NATURAL HEALTH TRENDS CORP
Form 10QSB
May 24, 2004

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

FORM 10-Q

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

For the quarterly period ended March 31, 2004

OR

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

For the transition period from ______ to ________.

Commission File Number: 0-25238

NATURAL HEALTH TRENDS CORP.

Incorporated in Florida

I.R.S. Employer Identification No. 59-2705336

12901 Hutton Drive
Dallas, Texas 75234
(972) 241-4080

Indicate by check mark whether the company (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 and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ].

Indicate by check mark whether the registrant is an accelerated filer (as defined by Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

As of May 10, 2004, the number of shares outstanding of the registrant's class of common stock, par value $0.001 per share, was 5,446,365.

NATURAL HEALTH TRENDS CORP.

Form 10-Q for the Three Months Ended March 31, 2004

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED BALANCE SHEETS

	March 31, 2004 (Unaudited)
ASSETS	
Current assets:	
Cash and cash equivalents	$ 15,266,262
Restricted cash	2,347,024
Accounts receivable	432,973
Inventories, net	5,766,889
Prepaid expenses and other	3,513,663
Total current assets	27,326,811

Property and equipment, net	869,637
Software	5,600,000
Goodwill	12,756,037
Database, net	593,058
Deposits and other assets	272,852
Total assets	$ 47,418,395

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:	
Accounts payable	$ 2,830,414
Accrued expenses	3,624,492
Accrued distributor commissions	4,930,758
Income taxes payable	1,831,887
Notes payable	238,760
Current portion of long-term debt	2,729,803
Deferred revenue	5,379,625
Other current liabilities	551,484
Total current liabilities	22,117,223
Long term debt	525,031
Total liabilities	22,642,254
Minority interest	626,681
Mezzanine common stock	960,000
Stockholders' equity:	
Preferred stock ($1,000 par value; authorized 1,500,000 shares)	--
Common stock ($0.001 par value; authorized 500,000,000 shares; issued and outstanding 5,446,365 and 4,656,409 shares as of March 31, 2004 and December 31, 2003, respectively)	5,446
Additional paid in capital	48,754,556
Accumulated deficit	(25,278,505)
Accumulated other comprehensive loss	(292,037)
Total stockholders' equity	23,189,460
Total liabilities and stockholders' equity	$ 47,418,395

The accompanying notes are an integral part of these consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Net Sales	$ 38,435,209	$ 11,240,317
Cost of sales	7,928,128	2,096,707
Gross profit	30,507,081	9,143,610
Operating expenses:		
Distributor commissions	20,204,655	4,581,118
Selling, general and administrative expenses	6,473,164	2,822,956
Total operating expenses	26,677,819	7,404,074
Income from operations	3,829,262	1,739,536
Other income (expense):		
Gain (loss) on foreign exchange	(8,868)	52,800
Other income, net	168,583	64,514
Interest expense, net	(913)	(8,400)
Total other income, net	158,802	108,914
Income from operations before taxes and minority interest	3,988,064	1,848,450
Income tax provision	(797,613)	(370,000)
Minority interest expense	(79,724)	(105,648)
Net income	3,110,727	1,372,802
Preferred stock dividends	--	402
Net income available to common stockholders	$ 3,110,727	$ 1,372,400
Basic income per common share	$ 0.67	$ 0.30
Diluted income per common share	$ 0.53	$ 0.28
Weighted average shares outstanding:		
Basic	4,667,288	4,511,391
Diluted	5,909,383	4,907,791

The accompanying notes are an integral part of these consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended March 31,	
	2004	2003
Net income	$ 3,110,727	$ 1,372,802
Other comprehensive income, net of tax:		
Foreign currency translation adjustment	(145,377)	24,840
Comprehensive income	$ 2,965,350	$ 1,397,642

The accompanying notes are an integral part of these consolidated financial statements.

NATURAL HEALTH TRENDS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ende	
	March 31,	
	2004	20
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 3,110,727	$ 1,3
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	197,989	3
Stock issued for services	10,500	
Minority interest of subsidiary	79,724	1
Imputed compensation	33,000	
Changes in assets and liabilities, excluding acquisitions of businesses:		
Accounts receivable	(194,486)	(
Inventories, net	(2,186,586)	
Prepaid expenses	(149,722)	1
Deposits and other assets	469,671	3

Accounts payable	825,274	(1,2
Accrued expenses	1,366,954	(2
Accrued distributor commissions	2,645,576	1
Income tax payable	389,232	3
Deferred revenue	(1,253,961)	(1,6
Other current liabilities	38,646	
Total Adjustments	2,271,811	(1,6
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	5,382,538	(2
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(65,561)	(2
Database purchase	--	(2
Increase in restricted cash	(983,836)	(
NET CASH USED IN INVESTING ACTIVITIES	(1,049,397)	(5
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments of notes payable and long-term debt	(54,577)	(
NET CASH USED IN FINANCING ACTIVITIES	(54,577)	(
EFFECT OF TRANSLATION ADJUSTMENTS ON CASH AND CASH EQUIVALENTS	(145,377)	
NET INCREASE (DECREASE) IN CASH	4,133,187	(8
CASH, BEGINNING OF PERIOD	11,133,075	3,8
CASH, END OF PERIOD	$ 15,266,262	$ 3,0

SUPPLEMENTAL DISCLOSURE OF NONCASH FINANCING AND INVESTING ACTIVITIES:	Three Months Ende March 31,	
	2004	20
Interest paid	$ 1,000	$
Income taxes (net of refunds) paid	$ 368,481	$

The accompanying notes are an integral part of these consolidated financial statements.

