

NAUTILUS, INC.  
Form 10-Q  
August 08, 2013

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-31321

NAUTILUS,  
INC.  
(Exact name  
of Registrant  
as specified  
in its  
charter)

Washington 94-3002667  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)  
17750 S.E. 6th Way

Vancouver, Washington 98683

(Address of principal executive offices, including zip code)

(360) 859-2900

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act:

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (do not check if a smaller reporting company) Smaller reporting company

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

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

The number of shares outstanding of the registrant's common stock as of July 31, 2013 was 31,116,508 shares.

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NAUTILUS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2013

PART I FINANCIAL INFORMATION

Page

Item 1. Financial Statements

Condensed Consolidated Balance Sheets (unaudited) - June 30, 2013 and December 31, 2012 2

Condensed Consolidated Statements of Operations (unaudited) - Three and Six Months Ended June 30, 2013 and 2012 3

Condensed Consolidated Statements of Comprehensive Income (unaudited) - Three and Six Months Ended June 30, 2013 and 2012 4

Condensed Consolidated Statements of Cash Flows (unaudited) - Six Months Ended June 30, 2013 and 2012 5

Notes to Condensed Consolidated Financial Statements (unaudited) 6

Item 2.

Management's Discussion and Analysis of Financial Condition and Results of Operations 13

Item 3. Quantitative and Qualitative Disclosures About Market Risk 22

Item 4. Controls and Procedures 22

PART II - OTHER INFORMATION

Item 1A. Risk Factors 23

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds 23

Item 6. Exhibits 23

Signature 24

## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

## NAUTILUS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited and in thousands)

|   | June 30,<br>2013 | December 31,<br>2012 |
|---|------------------|----------------------|
| Assets  |                  |                      |
| Cash and cash equivalents                               | \$ 28,370        | \$ 23,207            |
| Trade receivables, net of allowances of \$ 93 and \$ 93 | 8,141            | 21,767               |
| Inventories   | 13,348           | 18,787               |
| Prepays and other current assets                        | 4,363            | 5,750                |
| Income taxes receivable                                 | 77               | 101                  |
| Short-term notes receivable                             |                  | 82                   |
| Deferred income tax assets                              | 3,274            | 193                  |
| Total current assets                                    | 57,573           | 69,887               |
| Property, plant and equipment, net                      | 7,502            | 6,138                |
| Goodwill  | 2,784            | 2,940                |
| Other intangible assets, net                            | 13,641           | 14,666               |
| Long-term deferred income tax assets                    | 28,601           | 239                  |
| Other assets  | 434              | 441                  |
| Total assets  | \$ 110,535       | \$ 94,311            |
| Liabilities and Stockholders' Equity                    |                  |                      |
| Trade payables  | \$ 16,565        | \$ 32,753            |
| Accrued liabilities                                     | 5,698            | 8,171                |
| Warranty obligations, current portion                   | 2,134            | 2,278                |
| Deferred income tax liabilities                         |                  | 1,275                |
| Total current liabilities                               | 24,397           | 44,477               |
| Warranty obligations, non-current                       | 28               | 214                  |
| Income taxes payable, non-current                       | 2,873            | 2,812                |
| Deferred income tax liabilities, non-current            |                  | 1,484                |

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|  |            |           |
|--|------------|-----------|
| Other long-term liabilities  | 1,812      | 1,998     |
| Total liabilities  | 29,110     | 50,985    |
| Commitments and contingencies (Note 11)  |            |           |
| Stockholders' Equity:  |            |           |
| Common stock, no par value. 75,000 authorized, 31,110 and 30,924 shares issued and outstanding | 6,512      | 6,103     |
| Retained earnings  | 74,620     | 36,598    |
| Accumulated other comprehensive income   | 293        | 625       |
| Total stockholders' equity   | 81,425     | 43,326    |
| Total liabilities and stockholders' equity   | \$ 110,535 | \$ 94,311 |

See accompanying Notes to Condensed Consolidated Financial Statements.

## NAUTILUS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited and in thousands, except per share amounts)

|   | For the Three Months<br>Ended<br>June 30, |           | For the Six Months<br>Ended<br>June 30, |           |
|---|---|-----------|---|-----------|
|   | 2013                                      | 2012      | 2013                                    | 2012      |
| Net sales   | \$ 36,242                                 | \$ 39,583 | \$ 95,456                               | \$ 90,845 |
| Cost of sales   | 18,913                                    | 22,415    | 47,433                                  | 49,772    |
| Gross profit  | 17,329                                    | 17,168    | 48,023                                  | 41,073    |
| Operating expenses:   |   |           |   |           |
| Selling and marketing   | 13,768                                    | 12,557    | 32,394                                  | 28,623    |
| General and administrative                                    | 3,982                                     | 4,291     | 8,929                                   | 8,301     |
| Research and development                                      | 1,303                                     | 919       | 2,430                                   | 1,919     |
| Total operating expenses                                      | 19,053                                    | 17,767    | 43,753                                  | 38,843    |
| Operating income (loss)                                       | (1,724)                                   | (599)     | 4,270                                   | 2,230     |
| Other income (expense):                                       |   |           |   |           |
| Interest income   |   | 7         | 1                                       | 13        |
| Interest expense  | (6)                                       | (3)       | (15)                                    | 75        |
| Other   | 130                                       | (84)      | 21                                      | (86)      |
| Total other income (expense)                                  | 124                                       | (80)      | 7                                       | 2         |
| Income (loss) from continuing operations before income taxes  | (1,600)                                   | (679)     | 4,277                                   | 2,232     |
| Income tax provision (benefit)                                | (34,268)                                  | (193)     | (33,915)                                | 71        |
| Income (loss) from continuing operations                      | 32,668                                    | (486)     | 38,192                                  | 2,161     |
| Discontinued operation:                                       |   |           |   |           |
| Income (loss) from discontinued operation before income taxes | 113                                       | 237       | (261)                                   | 114       |
| Income tax benefit of discontinued operation                  | (82)                                      | (85)      | (91)                                    | (83)      |
| Income (loss) from discontinued operation                     | 195                                       | 322       | (170)                                   | 197       |
| Net income (loss)   | \$ 32,863                                 | \$ (164)  | \$ 38,022                               | \$ 2,358  |
| Basic income (loss) per share from continuing operations      | \$ 1.05                                   | \$ (0.02) | \$ 1.23                                 | \$ 0.07   |
| Basic income (loss) per share from discontinued operation     | 0.01                                      | 0.01      | (0.01)                                  | 0.01      |
| Basic net income (loss) per share <sup>(1)</sup>              | \$ 1.06                                   | \$ (0.01) | \$ 1.23                                 | \$ 0.08   |
| Diluted income (loss) per share from continuing operations    | \$ 1.04                                   | \$ (0.02) | \$ 1.22                                 | \$ 0.07   |
| Diluted income (loss) per share from discontinued operation   | 0.01                                      | 0.01      | (0.01)                                  | 0.01      |



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|  |    |        |    |        |    |        |    |        |
|--|----|--------|----|--------|----|--------|----|--------|
| Diluted net income (loss) per share    | \$ | 1.05   | \$ | (0.01) | \$ | 1.21   | \$ | 0.08   |
| Shares used in per share calculations: |    |        |    |        |    |        |    |        |
| Basic                                  |    | 31,058 |    | 30,878 |    | 31,003 |    | 30,878 |
| Diluted                                |    | 31,430 |    | 30,878 |    | 31,360 |    | 30,987 |

(1) May not add due to rounding.

See accompanying Notes to Condensed Consolidated Financial Statements.

NAUTILUS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited and in thousands)

|  | For the Three<br>Months Ended<br>June 30, |          | For the Six Months<br>Ended<br>June 30, |          |
|--|---|----------|---|----------|
|  | 2013                                      | 2012     | 2013                                    | 2012     |
| Net income (loss)  | \$ 32,863                                 | \$ (164) | \$ 38,022                               | \$ 2,358 |
| Other comprehensive income (loss):   |   |          |   |          |
| Foreign currency translation, net of income<br>tax expense of \$ 12, \$9, \$21 and \$1 | (185)                                     | (254)    | (332)                                   | (75)     |
| Comprehensive income (loss)  | \$ 32,678                                 | \$ (418) | \$ 37,690                               | \$ 2,283 |

See accompanying Notes to Condensed Consolidated Financial Statements.



