

NATURAL ALTERNATIVES INTERNATIONAL INC  
Form 10-Q  
February 12, 2013  
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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, 2012**  
**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.

Yes  No

Indicate by check mark whether NAI has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that NAI was required to submit and post such files).

Yes  No

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Indicate by check mark whether NAI is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

Yes  No

As of February 12, 2013, 6,853,409 shares of NAI's common stock were outstanding, net of 469,268 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 the following:

future financial and operating results, including projections of net sales, revenue, income or loss, net income or loss 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;

our ability to protect our intellectual property;

the outcome of litigation, regulatory and tax matters, the costs associated with such matters and the effect of such matters on our business and results of operations;

currency exchange rates, their effect on our results of operations, including amounts that may be reclassified as earnings, our ability to effectively hedge against foreign exchange risks and the extent to which we may seek to hedge against such risks;

future levels of our revenue concentration risk;

sources and availability of raw materials;

inventories, including the adequacy of inventory levels to meet future customer demand and the adequacy and intended use of our facilities;

development of new products and marketing strategies;

our ability to increase our marketing and advertising efforts for our Pathway to Healing® product line, the timing of such efforts and their effect on future sales;

manufacturing and distribution channels, product sales and performance, and timing of product shipments;

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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;

inflation rates and their impact on our operations and profitability;

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, acquisition, divestment and consolidation strategies, the success of such strategies, and the benefits we believe can be derived from such strategies;

personnel;

our ability to operate within the standards set by the U.S. Food and Drug Administration's (FDA) Good Manufacturing Practices (GMP);

our ability to successfully expand our operations outside the United States (U.S.);

the adequacy of reserves and allowances;

overall industry and market performance;

competition and competitive advantages resulting from our quality commitment;

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 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).

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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), and our other wholly owned subsidiaries.

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****NATURAL ALTERNATIVES INTERNATIONAL, INC.****Condensed Consolidated Balance Sheets****(In thousands, except share and per share data)**

|  | <b>December 31,<br/>2012<br/>(Unaudited)</b> | <b>June 30, 2012</b> |
|--|--|----------------------|
| <b>Assets</b>  |  |                      |
| Current assets:  |  |                      |
| Cash and cash equivalents  | \$ 16,996                                    | \$ 14,478            |
| Accounts receivable - less allowance for doubtful accounts of<br>\$113 at December 31, 2012 and \$122 at June 30, 2012   | 3,313  | 8,751                |
| Inventories, net   | 9,433  | 8,355                |
| Deferred income taxes  | 699  | 699                  |
| Income tax receivable  | 1,091  | 356                  |
| Prepaid expenses and other current assets  | 873  | 1,880                |
| <b>Total current assets</b>  | <b>32,405</b>                                | <b>34,519</b>        |
| Property and equipment, net  | 10,271                                       | 10,647               |
| Deferred income taxes  | 1,471  | 1,471                |
| Long-term pension asset  | 84   | 89                   |
| Other noncurrent assets, net   | 350  | 471                  |
| <b>Total assets</b>  | <b>\$ 44,581</b>                             | <b>\$ 47,197</b>     |
| <b>Liabilities and Stockholders' Equity</b>  |  |                      |
| Current liabilities:   |  |                      |
| Accounts payable   | \$ 2,165                                     | \$ 3,918             |
| Accrued liabilities  | 1,071  | 1,259                |
| Accrued compensation and employee benefits   | 774  | 1,331                |
| Income taxes payable   | 505  | 328                  |
| <b>Total current liabilities</b>   | <b>4,515</b>                                 | <b>6,836</b>         |
| Other noncurrent liabilities   | 43   |                      |
| Deferred rent  | 364  | 493                  |
| <b>Total liabilities</b>   | <b>4,922</b>                                 | <b>7,329</b>         |
| Commitments and contingencies  |  |                      |
| Stockholders' equity:  |  |                      |
| Preferred stock; \$.01 par value; 500,000 shares authorized; none issued or outstanding  |  |                      |
| Common stock; \$.01 par value; 20,000,000 shares authorized; issued and outstanding (net of treasury shares) 6,853,409 at December 31, 2012 and 6,938,687 at June 30, 2012 | 72   | 72                   |
| Additional paid-in capital   | 19,650                                       | 19,530               |

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|   |                  |                  |
|---|------------------|------------------|
| Accumulated other comprehensive (loss) income   | (437)            | 99               |
| Retained earnings   | 22,896           | 22,097           |
| Treasury stock, at cost, 469,268 shares at December 31, 2012 and 361,990 at June 30, 2012 | (2,522)          | (1,930)          |
| <b>Total stockholders' equity</b>   | <b>39,659</b>    | <b>39,868</b>    |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 44,581</b> | <b>\$ 47,197</b> |

*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents****NATURAL ALTERNATIVES INTERNATIONAL, INC.****Condensed Consolidated Statements of Income and Comprehensive (Loss) Income****(In thousands, except share and per share data)****(Unaudited)**

|  | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--|---------------------------|-------------|-------------------------|-------------|
|  | <b>December 31,</b>       |             | <b>December 31,</b>     |             |
|  | <b>2012</b>               | <b>2011</b> | <b>2012</b>             | <b>2011</b> |
| Net sales  | \$ 13,686                 | \$ 16,161   | \$ 30,146               | \$ 34,502   |
| Cost of goods sold   | 11,767                    | 12,808      | 24,643                  | 26,466      |
| Gross profit   | 1,919                     | 3,353       | 5,503                   | 8,036       |
| Selling, general & administrative expenses   | 2,192                     | 2,127       | 4,747                   | 4,463       |
| (Loss) income from operations  | (273)                     | 1,226       | 756                     | 3,573       |
| Other income (expense):  |                           |             |                         |             |
| Interest income  | 12                        | 5           | 21                      | 10          |
| Interest expense   | (5)                       | (31)        | (11)                    | (66)        |
| Foreign exchange (loss) gain   |                           | (5)         | (15)                    | 106         |
| Other, net   |                           | 4           |                         | 6           |
|  | 7                         | (27)        | (5)                     | 56          |
| (Loss) income before income taxes  | (266)                     | 1,199       | 751                     | 3,629       |
| (Benefit) provision for income taxes   | (368)                     | 414         | (48)                    | 1,316       |
| Net income   | \$ 102                    | \$ 785      | \$ 799                  | \$ 2,313    |
| Unrealized (loss) gain resulting from change in fair value of derivative instruments, net of tax | (292)                     | 436         | (536)                   | 830         |
| Comprehensive (loss) income  | \$ (190)                  | \$ 1,221    | \$ 263                  | \$ 3,143    |
| Net income per common share:   |                           |             |                         |             |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Basic                                       | \$ 0.01   | \$ 0.11   | \$ 0.12   | \$ 0.33   |
| Diluted                                     | \$ 0.01   | \$ 0.11   | \$ 0.12   | \$ 0.33   |
| Weighted average common shares outstanding: |           |           |           |           |
| Basic                                       | 6,890,943 | 6,971,486 | 6,904,375 | 6,992,371 |
| Diluted                                     | 6,900,169 | 6,985,341 | 6,914,586 | 6,999,604 |

*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents****NATURAL ALTERNATIVES INTERNATIONAL, INC.****Condensed Consolidated Statements of Cash Flows****(In thousands)****(Unaudited)**

|   | <b>Six Months Ended<br/>December 31,</b> |             |
|---|--|-------------|
|   | <b>2012</b>                              | <b>2011</b> |
| <b>Cash flows from operating activities</b>   |  |             |
| Net income  | \$ 799                                   | \$ 2,313    |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |  |             |
| (Decrease) increase of uncollectible accounts receivable                                    | (9)                                      | 57          |
| Depreciation and amortization   | 1,508                                    | 1,543       |
| Non-cash compensation   | 83                                       | 114         |
| Pension expense   | 5  | 25          |
| (Gain) loss on disposal of assets   | (12)                                     | 5           |
| Changes in operating assets and liabilities:  |  |             |
| Accounts receivable   | 5,447                                    | (1,658)     |
| Inventories, net  | (1,078)                                  | (6,194)     |
| Other assets  | 303                                      | 86          |
| Accounts payable and accrued liabilities  | (2,093)                                  | 1,123       |
| Income taxes  | (203)                                    | (265)       |
| Accrued compensation and employee benefits  | (557)                                    | (252)       |
| Net cash provided by (used in) operating activities   | 4,193                                    | (3,103)     |
| <b>Cash flows from investing activities</b>   |  |             |
| Capital expenditures  | (1,132)                                  | (963)       |
| Proceeds from sale of property & equipment  | 12                                       |             |
| Net cash used by investing activities   | (1,120)                                  | (963)       |
| <b>Cash flows from financing activities</b>   |  |             |
| Repurchase of common stock  | (592)                                    | (202)       |
| Issuance of common stock  | 37                                       |             |
| Net cash used by financing activities   | (555)                                    | (202)       |
| Net increase (decrease) in cash and cash equivalents  | 2,518                                    | (4,268)     |
| Cash and cash equivalents at beginning of period  | 14,478                                   | 15,461      |
| Cash and cash equivalents at end of period  | \$ 16,996                                | \$ 11,193   |
| <b>Supplemental disclosures of cash flow information</b>                                    |  |             |
| Cash paid during the period for:  |  |             |
| Interest  | \$ 13                                    | \$ 13       |

|       |        |          |
|-------|--------|----------|
| Taxes | \$ 169 | \$ 1,592 |
|-------|--------|----------|

*See accompanying notes to condensed consolidated financial statements.*

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(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, 2012 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, 2012 ( 2012 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 2012 Annual Report unless otherwise noted below.

