2008 we anticipate sales to this customer will trend towards sales levels experienced during the comparable period of fiscal 2007. Additionally, we have established relationships with two new customers and anticipate initial shipments of these products during late third or early fourth quarter of this year. We also expect our branded product sales

to improve over our second quarter results as we enter our stronger catalog season during the third and fourth quarters.

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Critical Accounting Policies and Estimates

The preparation of our financial statements requires that we make estimates and assumptions that affect the amounts reported in our financial statements and their accompanying notes. We have identified certain policies that we believe are important to the portrayal of our financial condition and results of operations. These policies require the application of significant judgment by our management. We base our estimates on our historical experience, industry standards, and various other assumptions that we believe are reasonable under the circumstances. Actual results could differ from these estimates under different assumptions or conditions. An adverse effect on our financial condition, changes in financial condition, and results of operations could occur if circumstances change that alter the various assumptions or conditions used in such estimates or assumptions.

Our critical accounting policies are discussed under Item 7 of our 2007 Annual Report. There have been no significant changes to these policies during the six months ended December 31, 2007.

Results of Operations

The results of our operations for the periods ended December 31 were as follows (dollars in thousands, except per share amounts):

	Three Months Ended December 31,			Six Months Ended December 31,		
	2007	2006	% Change	2007	2006	% Change
Private label contract manufacturing	$ 17,387	$ 20,147	(14)	$ 39,205	$ 41,117	(5)
Branded products	3,023	3,902	(23)	6,724	8,093	(17)
Total net sales	20,410	24,049	(15)	45,929	49,210	(7)
Cost of goods sold	16,158	18,347	(12)	36,383	37,993	(4)
Gross profit	4,252	5,702	(25)	9,546	11,217	(15)
Gross profit %	20.8%	23.7%		20.8%	22.8%	
Selling, general & administrative expenses	4,524	4,737	(4)	9,149	9,420	(3)
% of net sales	22.2%	19.7%		19.9%	19.1%	
(Loss) income from operations	(272)	965	(128)	397	1,797	(78)
% of net sales	(1.3%)	4.0%		0.9%	3.7%	
Other expense, net	27	119	(77)	55	349	(84)
(Loss) income before taxes	(299)	846	(135)	342	1,448	(76)
% of net sales	(1.5%)	3.5%		0.7%	2.9%	
Net (loss) income	$ (180)	$ 554	(132)	$ 243	$ 941	(74)
% of net sales	(0.9%)	2.3%		0.5%	1.9%	
Diluted net (loss) income per common share	$ (0.03)	$ 0.08	(138)	$ 0.03	$ 0.13	(77)

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The percentage decrease in contract manufacturing net sales was primarily attributed to the following for the periods ended December 31:

	Three Months Ended	Six Months Ended
Mannatech, Incorporated [(1)]	(13)	(3)
NSA International, Inc. [(2)]	3	(1)
Other customers [(3)]	(4)	(1)
Total	(14)%	(5)%

1 A decrease in net sales to Mannatech, Incorporated resulted primarily from the sale of lower volumes of established products in existing markets.

2 An increase in net sales to NSA International, Inc. in the three months ended December 31, 2007 resulted primarily from the sale of higher volumes of established products in existing markets. A decrease in net sales to NSA International, Inc. in the six months ended December 31, 2007 resulted primarily from the sale of lower volumes of established products in existing markets.

3 A decrease in net sales to other customers was primarily due to the discontinuation of customer relationships.

The percentage change in net sales of our branded products was primarily attributed to the following distribution channels:

	Three Months Ended	Six Months Ended
As We Change® catalog	(2)%	1%
FDM retail channel	(4)	(3)
Direct-to-consumer marketing programs [(1)]	(17)	(15)
Total	(23)%	(17)%

1 Net sales from our direct-to-consumer marketing programs decreased primarily from lower sales of the Dr. Cherry Pathway to Healing® product line.