## NAUTILUS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in thousands)

|   | For the Six Months<br>Ended<br>June 30, |          |
|---|---|----------|
|   | 2013                                    | 2012     |
| Cash flows from operating activities:   |   |          |
| Income from continuing operations   | \$ 38,192                               | \$ 2,161 |
| Income (loss) from discontinued operation   | (170)                                   | 197      |
| Net income  | 38,022                                  | 2,358    |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |          |
| Depreciation and amortization   | 1,644                                   | 1,528    |
| Bad debt expense (reduction)  | 417                                     | (123)    |
| Stock-based compensation  | 134                                     | 294      |
| Reduction of previously estimated asset disposal loss                             |   | (77)     |
| Loss on asset dispositions  | 4                                       | 14       |
| Deferred income taxes, net of valuation allowance                                 | (34,414)                                | 385      |
| Changes in operating assets and liabilities:                                      |   |          |
| Trade receivables, net  | 13,082                                  | 13,234   |
| Inventories   | 5,426                                   | (993)    |
| Prepaid and other current assets  | 1,377                                   | 1,445    |
| Income taxes  | (34)                                    | (200)    |
| Trade payables  | (16,155)                                | (11,645) |
| Accrued liabilities, including warranty obligations                               | (2,678)                                 | (1,676)  |
| Net cash provided by operating activities   | 6,825                                   | 4,544    |
| Cash flows from investing activities:   |   |          |
| Proceeds from sale of assets of discontinued operation                            | 110                                     | 217      |
| Purchases of software and equipment   | (1,941)                                 | (1,110)  |
| Net cash used in investing activities   | (1,831)                                 | (893)    |
| Cash flows from financing activities:   |   |          |
| Repayment of long-term borrowings   |   | (5,000)  |
| Proceeds from exercise of stock options   | 275                                     | 89       |
| Net cash provided by (used in) financing activities                               | 275                                     | (4,911)  |
| Effect of exchange rate changes on cash and cash equivalents                      | (106)                                   | (36)     |
| Increase (decrease) in cash and cash equivalents                                  | 5,163                                   | (1,296)  |

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|   |    |        |           |
|---|----|--------|-----------|
| Cash and cash equivalents:                        |    |        |           |
| Beginning of period                               |    | 23,207 | 17,427    |
| End of period                                     | \$ | 28,370 | \$ 16,131 |
| Supplemental disclosure of cash flow information: |    |        |           |
| Cash paid for interest                            | \$ | 16     | \$ 524    |
| Cash paid (refunded) for income taxes, net        |    | 188    | (119)     |

See accompanying Notes to Condensed Consolidated Financial Statements.

NAUTILUS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(1) GENERAL INFORMATION

Basis of Consolidation and Presentation

The accompanying condensed consolidated financial statements present the financial position, results of operations and cash flows of Nautilus, Inc. and its subsidiaries, all of which are wholly owned. Intercompany transactions and balances have been eliminated in consolidation.

The accompanying condensed consolidated financial statements have not been audited. We have condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ). Management believes the disclosures contained herein are adequate to make the information presented not misleading. However, these condensed consolidated financial statements should be read in conjunction with our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012 (the 2012 Form 10-K ).

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Further information regarding significant estimates can be found in our 2012 Form 10-K.

In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments necessary to present fairly our financial position as of June 30, 2013 and December 31, 2012 and our results of operations, comprehensive income and cash flows for the three and six months ended June 30, 2013 and 2012. Interim results are not necessarily indicative of results for a full year. Our revenues typically vary seasonally and this seasonality can have a significant effect on operating results, inventory levels and working capital needs.

Unless indicated otherwise, all information regarding our operating results pertain to our continuing operations.

New Accounting Pronouncements

ASU 2012-02

In July 2012, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2012-02, Intangibles Goodwill and Other: Testing Indefinite-Lived Intangible Assets for Impairment, which permits an entity to make a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset, other than goodwill, is impaired. Entities are required to test indefinite-lived intangible assets for impairment at least annually and more frequently if indicators of impairment exist. If an entity concludes, based on an evaluation of all relevant qualitative factors, that it is not more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount, it is not required to perform the quantitative impairment test for that asset. Because the qualitative assessment is optional, an entity is permitted to bypass it for any indefinite-lived intangible asset in any period and apply the quantitative test. ASU 2012-02 also permits the entity to resume performing the qualitative assessment in any subsequent period. ASU 2012-02 is effective for impairment tests performed for fiscal years beginning after September 15, 2012 and early adoption is permitted. The adoption of ASU 2012-02 in January 2013 did not have any impact on our financial position, results of operations or cash flows.

ASU 2013-02

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. Under ASU 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income ( AOCI ) by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those



amounts. The adoption of ASU 2013-02 in January 2013 did not have any impact on our financial position, results of operations or cash flows.

## (2) DISCONTINUED OPERATION

On September 25, 2009, in light of continuing operating losses in our Commercial business and in order to focus exclusively on managing our Direct and Retail businesses, we committed to a plan for the complete divestiture of our Commercial business, which qualified for held-for-sale accounting treatment. The Commercial business is presented as a Discontinued Operation in our Condensed Consolidated Statements of Operations for all periods.

The disposal of the Commercial business assets was completed in April 2011. We reached substantial completion of asset liquidation at December 2012. However, we continue to have minor legal and accounting expenses as we work with authorities on final deregistration of certain European entities. There was no revenue related to the Commercial business for the year ended December 31, 2012 or the six-month period ended June 30, 2013.

The following table summarizes liabilities for exit costs related to the discontinued operation, included in Accrued Liabilities and Other Long-Term Liabilities in our Condensed Consolidated Balance Sheets (in thousands):

|                                 | Facilities<br>Leases |
|---------------------------------|----------------------|
| Balance as of December 31, 2012 | \$ 1,118             |
| Adjustments                     |                      |
| Payments                        | (151)                |
| Balance as of June 30, 2013     | \$ 967               |

We expect the lease obligations to be paid out through 2016.

## (3) INVENTORIES

Inventories are stated at the lower of cost or market, with cost determined based on the first-in, first-out method. We establish inventory allowances for excess, slow-moving and obsolete inventory based on inventory levels, expected product life and forecasted sales. Inventories are written down to market value based on historical demand, competitive factors, changes in technology and product life cycles.

Net Inventories consisted of the following (in thousands):

|                      | June 30,<br>2013 | December 31,<br>2012 |
|----------------------|------------------|----------------------|
| Finished goods       | \$ 11,760        | \$ 17,148            |
| Parts and components | 1,588            | 1,639                |
|                      | \$ 13,348        | \$ 18,787            |

Inventory reserves, primarily related to excess parts inventories, were as follows (in thousands):

|                    | June 30,<br>2013 | December 31,<br>2012 |
|--------------------|------------------|----------------------|
| Inventory reserves | \$ 786           | \$ 1,011             |

## (4) PROPERTY, PLANT AND EQUIPMENT

Property, Plant and Equipment consisted of the following (in thousands):

|                               | Estimated Useful Life<br>(in years) | June 30,<br>2013 | December 31,<br>2012 |
|-------------------------------|-------------------------------------|------------------|----------------------|
| Leasehold improvements        | 5 to 20                             | \$ 2,852         | \$ 2,863             |
| Computer equipment            | 3 to 5                              | 36,386           | 36,107               |
| Machinery and equipment       | 3 to 5                              | 5,407            | 5,359                |
| Furniture and fixtures        | 5                                   | 672              | 870                  |
| Work in progress <sup>1</sup> | N/A                                 | 3,576            | 2,080                |
|                               |                                     | 48,893           | 47,279               |
| Accumulated depreciation      |                                     | (41,391)         | (41,141)             |
|                               |                                     | \$ 7,502         | \$ 6,138             |

<sup>1</sup> Work in progress includes internal use software development and production tooling construction in progress.