**Recent Accounting Pronouncements**

In May 2011, the FASB issued Accounting Standard Update (ASU) 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. The amendments in this update are the result of the work of the FASB and the International Accounting Standards Board (IASB) to develop common requirements for measuring fair value and for disclosing information about fair value measurements. We adopted ASU 2011-04 during our first quarter of fiscal 2013 and there was no significant impact to our consolidated financial statements as a result of our adoption of this amendment.

In June 2011, the FASB issued ASU 2011-05, Presentation of Comprehensive Income. ASU 2011-05 requires all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but continuous statements. If presented in two separate statements, the first statement should present total net income and its components followed immediately by a second statement of total other comprehensive income, its components and the total comprehensive income. In December 2011, the FASB issued ASU 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. ASU 2011-12 defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. The FASB has deferred those changes in order to reconsider whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. ASU 2011-12 does not impact the requirement of ASU 2011-05 to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. We adopted ASU 2011-05 during the first quarter of fiscal 2013 and there was no material impact on our financial position or results of operations as a result of our adoption of this pronouncement.

**Net Income per Common Share**

We compute net income per common share using the weighted average number of common shares outstanding during the period, and diluted net 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 income per common share computation. We calculated basic and diluted net income per common share as follows (in thousands, except per share data):

|                  | Three Months Ended |        | Six Months Ended |          |
|------------------|--------------------|--------|------------------|----------|
|                  | December 31,       |        | December 31,     |          |
|                  | 2012               | 2011   | 2012             | 2011     |
| <b>Numerator</b> |                    |        |                  |          |
| Net income       | \$ 102             | \$ 785 | \$ 799           | \$ 2,313 |

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| <b>Denominator</b>                                 |         |         |         |         |
|--|---------|---------|---------|---------|
| Basic weighted average common shares outstanding   | 6,891   | 6,971   | 6,905   | 6,992   |
| Dilutive effect of stock options                   | 9       | 14      | 10      | 8       |
| Diluted weighted average common shares outstanding | 6,900   | 6,985   | 6,915   | 7,000   |
| Basic net income per common share                  | \$ 0.01 | \$ 0.11 | \$ 0.12 | \$ 0.33 |
| Diluted net income per common share                | \$ 0.01 | \$ 0.11 | \$ 0.12 | \$ 0.33 |

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Shares related to stock options representing the right to acquire 491,700 shares of common stock for the three months ended December 31, 2012, and 491,700 shares for the six months ended December 31, 2012, were excluded from the calculation of diluted net income per common share, as the effect of their inclusion would have been anti-dilutive.

Shares related to stock options representing the right to acquire 535,000 shares of common stock for the three months ended December 31, 2011, and 555,875 shares for the six months ended December 31, 2011, were excluded from the calculation of diluted net income per common share, as the effect of their inclusion would have been anti-dilutive.

## **Revenue Recognition**

To recognize revenue, four basic criteria must be met: 1) there is evidence that an arrangement exists; 2) delivery has occurred; 3) the fee is fixed or determinable; and 4) collectability is reasonably assured. Revenue from sales transactions where the buyer has the right to return the product is recognized at the time of sale only if (1) the seller's price to the buyer is substantially fixed or determinable at the date of sale; (2) the buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product; (3) the buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product; (4) the buyer acquiring the product for resale has economic substance apart from that provided by the seller; (5) the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer; and (6) the amount of future returns can be reasonably estimated. We recognize revenue upon determination that all criteria for revenue recognition have been met. The criteria are usually met at the time title passes to the customer, which usually occurs upon shipment. Revenue from shipments where title passes upon delivery is deferred until the shipment has been delivered.

We followed the provisions of ASU No. 2009-13 for all multiple element agreements. Under this guidance, the delivered item(s) has value to the customer on a standalone basis and, if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in our control.

A delivered item is considered a separate unit of accounting when the delivered item has value to the partner on a standalone basis based on the consideration of the relevant facts and circumstances for each arrangement. Arrangement consideration is allocated at the inception of the agreement to all identified units of accounting based on their relative selling price. The relative selling price for each deliverable is determined using vendor specific objective evidence, or VSOE, of selling price or third-party evidence of selling price if VSOE does not exist. If neither VSOE nor third-party evidence of selling price exists, we use our best estimate of the selling price for the deliverable. The amount of allocable arrangement consideration is limited to amounts that are fixed or determinable. The consideration received is allocated among the separate units of accounting, and the applicable revenue recognition criteria are applied to each of the separate units. Changes in the allocation of the sales price between delivered and undelivered elements can impact revenue recognition but do not change the total revenue recognized under any agreement. If facts and circumstances dictate that the license has standalone value from the undelivered items, the license is identified as a separate unit of accounting and the amounts allocated to the license are recognized upon the delivery of the license, assuming the other revenue recognition criteria have been met. However, if the amounts allocated to the license through the relative selling price allocation exceed the upfront license fee, the amount recognized upon the delivery of the license is limited to the upfront fee received. If facts and circumstances dictate that the license does not have standalone value, the transaction price, including any upfront license fee payments received, are allocated to the identified separate units of accounting and recognized as those items are delivered.

In addition, we enter into arrangements that provide for milestone payments upon contractually stated events. Effective July 1, 2010, we adopted on a prospective basis, the Milestone Method of accounting under ASU 2010-17. Under the Milestone Method, we recognize consideration that is contingent upon the achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone is substantive in its entirety. A milestone is considered substantive when it meets all of the following three criteria: 1) The consideration is commensurate with either the entity's performance to achieve the milestone or the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from the entity's performance to achieve the milestone, 2) The consideration relates solely to past performance, and 3) The consideration is reasonable relative to all of the deliverables and payment terms within the arrangement. A milestone is defined as an event (i) that can only be achieved based in whole or in part on either the entity's performance or on the occurrence of a specific outcome resulting from the entity's performance, (ii) for which there is substantive uncertainty at the date the arrangement is entered into that the event will be achieved and (iii) that would result in additional payments being due to us.

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We record reductions to gross revenue for estimated returns of private label contract manufacturing products and branded products. The estimated returns are based on the trailing six months of private label contract manufacturing gross sales and our historical experience for both private label contract manufacturing and branded product returns. However, the estimate for product returns does not reflect the impact of a potential large product recall resulting from product nonconformance or other factors as such events are not predictable nor is the related economic impact estimable.

We currently own certain U.S. patents, and each patent's corresponding foreign patent applications. All of these patents and patent rights relate to the ingredient known as beta-alanine marketed and sold under the CarnoSyn<sup>®</sup> trade name. We have sold this ingredient to a customer for use in a limited market, and since March 2009 have had an agreement with Compound Solutions, Inc. (CSI) under which we have agreed to grant a license of certain of our patent rights to customers of CSI who purchase beta-alanine from CSI. Before October 1, 2011, we received a fee from CSI that varied based on the amount of net sales of beta-alanine sold by CSI less CSI's costs and other agreed upon expenses. As of October 1, 2011, we receive a fee from CSI that varies based on the quantity of beta-alanine sold by CSI and the source of such beta-alanine.

In June 2011, we entered into a license and supply agreement (Agreement) with Abbott Laboratories (Abbott) under which we agreed to grant an exclusive license to Abbott for the use of beta-alanine in certain medical foods and medical nutritionals. Under the terms of the agreement, Abbott paid an initial license fee of \$300,000, an additional fee of \$300,000 in January 2012, and upon achievement of certain milestones, an additional license fee of \$150,000 was paid on October 3, 2012. The license and supply agreement provided Abbott with the right to terminate the agreement at any time up to March 31, 2012, at which time, if not terminated, Abbott was required to pay \$4.3 million payable over six annual payments with the initial installment payment of \$708,334 due March 31, 2012.

In February 2012 and June 2012, we amended the Agreement and extended Abbott's termination rights initially through July 31, 2012 and then further through October 31, 2012 in exchange for two payments of \$354,167 each by Abbott to NAI. Abbott made the first payment on March 13, 2012 and the second payment on July 12, 2012. In October 2012, the Agreement was amended for a third time. Unless earlier terminated by Abbott, the amendment requires Abbott to pay to NAI (i) upon earlier of achievement of certain milestones or December 1, 2012, additional license fees of \$204,167; (ii) upon earlier of achievement of certain milestones or June 1, 2013, additional license fees of \$204,167; (iii) upon earlier of achievement of certain milestones or July 1, 2013, additional license fees of \$150,000; (iv) upon earlier of achievement of certain milestones or December 1, 2013, additional license fees of \$150,000; and (v) approximately \$2.8 million payable over four annual payments beginning on March 31, 2014. The payment noted in (i) was collected in December 2012.

Subject to certain other conditions set forth in the Agreement and amendments, and until terminated by either party, Abbott is required to purchase certain material exclusively from NAI and make royalty payments to NAI upon Abbott's sale of products subject to the Agreement. Because Abbott may terminate the agreement at any time up to December 1, 2013, there is no assurance NAI will receive any of the additional license fees or royalty payments described above. All milestone payments are recognized as revenue at the time of receipt as the payments are non-refundable and we have no continuing obligation as it relates to each payment. We have determined that each of the milestone payments meets the definition of a milestone and each milestone is substantive in accordance with the milestone method of revenue recognition.