4

NATURAL HEALTH TRENDS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED MARCH 31, 2004

(Unaudited)

1. BASIS OF PRESENTATION

Natural Health Trends Corp. ("NHTC" or "the Company") is a Florida corporation incorporated in 1988. NHTC is an international direct selling company which operates through subsidiaries that distribute products to promote health, wellness and vitality. Lexxus International, Inc., a wholly owned subsidiary and other Lexxus subsidiaries (collectively "Lexxus"), sell certain cosmetic products as well as "quality of life" products. eKaire.com, Inc. ("eKaire"), a wholly owned subsidiary, distributes nutritional supplements aimed at general health and wellness. Other active wholly or majority owned subsidiaries of NHTC and their countries of incorporation include:

- Lexxus International (SW Pacific) Pty. Ltd. (Australia)
- Kaire Nutraceuticals Australia Pty. Ltd. (Australia)
- Lexxus International (NZ) Ltd. (New Zealand)
- Kaire Nutraceuticals New Zealand Ltd. (New Zealand)
- Lexxus International Co., Ltd. (Taiwan)
- MyLexxus Europe AG (Switzerland)
- KGC Networks Pte. Ltd. (Singapore)
- Lexxus International Co., Ltd. (Hong Kong)
- MyLexxus Personal Care International (India) Pvt. Ltd. (India)
- Lexxus International Marketing, Pte. Ltd. (Singapore)
- Lexxus International Network Marketing, Inc. (the Philippines)
- Lexxus Korea Co., Ltd. (South Korea)
- I Luv My Pet, Inc. (U.S.)

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. As a result, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company's financial information as of March 31, 2004, and for the three months ended March 31, 2004 and 2003. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our 2003 Annual Report on Form 10-KSB.

NHTC's common stock, par value, $.001 per share (the "Common Stock") is listed on the Over the Counter Bulletin Board (the "OTCBB"). In March 2003, NHTC effected a 1-for-100 reverse stock split with respect to its outstanding shares of Common Stock. In addition, the trading symbol for the shares of its Common Stock changed from "NHTC" to "NHLC". All share references will give effect to the reverse stock split.

5

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation
The accompanying consolidated financial statements include the accounts of NHTC and all of its wholly and majority-owned subsidiaries, after the elimination of intercompany balances and transactions.

Reclassifications
Certain 2003 amounts in the consolidated statements of operations and the consolidated statements of cash flows have been reclassified to conform with the current year presentation.

Revenue Recognition
The Company's revenues are primarily derived from sales of products, sales of starter and renewal administrative enrollment packs and shipping fees. Product sales and direct expenses are recognized when the products are shipped. The Company defers revenue from the sale of its starter and renewal packs related to its administrative enrollment fee. The Company amortizes its deferred revenue and its associated direct costs over twelve months, the term of the membership. As of March 31, 2004, the Company had deferred revenue of approximately $5,380,000, of which approximately $1,544,000 pertained to goods shipped in the second quarter of 2004 and will be recognized as revenue at that time. Deferred revenue also included refundable distributor fees of approximately $3,836,000.

The Company also estimates and records a sales return allowance for possible sales refunds based on its historical experience on a country-by-country basis.

Shipping and Handling Cost
The Company records freight and shipping revenue collected from distributors as revenue. The Company records shipping and handling costs associated with customer shipments as cost of sales.

Commissions expense
Distributors are paid commissions based on their direct and indirect commissionable net sales and downline growth. Commissions are earned over 52 business periods and are paid two weeks in arrears. Commissions are accrued when earned.

Accounting for Stock-Based Compensation
Currently, NHTC follows Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and its related interpretations for stock options granted to employees and members of its board of directors. Under the recognition and measurement principles of APB 25, NHTC is not required to recognize any compensation expense unless the market price of the stock exceeds the exercise price on the date of grant, the terms of the grant are subsequently modified or in the case of variable options. The Financial Accounting Standards Board has recently issued a proposal to change the recognition and measurement principles for equity-based compensation granted to employees and board members. Under the proposed rules, NHTC would be required to recognize compensation expense related to stock options granted to employees and board members effective for the year beginning after December 15, 2004. The compensation expense would be calculated based on the expected number of options expected to vest and would be recognized over the stock options' vesting period. If this proposal is passed, NHTC would be required to recognize compensation expense related to stock options granted to its employees or board members, which could have a material effect on its consolidated financial condition and results of operations.