## (5) GOODWILL AND OTHER INTANGIBLE ASSETS

## Goodwill

The rollforward of Goodwill was as follows (in thousands):

|                                   |          |
|-----------------------------------|----------|
| Balance as of December 31, 2011   | \$ 2,873 |
| Currency exchange rate adjustment | 67       |
| Balance as of December 31, 2012   | 2,940    |
| Currency exchange rate adjustment | (156)    |
| Balance as of June 30, 2013       | \$ 2,784 |

## Other Intangible Assets

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Other Intangible Assets consisted of the following (in thousands):

|                                    | Estimated<br>Useful<br>Life<br>(in years) | June 30,<br>2013 | December 31,<br>2012 |
|------------------------------------|---|------------------|----------------------|
| Indefinite-lived trademarks        | N/A                                       | \$ 9,052         | \$ 9,052             |
| Patents                            | 8 to 16                                   | 18,154           | 18,154               |
|                                    |   | 27,206           | 27,206               |
| Accumulated amortization - patents |   | (13,565)         | (12,540)             |
|                                    |   | \$ 13,641        | \$ 14,666            |

Amortization expense was as follows (in thousands):

|                     | Three<br>Months<br>Ended<br>June 30,<br>2013 | 2012   | Six Months<br>Ended<br>June 30,<br>2013 | 2012    |
|---------------------|--|--------|---|---------|
| Patent amortization | \$ 512                                       | \$ 512 | \$1,025                                 | \$1,025 |

Future amortization of patents is as follows (in thousands):

|                   |         |
|-------------------|---------|
| Remainder of 2013 | \$1,025 |
| 2014              | 2,040   |
| 2015              | 828     |
| 2016              | 430     |
| 2017              | 143     |
| Thereafter        | 123     |
|                   | \$4,589 |



## (6) ACCRUED LIABILITIES

Accrued Liabilities consisted of the following (in thousands):

|                                       | June 30,<br>2013 | December 31,<br>2012 |
|---------------------------------------|------------------|----------------------|
| Exit costs of discontinued operations | \$ 309           | \$ 340               |
| Payroll and related liabilities       | 2,119            | 3,327                |
| Royalties                             | 669              | 1,063                |
| Legal and professional fees           | 420              | 834                  |
| Other                                 | 2,181            | 2,607                |
|                                       | \$ 5,698         | \$ 8,171             |

## (7) PRODUCT WARRANTIES

Our products carry limited, defined warranties for defects in materials or workmanship which, according to their terms, generally obligate us to pay the costs of supplying and shipping replacement parts to customers and, in certain instances, pay for labor and other costs to service products. Outstanding product warranty periods range from sixty days to, in limited circumstances, the lifetime of certain product components. We record a liability at the time of sale for the estimated costs of fulfilling future warranty claims. If necessary, we adjust the liability for specific warranty-related matters when they become known and are reasonably estimable. Estimated warranty expense is included in Cost of Sales, based on historical warranty claim experience and available product quality data. Warranty expense is affected by the performance of new products, significant manufacturing or design defects not discovered until after the product is delivered to the customer, product failure rates, and higher or lower than expected repair costs. If warranty expense differs from previous estimates, or if circumstances change such that the assumptions inherent in previous estimates are no longer valid, the amount of product Warranty Obligations is adjusted accordingly.

Changes in our product Warranty Obligations were as follows (in thousands):

|                                       | Six Months<br>Ended June 30, |          |
|---------------------------------------|------------------------------|----------|
|                                       | 2013                         | 2012     |
| Warranty accrual, beginning of period | \$ 2,492                     | \$ 2,017 |

|                                 |          |          |
|---------------------------------|----------|----------|
| Reductions for warranty charges | (862)    | (968)    |
| Adjustments                     | (186)    | (171)    |
| Additions to warranty reserve   | 718      | 1,275    |
| Warranty accrual, end of period | \$ 2,162 | \$ 2,153 |

Total outstanding obligations of our former Commercial business included in product Warranty Obligations were \$0.1 million and \$0.4 million, respectively, as of June 30, 2013 and December 31, 2012.

#### (8) INCOME TAX PROVISION (BENEFIT)

In the second quarter of 2013, we evaluated the potential realization of our Deferred Income Tax Assets, considering both positive and negative evidence, including cumulative income or loss for the past three years and forecasted taxable income. As a result of this evaluation we concluded that, as of June 30, 2013, a majority of the existing valuation allowance on our domestic Deferred Income Tax Assets was no longer required. Accordingly, an income tax benefit of \$35.8 million was recorded during the six-month period ended June 30, 2013 related to the reduction of our existing valuation allowance.

Evaluating the need for, and amount of, a valuation allowance for deferred tax assets often requires significant judgment and extensive analysis of all available evidence on a jurisdiction-by-jurisdiction basis. Such judgments require us to interpret existing tax law and other published guidance as applied to our circumstances. As part of this assessment, we consider both positive and negative evidence. The weight given to the potential effect of positive and negative evidence must be commensurate with the extent to which the strength of the evidence can be objectively verified. We generally consider the following, but are not limited to, objectively verified evidence to determine the likelihood of realization of the deferred tax assets:

Our current financial position and our historical results of operations for recent years. We generally consider cumulative pre-tax losses in the three-year period ending with the current quarter to be significant

negative evidence regarding our future profitability. A pattern of objectively-measured recent financial reporting losses is heavily weighted as a source of negative evidence. Further, we also consider the historical and current financial trends in the recent years.

Sources of taxable income of the appropriate character. Future realization of deferred tax assets is dependent on projected taxable income of the appropriate character from our continuing operations. Future reversals of existing temporary differences are heavily-weighted sources of objectively verifiable positive evidence. Projections of future taxable income exclusive of reversing temporary differences are a source of positive evidence only when the projections are combined with a history of recent profits and current financial trends and can be reasonably estimated.

Carry-back and carry-forward periods available. The long carry-back and carry-forward periods permitted under the tax law are objectively verified positive evidence.

Tax planning strategies. Tax planning strategies can be, depending on their nature, heavily weighted sources of objectively verifiable positive evidence when the strategies are available and can be reasonably executed. We consider tax planning strategies only if they are feasible and justifiable considering our current operations and our strategic plan. Tax planning strategies, if executed, may accelerate the recovery of a deferred tax asset so the tax benefit of the deferred tax asset can be carried back.

During 2008, we determined that it was no longer more likely than not that the tax benefits from the existing U.S. deferred tax assets would be realized due to the substantial amount of the cumulative accounting losses realized in the recent years in the U.S. and the large taxable losses incurred in the U.S. in 2007 and 2008. Accordingly, we established a full valuation allowance against our U.S. net deferred tax assets in 2008.

Each quarter, we assess the total weight of positive and negative evidence and re-evaluate whether any adjustments or release of all or any portion of valuation allowance is appropriate. In our assessment during the second quarter of 2013, we heavily weighted the positive evidence of 1) cumulative profits realized in recent years combined with the upward financial trends of current periods; and 2) future realization of the existing U.S. deferred tax assets. Given our recent improved financial performance, which includes a sustained cumulative accounting profit through 2013, we are projecting a positive forecasted taxable income in 2013 in the U.S. Accordingly, based on our review of the objective evidence and our detailed analysis during the second quarter of 2013, we determined that a portion of our U.S. domestic valuation allowance was no longer required.

The remaining valuation allowance at June 30, 2013 relates to certain domestic loss carryforwards and other credits that we may not be able to utilize primarily due to their shorter remaining carryforward periods. Should it be determined in the future that it is more likely than not that our Deferred Income Tax Assets will be realized, an additional valuation allowance would be released during the period in which such an assessment is made.

Further, there have been no material changes to our foreign operations since December 31, 2012 and, accordingly, we maintained our existing valuation allowance on foreign Deferred Income Tax Assets in such jurisdictions at June 30,



2013.

## (9) INCOME (LOSS) PER SHARE

Basic Income (Loss) Per Share was computed using the weighted average number of common shares outstanding. For the computation of Diluted Income (Loss) Per Share, the number of basic weighted average shares outstanding was increased by dilutive potential common shares related to stock-based awards, as determined by the treasury stock method.