We recorded royalty and licensing income as a component of revenue in the amount of \$824,000 during the three months ended December 31, 2012 and \$2.2 million during the six months ended December 31, 2012. We recorded royalty and licensing income as a component of revenue in the amount of \$720,000 during the three months ended December 31, 2011 and \$2.1 million during the six months ended December 31, 2011. These royalty and licensing income amounts resulted in royalty expense paid to the original patent holders from whom NAI acquired the patents and its patent rights. We recognized royalty expense as a component of cost of goods sold in the amount of \$97,000 during the three months ended December 31, 2012 and \$293,000 during the six months ended December 31, 2012. We recognized royalty expense as a component of cost of goods sold in the amount of \$108,000 during the three months ended December 31, 2011 and \$370,000 during the six months ended December 31, 2011.

**Stock-Based Compensation**

We have an omnibus incentive plan that was approved by our Board of Directors effective as of October 15, 2009 and approved by our stockholders at the Annual Meeting of Stockholders held on November 30, 2009. Under the plan, we may grant nonqualified and incentive stock options and other stock-based awards to employees, non-employee directors and consultants. Our prior equity incentive plan was terminated effective as of November 30, 2009.

We estimate the fair value of stock option awards at the date of grant 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 we assume 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.

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On September 3, 2012, we granted 12,000 restricted stock shares to the members of our Board of Directors pursuant to our 2009 Omnibus Incentive plan. Each member of our Board of Directors received 3,000 restricted shares of our common stock, which will vest over three years. These shares cannot be sold or otherwise transferred and the rights to receive dividends are forfeitable, if declared by our Board of Directors, until they become vested.

Our net income included stock based compensation expense of approximately \$43,000 for the three months ended December 31, 2012 and approximately \$83,000 for the six months ended December 31, 2012. Our net income included stock based compensation expense of approximately \$58,000 for the three months ended December 31, 2011 and approximately \$114,000 for the six months ended December 31, 2011.

**Fair Value of Financial Instruments**

Fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. We use a three-level hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from independent sources. Unobservable inputs are inputs that reflect our assumptions about the inputs that market participants would use in pricing the asset or liability and are developed based on the best information available under the circumstances.

The fair value hierarchy is broken down into three levels based on the source of inputs. In general, fair values determined by Level 1 inputs use quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. We classify cash, cash equivalents, and marketable securities balances as Level 1 assets. Fair values determined by Level 2 inputs are based on quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and models for which all significant inputs are observable or can be corroborated, either directly or indirectly by observable market data. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. These include certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

As of December 31, 2012 and June 30, 2012, we did not have any financial assets or liabilities classified as Level 1. We classify derivative forward exchange contracts as Level 2 assets. The fair value of our forward exchange contracts as of December 31, 2012 was a net liability of \$66,000. The fair value of our forward exchange contracts as of June 30, 2012 was an asset of \$922,000. As of December 31, 2012 and June 30, 2012, we did not have any financial assets or liabilities classified as Level 3. We did not transfer any assets between Levels 1, 2 and 3 during fiscal 2012 or the three month period ended December 31, 2012.

**B. Inventories, net**

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

|                  | December 31,<br>2012 | June 30,<br>2012 |
|------------------|----------------------|------------------|
| Raw materials    | \$ 7,518             | \$ 6,344         |
| Work in progress | 1,365                | 1,058            |
| Finished goods   | 1,283                | 1,530            |
| Reserves         | (733)                | (577)            |
|                  | \$ 9,433             | \$ 8,355         |

**C. Property and Equipment, net**

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

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|   | <b>Depreciable<br/>Life In Years</b> | <b>December 31,<br/>2012</b> | <b>June 30,<br/>2012</b> |
|---|--------------------------------------|------------------------------|--------------------------|
| Land  | N/A                                  | \$ 393                       | \$ 393                   |
| Building and building improvements              | 7 39                                 | 2,780                        | 2,756                    |
| Machinery and equipment                         | 3 12                                 | 26,240                       | 25,876                   |
| Office equipment and furniture                  | 3 5                                  | 3,030                        | 3,023                    |
| Vehicles  | 3                                    | 136                          | 136                      |
| Leasehold improvements                          | 1 15                                 | 10,438                       | 10,136                   |
| <b>Total property and equipment</b>             |                                      | <b>43,017</b>                | <b>42,320</b>            |
| Less: accumulated depreciation and amortization |                                      | (32,746)                     | (31,673)                 |
| <b>Property and equipment, net</b>              |                                      | <b>\$ 10,271</b>             | <b>\$ 10,647</b>         |

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**D. Debt**

On December 16, 2010, we executed a Credit Agreement ( Credit Agreement ) with Wells Fargo Bank, National Association. This Credit Agreement replaced our previous credit facility and provides us with a line of credit of up to \$5.0 million. The line of credit may be used to finance working capital requirements. In consideration for granting the line of credit and each subsequent extension amendment, we pay an annual commitment fee of \$12,500. There are no amounts currently drawn under the line of credit.

Under the terms of the Credit Agreement, borrowings are subject to eligibility requirements including maintaining (i) net income after taxes of not less than \$750,000 on a trailing four quarter basis as of the end of each calendar quarter beginning with the four quarter period ended December 31, 2010; and (ii) a ratio of total liabilities to tangible net worth of not greater than 1.25 to 1.0 at any time. Any amounts outstanding under the line of credit will bear interest at a fixed or fluctuating interest rate as elected by NAI from time to time; provided, however, that if the outstanding principal amount is less than \$100,000 such amount shall bear interest at the then applicable fluctuating rate of interest. If elected, the fluctuating rate per annum would be equal to 2.75% above the daily one month LIBOR rate as in effect from time to time. If a fixed rate is elected, it would equal a per annum rate of 2.50% above the LIBOR rate in effect on the first day of the applicable fixed rate term. Any amounts outstanding under the line of credit must be paid in full on or before November 1, 2014; provided, however, that we must maintain a zero balance on advances under the line of credit for a period of at least 30 consecutive days during each fiscal year. Amounts outstanding that are subject to a fluctuating interest rate may be prepaid at any time without penalty. Amounts outstanding that are subject to a fixed interest rate may be prepaid at any time in minimum amounts of \$100,000, subject to a prepayment fee equal to the sum of the discounted monthly differences for each month from the month of prepayment through the month in which the then applicable fixed rate term matures.

Our obligations under the Credit Agreement are secured by our accounts receivable and other rights to payment, general intangibles, inventory, equipment and fixtures. We also have a foreign exchange facility with Wells Fargo in effect until November 1, 2013, and with Bank of America, N.A. in effect until March 15, 2013.

On December 31, 2012, we were in compliance with all of the financial and other covenants required under the Credit Agreement.

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 1.3 million, or approximately \$1.4 million, which was the initial maximum aggregate amount that could be outstanding at any one time under the credit facility. This maximum amount is reduced annually by CHF 160,000, or approximately \$175,000. 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 \$547,000. As of December 31, 2012, there was no outstanding balance under this 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 \$1,094), 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.

We did not use our working capital line of credit nor did we have any long-term debt outstanding during the six months ended December 31, 2012. As of December 31, 2012, we had \$5.5 million available under our credit facilities.

**E. 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, we adopted an amendment to freeze benefit accruals to the participants. 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.

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

|                                | Three Months Ended<br>December 31, |       | Six Months Ended<br>December 31, |       |
|--------------------------------|------------------------------------|-------|----------------------------------|-------|
|                                | 2012                               | 2011  | 2012                             | 2011  |
| Interest cost                  | \$ 22                              | \$ 23 | \$ 44                            | \$ 46 |
| Expected return on plan assets | (3)                                | (10)  | (5)                              | (20)  |
| Net periodic expense           | \$ 19                              | \$ 13 | \$ 39                            | \$ 26 |

**F. Economic Dependency**

We had substantial net sales to certain customers during the periods shown in the following table. The loss of any of these customers, or a significant decline in sales, or the growth rate of sales to these customers, or in their ability to make payments when due, 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 private label contract manufacturing net sales were as follows (dollars in thousands):

|            | Three Months Ended December 31, |                            |                          |                            | Six Months Ended December 31, |                            |                          |                            |
|------------|---------------------------------|----------------------------|--------------------------|----------------------------|-------------------------------|----------------------------|--------------------------|----------------------------|
|            | 2012                            |                            | 2011                     |                            | 2012                          |                            | 2011                     |                            |
|            | Net Sales by<br>Customer        | % of Total<br>Net<br>Sales | Net Sales by<br>Customer | % of Total<br>Net<br>Sales | Net Sales by<br>Customer      | % of Total<br>Net<br>Sales | Net Sales by<br>Customer | % of Total<br>Net<br>Sales |
| Customer 1 | \$ 7,335                        | 59 %                       | \$ 8,056                 | 54 %                       | \$ 15,059                     | 55 %                       | \$ 16,481                | 52 %                       |
| Customer 2 | 1,709                           | 14                         | 3,551                    | 24                         | 4,618                         | 17                         | 7,836                    | 25                         |
| Customer 3 | 1,361                           | 11                         | (a)                      | (a)                        | (a)                           | (a)                        | (a)                      | (a)                        |
|            | \$ 10,405                       | 84 %                       | \$ 11,607                | 78 %                       | \$ 19,677                     | 72 %                       | \$ 24,317                | 77 %                       |

(a) Sales were less than 10% of the respective period's total private label contract manufacturing net sales.