For disclosure purposes in according with Statement of Financial Accounting Standards 123 ("SFAS 123"), the fair value of options is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for stock options granted during the period, respectively: annual dividends of $0 for both years; expected volatility of 100% and 200% for 2004 and 2003, respectively; risk free interest rate of 4.25% and 7.00% for 2004 and

2003, respectively; and expected life of 3 years for 2004 and 2003, respectively. There were no stock options granted during the three months ended March 31, 2004 or 2003. If NHTC had recognized compensation cost of stock options in accordance with SFAS 123, NHTC's proforma income and net income per share would have been as follows:

	Three Months Ended March 31,	
	2004	2003
Net income available to common stockholders	$ 3,110,727	$ 1,372
Add: Stock-based employee compensation expense included in reported net income, net of tax effect	--	
Deduct: Total stock-based employee compensation expense determined under fair value based method, net of tax effect	(5,542)	(9
Pro forma net income available to common stockholders	$ 3,105,185	$ 1,362
Basic income per share:		
As reported	$ 0.67	$
Pro forma	$ 0.67	$
Diluted income per share:		
As reported	$ 0.53	$
Pro forma	$ 0.53	$

Earnings Per Share
Basic earnings per share is computed based on the weighted average number of common shares outstanding during the periods presented. Diluted earnings per share data gives effect to all potentially dilutive common shares that were outstanding during the periods presented.

Net income per share from operations for the three months ended March 31, 2004 and 2003 are as follows:

	Three Mont March
	2004
Basic Calculation:	
Net income available to common stockholders	$ 3,110,727
Weighted average number of shares outstanding	4,667,288
Basic net income per share from operations	$ 0.67

Diluted Calculation:

Net income available to common stockholders	$ 3,110,727
Weighted average number of shares outstanding	6,000,788
Net effect of dilutive stock options and warrants based upon treasury stock method	(91,405)
Weighted average number of shares outstanding assuming full conversion of all potentially dilutive securities	5,909,383
Diluted net income per share from operations	$ 0.53

Accounting for Software
As part of the Marketvision Communications Corp. acquisition (see Business Combinations), the Company acquired approximately $5,600,000 of computer software and programs. The valuation of the software was determined by a third party appraisal firm. The software is classified as a non-current asset in the balance sheet and is being amortized over a seven-year period beginning April 1, 2004.

Recently Issued Accounting Standards
FASB Interpretation No. 45. In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45). FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The recognition provisions of FIN 45 are effective for any guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002. The adoption of FIN 45 did not have a material effect on the Company's financial position, results of operations, or cash flows.

FASB Interpretation No. 46 and 46R. In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities." Interpretation 46 changes the criteria by which one company includes another entity in its consolidated financial statements. Previously, the criteria were based on control through voting interest. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. A company that consolidates a variable interest entity is called the primary beneficiary of that entity. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after December 31 2003. In December 2003, FASB issued a revision to FASB Interpretation No. 46 to clarify some of the provisions and to exempt certain entities from its requirements. Under the new guidance, special effective date provisions apply to enterprises that have fully or partially applied Interpretation 46 prior to issuance of the revised interpretation. Otherwise, application of Interpretation 46R is required in financial statements of public entities that have interests in structures that are commonly referred to as special-purpose entities ("SPE's") for periods ending after December 15, 2003. Application by public entities, other than business issuers, for all other types of variable interest entities other than SPE's is required in financial statements for periods ending after March 15, 2004. NHTC does not have interest in structures commonly referred to as SPE's, therefore the adoption of Interpretation 46R is not expected to have a material impact on NHTC's consolidated financial position, results of operations or cash flows.

SFAS 149. In April 2003, FASB issued Statements of Financial Accounting Standards No. 149 ("SFAS 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS 149 amends SFAS

8

133 "Accounting for Derivatives Instruments and Hedging Activities" and the related implementation guidance and is effective for contracts entered into or modified after June 30, 2003, except for hedging relationships designated after June 30, 2003. SFAS 149 clarifies the definition of a derivative and amends the financial accounting and reporting required for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. In addition, SFAS 149 improves the financial reporting requirements by requiring a more consistent reporting of contracts as either derivatives or hybrid instruments. The adoption of this standard did not have a significant impact on the Company's financial condition, results of operations, or cash flows.

3. BUSINESS COMBINATIONS

The Company entered into the following business combinations during the three months ended March 31, 2004:

Purchase of the Minority Interest of Lexxus International, Inc.

As of March 29, 2004, the Company purchased 4,900 shares of common stock owned by the minority stockholders of Lexxus International, Inc., a Delaware corporation ("Lexxus"), (representing the 49% interest in Lexxus not owned by the Company) in exchange for 100,000 shares of restricted NHTC common stock. The total purchase price, including acquisition related costs of approximately $15,000, was approximately $1,977,000 based upon the average closing price of NHTC common stock of $23.08 discounted by 15% due to the restrictions contained in the purchase agreement. The average closing price of $23.08 was calculated based on the closing price of NHTC Common Stock a few days before and after the acquisition was announced. The entire purchase price was allocated to goodwill.

Purchase of Marketvision Communications Corp.

Effective on March 31, 2004, the Company entered into a merger agreement with Marketvision Communications Corp. ("Marketvision"), pursuant to which the Company acquired all of the outstanding capital stock of Marketvision in exchange for 690,000 shares of NHTC restricted common stock (the "Issued Shares"), promissory notes in the aggregate principle amount of approximately $3,203,403 and a cash payment of $1,336,875 in April 2004 for a total purchase price of approximately $18,227,000, including acquisition costs of approximately $150,000. The shares issued were valued at the average closing price of NHTC Common Stock of $23.08 discounted by 15% due to certain restrictions contained in the purchase agreement. The average closing price of $23.08 was calculated based on the closing price of NHTC Common Stock a few days before and after the acquisition was announced. Marketvision is the exclusive developer and service provider of the direct selling software used by the Company since mid-2001. Based upon the number of new distributors enrolled, Marketvision charged the Company approximately $861,000 and $263,000 for services provided during the three months ended March 31, 2004 and 2003, respectively.