Gross profit margin decreased 2.9 percentage points from the comparable quarter and 2.0 percentage points from the comparable six month period last year. The change in gross profit margin was primarily due to the following for the periods ended December 31:

	Three Months Ended	Six Months Ended
Branded products operations	(1.1)%	(2.3)%
Contract manufacturing:		
Shift in sales and material mix	5.4	2.8
Incremental overhead expenses	(1.3)	(0.7)
Incremental direct and indirect labor	(6.6)	(3.3)
Other	0.7	1.5

Total	(2.9)%	(2.0)%

Selling, general and administrative expenses decreased $213,000, or 4%, from the comparable quarter last year and $271,000, or 3%, from the comparable year to date period last year. The decrease was primarily attributed to savings in selling, general and administrative expenses for our branded products.

Other expense, net decreased $92,000 from the comparable quarter, and $294,000 from the comparable six month period, last year primarily due to a decrease in interest expense of $86,000 and $197,000, respectively, resulting from lower utilization of our line of credit. Additionally, foreign exchange gains increased $94,000 during the six month period due to the strengthening of the Euro and the related impact on the translation of Euro denominated cash and receivables.

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Liquidity and Capital Resources

Our primary sources of liquidity and capital resources are cash flows provided by operating activities and the availability of borrowings under our credit facility. Net cash provided by operating activities was $2.0 million for the six months ended December 31, 2007 compared to $9.6 million in the comparable period in the prior year.

At December 31, 2007, changes in accounts receivable, consisting primarily of amounts due from our private label contract manufacturing customers, used $576,000 in cash during the six months ended December 31, 2007 compared to providing $8.2 million in the comparable period in the prior year. Cash used by accounts receivable in the six months ended December 31, 2007 was due to an increase in customer sales at the end of the period. Days sales outstanding was 22 days as of December 31, 2007 compared to 33 days as of December 31, 2006.

Approximately $1.3 million of our operating cash flow was generated by NAIE in the six months ended December 31, 2007. As of December 31, 2007, NAIE s undistributed retained earnings were considered indefinitely reinvested.

Capital expenditures were $723,000 during the six months ended December 31, 2007 compared to $1.4 million in the comparable period in the prior year. Capital expenditures during the six months ended December 31, 2007 and December 31, 2006 were primarily for manufacturing equipment in our Vista, California and Manno, Switzerland facilities and computer software and hardware expenditures for our RHL facility.

Cash used in financing activities for the six months ended December 31, 2007 included $724,000 of cash used to repurchase our common stock. On June 29, 2007, the independent members of the Board of Directors approved the repurchase of 100,000 shares of our common stock from Mark LeDoux, our Chief Executive Officer and the Chairman of the Board, his wife, their family limited partnership and related children s trust, conditioned on a purchase price equal to a 10% discount from the closing price on such date. The repurchase was completed on July 6, 2007.

Our consolidated debt decreased to $3.7 million at December 31, 2007 from $4.6 million at June 30, 2007 primarily due to payments on our term loans.

As of December 31, 2007 we have a bank credit facility of $16.4 million, comprised of a $7.5 million working capital line of credit and $8.9 million in term loans. The working capital line of credit is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has an interest rate of Prime Rate or LIBOR plus 1.75%, as elected by NAI from time to time, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. The term loans consist of a $1.1 million, fifteen year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a $700,000, ten year term loan with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; a $1.8 million, four year term loan, secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, at an interest rate of LIBOR plus 2.10%; a $1.5 million, five year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%; and a $3.8 million, four year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%. As of December 31, 2007, there was no amount outstanding on the working capital line of credit and the amount outstanding on the term loans was $3.7 million. Monthly payments on the term loans are approximately $143,000 plus interest. The maturity date of the line of credit is November 1, 2009.

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As of December 31, 2007, we were not in compliance with our quarterly net after-tax income covenant under our credit facility, which requires us to have at least $1.00 of after-tax net income for each quarter. Our lender agreed to waive its default rights as a result of this covenant violation as of December 31, 2007.