We buy certain products, including beta-alanine, 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,               |                                |   |                                |
|--|---|--------------------------------|---|--------------------------------|---|--------------------------------|---|--------------------------------|
|  | 2012  |                                | 2011  |                                | 2012  |                                | 2011  |                                |
|  | Raw Material<br>Purchases<br>by<br>Supplier | % of Total<br>Raw<br>Purchases | Raw Material<br>Purchases<br>by<br>Supplier | % of Total<br>Raw<br>Purchases | Raw Material<br>Purchases<br>by<br>Supplier | % of Total<br>Raw<br>Purchases | Raw Material<br>Purchases<br>by<br>Supplier | % of Total<br>Raw<br>Purchases |
|  | \$ 732                                      | 13 %                           | (a)   | (a)                            | \$ 1,223                                    | 10 %                           | (a)   | (a)                            |

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|            |        |      |          |      |          |      |          |      |
|------------|--------|------|----------|------|----------|------|----------|------|
| Supplier 1 |        |      |          |      |          |      |          |      |
| Supplier 2 | (a)    | (a)  | \$ 2,106 | 21 % | (a)      | (a)  | \$ 2,106 | 13 % |
|            |        |      |          |      |          |      |          |      |
|            | \$ 732 | 13 % | \$ 2,106 | 21 % | \$ 1,223 | 10 % | \$ 2,106 | 13 % |

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

**G. Segment Information**

As a result of our efforts to commercialize our patent and trademark estate and the increased level of income we have received from such efforts, beginning with the first quarter of fiscal 2012, our business consists of three segments for financial reporting purposes. The three segments are identified as (i) private label contract manufacturing, which primarily relates to the provision of private label contract manufacturing services to companies that market and distribute nutritional supplements and other health care products, (ii) patent and trademark licensing, which primarily includes royalty income from our license and supply agreements associated with the sale and use of beta-alanine under our CarnosSyn® trade name, and (iii) branded products, which relates to the marketing and distribution of our branded nutritional supplements and consists primarily of the products sold under our Pathway to Healing® product line.

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, corporate legal, finance, information technology, and other corporate level related expenses, which are not allocated to any segment. The accounting policies of our segments are the same as those described in Note A above and in the consolidated financial statements included in our 2012 Annual Report other than the change in the number of segments.

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

|                                      | Three Months Ended<br>December 31, |           | Six Months Ended<br>December 31, |           |
|--------------------------------------|------------------------------------|-----------|----------------------------------|-----------|
|                                      | 2012                               | 2011      | 2012                             | 2011      |
| <b>Net Sales</b>                     |                                    |           |                                  |           |
| Private label contract manufacturing | \$ 12,524                          | \$ 15,038 | \$ 27,268                        | \$ 31,644 |
| Patent and trademark licensing       | 824                                | 720       | 2,198                            | 2,054     |
| Branded products                     | 338                                | 403       | 680                              | 804       |
|                                      | \$ 13,686                          | \$ 16,161 | \$ 30,146                        | \$ 34,502 |

|   | Three Months Ended<br>December 31, |          | Six Months Ended<br>December 31, |          |
|---|------------------------------------|----------|----------------------------------|----------|
|   | 2012                               | 2011     | 2012                             | 2011     |
| <b>(Loss) Income from Operations</b>          |                                    |          |                                  |          |
| Private label contract manufacturing          | \$ 624                             | \$ 2,123 | \$ 2,570                         | \$ 5,106 |
| Patent and trademark licensing                | 171                                | 189      | 318                              | 802      |
| Branded products                              | 40                                 | 72       | 74                               | 120      |
| Income from operations of reportable segments | 835                                | 2,384    | 2,962                            | 6,028    |
| Corporate expenses not allocated to segments  | (1,108)                            | (1,158)  | (2,206)                          | (2,455)  |
|   | \$ (273)                           | \$ 1,226 | \$ 756                           | \$ 3,573 |

|                                      | December 31,<br>2012 | June 30,<br>2012 |
|--------------------------------------|----------------------|------------------|
| <b>Total Assets</b>                  |                      |                  |
| Private label contract manufacturing | \$ 43,741            | \$ 43,975        |
| Patent and trademark licensing       | 470                  | 2,964            |
| Branded products                     | 370                  | 258              |
|                                      | \$ 44,581            | \$ 47,197        |

Our private label contract manufacturing products are sold both in the U.S. and in markets outside the U.S., including Europe, Australia and Asia. Our primary market outside the U.S. is Europe. Our patent and trademark licensing activities are primarily based in the U.S. and our branded products are only sold in the U.S.

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

|               | Three Months Ended<br>December 31, |          | Six Months Ended<br>December 31, |           |
|---------------|------------------------------------|----------|----------------------------------|-----------|
|               | 2012                               | 2011     | 2012                             | 2011      |
| United States | \$ 8,173                           | \$ 8,869 | \$ 17,804                        | \$ 19,059 |

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|                                   |           |           |           |           |
|-----------------------------------|-----------|-----------|-----------|-----------|
| Markets outside the United States | 5,513     | 7,292     | 12,342    | 15,443    |
| Total net sales                   | \$ 13,686 | \$ 16,161 | \$ 30,146 | \$ 34,502 |

Products manufactured by NAIE accounted for approximately 74% of net sales in markets outside the U.S. for the three months ended December 31, 2012, and 67% for the three months ended December 31, 2011. NAIE accounted for 71% of net sales in markets outside the U.S. for the six months ended December 31, 2012, and 65% for the six months ended December 31, 2011. No products manufactured by NAIE were sold in the U.S. during the six months ended December 31, 2012 and 2011.

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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 (in thousands):

|               | Long-Lived Assets    |                  | Total Assets         |                  | Capital Expenditures<br>Six Months Ended |                      |
|---------------|----------------------|------------------|----------------------|------------------|--|----------------------|
|               | December 31,<br>2012 | June 30,<br>2012 | December 31,<br>2012 | June 30,<br>2012 | December 31,<br>2012                     | December 31,<br>2011 |
| United States | \$ 9,428             | \$ 10,287        | \$ 30,807            | \$ 33,556        | \$ 417                                   | \$ 813               |
| Europe        | 2,748                | 2,391            | 13,774               | 13,641           | 715                                      | 150                  |
|               | \$ 12,176            | \$ 12,678        | \$ 44,581            | \$ 47,197        | \$ 1,132                                 | \$ 963               |

**H. Income Taxes**

The effective tax rate for the three months ended December 31, 2012 was a benefit of 138.3% and the effective tax rate for the six months ended December 31, 2012 was a benefit of 6.4%. The current period tax benefit is related to the current period domestic pre-tax loss and our consolidated tax rate differs from the U.S. federal statutory rate of 34% primarily due to the recognition of state taxes offset by the favorable impact of foreign earnings taxed at less than the U.S. statutory rate.

To determine our quarterly provision for income taxes, we use an estimated annual effective tax rate, which is based on expected annual income, statutory tax rates and tax planning opportunities available in the various jurisdictions to which the Company is subject. Certain significant or unusual items are separately recognized in the quarter in which they occur and can be a source of variability in the effective tax rate from quarter to quarter. We recognize interest and penalties related to uncertain tax positions, if any, as an income tax expense.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences of temporary differences between the financial reporting basis and tax basis of our assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

We are subject to taxation in the U.S., Switzerland and various state jurisdictions. Our tax years for the fiscal year ended June 30, 2005 and forward are subject to examination by U.S. and state tax authorities and our tax years for the fiscal year ended June 30, 2007 and forward are subject to examination by the Switzerland tax authorities.

We do not record U.S. income tax expense for NAIE's retained earnings that are declared as indefinitely reinvested offshore, thus reducing our overall income tax expense. The amount of earnings designated as indefinitely reinvested in NAIE is based on the actual deployment of such earnings in NAIE's assets and our expectations of the future cash needs of our U.S. and foreign entities. Income tax laws are also a factor in determining the amount of foreign earnings to be indefinitely reinvested offshore.

It is our policy to establish reserves based on management's assessment of exposure for certain positions taken in previously filed tax returns that may become payable upon audit by tax authorities. The tax reserves are analyzed quarterly and adjustments are made as events occur that we believe warrant adjustments to the reserves.

**I. Treasury Stock**

On June 2, 2011, the Board of Directors authorized the repurchase of up to \$2.0 million of our common stock. Under the repurchase plan, we may, from time to time, purchase shares of our common stock, depending upon market conditions, in open market or privately negotiated transactions. For the year ended June 30, 2012, we purchased 75,026 shares at a weighted average cost of \$5.39 per share and a total cost of

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\$405,000, including commissions and fees. During the six months ended December 31, 2012, we purchased an additional 107,278 shares at a weighted average cost of \$5.52 per share and a total cost of \$592,000 including commissions and fees.

### **J. Derivatives and Hedging**

We are exposed to gains and losses resulting from fluctuations in foreign currency exchange rates relating to forecasted product sales denominated in foreign currencies and transactions of NAIE, our foreign subsidiary. As part of our overall strategy to manage the level of exposure to the risk of fluctuations in foreign currency exchange rates, we may use foreign exchange contracts in the form of forward contracts. There can be no guarantee any such contracts, to the extent we enter into such contracts, will be effective hedges against our foreign currency exchange risk.