Management believes that this transaction is in the best interests of the Company because (i) the success of the Company's business is dependent upon Marketvision's direct selling software and (ii) the Company projects enrolling a significant number of new distributors in the future, which would be very expensive under the former compensation agreement between the Company and Marketvision. Since the former owners of Marketvision include Terry LaCore, a member of the Company's Board of Directors and the Chief Executive Officer of Lexxus International, Inc., a wholly owned subsidiary of NHTC, the Board of Directors hired the independent appraisal firm of Bernstein, Conklin & Balcombe to assess the fairness of the transaction with Marketvision from a financial point of view. In March 2004, Bernstein, Conklin & Balcombe delivered its opinion to the Company's Board of Directors that the Marketvision transaction is fair to the Company from a financial point of view.

In addition, the Company entered into a Shareholder's Agreement with the former shareholders of Marketvision. Such agreement contained customary terms and conditions, including restrictions on transfers of the NHTC shares, rights of first refusal and indemnification. Further, the Shareholder's Agreement contains a one time put right related to 240,000 NHTC shares for the benefit of the former shareholders of Marketvision (other than Mr. LaCore) that requires NHTC, during the six month period commencing eighteen months following the earlier of (i) the first anniversary of the closing date, or (ii) the date on which the Issued Shares are registered with the Securities and Exchange Commission (the "SEC") for resale to the public, to repurchase all or part of the NHTC shares still owned by the such stockholders for $4.00 per share less any amount previously received by such stockholders from the sale of their shares of NHTC stock. The Company has recorded this obligation of $960,000 as mezzanine common stock in the balance sheet at March 31, 2004. The agreement also provided the former stockholders of Marketvision with piggyback registration rights in the event we file a registration statement with the SEC, other than on Forms S-4 or S-8, stock option grants for the former stockholders (other than Mr. LaCore) as well as three-year employment agreements for the former stockholders, other than Mr. LaCore. In the event that the Company defaults on its payment obligations under the notes or the employment agreements, an entity owned by the former shareholders of Marketvision (other than Mr. LaCore) has certain rights to use, develop, modify, market, distribute and sublicense the Marketvision software to third parties.

Operations of Marketvision subsequent to March 31, 2004 will be included in the Company's consolidated financial statements. The transaction was accounted for as a business combination and the purchase price was allocated among the assets acquired based on their estimated fair market values. The assets of Marketvision included certain computer equipment and developed software.

The purchase price was calculated as follows:

690,000 shares of NHTC Common Stock valued at $23.08 per share less 15% discount for restrictions associated with the stock issued	$ 13,536,420
Cash paid in April 2004	1,336,875
Promissory notes issued at closing	3,203,403
Acquisition costs	150,302
Total purchase price	$ 18,227,000

The purchase price was allocated among assets acquired based on their estimated fair market values as follows:

Trade receivables due from NHTC and affiliates	$ 1,866,528
Property and equipment	25,000
Amortizable intangible assets	5,600,000
Goodwill	10,735,472
Deferred taxes	(1,904,000)
Deferred tax asset recognized for the Company's loss carryforward based upon offset against Marketvision's deferred tax liabilities	1,904,000
Total purchase price allocation	$ 18,227,000

Amortizable intangibles acquired will be amortized over their estimated life of seven years. The purchase price allocation is based on preliminary estimates, including estimates of federal tax contingencies, which are subject to change once additional information becomes available. Changes to these estimates could result in changes to the purchase price allocation.

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

The following Management's Discussion and Analysis should be read in conjunction with Management's Discussion and Analysis included in our Annual Report on Form 10-KSB for the year ended December 31, 2003, filed with the Securities and Exchange Commission ("SEC"), and our other filings, including Current Reports on Form 8-K, filed with the SEC through the date of this Report.

Company Overview

NHTC is an international network marketing organization. NHTC controls subsidiaries that distribute products through three separate direct selling networks that promote health, wellness and vitality. Lexxus International, Inc., and other Lexxus subsidiaries (collectively, "Lexxus") sell certain cosmetic products as well as "quality of life" products. eKaire.com, Inc., ("eKaire"), a wholly-owned subsidiary, distributes nutritional supplements aimed at general health and wellness. I Luv My Pet, Inc., ("ILMP"), a wholly-owned subsidiary, distributes nutritional supplements for dogs and cats. NHTC operates its Lexxus, eKaire and ILMP direct selling operations as a single segment and primarily sells its products through a network of commissioned distributors. NHTC aggregates the Lexxus and eKaire operating segments because it believes it operates as a single reportable segment selling its products in similar distribution channels in each of its operations. Operations of ILMP are not material for the three months ended March 31, 2004 since it commenced in the fourth quarter of 2003.

Net Sales. NHTC derives its revenue from sales of its products, sales of its starter and renewal administrative enrollment packs, and from shipping fees. Substantially all of its product sales are to independent distributors at published wholesale prices. NHTC believes the vast majority of its product sales are for personal consumption; however, NHTC cannot distinguish its personal consumption sales from its other sales because it has no involvement in its products after delivery other than usual and customary product returns.

Cost of sales consists of products purchased from third-party manufacturers, costs of promotional materials sold to NHTC's distributors, freight, provisions for slow moving or obsolete inventories and the cost of NHTC's third party service provider.