As of December 31, 2007, NAIE, our wholly owned subsidiary, had a credit facility to provide it with a credit line of up to CHF 1,140,000, or approximately $1.0 million, which amount will be reduced by CHF 160,000, or approximately $142,000, at the end of each calendar year. On February 19, 2007, NAIE amended its credit facility to provide that the maximum aggregate amount that may be outstanding under the facility cannot be reduced below CHF 500,000, or approximately $444,000. As of December 31, 2007, there was no outstanding balance under the credit facility.

Under its credit facility, NAIE may draw amounts either as current account loan credits to its current or future bank accounts or as fixed loans with a maximum term of 24 months. Current account loans will bear interest at the rate of 5% per annum. Fixed loans will bear interest at a rate determined by the parties based on current market conditions and must be repaid pursuant to a repayment schedule established by the parties at the time of the loan. If a fixed loan is repaid early at NAIE s election or in connection with the termination of the credit facility, NAIE will be charged a pre-payment penalty equal to 0.1% of the principal amount of the fixed loan or CHF 1,000 (approximately $900), whichever is greater. The bank reserves the right to refuse individual requests for an advance under the credit facility, although its exercise of such right will not have the effect of terminating the credit facility as a whole.

As of December 31, 2007, we had $5.0 million in cash and cash equivalents and $7.5 million available under our line of credit. We believe our available cash, cash equivalents and potential cash flows from operations will be sufficient to fund our current working capital needs, capital expenditures and debt payments through at least the next 12 months.

Off-Balance Sheet Arrangements

As of December 31, 2007, we did not have any significant off-balance sheet debt nor did we have any transactions, arrangements, obligations (including contingent obligations) or other relationships with any unconsolidated entities or other persons that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses material to investors.

Recent Accounting Pronouncements

Recent accounting pronouncements are discussed under Item 7 of our 2007 Annual Report. As of December 31, 2007, other than the pronouncements discussed in our 2007 Annual Report, we are not aware of any other pronouncements that materially affect our financial position or results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk, which is the potential loss arising from adverse changes in market rates and prices, such as foreign currency exchange and interest rates. We generally do not enter into derivatives or other financial instruments for trading or speculative purposes. We may, however, enter into financial instruments to try to manage and reduce the impact of changes in foreign currency exchange rates. We cannot predict with any certainty our future exposure to fluctuations in foreign currency exchange and interest rates or other market risks or the impact, if any, such fluctuations may have on our future business, product pricing, consolidated financial condition, results of operations or cash flows. The actual impact of any fluctuations in foreign currency exchange or interest rates may differ significantly from those discussed below.

Interest Rates

At December 31, 2007, we had fixed rate debt of $382,000 and variable rate debt of approximately $3.3 million. The interest rates on our variable rate debt range from LIBOR plus 1.75% to LIBOR plus 2.25%. As of December 31, 2007, the weighted average effective interest rate on our variable rate debt was 8.0%. An immediate one hundred basis point (1.0%) increase in the interest rates on our variable rate debt, holding other variables constant, would have increased our interest expense by $15,000 for the six months ended December 31, 2007. Interest rates have been at or near historic lows in recent years but have been increasing during the past year. There can be no guarantee that interest rates will not rise further. Any increase in interest rates may adversely affect our results of operations and financial condition.

Foreign Currencies

To the extent our business continues to expand outside the United States, an increasing share of our net sales and cost of sales may be transacted in currencies other than the United States dollar. Accounting practices require that our non-United States dollar-denominated transactions be converted to United States dollars for reporting purposes. Consequently, our reported net earnings may be significantly affected by fluctuations in currency exchange rates. When the United States dollar strengthens against currencies in which products are sold or weakens against currencies in which we incur costs, net sales and costs could be adversely affected.