During the three and six months ended December 31, 2012 we had forward contracts designated as cash flow hedges primarily to protect against the foreign exchange risks inherent in our forecasted sales of products at prices denominated in currencies other than the U.S. Dollar. These contracts are expected to be settled through February 2014. For derivative instruments that are designated and qualify as cash flow hedges, we record the effective portion of the gain or loss on the derivative in accumulated other comprehensive income ( OCI ) as a separate component of stockholders' equity and subsequently reclassify these amounts into earnings in the period during which the hedged transaction is recognized in earnings.

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For foreign currency contracts designated as cash flow hedges, hedge effectiveness is measured using the spot rate. Changes in the spot-forward differential are excluded from the test of hedge effectiveness and are recorded currently in earnings as interest expense. We measure effectiveness by comparing the cumulative change in the hedge contract with the cumulative change in the hedged item. During the three and six months ended December 31, 2012, we did not have any material losses or gains related to the ineffective portion of our hedging instruments in the Condensed Consolidated Statements of Operations and Comprehensive Income. No hedging relationships were terminated as a result of ineffective hedging or forecasted transactions no longer probable of occurring for foreign currency forward contracts. We monitor the probability of forecasted transactions as part of the hedge effectiveness testing on a quarterly basis.

As of December 31, 2012, the notional amounts of our foreign exchange contracts designated as cash flow hedges were approximately \$12.2 million (EUR 9.3 million). As of December 31, 2012, a net loss of approximately \$107,000 related to derivative instruments designated as cash flow hedges was recorded in OCI. It is expected that \$62,000 will be reclassified into earnings in the next 12 months along with the earnings effects of the related forecasted transactions.

As of December 31, 2012, the fair value of our cash flow hedges was a net liability of \$66,000, of which \$23,000 was classified in accrued liabilities and \$43,000 was classified in other noncurrent liabilities in our Condensed Consolidated Balance Sheets. During the three months ended December 31, 2012 we recognized \$292,000 of losses in OCI and reclassified \$193,000 of gains from OCI to revenue. During the six months ended December 31, 2012 we recognized \$384,000 of losses in OCI and reclassified \$507,000 of gains from OCI to revenue. As of December 31, 2011, \$1.2 million of the fair value of our cash flow hedges was classified in prepaids and other current assets and \$248,000 was classified in other noncurrent assets, net in our Condensed Consolidated Balance Sheets. During the three months ended December 31, 2011 we recognized \$942,000 of gains in OCI and reclassified \$266,000 of gains from OCI to revenue. During the six months ended December 31, 2011 we recognized \$1.7 million of gains in OCI and reclassified \$363,000 of gains from OCI to revenue.

## **K. 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 operation. However, a settlement payment or unfavorable outcome could adversely impact our results of operation. 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.

On August 20, 2009, NAI filed a lawsuit in the U.S. District Court for the District of Delaware, accusing Vital Pharmaceutical, Inc. (VPX) and DNP International Co., Inc. (DNP) of infringing certain patents owned by NAI relating to the ingredient known as beta-alanine marketed and sold under the CarnoSyn® trade name. On August 8, 2011, a settlement agreement was reached between NAI and VPX. On August 3, 2011, NAI and CSI filed an amended and supplemental complaint against DNP reasserting claims for unfair competition and violation of the Delaware Deceptive Trade Practices Act. On September 8, 2011, NAI and CSI filed a voluntary notice of dismissal of the amended and supplemental complaint against DNP and filed a new complaint in the U.S. District Court for the District of Delaware alleging similar claims of unfair competition, violation of the Delaware Deceptive Trade Practices Act and interference with business relations. On December 22, 2011, DNP filed a complaint in the U.S. District Court for the District of Delaware against NAI and CSI for declaratory judgment of non-infringement and invalidity of three of NAI's patents. On January 27, 2012, DNP amended its complaint to add declaratory judgment claims against a fourth NAI patent (381 patent). On February 6, 2012, the Company and CSI moved to dismiss the cases related to the three previously asserted patents for lack of subject matter jurisdiction. On the same day, the Company filed its answer and counterclaims for infringement by DNP of the 381 patent. DNP subsequently agreed to voluntarily dismiss CSI from the lawsuit. On March 2, 2012, the Court ordered the dismissal of CSI. The Company's motion is still pending before the Court.

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On December 21, 2011, NAI filed a lawsuit in the U.S. District Court for the Southern District of Texas, Houston Division, accusing Woodbolt Distribution, LLC, also known as Cellucor (Woodbolt), Vitaquest International, Inc., d/b/a Garden State Nutritionals (Garden State) and F.H.G. Corporation, d/b/a Integrity Nutraceuticals (Integrity), of infringing NAI's 381 patent. The complaint alleges that Woodbolt sells nutritional supplements, including supplements containing beta-alanine such as C4 Extreme, M5 Extreme, and N-Zero Extreme, that infringe the 381 patent. Woodbolt, in turn, filed a complaint seeking a declaratory judgment of non-infringement and invalidity of the 381 patent in the U.S. District Court for the District of Delaware. On February 17, 2012, Woodbolt filed a First Amended Complaint, realleging its original claims against the Company and asserting new claims of violation of the Sherman Antitrust Act (15 U.S.C. § 2) and Unfair Competition. The Company reasserted the arguments in its prior motion to dismiss and moved to dismiss the new claims asserted by Woodbolt. On January 23, 2013, the Delaware Court granted the Company's motion to dismiss Woodbolt's case. On June 5, 2012, the Court in the above-referenced Texas case consolidated the pending suit with a second patent infringement case filed against Woodbolt by the Company on May 3, 2012, asserting infringement of its 422 patent. On November 9, 2012, NAI filed a supplemental complaint adding allegations of infringement of Woodbolt's Cellucor Cor Performance β-BCAA and Cellucor Cor Performance Creatine products. Woodbolt has also requested *inter partes* reexamination of the 381 and 422 patents by the USPTO. On July 26, 2012, the USPTO accepted the request to reexamine the 381 patent and on August 17, 2012 the USPTO accepted the request to re-examine the 422 patent.

A declaration of non-infringement, invalidity or unenforceability of certain of our patents could have a material adverse impact upon our business results, operations, and financial condition.

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### **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, 2012. 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 2012 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 U.S. 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, new product introductions, the demand for such customers' products, and general industry and economic conditions. Our revenue also includes royalty, licensing revenue, and raw material sales generated from our patent estate pursuant to license and supply agreements with third parties for the distribution and use of the ingredient known as beta-alanine and sold under the CarnoSyn® trade name.

A cornerstone of our business strategy is to achieve long-term growth and profitability and to diversify our sales base. We have sought and expect to continue to seek to diversify our sales by developing relationships with additional, quality-oriented, private label contract manufacturing customers, commercializing our patent estate through contract manufacturing, royalty and license agreements, and developing and growing our own line of branded products.

During the first six months of fiscal 2013, our net sales were 12.6% lower than in the first six months of fiscal 2012. Private label contract manufacturing sales decreased 13.8% due primarily to lower volumes of existing products to existing customers and lower average EUR exchange rate partially offset by new product sales to new customers. Revenue concentration risk for our two largest private label contract manufacturing customers decreased to 72% as a percentage of our total private label contract manufacturing sales for the first six months of fiscal 2013 compared to 77% in the first six months of fiscal 2012. We expect our contract manufacturing revenue concentration percentage for our two largest customers to decrease marginally during the remainder of fiscal 2013 with the anticipated increased sales to other existing customers.

During the first six months of fiscal 2013, CarnoSyn® beta-alanine royalty and licensing revenue increased 7.0% to \$2.2 million as compared to \$2.1 million for the first six months of fiscal 2012. Included in the royalty and licensing revenue during the first six months of fiscal 2013 was \$103,000 of raw material sales of beta-alanine as compared to zero raw material sales in the same period in fiscal 2012. During the second and third quarters of fiscal 2012, we purchased approximately \$3.2 million of beta-alanine raw material to help ensure sufficient inventory to meet anticipated future customer demand. During the third and fourth quarters of fiscal 2012, we sold or used a majority of this inventory. As of December 31, 2012, our beta-alanine raw material inventory level had been reduced to zero. We do not anticipate the direct purchase and sale of material quantities of beta-alanine raw material during the remainder of fiscal 2013.

To protect our CarnoSyn® business and its underlying patent estate, we incurred litigation and patent compliance expenses of approximately \$1.4 million during the first six months of fiscal 2013 and \$765,000 during the comparable period in fiscal 2012. We describe our efforts to protect our patent estate in more detail under Item 1 of Part II of 2012 Annual Report. Our ability to maintain or further increase our beta-alanine royalty and licensing revenue will depend in large part on the availability of the raw material beta-alanine when and in the amounts needed, the ability to expand distribution of beta-alanine to new and existing customers, maintaining our patent rights, and the continued compliance by third parties with our patent and trademark rights.

Net sales from our branded products declined 15.4% in the first six months of fiscal 2013 as compared to the first six months of fiscal 2012 due to the continued softening of sales of our Pathway to Healing® product line. During fiscal 2011 and 2012, we re-launched our Pathway to Healing® product line with updated product formulation, packaging, and marketing activities.