The weighted average numbers of shares outstanding used to compute Income (Loss) Per Share were as follows (in thousands):

|  | Three Months<br>Ended<br>June 30, |        | Six Months<br>Ended<br>June 30, |        |
|--|-----------------------------------|--------|---------------------------------|--------|
|  | 2013                              | 2012   | 2013                            | 2012   |
| Shares used to calculate basic income (loss) per share             | 31,058                            | 30,878 | 31,003                          | 30,878 |
| Dilutive effect of outstanding options and performance stock units | 372                               |        | 357                             | 109    |
| Shares used to calculate diluted income (loss) per share           | 31,430                            | 30,878 | 31,360                          | 30,987 |

The weighted average numbers of shares outstanding listed in the table below were anti-dilutive and excluded from the computation of Diluted Income (Loss) Per Share, primarily because the average market price did not exceed the exercise price. These shares may be dilutive potential common shares in the future (in thousands):

|                         | Three<br>Months<br>Ended<br>June 30, |       | Six Months<br>Ended<br>June 30, |       |
|-------------------------|--------------------------------------|-------|---------------------------------|-------|
|                         | 2013                                 | 2012  | 2013                            | 2012  |
| Stock options           | 307                                  | 1,126 | 306                             | 1,046 |
| Performance stock units | 75                                   | 197   | 88                              | 49    |

#### (10) SEGMENT INFORMATION

We have two reportable segments Direct and Retail. Contribution is the measure of profit or loss, defined as net sales less product costs and directly attributable expenses. Directly attributable expenses include Selling and Marketing expenses, General and Administrative expenses, and Research and Development expenses that are directly related to segment operations. Segment assets are those directly assigned to an operating segment's operations, primarily Accounts Receivable, Inventories and Intangible Assets. Unallocated assets primarily include shared information technology infrastructure, distribution centers, corporate headquarters, Prepaids and Other Current Assets, Deferred Income Tax Assets and Other Assets. Capital expenditures directly attributable to the Direct and Retail segments were not significant in any period.

Following is summary information by reportable segment (in thousands):

|                            | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|----------------------------|--------------------------------|-----------|------------------------------|-----------|
|                            | 2013                           | 2012      | 2013                         | 2012      |
| Net sales:                 |                                |           |                              |           |
| Direct                     | \$ 25,314                      | \$ 24,707 | \$ 67,949                    | \$ 58,441 |
| Retail                     | 10,175                         | 14,030    | 25,309                       | 30,669    |
| Unallocated royalty income | 753                            | 846       | 2,198                        | 1,735     |
| Consolidated net sales     | \$ 36,242                      | \$ 39,583 | \$ 95,456                    | \$ 90,845 |
| Contribution:              |                                |           |                              |           |
| Direct                     | \$ 508                         | \$ 993    | \$ 7,217                     | \$ 4,021  |

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|                            |          |          |           |          |
|----------------------------|----------|----------|-----------|----------|
| Retail                     | 140      | 1,088    | 2,100     | 3,355    |
| Unallocated royalty income | 753      | 846      | 2,198     | 1,735    |
| Consolidated contribution  | \$ 1,401 | \$ 2,927 | \$ 11,515 | \$ 9,111 |

Reconciliation of consolidated contribution to income

|   |           |          |           |          |
|---|-----------|----------|-----------|----------|
| (loss) from continuing operations:              |           |          |           |          |
| Consolidated contribution                       | \$ 1,401  | \$ 2,927 | \$ 11,515 | \$ 9,111 |
| Less expenses not directly related to segments: |           |          |           |          |
| Operating expenses                              | (3,125)   | (3,526)  | (7,245)   | (6,881)  |
| Other income (expense), net                     | 124       | (80)     | 7         | 2        |
| Income tax (expense) benefit                    | 34,268    | 193      | 33,915    | (71)     |
| Income (loss) from continuing operations        | \$ 32,668 | \$ (486) | \$ 38,192 | \$ 2,161 |

There was no material change in the allocation of assets by segment during the first six months of 2013 and, accordingly, assets by segment are not presented.

## (11) COMMITMENTS AND CONTINGENCIES

### Guarantees, Commitments and Off-Balance Sheet Arrangements

As of June 30, 2013, we had approximately \$0.6 million in standby letters of credit with certain vendors with expiration dates through March 2014.

We have long lead times for inventory purchases and, therefore, must secure factory capacity from our vendors in advance. As of June 30, 2013, we had approximately \$10.0 million in non-cancelable market-based purchase obligations, primarily for inventory purchases expected to be received within the next twelve months. Purchase obligations can vary from quarter to quarter and versus the same period in prior years due to a number of factors, including the amount of products that are shipped directly to Retail customer warehouses versus through Nautilus warehouses.

In the ordinary course of business, we enter into agreements that require us to indemnify counterparties against third-party claims. These may include: agreements with vendors and suppliers, under which we may indemnify them against claims arising from use of their products or services; agreements with customers, under which we may indemnify them against claims arising from their use or sale of our products; real estate and equipment leases, under which we may indemnify lessors against third-party claims relating to the use of their property; agreements with licensees or licensors, under which we may indemnify the licensee or licensor against claims arising from their use of our intellectual property or our use of their intellectual property; and agreements with parties to debt arrangements, under which we may indemnify them against claims relating to their participation in the transactions.

The nature and terms of these indemnification obligations vary from contract to contract, and generally a maximum obligation is not stated within the agreements. We hold insurance policies that mitigate potential losses arising from certain types of indemnification obligations. Management does not deem these obligations to be significant to our financial position, results of operations or cash flows and, therefore, no related liabilities were recorded as of June 30, 2013.

### Guarantees, Commitments and Contingencies of Discontinued Operation

We retained certain warranty obligations in connection with our discontinued Commercial operation and remain contingently liable for certain product warranty obligations which were assumed by buyers of our Commercial business product lines to the extent a buyer fails to fulfill its assumed obligations. Uncertainties exist with respect to these warranty obligations, as units previously sold to customers approach end-of-life and settlements are reached with certain customers in connection with our exit from our discontinued Commercial operation. As of June 30, 2013, our Warranty Obligations included \$0.1 million for estimated future warranty costs of the discontinued Commercial operation.

Legal and Tax Matters

We are party to various legal proceedings arising from normal course of business activities. In addition, our tax filings are subject to audit by authorities in the jurisdictions where we conduct business, which may result in assessments of additional taxes. Management believes it has adequately provided for obligations that would result from these legal and tax proceedings. Management believes that the ultimate resolution of these matters will not have a material effect on our financial position, results of operations or cash flows.

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

The following discussion and analysis is based upon our financial statements as of the dates and for the periods presented in this section. You should read this discussion and analysis in conjunction with the financial statements and notes thereto found in Part I, Item 1 of this Form 10-Q and our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012 (the 2012 Form 10-K ). All references to the second quarter and first six months of 2013 and 2012 mean the three and six-month periods ended June 30, 2013 and 2012, respectively. Unless the context otherwise requires, Nautilus, we, us and our refer to Nautilus, Inc. and its subsidiaries. Unless indicated otherwise, all information regarding our operating results pertains to our continuing operations.

Our results of operations may vary significantly from period-to-period. Our revenues typically fluctuate due to the seasonality of our industry, customer buying patterns, product innovation, the nature and level of competition for health and fitness products, our ability to procure products to meet customer demand, the level of spending on, and effectiveness of, our media and advertising programs and our ability to attract new customers and maintain existing sales relationships. In addition, our revenues are highly susceptible to economic factors, including, among other things, the overall condition of the economy and the availability of consumer credit in both the United States and Canada. Our profit margins may vary in response to the aforementioned factors and our ability to manage product costs. Profit margins may also be affected by fluctuations in the costs or availability of materials used to manufacture our products, product warranty costs, the cost of fuel, and changes in costs of other distribution or manufacturing-related services. Our operating profits or losses may also be affected by the efficiency and effectiveness of our organization. Historically, our operating expenses have been influenced by media costs to produce and air television advertisements of our products, facility costs, operating costs of our information and communications systems, product supply chain management, customer support and new product development activities. In addition, our operating expenses have been affected from time-to-time by asset impairment charges, restructuring charges and other significant unusual or infrequent expenses.