Distributor commissions are dependent on the sales mix and typically range between 43% to 53% of net sales. Commissions are paid to NHTC's independent distributors in accordance with its global compensation plan based on commissionable net sales, which consist of finished products.

Foreign exchange. NHTC is exposed to certain market risks, including changes in currency exchange rates as measured against the United States dollar. The value of the United States dollar may affect NHTC's financial results. Changes in exchange rates could positively or negatively affect its financial results, as expressed in United States dollars. The effect of the translation of the Company's foreign operations are included in accumulated other comprehensive income within stockholder's equity and such do not impact the statement of operations.

Effect of inflation. NHTC believes inflation has not had a material impact on its operations or profitability.

Critical Accounting Policies and Estimates

For a complete review of NHTC's critical accounting policies and new accounting pronouncements that may impact NHTC's operations, refer to the Annual Report on Form 10-KSB for the year ended December 31, 2003. In response to SEC Release No. 33-8040, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies" and SEC Release Number 33-8056, "Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of

Operations," NHTC has identified certain policies that are important to the portrayal of its consolidated financial condition and consolidated results of operations. These policies require the application of significant judgment by NHTC's management. NHTC periodically analyzes the need for certain estimates, including the need for such items as reserves for inventory valuation, impairment of long-lived assets, revenue recognition, sales returns, and contingencies. NHTC bases any estimates needed on its historical experience, industry standards, and various other assumptions that may be reasonable under the circumstances. NHTC cautions its readers that actual results could differ from its estimates under different assumptions or conditions. If circumstances change relating to the various assumptions or conditions used in such estimates NHTC could experience an adverse effect on its consolidated financial condition, changes in financial condition, and results of operations. NHTC's critical accounting policies at March 31, 2004 include the following:

Inventory Valuation

NHTC's inventory carrying value is reviewed and compared to the net realizable value of its inventory and any inventory value in excess of net realizable value is written down. In addition, NHTC reviews its inventory for obsolescence and any inventory identified as obsolete is reserved or written off. NHTC's determination of obsolescence is based on assumptions about the demand for its products, product expiration dates, estimated future sales, and management's future plans.

Asset Impairment

NHTC reviews the book value of its property and equipment and other long-term assets whenever an event or change in circumstances indicates that the net book value of an asset or group of assets may be unrecoverable. NHTC's impairment review includes a comparison of future projected cash flows (undiscounted and without interest charges) generated by the asset or group of assets with its associated carrying value. NHTC believes its expected future cash flows approximate or exceed its net book value. However, if circumstances change and the net book value of the asset or group of assets exceeds expected cash flows, NHTC would have to recognize an impairment loss to the extent the net book value of an asset exceeds its fair value.

Allowance for Sales Returns

The Company maintains an allowance for sales returns and refunds based on the return practices and policies by country and our historical experience. The allowance for sales returns may need to be adjusted if actual sales returns differ from estimates.

Revenue Recognition and Deferred Costs

Product sales are recognized when shipped. NHTC defers revenue received from the sale of its starter and renewal administrative packs due to the twelve-month term of the membership. Such fees actually received are recognized as revenue on a straight-line basis over the twelve-month term of the membership. In addition, NHTC defers and recognizes to cost of sales on a straight line basis the actual cost paid to a third party associated with the administrative enrollment fees received from distributors. Although NHTC has no immediate plans to significantly change the terms or conditions of the starter or renewal memberships, any changes in the future could result in additional revenue deferrals or could cause NHTC to recognize its deferred revenue over a longer period of time.

Tax Valuation Allowances

The Company evaluates the probability of realizing the future benefits of any of its deferred tax assets and records a valuation allowance when it believes a portion or all of its deferred tax assets may not be realized. If the Company is unable to realize the expected future benefits of its deferred tax assets, it would be required to provide an additional valuation allowance. As of March 31, 2004, the Company had recorded a valuation allowance of approximately $111,000 related to the net deferred tax assets of the Company at that date.

Results of Operations

Three Months Ended March 31, 2004 Compared to the Three Months Ended March 31, 2003

The following table summarizes NHTC's consolidated operating results as a percentage of net sales for each of the years indicated:

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Net sales	100.0%	100.0%
Cost of sales	20.6%	18.7%

Gross profit	79.4%	81.3%
Operating expenses:		
Distributor commissions	52.6%	40.8%
Selling, general and administrative expenses	16.8%	25.1%
Total operating expenses	69.4%	65.9%
Income from operations	10.0%	15.4%
Other income	.4%	1.0%
Income from continuing operations before taxes and minority interest expense	10.4%	16.4%
Income tax expense and minority interest	(2.3%)	(4.2%)
Net income	8.1%	12.2%

Net Sales

Net sales were approximately $38,435,000 for the three months ended March 31, 2004 compared to $11,240,000 for the three months ended March 31, 2003. This increase of approximately $27,195,000 or 242% was primarily attributable to the increased number of active Lexxus distributors (approximately $17.4 million or 64% of the increase), Lexxus's expansion into new markets, including South Korea in the second quarter of 2003 (approximately $1.1 million or 4% of the increase), sales of new products (approximately $4.7 million or 17% of the increase) and the shipment of Hong Kong orders in backlog as of December 31, 2003 (approximately $4.0 million or 15% of the increase).