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During the remainder of fiscal 2013, we plan to continue to focus on:

Leveraging our state of the art, certified facilities to (1) increase the value of the goods and services we provide to our highly valued private label contract manufacturing customers, and (2) assist us in developing relationships with additional quality oriented customers;

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Expanding the commercialization of our beta-alanine patent estate through contract manufacturing, royalty and license agreements and protecting our proprietary rights;

Implementing focused initiatives to grow our Pathway to Healing® product line; and

Improving operational efficiencies and managing costs and business risks to improve profitability.

**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 2012 Annual Report and recent accounting pronouncements are discussed under Note A of our Notes to Condensed Consolidated Financial Statements contained in this Quarterly Report. There have been no significant changes to these policies or pronouncements during the three and six months ended December 31, 2012 other than as listed under Note A of our Notes to Condensed Consolidated Financial Statement contained in this Quarterly Report.

**Results of Operations**

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

|  | Three Months Ended<br>December 31, |           |             | Six Months Ended<br>December 31, |           |             |
|--|------------------------------------|-----------|-------------|----------------------------------|-----------|-------------|
|  | 2012                               | 2011      | %<br>Change | 2012                             | 2011      | %<br>Change |
| Private label contract manufacturing       | \$ 12,524                          | \$ 15,038 | (16.7)      | \$ 27,268                        | \$ 31,644 | (13.8)      |
| Patent and trademark licensing             | 824                                | 720       | 14.4        | 2,198                            | 2,054     | 7.0         |
| Branded products                           | 338                                | 403       | (16.1)      | 680                              | 804       | (15.4)      |
| Total net sales                            | 13,686                             | 16,161    | (15.3)      | 30,146                           | 34,502    | (12.6)      |
| Cost of goods sold                         | 11,767                             | 12,808    | (8.1)       | 24,643                           | 26,466    | (6.9)       |
| Gross profit                               | 1,919                              | 3,353     | (42.8)      | 5,503                            | 8,036     | (31.5)      |
| Gross profit %                             | 14.0%                              | 20.7%     |             | 18.3%                            | 23.3%     |             |
| Selling, general & administrative expenses | 2,192                              | 2,127     | 3.1         | 4,747                            | 4,463     | 6.4         |
| % of net sales                             | 16.0%                              | 13.2%     |             | 15.7%                            | 12.9%     |             |
| (Loss) income from operations              | (273)                              | 1,226     | (122.3)     | 756                              | 3,573     | (78.8)      |
| % of net sales                             | (2.0)%                             | 7.6%      |             | 2.5%                             | 10.4%     |             |
| Other (income) expense, net                | (7)                                | 27        | 125.9       | 5                                | (56)      | (108.9)     |
| (Loss) income before income taxes          | (266)                              | 1,199     | (122.2)     | 751                              | 3,629     | (79.3)      |
| % of net sales                             | (1.9)%                             | 7.4%      |             | 2.5%                             | 10.5%     |             |
| Income tax (benefit) expense               | (368)                              | 414       | (188.9)     | (48)                             | 1,316     | (103.6)     |
| Net income                                 | \$ 102                             | \$ 785    | (87.0)      | \$ 799                           | \$ 2,313  | (65.5)      |

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|                |      |      |      |      |
|----------------|------|------|------|------|
| % of net sales | 0.7% | 4.9% | 2.7% | 6.7% |
|----------------|------|------|------|------|

The percentage decrease in contract manufacturing net sales was primarily attributed to the following for the periods ended December 31, 2012:

|  | <b>Three Months<br/>Ended</b> | <b>Six Months<br/>Ended</b> |
|--|-------------------------------|-----------------------------|
| Mannatech, Incorporated <sup>(1)</sup> | (12.2)%                       | (10.2)%                     |
| NSA International, Inc. <sup>(2)</sup> | (4.8)                         | (4.5)                       |
| Other customers                        | 0.3                           | 0.9                         |
| Total                                  | (16.7)%                       | (13.8)%                     |

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- <sup>1</sup> Net sales to Mannatech, Incorporated decreased primarily as a result of lower volumes of established products in existing markets.
- <sup>2</sup> The decrease in net sales to NSA International, Inc. (NSA) for the three months ended December 31, 2012 included a decrease in international sales of 15.2% and a decrease in domestic sales of 2.9%. The decrease in net sales to NSA for the six months ended December 31, 2012 included a decrease in international sales of 14.0% and a decline in domestic sales of 3.4%. The international sales decreases were primarily due to decreased demand by NSA's consumers and lower average EUR exchange rate. The domestic decreases were primarily due to lower average sales prices and lower volumes of existing products.

Net sales from our branded products segment decreased 16.1% during the second quarter of fiscal 2013 as compared to the comparable quarter in fiscal 2012 and 15.4% during the six months ended December 31, 2012 compared to the comparable six month period last year due primarily to the continuing decline in our customer base for this product line.

Gross profit margin decreased 6.7 percentage points during the second quarter of fiscal 2013 from the comparable quarter in fiscal 2012 and 5.0 percentage points during the six months ended December 31, 2012 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, 2012:

|  | Three Months<br>Ended | Six Months<br>Ended |
|--|-----------------------|---------------------|
| Contract manufacturing:                              |                       |                     |
| Shift in sales and material mix <sup>(1)</sup>       | (0.1) %               | (1.0) %             |
| Incremental overhead expenses <sup>(1)</sup>         | (4.2)                 | (2.2)               |
| Incremental direct and indirect labor <sup>(1)</sup> | (3.7)                 | (2.8)               |
| Patent and trademark licensing <sup>(2)</sup>        | 1.5                   | 1.2                 |
| Branded products operations <sup>(3)</sup>           | (0.2)                 | (0.2)               |
| <b>Total</b>   | <b>(6.7) %</b>        | <b>(5.0) %</b>      |

- <sup>1</sup> Private label contract manufacturing gross profit margin decreased 8.5 percentage points in the second quarter of fiscal 2013 and 6.4 percentage points in the first six months of fiscal 2013 as compared to the comparable periods in fiscal 2012. The decrease in gross profit as a percentage of sales was primarily due to higher per unit manufacturing costs associated with lower production levels.
- <sup>2</sup> Patent and trademark licensing gross profit margin increased 3.2 percentage points to 88.2% in the second quarter of fiscal 2013 from 85.0% in the second quarter of fiscal 2012 due to a change in the mix of the source of revenue in fiscal 2013 as compared to fiscal 2012. Revenue for the second quarter of fiscal 2013 included \$354,000 of license fee revenue which generated a gross profit margin of 95.0% while beta-alanine license fee revenue was zero during the second quarter of fiscal 2012. During the first six months of fiscal 2013, patent and trademark licensing gross profit margin increased 0.9 percentage points to 82.9% from 82.0% in the first six months of fiscal 2012 due to a change in the mix of the source of revenue in fiscal 2013 as compared to fiscal 2012. Revenue for the first six months of fiscal 2013 included \$708,000 of license fee revenue which generated a gross profit margin of 95.0% and \$103,000 of beta-alanine raw material sales which generated a gross profit margin of 19.3%. Beta-alanine license fee revenue and beta-alanine raw material sales were zero during the first six months of fiscal 2012.
- <sup>3</sup> Branded products gross profit margin decreased 7.2 percentage points to 40.5% in the second quarter of fiscal 2013 from 47.7% in the second quarter of fiscal 2012. During the first six months of fiscal 2013, gross profit percentage decreased 6.6 percentage points to 38.7% from 45.4% during the first six months of fiscal 2012. The decrease in gross profit margin is due primarily to sales mix and higher inventory write-offs.

Selling, general and administrative expenses increased \$65,000, or 3.1%, during the second quarter fiscal 2013 as compared to the comparable prior year period. This increase was attributed to a \$133,000 increase in patent and trademark licensing costs primarily attributed to increased patent litigation and prosecution expenses partially offset by a \$45,000 decrease in operating costs from our domestic contract manufacturing

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operation primarily related to decreased employee compensation. Selling, general and administrative expenses for our branded products business decreased \$23,000 as compared to the same prior year period. During the first six months of fiscal 2013, selling, general and administrative expenses increased \$284,000, or 6.4%, as compared to the comparable prior year period. This increase was attributed to a \$620,000 increase in patent and trademark licensing costs primarily attributed to increased patent litigation and prosecution expenses partially offset by a \$280,000 decrease in operating costs from our domestic contract manufacturing operation primarily related to decreased employee compensation. Selling, general and administrative expenses for our branded products business decreased \$55,000 as compared to the same prior year period.

Other expense, net decreased \$34,000 during the second quarter of fiscal 2013 from the comparable quarter last year primarily due primarily to lower net interest cost related to our for exchange contracts. Other expense, net increased \$61,000 during the six month period ended December 31, 2012 from the comparable six month period last year due primarily to unfavorable foreign currency exchange activity.

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Our income tax expense decreased \$782,000 to a benefit during the second quarter of fiscal 2013 and \$1.4 million during the six months ended December 31, 2012 as compared to the same periods in the prior fiscal year. The decreases were primarily due to lower pre-tax income as compared to the comparable prior year periods.

### **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 \$4.2 million for the six months ended December 31, 2012 compared to \$3.1 million used by operating activities in the comparable period in the prior year.