As a result of the above and other factors, our period-to-period operating results may not be indicative of future performance. You should not place undue reliance on our operating results and should consider our prospects in light of the risks, expenses and difficulties typically encountered by us and other companies, both within and outside our industry. We may not be able to successfully address these risks and difficulties and, consequently, we cannot assure you any future growth or profitability. For more information, see our discussion of Risk Factors located at Part I, Item 1A of our 2012 Form 10-K.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as plan, expect, aim, believe, project, intend, estimate, will, and other terms of similar meaning typically identify forward-looking statements. The forward-looking statements in

this report include, without limitation: our prospects, resources or capabilities; current or future financial trends; future operating results; future plans for introduction of new products; anticipated demand for our new and existing products; maintenance of appropriate inventory levels; growth in revenues and profits; leverage of operating expenses; future revenues from our licensing initiative; results of increased media investment in the Direct segment; continued improvement in operating margins; anticipated consumer credit financing approval rates for the remainder of 2013; expectations for increased Research and Development expenses; the amount expected to be spent on software and equipment in 2013; fluctuations in Net sales due to seasonality; and our ability to continue to fund our operating and capital needs for the following twelve-month period. Forward-looking statements also include any statements related to our expectations regarding future business and financial performance or conditions, anticipated sales growth across markets, distribution channels and product categories, expenses and gross margins, profits or losses, losses from discontinued operation, settlements of warranty obligations, new product introductions, financing and working capital requirements and resources. These forward-looking statements, and others we make from time-to-time, are subject to a number of risks and uncertainties. Many factors could cause actual results to differ materially from those projected in forward-looking statements, including the risks described in Part I, Item 1A, Risk Factors, in our 2012 Form 10-K as supplemented or modified in our quarterly reports on Form 10-Q. We do not undertake any duty to update forward-looking statements after the date they are made or to conform them to actual results or to changes in circumstances or expectations.

## Available Information

We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, available free of charge on our website, [www.nautilusinc.com](http://www.nautilusinc.com). In addition, our Code of Business Conduct and Ethics, corporate governance policies, and the charters of our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee are available on our website. The information presented on our website is not part of this report.

## Overview

We are committed to providing innovative, quality solutions to help people achieve a fit and healthy lifestyle. Our principal business activities include designing, developing, sourcing and marketing high-quality cardio and strength fitness products and related accessories for consumer use, primarily in the United States and Canada. Our products are sold under some of the most-recognized brand names in the fitness industry: Nautilus<sup>®</sup>, Bowflex<sup>®</sup>, Schwinn<sup>®</sup>, Schwinn Fitness and Univers<sup>®</sup>.

We market our products through two distinct distribution channels, Direct and Retail, which we consider to be separate business segments. Our Direct business offers products directly to consumers through television advertising, catalogs and the Internet. Our Retail business offers our products through a network of independent retail companies with stores and websites located in the United States and internationally. We also derive a portion of our revenue from the licensing of our brands and intellectual property.

Net sales for the first six months of 2013 were \$95.5 million, an increase of \$4.6 million, or 5.1%, as compared to net sales of \$90.8 million for the first six months of 2012. Net sales of our Direct segment for the first six months of 2013 rose \$9.5 million, or 16.3%, compared to the first six months of 2012, primarily due to increased consumer demand for our new products, including the Bowflex<sup>®</sup> UpperCut and CoreBody Reformer<sup>®</sup>, and for our cardio products, especially the Bowflex<sup>®</sup> TreadClimber<sup>®</sup>. Net sales of our Retail segment for the first six months of 2013 declined by \$5.4 million, or 17.5%, compared to the first six months of 2012. The year-over-year decline in Retail net sales reflects lower sales of certain cardio products, including indoor bikes and ellipticals, during the 2013 period, as well as comparatively higher sales in the prior period as our customers' typical buying patterns shifted into the second quarter last year from the third and fourth quarters due to pricing increases that were implemented mid-year 2012.

Income from continuing operations was \$38.2 million for the first six months of 2013, or \$1.22 per diluted share, compared to income from continuing operations of \$2.2 million, or \$0.07 per diluted share, for the first six months of 2012. The \$38.2 million in the first six months of 2013 included a \$35.8 million credit related to the reversal of our deferred tax asset valuation allowance.



Net income for the first six months of 2013 was \$38.0 million, compared to net income of \$2.4 million for the first six months of 2012. Net income per diluted share was \$1.21 for the first six months of 2013, compared to \$0.08 per diluted share for the first six months of 2012.

In addition to the reversal of our deferred tax asset valuation allowance, the improvement in our results of continuing operations for the first six months of 2013 was driven primarily by strong demand and higher sales in our Direct channel and a 510 basis point overall improvement in our gross margin over the same period of last year. The increase in gross margin was attributable to increases in both the Direct and Retail businesses, as well as increased royalty income.

#### Discontinued Operation

Results from discontinued operation relate to the disposal of our former Commercial business, which was completed in April 2011. We reached substantial completion of asset liquidation at December 2012. However, we continue to have minor legal and accounting expenses as we work with authorities on final deregistration of each entity.

## Results of Operations

Results of operations information was as follows (dollars in thousands):

|   | For the Three Months |           | Change   |          |
|---|----------------------|-----------|----------|----------|
|   | Ended June 30,       |           |          |          |
|   | 2013                 | 2012      | \$       | %        |
| Net sales   | \$ 36,242            | \$ 39,583 | (3,341)  | (8.4)%   |
| Cost of sales                                       | 18,913               | 22,415    | (3,502)  | (15.6)%  |
| Gross profit  | 17,329               | 17,168    | 161      | 0.9%     |
| Operating expenses:                                 |                      |           |          |          |
| Selling and marketing                               | 13,768               | 12,557    | 1,211    | 9.6%     |
| General and administrative                          | 3,982                | 4,291     | (309)    | (7.2)%   |
| Research and development                            | 1,303                | 919       | 384      | 41.8%    |
| Total operating expenses                            | 19,053               | 17,767    | 1,286    | 7.2%     |
| Operating loss                                      | (1,724)              | (599)     | (1,125)  | (187.8)% |
| Other income (expense):                             |                      |           |          |          |
| Interest income                                     |                      | 7         | (7)      |          |
| Interest expense                                    | (6)                  | (3)       | (3)      |          |
| Other   | 130                  | (84)      | 214      |          |
| Total other income (expense), net                   | 124                  | (80)      | 204      |          |
| Loss from continuing operations before income taxes | (1,600)              | (679)     | (921)    |          |
| Income tax benefit                                  | (34,268)             | (193)     | (34,075) |          |
| Income (loss) from continuing operations            | 32,668               | (486)     | 33,154   |          |
| Income from discontinued operations, net of tax     | 195                  | 322       | (127)    |          |
| Net income (loss)                                   | \$ 32,863            | \$(164)   | 33,027   |          |

|                            | For the Six Months |           | Change   |        |
|----------------------------|--------------------|-----------|----------|--------|
|                            | Ended June 30,     |           |          |        |
|                            | 2013               | 2012      | \$       | %      |
| Net sales                  | \$ 95,456          | \$ 90,845 | \$ 4,611 | 5.1%   |
| Cost of sales              | 47,433             | 49,772    | (2,339)  | (4.7)% |
| Gross profit               | 48,023             | 41,073    | 6,950    | 16.9%  |
| Operating expenses:        |                    |           |          |        |
| Selling and marketing      | 32,394             | 28,623    | 3,771    | 13.2%  |
| General and administrative | 8,929              | 8,301     | 628      | 7.6%   |
| Research and development   | 2,430              | 1,919     | 511      | 26.6%  |
| Total operating expenses   | 43,753             | 38,843    | 4,910    | 12.6%  |
| Operating income           | 4,270              | 2,230     | 2,040    | 91.5%  |
| Other income (expense):    |                    |           |          |        |
| Interest income            | 1                  | 13        | (12)     |        |