Cost of Sales

Cost of sales was approximately $7,928,000 or 20.6% of net sales for the three months ended March 31, 2004 compared with approximately $2,097,000 or 18.7% of net sales for the three months ended March 31, 2003. This increase of approximately $5,831,000 or 278% was primarily attributable to increased net sales and the Lexxus product mix compared to eKaire product mix in 2004 compared to 2003. Cost of sales as a percentage of net sales increased which is primarily attributable to the change of product mix sold in 2004 and the costs of bulk shipments to Asia due to higher sales volumes in that region.

Gross Profit

Gross profit was approximately $30,507,000 or 79.4% of net sales for the three months ended March 31, 2004 compared with approximately $9,144,000 or 81.3% of net sales for the three months ended March 31, 2003. This increase of approximately $21,363,000 or 234% was attributable to the increase in gross

sales of Lexxus products partially offset by the cost of sales as a percentage of net sales increased due to the change of product mix sold in 2004 and the costs of bulk shipment to Asia due to higher sales volumes in that region.

Distributor Commissions

Distributor commissions were approximately $20,205,000 or 52.6% of net sales for the three months ended March 31, 2004 compared with approximately $4,581,000 or 40.8% of net sales for the three months ended March 31, 2003. This increase of approximately $15,624,000 or 341% was directly related to the increase in net sales, the terms of the compensation plans and promotions held during the first quarter of 2004.

Selling, General and Administrative Expenses

Selling, general and administrative costs were approximately $6,473,000 or 16.8% of net sales for the three months ended March 31, 2004 compared with approximately $2,823,000 or 25.1 % of net sales for the three months ended March 31, 2003. This increase of approximately $3,650,000 or 129% was attributable to the administrative expenses associated with the new office in Seoul, South Korea, which was opened in the second quarter of 2003, and the balance of the increase resulted from sales and marketing conventions, promotions and trainings, especially in the Hong Kong and Korean operations. Selling, general and administrative expenses decreased as a percentage of net sales to 16.8% in 2004 compared to 25.1% in 2003 due to operating efficiencies and economies of scale gained with higher volumes of net sales.

Other Income (Expense)

Other income was approximately $159,000 for the three months ended March 31, 2004 compared with income of approximately $109,000 for the three months ended March 31, 2003. This increase of approximately $50,000 was due to an increase in other income partially offset by a recognized loss on foreign exchange in 2004.

Income Taxes

Income taxes were approximately $798,000 or 20.0% of income before taxes and minority interest for the three months ended March 31, 2004 compared with $370,000 or 20.0% of income before taxes and minority interest for the three months ended March 31, 2003. The decrease in effective tax rate was attributable to use of net operating losses in the U.S. and lower effective tax rates on foreign earnings in 2004.

Minority Interest, Net of Taxes

Minority interest expense was approximately $80,000 for the three months ended March 31, 2004, which is comparable with approximately $106,000 for the three months ended March 31, 2003.

Net Income

Net income was approximately $3,111,000 or 8.1% of net sales for the three months ended March 31, 2004 compared to net income of approximately $1,373,000 or 12.2% of net sales for the three months ended March 31, 2003. Compared to 2003, this increase in 2004 is due to significantly larger net sales, smaller selling, general and administrative expenses as a percentage of net sales partially offset by larger cost of sales and distributor commissions as a percentage of net sales.

Liquidity and Capital Resources

NHTC has historically funded the working capital and capital expenditure requirements primarily from cash provided through sales of products, through borrowings from institutions and individuals and issuance of preferred stock.

At March 31, 2004, the ratio of current assets to current liabilities was 1.24 to 1.0 and NHTC had working capital of approximately $5,210,000.

Cash provided by operations for the three months ended March 31, 2004 was approximately $5,383,000. Cash used by investing activities during the period was approximately $1,049,000, which primarily relates to the increase of restricted cash related to the credit card reserve. Cash used in financing activities during the period was approximately $55,000 utilized for the repayment of notes payable and long-term debt. Total cash increased by approximately $4,133,000 during the period.

NHTC has generated positive cash flows from its operations over the past three years and believes that its existing liquidity and cash flows from operations, including cash and cash equivalents totaling approximately $17,613,000 should be adequate to fund normal business operations expected in the future.

NHTC intends to continue to open additional operations in new foreign markets in coming years. In 2004, NHTC plans to expand into Mexico and possibly other countries in 2005. The estimated cost to expand into a new country is approximately $2-3 million in the aggregate, of which approximately $500,000 will relate to capital asset purchases that will be depreciated over the life of the assets or lease term.

On March 31, 2004, the Company entered into a merger agreement with Marketvision Communications Corp. ("Marketvision"), pursuant to which the Company acquired all of the outstanding capital stock of Marketvision in exchange for the issuance of 690,000 shares of NHTC restricted common stock, promissory notes in the aggregate principle amount of approximately $3,203,403 and a cash payment of $1,336,875 for a total purchase price of approximately $18,227,000, including acquisition costs of approximately $150,000. Marketvision is the exclusive developer and service provider of the direct selling software used by the Company since mid-2001.

On April 12, 2004, an investigative television program was aired nationwide in the People's Republic of China with respect to the operation of the Company's Lexxus Hong Kong subsidiary and the Lexxus representative office located in Beijing. The report alleged, among other things, that unlicensed network-marketing activities were being conducted by Lexxus' independent distributors in China and that many independent distributors were unsuccessful in their efforts to generate profits. Lexxus currently conducts operations in 30 countries, including Hong Kong, and requires that its independent distributors comply with all applicable local laws.