Our main exchange rate exposures are with the Swiss Franc and the Euro against the United States dollar. This is due to NAIE s operations in Switzerland and the payment in Euros by our largest customer for finished goods. Additionally, we pay our NAIE employees and certain operating expenses in Swiss Francs. We may enter into forward exchange contracts, foreign currency borrowings and option contracts to hedge our foreign currency risk. Our goal in seeking to manage foreign currency risk is to provide reasonable certainty to the functional currency value of foreign currency cash flows and to help stabilize the value of non-United States dollar-denominated earnings.

From time to time, we purchase option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros The risk of loss associated with the options is limited to the purchase price paid for the option contracts. Option contracts outstanding at any time during the quarter ended December 31, 2007 were as follows:

Number of Option Contracts Purchased	Purchase Date	Expiration Dates	Notional Amount	Weighted Average Strike Price	Purchase Price
Three (3)	January 18, 2007	Monthly from August 2007 to October 2007	$1.9 million	$1.24	$12,000
Three (3)	April 3, 2007	Monthly from November 2007 to January 2008	$1.9 million	$1.29	$18,000
Three (3)	August 14, 2007	Monthly from February 2008 to April 2008	$1.9 million	$1.29	$10,000
Three (3)	September 7, 2007	Monthly from May 2008 to July 2008	$1.9 million	$1.29	$12,000

On December 31, 2007, the Swiss Franc closed at 1.13 to 1.00 United States dollar and the Euro closed at 0.68 to 1.00 United States dollar. A 10% adverse change to the exchange rates between the Swiss Franc and the Euro against the United States dollar, holding other variables constant, would have decreased our net income for the six months ended December 31, 2007 by $421,000.

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ITEM 4. CONTROLS AND PROCEDURES

We maintain certain disclosure controls and procedures as defined under the Securities Exchange Act of 1934, as amended (1934 Act). They are designed to help ensure that material information is: (1) gathered and communicated to our management, including our principal executive and financial officers, in a manner that allows for timely decisions regarding required disclosures; and (2) recorded, processed, summarized, reported and filed with the SEC as required under the 1934 Act and within the time periods specified by the SEC.

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 as of December 31, 2007. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective for their intended purpose described above as of December 31, 2007 because of the material weakness previously identified (as described below), for which remediation efforts are ongoing.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis. In connection with management s evaluation of our disclosure controls and procedures as of September 30, 2007, management determined that a material weakness in internal control over financial reporting existed regarding our annual goodwill impairment analysis necessary for the preparation of our 2007 Annual Report. In particular, management determined that we did not have an appropriate process in place to develop and support the forecasts and plans necessary to complete our annual goodwill impairment analysis in a timely manner. As a result, we were unable to timely file our 2007 Annual Report.

There were no changes to our internal controls during the quarter ended December 31, 2007 that have materially affected, or that are reasonably likely to materially affect, our internal controls. The matter identified above and the steps necessary to remediate such weakness remain under review by management and our Board of Directors. In addition, at the end of our 2008 fiscal year, management will be required to provide an assessment of the effectiveness of our internal control over financial reporting. We are in the process of performing the system and process documentation, evaluation and testing required for management to make this assessment. We have not completed this process or our assessment. In the course of evaluation and testing, management may identify additional deficiencies that will need to be addressed and remediated. There can be no assurance that our remediation efforts will be successful or that our control procedures will be effective in accomplishing their objectives at all times.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operations. However, a settlement payment or unfavorable outcome could adversely impact our results of operations. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

As of February 7, 2008, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described under Item 1A of our 2007 Annual Report, as well as the other information in our 2007 Annual Report, this report and other reports and documents we file with the SEC, when evaluating our business and future prospects. If any of the identified risks actually occur, our business, financial condition and results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you could lose all or a portion of the value of your investment in our common stock.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Our annual meeting of stockholders was held on December 11, 2007. The following table sets forth the matters voted upon at the meeting and the results of the voting on each matter voted upon:

Matter Voted Upon	Votes For	Withheld	Votes Against	Abstentions	Broker Non-Votes
Election of two Class II directors to serve until the next annual meeting of stockholders held to elect Class II directors and until their respective successors are elected and qualified:					
Alan G. Dunn	5,915,063	61,297			