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|  |           |          |           |
|--|-----------|----------|-----------|
| Interest expense                                       | (15)      | 75       | (90)      |
| Other  | 21        | (86)     | 107       |
| Total other income (expense), net                      | 7         | 2        | 5         |
| Income from continuing operations before income taxes  | 4,277     | 2,232    | 2,045     |
| Income tax provision (benefit)                         | (33,915)  | 71       | (33,986)  |
| Income from continuing operations                      | 38,192    | 2,161    | 36,031    |
| Income (loss) from discontinued operations, net of tax | (170)     | 197      | (367)     |
| Net income   | \$ 38,022 | \$ 2,358 | \$ 35,664 |

Results of operations information by segment was as follows (dollars in thousands):

|                | For the Three Months<br>Ended June 30, |           | Change                    |         |
|----------------|--|-----------|---------------------------|---------|
|                | 2013                                   | 2012      | \$                        | %       |
| Net sales:     |  |           |                           |         |
| Direct         | \$ 25,314                              | \$ 24,707 | \$ 607                    | 2.5%    |
| Retail         | 10,175                                 | 14,030    | (3,855)                   | (27.5)% |
| Royalty income | 753                                    | 846       | (93)                      | (11.0)% |
|                | \$ 36,242                              | \$ 39,583 | \$ (3,341)                | (8.4)%  |
| Cost of sales: |  |           |                           |         |
| Direct         | \$ 10,721                              | \$ 11,084 | \$ (363)                  | (3.3)%  |
| Retail         | 8,192                                  | 11,331    | (3,139)                   | (27.7)% |
| Royalty income |  |           |                           |         |
|                | \$ 18,913                              | \$ 22,415 | \$ (3,502)                | (15.6)% |
| Gross profit:  |  |           |                           |         |
| Direct         | \$ 14,593                              | \$ 13,623 | \$ 970                    | 7.1%    |
| Retail         | 1,983                                  | 2,699     | (716)                     | (26.5)% |
| Royalty income | 753                                    | 846       | (93)                      | (11.0)% |
|                | \$ 17,329                              | \$ 17,168 | \$ 161                    | 0.9%    |
| Gross margin:  |  |           |                           |         |
| Direct         | 57.6%                                  | 55.1%     | 250 basis point<br>change |         |
| Retail         | 19.5%                                  | 19.2%     | 30 basis point<br>change  |         |

|                | For the Six Months<br>Ended June 30, |           | Change   |         |
|----------------|--------------------------------------|-----------|----------|---------|
|                | 2013                                 | 2012      | \$       | %       |
| Net sales:     |                                      |           |          |         |
| Direct         | \$ 67,949                            | \$ 58,441 | \$ 9,508 | 16.3%   |
| Retail         | 25,309                               | 30,669    | (5,360)  | (17.5)% |
| Royalty income | 2,198                                | 1,735     | 463      | 26.7%   |
|                | \$ 95,456                            | \$ 90,845 | \$ 4,611 | 5.1%    |
| Cost of sales: |                                      |           |          |         |
| Direct         | \$ 27,879                            | \$ 25,754 | \$ 2,125 | 8.3%    |

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|                |           |           |            |         |
|----------------|-----------|-----------|------------|---------|
| Retail         | 19,554    | 24,018    | (4,464)    | (18.6)% |
| Royalty income |           |           |            |         |
|                | \$ 47,433 | \$ 49,772 | \$ (2,339) | (4.7)%  |

Gross profit:

|                |           |           |          |         |
|----------------|-----------|-----------|----------|---------|
| Direct         | \$ 40,070 | \$ 32,687 | \$ 7,383 | 22.6%   |
| Retail         | 5,755     | 6,651     | (896)    | (13.5)% |
| Royalty income | 2,198     | 1,735     | 463      | 26.7%   |
|                | \$ 48,023 | \$ 41,073 | \$ 6,950 | 16.9%   |

Gross margin:

|        |       |       |                           |
|--------|-------|-------|---------------------------|
| Direct | 59.0% | 55.9% | 310 basis point<br>change |
| Retail | 22.7% | 21.7% | 100 basis point<br>change |

The following tables compare the net sales of our major product lines within each business segment (dollars in thousands):

|                                  | For the Three<br>Months |           | Change     |         |
|----------------------------------|-------------------------|-----------|------------|---------|
|                                  | Ended June 30,<br>2013  | 2012      | \$         | %       |
| Direct net sales:                |                         |           |            |         |
| Cardio products <sup>(1)</sup>   | \$ 20,461               | \$ 19,466 | \$ 995     | 5.1%    |
| Strength products <sup>(2)</sup> | 4,853                   | 5,241     | (388)      | (7.4)%  |
|                                  | 25,314                  | 24,707    | 607        | 2.5%    |
| Retail net sales:                |                         |           |            |         |
| Cardio products <sup>(1)</sup>   | 3,447                   | 7,101     | (3,654)    | (51.5)% |
| Strength products <sup>(2)</sup> | 6,728                   | 6,929     | (201)      | (2.9)%  |
|                                  | 10,175                  | 14,030    | (3,855)    | (27.5)% |
| Royalty income                   | 753                     | 846       | (93)       | (11.0)% |
|                                  | \$ 36,242               | \$ 39,583 | \$ (3,341) | (8.4)%  |

|                                  | For the Six<br>Months  |           | Change    |         |
|----------------------------------|------------------------|-----------|-----------|---------|
|                                  | Ended June 30,<br>2013 | 2012      | \$        | %       |
| Direct net sales:                |                        |           |           |         |
| Cardio products <sup>(1)</sup>   | \$ 56,104              | \$ 45,942 | \$ 10,162 | 22.1%   |
| Strength products <sup>(2)</sup> | 11,845                 | 12,499    | (654)     | (5.2)%  |
|                                  | 67,949                 | 58,441    | 9,508     | 16.3%   |
| Retail net sales:                |                        |           |           |         |
| Cardio products <sup>(1)</sup>   | 10,345                 | 17,566    | (7,221)   | (41.1)% |
| Strength products <sup>(2)</sup> | 14,964                 | 13,103    | 1,861     | 14.2%   |
|                                  | 25,309                 | 30,669    | (5,360)   | (17.5)% |
| Royalty income                   | 2,198                  | 1,735     | 463       | 26.7%   |
|                                  | \$ 95,456              | \$ 90,845 | \$ 4,611  | 5.1%    |

(1) Cardio products include: TreadClimbers, treadmills, exercise bikes, ellipticals, CoreBody Reformer® and DVDs.

(2) Strength products include: home gyms, selectorized dumbbells, kettlebell weights, UpperCut and accessories.

Direct

The 2.5% and 16.3% increases, respectively, in Direct Net Sales in the three and six-month periods of 2013 compared to the same periods of 2012 were primarily related to increased consumer demand for our new products, including the Bowflex® UpperCut™ and CoreBody Reformer®, and for our cardio products, especially the Bowflex® TreadClimber®, which we believe was driven by increased advertising effectiveness, improved call center effectiveness and higher U.S. consumer credit approval rates.

Combined consumer credit approvals by our primary and secondary U.S. third-party financing providers increased to 34% and 35%, respectively, in the three and six-month periods of 2013 from 30% in both of the corresponding periods of 2012. We expect U.S. consumer credit financing approval rates during the remainder of 2013 to remain in the 30-35% range.

The increases in Direct Net Sales of cardio products in the three and six-month periods of 2013 compared to the same periods of 2012 were partially offset by 7.4% and 5.2% declines, respectively, in Direct Net Sales of strength products, primarily rod-based home gyms. The declines in sales of rod-based home gyms were attributable, in part, to the reduction of advertising for these products, as management determined that television ad spending on this mature product category was generating suboptimal returns. We continue to market and sell rod-based home gyms through more cost efficient online media.

The increases in Cost of Sales of our Direct business were almost entirely related to the growth in Direct Net Sales and were partially offset by the improvements in gross margin.

The 250 and 310 basis point increases in the gross margin of our Direct business for the three and six-month periods of 2013 compared to the same periods of 2012, respectively, were primarily due to greater absorption of fixed supply chain costs due to higher sales volume.