After a thorough internal investigation of the issues raised in the television program, the Company has concluded that additional training and development of the Lexxus independent distributors was warranted. Accordingly, our Lexxus Hong Kong subsidiary has commenced intensive training of its independent distributors with respect to (i) the Chinese legal requirements and (ii) the need for descriptions of business opportunities available to potential distributors to be accurate and balanced.

Due to the adverse publicity caused by the airing of the television program, gross sales (before returns and refunds) for the Lexxus Hong Kong operations have declined from an average of approximately $285,000 per day during the quarter ended March 31, 2004 to an average of approximately $110,000 per day during the thirty (30) day period since April 12, 2004. It is difficult to predict when, if ever, sales from the Lexxus Hong Kong operations will increase to prior levels. In order to accommodate the concerns of many independent distributors, Lexxus has extended its existing 14-day return policy to allow returns for a six-month period for customers who purchased products during the two-week period prior to the airing of the television program. Consequently, this may adversely affect the Company's results of operations due to an increase in sales returns and refunds for all or part of the remainder of the current fiscal year.

Direct sales and foreign investment in the direct sales industry are very tightly regulated in China. The Company believes that one or more investigations of Lexxus' operations in China may have been initiated by the Beijing Municipal Administration of Industry and Commerce and/or the Beijing Municipal Public Security Bureau. The Company has been unable to determine whether these investigations are ongoing or whether there are any other investigations that have been initiated or are under consideration by the Chinese government. Nevertheless, Lexxus has increased its efforts to obtain a license to engage in business in China by engaging lobbyists and specialized legal counsel. Expenses and fees incurred by the Company in connection with these efforts may also adversely affect the Company's results of operations during the remainder of the current fiscal year. The Company is currently unable to predict whether it will be successful in obtaining a license to operate in China, and if it is successful, when it will be permitted to commence operations there. Further, even if the Company is successful in obtaining a license to do business in China, it is uncertain as to whether the Company will generate profits from such operations.

NHTC is considering various alternatives pertaining to raising additional capital to fund the repayment of the promissory notes issued in connection with the Marketvision transaction, to continue its expansion into new markets, to fund its operations in the event that sales in the Lexxus Hong Kong subsidiary do not increase materially and/or to make other acquisitions to further expand its business. If NHTC's existing capital resources or cash flows become insufficient to meet its current business plans and projections, and if NHTC would be required to raise additional funds, there is no assurance that funds could be raised on favorable terms, if at all.

Off-Balance Sheet Arrangements

NHTC does not utilize off-balance sheet financing arrangements other than in the normal course of business. NHTC finances the use of certain facilities, office and computer equipment, and automobiles under various operating lease agreements.

Forward Looking Statements

Certain statements contained in this Quarterly Report on Form 10-Q constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements included in this Quarterly Report, other than statements of historical facts, regarding our strategy, future operations, financial position, estimated revenues, projected costs, prospects, plans and objectives are forward-looking statements. When used in this Quarterly Report, the words "will," "believe," "anticipate," "intend," "estimate," "expect," "project" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. We cannot guarantee future results, levels of activity, performance or achievements, and you should not place undue reliance on our forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or strategic investments. In addition, any forward-looking statements represent our expectation only as of the day this Quarterly Report was first filed with the SEC and should not be relied on as representing our expectations as of any subsequent date. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our expectations change.

Although we believe that the expectations reflected in any of our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in any of our forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and to inherent risks and uncertainties, such as those disclosed in this Quarterly Report. Important

factors that could cause our actual results, performance and achievements, or industry results to differ materially from estimates or projections contained in forward-looking statements include, among others, the following:

- our relationship with our distributors;
- our need to continually recruit new distributors;
- our internal controls and accounting methods may require further modification;
- regulatory matters governing our products and network marketing system;
- adverse publicity associated with our products or network marketing organizations;
- product liability claims;
- our reliance on outside manufacturers;
- risks associated with operating internationally, including foreign exchange risks;
- product concentration;
- dependence on increased penetration of existing markets;
- the competitive nature of our business; and
- our ability to generate sufficient cash to operate and expand our business.

Market data and other statistical information used throughout this report is based on independent industry publications, government publications, reports by market research firms or other published independent sources and on our good faith estimates, which are derived from our review of internal surveys and independent sources. Although we believe that these sources are reliable, we have not independently verified the information and cannot guarantee its accuracy or completeness.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

NHTC does not engage in trading market risk sensitive instruments and does not purchase investments as hedges or for purposes "other than trading" that are likely to expose it to certain types of market risk, including interest rate, commodity price or equity price risk. NHTC has not issued any debt instruments, entered into any forward or future contracts, purchased any options or entered into any swaps.

Currency Risk and Exchange Rate Information

Some of NHTC's revenue and some of their expenses are recognized outside of the United States, except for inventory purchases, which are primarily transacted in U.S. dollars from vendors in the United States. The local currency of each subsidiary's primary markets is considered the functional currency. Revenue and expenses are translated at the weighted average exchange rates for the periods reported. Therefore, the reported revenue and earnings will be positively impacted by a weakening of the U.S. dollar and will be negatively impacted by a strengthening of the U.S. dollar. Given the uncertainty of exchange rate fluctuations, we cannot estimate the effect of these fluctuations on our future business, product pricing, results of operations or financial condition.