At December 31, 2012, changes in accounts receivable, consisting primarily of amounts due from our private label contract manufacturing customers and our patent and trademark licensing activities, provided \$5.4 million in cash during the six months ended December 31, 2012 compared to using \$1.7 million in the comparable period in the prior year. The increase in cash provided by accounts receivable during the six months ended December 31, 2012 was the result of lower private label contract manufacturing sales and the collection of amounts due from sales of beta-alanine raw materials. Days sales outstanding was 37 days as of December 31, 2012 compared to 22 days as of December 31, 2011.

At December 31, 2012, changes in inventory used \$1.1 million in cash as compared to using \$6.2 million of cash in the comparable prior year period. The decrease in cash used by inventory during the six months ended December 31, 2012 was primarily related to timing of inventory shipments and receipts, cessation of beta-alanine raw material purchases and decreased sales demand.

Approximately \$996,000 of our operating cash flow was generated by NAIE in the six months ended December 31, 2012. As of December 31, 2012, NAIE's undistributed retained earnings were considered indefinitely reinvested.

Capital expenditures were \$1.1 million during the six months ended December 31, 2012 compared to \$1.0 million in the comparable period in the prior year. Capital expenditures during the six months ended December 31, 2012 and December 31, 2011 were primarily for manufacturing equipment in our Vista, California and Manno, Switzerland facilities

We did not have any consolidated debt as of either December 31, 2012 or June 30, 2012.

On December 16, 2010, we executed a Credit Agreement ( Credit Agreement ) with Wells Fargo Bank, National Association. This Credit Agreement replaced our previous credit facility and provides us with a line of credit of up to \$5.0 million. The line of credit may be used to finance working capital requirements. In consideration for granting the line of credit and each subsequent extension amendment, we pay an annual commitment fee of \$12,500. There are no amounts currently drawn under the line of credit.

Under the terms of the Credit Agreement, borrowings are subject to eligibility requirements including maintaining (i) net income after taxes of not less than \$750,000 on a trailing four quarter basis as of the end of each calendar quarter beginning with the four quarter period ended December 31, 2010; and (ii) a ratio of total liabilities to tangible net worth of not greater than 1.25 to 1.0 at any time. Any amounts outstanding under the line of credit will bear interest at a fixed or fluctuating interest rate as elected by NAI from time to time; provided, however, that if the outstanding principal amount is less than \$100,000 such amount shall bear interest at the then applicable fluctuating rate of interest. If elected, the fluctuating rate per annum would be equal to 2.75% above the daily one month LIBOR rate as in effect from time to time. If a fixed rate is elected, it would equal a per annum rate of 2.50% above the LIBOR rate in effect on the first day of the applicable fixed rate term. Any amounts outstanding under the line of credit must be paid in full on or before November 1, 2014; provided, however, that we must maintain a zero balance on advances under the line of credit for a period of at least 30 consecutive days during each fiscal year. Amounts outstanding that are subject to a fluctuating interest rate may be prepaid at any time without penalty. Amounts outstanding that are subject to a fixed interest rate may be prepaid at any time in minimum amounts of \$100,000, subject to a prepayment fee equal to the sum of the discounted monthly differences for each month from the month of prepayment through the month in which the then applicable fixed rate term matures.

Our obligations under the Credit Agreement are secured by our accounts receivable and other rights to payment, general intangibles, inventory, equipment and fixtures. We also have a foreign exchange facility with Wells Fargo in effect until November 1, 2013, and with Bank of America, N.A. in effect until March 15, 2013.

On December 31, 2012, we were in compliance with all of the financial and other covenants required under the Credit Agreement.

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 1.3 million, or approximately \$1.4 million, which was the initial maximum aggregate amount that could be outstanding at any one time under the credit facility. This maximum amount is reduced annually by CHF 160,000, or approximately \$175,000. On February 19, 2007, NAIE amended

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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 \$547,000. As of December 31, 2012, there was no outstanding balance under this credit facility.

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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 \$1,094), 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, 2012, we had \$17.0 million in cash and cash equivalents and \$5.5 million available under our credit facilities. Of these amounts, \$7.1 million of cash and cash equivalents and \$547,000 of the amount available under our credit facilities were held by NAIE. Our intent is to permanently reinvest all of our earnings from foreign operations, and we do not currently anticipate that we will need funds generated from foreign operations to fund our domestic operations. In the event funds from foreign operations are needed to fund our U.S. operations, we may be required to accrue and pay additional U.S. taxes to repatriate any such funds. Overall, we believe our available cash, cash equivalents and potential cash flows from operations will be sufficient to fund our current working capital needs and capital expenditures through at least the next 12 months.

### **Off-Balance Sheet Arrangements**

As of December 31, 2012, we did not have any 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 in the notes to our consolidated financial statements included under Item 1 of this report. Other than those pronouncements, we are not aware of any other pronouncements that materially affect our financial position or results of operations.

## **ITEM 4. CONTROLS AND PROCEDURES**

We maintain certain disclosure controls and procedures as defined under the Securities Exchange Act of 1934. 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 Securities Exchange Act of 1934 and within the time periods specified by the SEC.

Our management, with the participation of our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial and accounting officer), evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2012. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective for their intended purpose described above as of December 31, 2012.

There were no changes to our internal control over financial reporting during the quarterly period ended December 31, 2012 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****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 operation. However, a settlement payment or unfavorable outcome could adversely impact our results of operation. 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.

On August 20, 2009, NAI filed a lawsuit in the U.S. District Court for the District of Delaware, accusing Vital Pharmaceutical, Inc. (VPX) and DNP International Co., Inc. (DNP) of infringing certain patents owned by NAI relating to the ingredient known as beta-alanine marketed and sold under the CarnoSyn® trade name. On August 8, 2011, a settlement agreement was reached between NAI and VPX. On August 3, 2011, NAI and CSI filed an amended and supplemental complaint against DNP reasserting claims for unfair competition and violation of the Delaware Deceptive Trade Practices Act. On September 8, 2011, NAI and CSI filed a voluntary notice of dismissal of the amended and supplemental complaint against DNP and filed a new complaint in the U.S. District Court for the District of Delaware alleging similar claims of unfair competition, violation of the Delaware Deceptive Trade Practices Act and interference with business relations. On December 22, 2011, DNP filed a complaint in the U.S. District Court for the District of Delaware against NAI and CSI for declaratory judgment of non-infringement and invalidity of three of NAI's patents. On January 27, 2012, DNP amended its complaint to add declaratory judgment claims against a fourth NAI patent (381 patent). On February 6, 2012, the Company and CSI moved to dismiss the cases related to the three previously asserted patents for lack of subject matter jurisdiction. On the same day, the Company filed its answer and counterclaims for infringement by DNP of the 381 patent. DNP subsequently agreed to voluntarily dismiss CSI from the lawsuit. On March 2, 2012, the Court ordered the dismissal of CSI. The Company's motion is still pending before the Court.

On December 21, 2011, NAI filed a lawsuit in the U.S. District Court for the Southern District of Texas, Houston Division, accusing Woodbolt Distribution, LLC, also known as Cellucor (Woodbolt), Vitaquest International, Inc., d/b/a Garden State Nutritionals (Garden State) and F.H.G. Corporation, d/b/a Integrity Nutraceuticals (Integrity), of infringing NAI's 381 patent. The complaint alleges that Woodbolt sells nutritional supplements, including supplements containing beta-alanine such as C4 Extreme, M5 Extreme, and N-Zero Extreme, that infringe 381 patent. Woodbolt, in turn, filed a complaint seeking a declaratory judgment of non-infringement and invalidity of the 381 patent in the U.S. District Court for the District of Delaware. On February 17, 2012, Woodbolt filed a First Amended Complaint, realleging its original claims against the Company and asserting new claims of violation of the Sherman Antitrust Act (15 U.S.C. § 2) and Unfair Competition. The Company reasserted the arguments in its prior motion to dismiss and moved to dismiss the new claims asserted by Woodbolt. On January 23, 2013, the Delaware Court granted the Company's motion to dismiss Woodbolt's case. On June 5, 2012, the Court in the above-referenced Texas case consolidated the pending suit with a second patent infringement case filed against Woodbolt by the Company on May 3, 2012, asserting infringement of its 422 patent. On November 9, 2012, NAI filed a supplemental complaint adding allegations of infringement of Woodbolt's Cellucor Cor Performance B-BCAA and Cellucor Cor Performance Creatine products. Woodbolt has also requested *inter partes* reexamination of the 381 and 422 patents by the USPTO. On July 26, 2012, the USPTO accepted the request to reexamine the 381 patent and on August 17, 2012 the USPTO accepted the request to re-examine the 422 patent.

A declaration of non-infringement, invalidity or unenforceability of certain of our patents could have a material adverse impact upon our business results, operations, and financial condition.

**ITEM 1A. RISK FACTORS**

You should carefully consider the risks described under Item 1A of our 2012 Annual Report, as well as the other information in our 2012 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.