## Retail

The 27.5% and 17.5% decreases, respectively, in Retail Net Sales in the three and six-month periods of 2013 compared to the same periods of 2012 were primarily due to 51.5% and 41.1% declines, respectively, in cardio sales, primarily indoor bikes and ellipticals. The decline in the six-month period was partially offset by the 14.2% increase in Retail Net Sales of strength products, which was primarily due to higher sales of selectorized dumbbells. Retail segment sales in the second quarter of 2012 benefitted from some Retail customers accelerating a portion of their purchases into the second quarter compared to their typical buying patterns as a result of pricing increases that took effect mid-year 2012. In addition, the overall retail environment for fitness equipment remained soft in the second quarter of fiscal 2013.

The declines in Retail Cost of Sales for the three and six-month periods of 2013 were almost entirely due to the declines in Retail Net Sales, and were partially offset by the improvements in Retail gross margin.

The 30 and 100 basis point improvements, respectively, in Retail gross margin were primarily due to the positive impact of retail pricing strategies implemented in the third quarter of 2012.

## Selling and Marketing

| Dollars in thousands  | Three Months   |           | Change   |      |
|-----------------------|----------------|-----------|----------|------|
|                       | Ended June 30, |           | \$       | %    |
|                       | 2013           | 2012      |          |      |
| Selling and Marketing | \$ 13,768      | \$ 12,557 | \$ 1,211 | 9.6% |
| As % of Net Sales     | 38.0%          | 31.7%     |          |      |

| Dollars in thousands  | Six Months     |           | Change   |       |
|-----------------------|----------------|-----------|----------|-------|
|                       | Ended June 30, |           | \$       | %     |
|                       | 2013           | 2012      |          |       |
| Selling and Marketing | \$ 32,394      | \$ 28,623 | \$ 3,771 | 13.2% |
| As % of Net Sales     | 33.9%          | 31.5%     |          |       |

The increases in Selling and Marketing were primarily due to increases in media advertising, which also contributed to the improvement in Net Sales in the six-month period ended June 30, 2013 compared to the same period of 2012. In addition, the six-month period was also affected by a \$0.6 million increase in finance fees related to increased Net Sales.



Media advertising expense of our Direct business is the largest component of Selling and Marketing and was as follows:

| Dollars in thousands | Three Months Ended |          | Change |       |
|----------------------|--------------------|----------|--------|-------|
|                      | June 30,           |          |        |       |
|                      | 2013               | 2012     | \$     | %     |
| Media advertising    | \$ 7,310           | \$ 6,416 | \$ 894 | 13.9% |

| Dollars in thousands | Six Months Ended |           | Change   |       |
|----------------------|------------------|-----------|----------|-------|
|                      | June 30,         |           |          |       |
|                      | 2013             | 2012      | \$       | %     |
| Media advertising    | \$ 17,274        | \$ 15,121 | \$ 2,153 | 14.2% |

We made strategic increases in media advertising investment in the three and six-month periods of 2013 to further support the launch of UpperCut and to begin building sales leads for all Direct products in the second half of 2013.

## General and Administrative

| Dollars in thousands       | Three Months Ended June 30, |          | Change   |        |
|----------------------------|-----------------------------|----------|----------|--------|
|                            | 2013                        | 2012     | \$       | %      |
| General and Administrative | \$ 3,982                    | \$ 4,291 | \$ (309) | (7.2)% |
| As                         | 11.0%                       | 10.8%    |          |        |

| Dollars in thousands       | Six Months Ended June 30, |          | Change |      |
|----------------------------|---------------------------|----------|--------|------|
|                            | 2013                      | 2012     | \$     | %    |
| General and Administrative | \$ 8,929                  | \$ 8,301 | \$ 628 | 7.6% |
| As                         | 9.4%                      | 9.1%     |        |      |

The decrease in General and Administrative in the three-month period ended June 30, 2013 was primarily due to approximately \$0.3 million of one-time lease write-offs in the second quarter of 2012. In the six-month period of 2013, this decrease was offset by an approximately \$0.3 million increase in infrastructure costs and a \$0.4 million increase in employee related costs. The increase as a percentage of Net Sales in the three-month period ended June 30, 2013 compared to the same period of the prior year was primarily due to lower Net Sales. The increase as a percentage of Net Sales in the six-month period ended June 30, 2013 compared to the same period of 2012 was primarily due to one-time negative anomalies in the first quarter of 2013 and one-time positive anomalies in the same period last year, generally related to personnel changes.

## Research and Development

| Dollars in thousands     | Three Months Ended June 30, |        | Change |       |
|--------------------------|-----------------------------|--------|--------|-------|
|                          | 2013                        | 2012   | \$     | %     |
| Research and Development | \$ 1,303                    | \$ 919 | \$ 384 | 41.8% |
| As                       | 3.6%                        | 2.3%   |        |       |

| Dollars in thousands     | Six Months Ended June 30, |          | Change |       |
|--------------------------|---------------------------|----------|--------|-------|
|                          | 2013                      | 2012     | \$     | %     |
| Research and Development | \$ 2,430                  | \$ 1,919 | \$ 511 | 26.6% |
| As                       | 2.5%                      | 2.1%     |        |       |

The increases in Research and Development were primarily due to our continued investment in new products. We expect Research and Development expense to increase for the full year 2013, compared to 2012, as we continue to invest in new product development and resource capabilities.

#### Interest Expense

Negative Interest Expense of \$0.1 million in the first six months of 2012 arose from the early repayment in March 2012 of our Increasing-Rate Senior Discount Notes. Early repayment of the notes resulted in a lower average effective interest rate over the term of the notes than would have applied if the notes had been held to maturity. In prior periods, we used the average effective interest rate as if the notes were held to maturity in determining the amount of interest expense incurred.

#### Other Expense

Other expense primarily relates to the effect of exchange rate fluctuations between the U.S. and Canada.

## Income Tax Provision (Benefit)

| Dollars in thousands | Three Months   |         | Change     |     |
|----------------------|----------------|---------|------------|-----|
|                      | Ended June 30, |         | \$         | %   |
|                      | 2013           | 2012    |            |     |
| Income Tax Benefit   | \$(34,268)     | \$(193) | \$(34,075) | n/m |

| Dollars in thousands           | Six Months     |       | Change     |     |
|--------------------------------|----------------|-------|------------|-----|
|                                | Ended June 30, |       | \$         | %   |
|                                | 2013           | 2012  |            |     |
| Income Tax Provision (Benefit) | \$(33,915)     | \$ 71 | \$(33,986) | n/m |

n/m Not meaningful.

Income Tax Benefit for the three and six-month periods of 2013 was attributable to a partial release of U.S domestic valuation allowance. Income tax benefit for the second quarter of 2012 was primarily related to the expiration of statutes of limitation applicable to our liabilities for uncertain tax positions in certain jurisdictions.

In the second quarter of 2013, we evaluated the potential realization of our Deferred Income Tax Assets, considering both positive and negative evidence, including cumulative income or loss for the past three years and forecasted taxable income. As a result of this evaluation we concluded that, as of June 30, 2013, a majority of the existing valuation allowance on our domestic Deferred Income Tax Assets was no longer required. Accordingly, an income tax benefit of \$35.8 million was recorded during the six-month period ended June 30, 2013 related to the reduction of our existing valuation allowance.

The remaining U.S. domestic valuation allowance of \$8.5 million at June 30, 2013 relates to certain domestic loss carryforwards and other credits that we may not be able to utilize primarily due to their shorter remaining carryforward periods. Should it be determined in the future that it is more likely than not that our Deferred Income Tax Assets will be realized, an additional valuation allowance would be released during the period in which such an assessment is made.

Further, there have been no material changes to our foreign operations since December 31, 2012 and, accordingly, we intend to maintain our existing valuation allowance on foreign Deferred Income Tax Assets in such jurisdictions at June 30, 2013.

See Note 8 of Notes to Condensed Consolidated Financial Statements for additional information.

## LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2013, we had \$28.4 million of Cash and Cash Equivalents, compared to \$23.2 million as of December 31, 2012. Cash provided by operating activities was \$6.8 million for the first six months of 2013, compared to cash provided by operating activities of \$4.5 million for the first six months of 2012. We expect our Cash and Cash Equivalents at June 30, 2013, along with cash expected to be generated from operations, to be sufficient to fund our operating and capital requirements for at least twelve months from June 30, 2013.