Seasonality

In addition to general economic factors, NHTC is impacted by seasonal factors and trends such as major cultural events and vacation patterns. For example, most Asian markets celebrate their respective local New Year in the first quarter, which generally has a negative impact on that quarter. We believe that direct selling in the United States and Europe is also generally negatively impacted during the month of August, which is in our third quarter, when many individuals, including our distributors, traditionally take time off for vacations.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified

17

in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our President and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

During the quarters ended September 30 and December 31, 2003, the Company re-evaluated its financial statements for the years ended December 31, 2002 and 2001, the quarterly periods included in such years and the quarterly periods ended March 31, June 30 and September 30, 2003. As a result of such review, the Company determined that it inadvertently applied the incorrect accounting treatment with respect to the following items:

(i) revenue recognition with respect to administrative enrollment fees;
(ii) revenue cut-off between 2002 and 2003;
(iii) accounts receivable reconciliation to supporting documents;
(iv) reserves established for product returns and refunds;
(v) the gain recorded in connection with the sale of a subsidiary in 2001;
(vi) income tax provisions; and
(vii) stock option based compensation.

Consequently, the Company amended and restated its financial statements for each quarter in 2001, 2002 and 2003 as well as for the years ended December 31, 2001 and 2002 with respect to each of the foregoing items (collectively, the "Restatement Items").

An evaluation of the Company's disclosure controls and procedures (as defined in Section 13(a)-14(c) of the Exchange Act) as of March 31, 2004 was carried out under the supervision and with the participation of the Company's President and Chief Financial Officer and other members of the Company's senior management. The Company's President and Chief Financial Officer concluded that the Company's disclosure controls and procedures as currently in effect are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to the Company's management (including the President and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. During the quarter ended March 31, 2004, the Company made changes to improve its internal controls over financial reporting with respect to (i) each of the Restatement Items, and (ii) monthly financial reports provided to the Company by its subsidiaries. The

Company is in the process of hiring additional accounting staff to supplement the existing personnel. In addition, the Company is developing policies and procedures to strengthen its international reporting including revenue recognition, sales and expense cut-off and sales returns. The Company plans to implement additional controls and procedures sufficient to accurately report their financial performance on a timely basis. There have been no other changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the quarter ended March 31, 2004, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company intends to continually review and evaluate the design and effectiveness of its disclosure controls and procedures and to improve its controls and procedures over time and to correct any deficiencies that it may discover in the future. The goal is to ensure that senior management has timely access to all material financial and non-financial information concerning the Company's business. While the Company believes the present design of its disclosure controls and procedures is effective to achieve its goal, future events affecting its business may cause the Company to modify its disclosure controls and procedures.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

There have been no material changes in, or additions to the legal proceedings previously reported in NHTC's Annual Report on Form 10-KSB for the year ended December 31, 2003 as filed with the SEC on April 13, 2004.

Item 2. Changes in Securities; Use of Proceeds and Issuer Purchases of Equity Securities

As of March 29, 2004, the Company purchased 4,900 shares of common stock owned by the minority shareholders of Lexxus International, Inc., a Delaware corporation ("Lexxus"), (representing the 49% interest in Lexxus not owned by the Company) in exchange for 100,000 shares of restricted NHTC common stock. The total purchase price, including acquisition related costs, was approximately $1,977,000 based upon the closing price of NHTC common stock. The Company issued the shares of common stock pursuant to Section 4(2) of the Securities Act of 1933, as amended.

Effective on March 31, 2004, the Company entered into a merger agreement with Marketvision Communications Corp. ("Marketvision"), pursuant to which the Company acquired all of the outstanding capital stock of Marketvision in exchange for the issuance of 690,000 shares of NHTC restricted common stock (the "Issued Shares"), promissory notes in the aggregate principle amount of approximately $3,203,403 and a cash payment of $1,336,875 for a total purchase price of approximately $18,227,000, including acquisition costs. Marketvision is the exclusive developer and service provider of the direct selling software used by the Company since mid-2001. The Company issued the shares of common stock pursuant to Section 4(2) of the Securities Act of 1933, as amended.

Item 3. Defaults upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Item 5. Other Information

The Company and its legal counsel have reviewed the listing criteria of The Nasdaq National Market and believe that the Company currently satisfies the quantitative listing requirements; provided however, that the Company currently has two (2) independent directors and Nasdaq listed companies must have at least three (3) independent directors. Accordingly, the Company intends to file in the near future a listing application with The Nasdaq Stock Market for the quotation of its shares of common stock, and to appoint an additional independent director to its Board of Directors and its Audit Committee. No assurance can be given that the Company will submit a listing application to Nasdaq, that if it is submitted, it will be approved by Nasdaq, or if it is approved, when the Company's shares will be quoted thereon.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31. Certification of Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act of 2002.
32. Certification of Chief Financial Officer required by Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

On April 15, 2004, the Company filed a Form 8-K with the SEC in connection with its announcement of the acquisition of Marketvision Communications Corp.

SIGNATURE

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

NATURAL HEALTH TRENDS CORP.

By: /s/ MARK D. WOODBURN

Mark D. Woodburn
President and CFO

Date: May 24, 2004