**Table of Contents****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Repurchases**

During the quarter ended December 31, 2013, we repurchased 79,845 shares of our common stock at a total cost of \$442,000 (including commissions and transaction fees) as set forth below:

| Period                                   | (a)<br>Total Number of<br>Shares Purchased | (b)<br>Average Price<br>Paid per Share | (c)<br>Total Number of<br>Shares<br>Purchased as Part of<br>Publicly Announced<br>Plans or Programs <sup>1</sup> | (d)<br>Maximum Number (or Approximate<br>Dollar Value) of Shares that May<br>Yet Be Purchased Under the Plans<br>or Programs (as of December 31, 2012) |
|--|--|--|--|--|
| October 1, 2012 to<br>October 31, 2012   |  |  |  |  |
| November 1, 2012 to<br>November 30, 2012 | 57,780                                     | \$5.44                                 | 57,780   |  |
| December 1, 2012 to<br>December 31, 2012 | 22,065                                     | \$5.79                                 | 22,065   |  |
| Total                                    | 79,845                                     |  | 79,845   | \$576,921  |

1. On June 3, 2011, we announced a plan to repurchase up to \$2 million in shares of our common stock. Under the plan, we may, from time to time, purchase shares of our common stock, depending upon market conditions, in open market or privately negotiated transactions.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 5. OTHER INFORMATION**

None.

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The following exhibit index shows those exhibits filed with this report and those incorporated by reference:

| Exhibit Number | Description  | Incorporated By Reference To  |
|----------------|--|---|
| 3(i)           | Amended and Restated Certificate of Incorporation of Natural Alternatives International, Inc. filed with the Delaware Secretary of State on January 14, 2005   | Exhibit 3(i) of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005  |
| 3(ii)          | Amended and Restated By-laws of Natural Alternatives International, Inc. dated as of February 9, 2009  | Exhibit 3(ii) of NAI's Current Report on Form 8-K dated February 9, 2009, filed with the commission on February 13, 2009                              |
| 4(i)           | Form of NAI's Common Stock Certificate   | Exhibit 4(i) of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005              |
| 10.1           | 1999 Omnibus Equity Incentive Plan as adopted effective May 10, 1999, amended effective January 30, 2004, and further amended effective December 3, 2004*  | Exhibit 10.1 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005  |
| 10.2           | Amended and Restated Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Dr. Reginald B. Cherry   | Exhibit 10.11 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004            |
| 10.3           | Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc.   | Exhibit 10.12 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004            |
| 10.4           | First Amendment to Exclusive License Agreement effective as of December 10, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc.  | Exhibit 10.13 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005 |
| 10.5           | Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company (lease reference date June 12, 2003)                                       | Exhibit 10.10 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, filed with the commission on November 5, 2003 |
| 10.6           | Form of Indemnification Agreement entered into between NAI and each of its directors   | Exhibit 10.15 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004            |
| 10.7           | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation)   | Exhibit 10.19 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, filed with the commission on May 13, 2005         |
| 10.8           | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated July 25, 2003 (English translation)   | Exhibit 10.19 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005             |
| 10.9           | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated June 8, 2004 (English translation)  | Exhibit 10.20 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005             |
| 10.10          | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated February 7, 2005 (English translation)  | Exhibit 10.21 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005             |
| 10.11          | Amendment effective as of September 15, 2005 to Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation)   | Exhibit 10.24 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, filed with the commission on November 4, 2005 |
| 10.12          | Loan Agreement between NAIE and Credit Suisse dated as of September 22, 2006, including general conditions (portions of the Loan Agreement have been omitted pursuant to a request for confidential treatment) | Exhibit 10.36 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2006, filed with the commission on November 1, 2006 |

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| 10.13 | First Amendment to Loan Agreement between NAIE and Credit Suisse dated as of February 19, 2007 | Exhibit 10.41 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007, filed with the commission on May 14, 2007 |
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| 10.14 | 2009 Omnibus Incentive Plan*   | Exhibit D of NAI's definitive Proxy Statement filed with the commission on October 16, 2009  |
| 10.15 | Manufacturing Agreement by and between NSA, Inc. and NAI dated April 1, 2005   | Exhibit 10.43 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.16 | Manufacturing Agreement by and between Mannatech, Inc. and NAI dated April 22, 1998  | Exhibit 10.44 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.17 | First Amendment to Manufacturing Agreement by and between Mannatech, Incorporated and NAI dated May 23, 2003                                       | Exhibit 10.45 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.18 | Second Amendment to Manufacturing Agreement by and between Mannatech, Incorporated and NAI dated July 1, 2003                                      | Exhibit 10.46 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.19 | Third Amendment to Manufacturing Agreement by and between Mannatech, Incorporated and NAI dated July 1, 2004                                       | Exhibit 10.47 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.20 | Fourth Amendment to Manufacturing Agreement by and among Mannatech, Incorporated, Mannatech Swiss International GmbH and NAI dated January 1, 2008 | Exhibit 10.48 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.21 | Manufacturing Sales Agreement by and between Mannatech, Incorporated and NAI dated November 19, 2004   | Exhibit 10.49 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.22 | Amendment to Manufacturing Sales Agreement by and among Mannatech, Incorporated, Mannatech Swiss International GmbH and NAI dated January 1, 2008  | Exhibit 10.50 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.23 | Exclusive Manufacturing Agreement by and between NSA, Inc., NAI and NAIE dated as of April 1, 2005   | Exhibit 10.51 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2009, filed with the commission on February 16, 2010  |
| 10.24 | Amended and Restated Employment Agreement dated as of August 31, 2010, by and between NAI and Mark A. LeDoux*                                      | Exhibit 10.41 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2010, filed with the commission on September 17, 2010             |
| 10.25 | Amended and Restated Employment Agreement dated as of August 31, 2010, by and between NAI and Kenneth E. Wolf                                      | Exhibit 10.42 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2010, filed with the commission on September 17, 2010             |
| 10.26 | License and Fee Agreement effective November 10, 2010 by and among Roger Harris, Mark Dunnett, Kenny Johansson and NAI                             | Exhibit 10.40 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2010, filed with the commission on November 12, 2010 |
| 10.27 | Credit Agreement by and between NAI and Wells Fargo Bank, N.A. effective as of December 1, 2010  | Exhibit 10.1 of NAI's Current Report on Form 8-K dated December 16, 2010, filed with the commission on December 22, 2010                               |
| 10.28 | ISDA 2002 Master Agreement dated as of March 10, 2011 by and between Bank of America N.A. and NAI (with Schedule dated March 10, 2011)             | Exhibit 10.31 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2011, filed with the commission on May 16, 2011          |
| 10.29 | Agreement to License by and between NAI and Compound Solutions, Inc. effective as of July 1, 2011  | Exhibit 10.31 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2011, filed with the commission on September 22, 2011             |
| 10.30 | First Amendment to Credit Agreement by and between NAI and Wells Fargo Bank, N.A. effective as of November 28, 2011                                | Exhibit 10.1 of NAI's Current Report on Form 8-K dated December 27, 2011, filed with the commission on December 30, 2011                               |
| 10.31 | Revolving Line of Credit Note made by NAI for the benefit of Wells Fargo Bank, N.A. dated November 28, 2011 in the amount of \$5,000,000           | Exhibit 10.2 of NAI's Current Report on Form 8-K dated December 27, 2011, filed with the commission on December 30, 2011                               |
| 10.32 | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated January 1, 2012 (English translation)                         | Exhibit 10.32 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2011, filed with the commission on February 13, 2012  |
| 10.33 |  |  |

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|       | First Amendment to Agreement to License by and between NAI and Compound Solutions, Inc. effective as of January 6, 2012 | Exhibit 10.33 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2012, filed with the commission on May 14, 2012 |
| 10.34 | Second Amendment to Agreement to License by and between NAI and Compound Solutions, Inc. effective as of March 19, 2012 | Exhibit 10.34 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2012, filed with the commission on May 14, 2012 |

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| 10.35   | First Amendment to Manufacturing Agreement by and between NSA, Inc. and NAI effective as of April 1, 2012                               | Exhibit 10.35 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2012, filed with the commission on May 14, 2012 |
| 10.36   | First Amendment to Exclusive Manufacturing Agreement by and between NSA, Inc., NAI and NAIE effective as of April 1, 2005.              | Exhibit 10.36 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2012, filed with the commission on May 14, 2012 |
| 10.37   | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated September 3, 2012 (English translation).           | Exhibit 10.37 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2012, filed with the commission on September 21, 2012    |
| 10.38   | Second Amendment to Credit Agreement by and between NAI and Wells Fargo Bank, N.A. effective as of December 7, 2012                     | Filed herewith  |
| 10.39   | Revolving Line of Credit Note made by NAI for the benefit of Wells Fargo Bank, N.A. dated December 7, 2012 in the amount of \$5,000,000 | Filed herewith  |
| 31.1    | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer   | Filed herewith  |
| 31.2    | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer   | Filed herewith  |
| 32      | Section 1350 Certification  | Furnished herewith  |
| 101.INS | XBRL Instance Document**  | Furnished herewith  |
| 101.SCH | XBRL Taxonomy Extension Schema Document**   | Furnished herewith  |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document**   | Furnished herewith  |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document**  | Furnished herewith  |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document**   | Furnished herewith  |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document**  | Furnished herewith  |

\* Indicates management contract or compensatory plan or arrangement.

\*\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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**SIGNATURES**

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

Date: February 12, 2013

NATURAL ALTERNATIVES INTERNATIONAL, INC.

By: /s/ Mark A. LeDoux  
Mark A. LeDoux, Chief Executive Officer

(principal executive officer)

By: /s/ Kenneth E. Wolf  
Kenneth E. Wolf, Chief Financial Officer

Mr. Wolf is the principal financial officer of Natural Alternatives International, Inc. and has been duly authorized to sign on its behalf.