The increase in cash flows from operating activities was primarily due to changes in our operating assets and liabilities as discussed below, as well as increased Net Income of \$38.0 million for the six months ended June 30, 2013, compared to Net Income of \$2.4 million for the six months ended June 30, 2012. Net income for the six months ended June 30, 2013 included a \$35.8 million non-cash credit related to the reduction of our existing valuation allowance.

Trade Receivables decreased \$13.7 million to \$8.1 million as of June 30, 2013, compared to \$21.8 million as of December 31, 2012, due to seasonally lower activity with our Retail business customers. Days sales outstanding at June 30, 2013 were 20.2 days compared to 23.7 days as of December 31, 2012.

Inventories decreased \$5.5 million to \$13.3 million as of June 30, 2013, compared to \$18.8 million as of December 31, 2012, as we intentionally lower inventories through the second quarter, which is our seasonally slowest quarter of the year.

Deferred Income Tax Assets, net increased \$34.2 million to \$31.9 million as of June 30, 2013, compared to a net liability of \$2.3 million as of December 31, 2012, primarily due to the release of \$35.8 million of valuation allowance during the six-month period ended June 30, 2013 as discussed in more detail above.

Trade Payables decreased \$16.2 million to \$16.6 million as of June 30, 2013, compared to \$32.8 million as of December 31, 2012, due to lower inventory purchases and the timing of those purchases in the second quarter of 2013.

Accrued Liabilities decreased \$2.5 million to \$5.7 million as of June 30, 2013 compared to \$8.2 million as of December 31 2012, primarily due to incentive compensation payments made in the first quarter of 2013 that related to 2012 performance.

Cash used in investing activities for purchases of software and equipment was \$1.9 million for the six months ended June 30, 2013 and was primarily related to implementation of new software and hardware information system upgrades and new product tooling equipment. We anticipate spending \$2.5 million in all of 2013 for software and equipment.

#### Financing Arrangements

We have a Credit Agreement (the Loan Agreement ) with Bank of the West that provides for a \$15,750,000 maximum revolving secured credit line. The line of credit is available through March 31, 2015 for working capital, standby letters of credit and general corporate purposes. Borrowing availability under the Loan Agreement is subject to our compliance with certain financial and operating covenants at the time borrowings are requested. Standby letters of credit under the Loan Agreement are treated as a reduction of the available borrowing amount and are subject to covenant testing.

The interest rate applicable to borrowings under the Loan Agreement is based on either, at our discretion, Bank of the West's base rate, a floating rate or LIBOR, plus an applicable margin based on certain financial performance metrics. Our borrowing rate was 1.7% as of June 30, 2013. The Loan Agreement contains customary covenants, including minimum fixed charge coverage ratio and leverage ratio, and limitations on capital expenditures, mergers and acquisitions, indebtedness, liens, dispositions, dividends and investments. The Loan Agreement also contains customary events of default. Upon an event of default, the lender has the option of terminating its credit commitment and accelerating all obligations under the Loan Agreement. Borrowings under the Loan Agreement are collateralized by substantially all of our assets, including intellectual property assets.

As of June 30, 2013, we had no outstanding borrowings and \$0.6 million in standby letters of credit issued under the Loan Agreement. As of June 30, 2013, we were in compliance with the financial covenants of the Loan Agreement and approximately \$15.1 million was available for borrowing.

### Commitments and Contingencies

For a description of our commitments and contingencies, refer to Note 11 to our condensed consolidated financial statements in Item 1 of this Form 10-Q.

### Seasonality

We expect our sales from fitness equipment products to vary seasonally. Sales are typically strongest in the first and fourth quarters, followed by the third quarter, and are generally weakest in the second quarter. We believe that various factors, such as the broadcast of network season finales and seasonal weather patterns, influence television viewers and cause our advertising on cable television stations to be less effective in the second quarter than in other periods. In addition, during the spring and summer months, consumers tend to be involved in outdoor activities, including outdoor exercise, which impacts sales of indoor fitness equipment. This seasonality can have a significant effect on our inventory levels, working capital needs and resource utilization.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our critical accounting policies have not changed from those discussed in our 2012 Form 10-K. Please refer to Note 8 of Notes to Condensed Consolidated Financial Statements for a discussion of the reversal of our valuation allowance for certain deferred tax assets.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

#### Interest Rate Risk

Our exposure to market risk from changes in interest rates relates primarily to our cash and cash equivalents. The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This is accomplished by investing in diversified investments, consisting only of investment-grade securities.

As of June 30, 2013, we held cash and cash equivalents of \$28.4 million. Given that cash equivalents mature within three months or less from the date of purchase, a decline in interest rates over time would reduce our interest income, but would not have a material impact on our results of operations, financial position or cash flows. In addition, due to the nature of our cash equivalents, a decline in interest rates would not materially affect the fair value of our cash equivalents.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

In accordance with Rule 13a-15 of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and Acting Principal Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, our management, including the Chief Executive Officer and Acting Principal Financial Officer, has concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.



Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the three months ended June 30, 2013, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II OTHER INFORMATION

## Item 1A. Risk Factors

We operate in an environment that involves a number of risks and uncertainties. The risks and uncertainties described in our 2012 Form 10-K are not the only risks and uncertainties that we face. Additional risks and uncertainties that presently are not considered material or are not known to us, and therefore are not mentioned herein, may impair our business operations. If any of the risks described in our 2012 Form 10-K actually occur, our business, operating results and financial position could be adversely affected. There has not been a material change to the risk factors as set forth in our 2012 Form 10-K.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Repurchases of Equity Securities

We made the following repurchases of our common stock during the second quarter of 2013:

|                     | Total number of shares purchased <sup>(1)</sup> | Average price paid per share | Total number of shares purchased as part of publicly announced plan | Maximum dollar amount of shares that may yet be purchased under the plan |
|---------------------|---|------------------------------|---|--|
| April 1 to April 30 | 6,841   | \$ 7.31                      |   |  |
| May 1 to May 31     | 1,690   | 8.01                         |   |  |
| June 1 to June 30   | 1,689   | 8.69                         |   |  |
| Total               | 10,220  | 7.65                         |   |  |

<sup>(1)</sup> Consists of shares withheld from delivery upon settlement of the vesting portion of stock unit awards granted to certain of our executive officers. With respect to a restricted unit award granted to Bruce M. Cazenave, our Chief Executive Officer, we will withhold from the settlement of each monthly vesting portion of the award the number of shares sufficient to satisfy Mr. Cazenave's tax withholding obligation incident to such vesting, unless Mr. Cazenave

should first elect to satisfy the tax obligation by cash payment to us. We do not have any publicly announced equity securities repurchase plans or programs.

Item 6. Exhibits

The following exhibits are filed herewith and this list is intended to constitute the exhibit index:

- 10.1 Program Agreement between Nautilus, Inc. and Genesis Bankcard Services, Inc. (Confidential Treatment has been requested with respect to portions of this exhibit).
  - 10.2\* Form of Non-Employee Director Restricted Stock Unit Award Agreement.
  - 31.1 Certification of Chief Executive Officer and Acting Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
  - 32.1 Certification of Chief Executive Officer and Acting Chief Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.
  - 101.INS\*\* XBRL Instance Document.
  - 101.SCH\*\*XBRL Taxonomy Extension Schema Document.
  - 101.CAL\*\*XBRL Taxonomy Extension Calculation Linkbase Document.
  - 101.DEF\*\*XBRL Taxonomy Extension Definition Linkbase Document.
  - 101.LAB\*\*XBRL Taxonomy Extension Label Linkbase Document.
  - 101.PRE\*\*XBRL Taxonomy Extension Presentation Linkbase Document.
- \* Indicates management compensatory plan or arrangement.
  - \*\* Pursuant to Rule 406T of Regulation S-T, the Interactive data Files on Exhibit 101, submitted electronically herewith, 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 and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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.

NAUTILUS, INC.

Date: August 8, 2013 By: /s/ Bruce M. Cazenave  
Bruce M. Cazenave  
Chief Executive Officer  
(Principal Executive Officer, Acting Principal Financial  
Officer and Acting Principal Accounting Officer  
and for the Registrant)