

MEDIFAST INC  
Form 10-Q  
November 12, 2013

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**  
**FORM 10-Q**

**<sup>x</sup> QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the quarter period ended September 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

**Medifast, Inc.**

**(Exact name of registrant as specified in its charter)**

**Delaware** **13-3714405**  
**(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)**

**11445 Cronhill Drive**  
**Owings Mills, MD 21117**  
**Telephone Number: (410) 581-8042**

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 16 (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 is a large accelerated filer, an accelerated filer, or a non-accelerate filer. See definition of "accelerated filer and large accelerated filer" in Rule 12 b-2 of the Exchange Act (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

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

<b>Class</b>	<b>Outstanding at November 12, 2013</b>
<b>Common stock, \$.001 par value per share</b>	<b>13,884,293</b>

**Medifast, Inc. and subsidiaries**

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**MEDIFAST, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

	(Unaudited) September 30, 2013	(Audited) December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 47,980,000	\$ 39,937,000
Accounts receivable-net of allowance for sales returns and doubtful accounts of \$731,000 and \$542,000	1,932,000	2,148,000
Inventory	17,451,000	20,804,000
Investment securities	34,028,000	20,057,000
Income taxes, prepaid	2,555,000	873,000
Prepaid expenses and other current assets	2,035,000	3,296,000
Deferred tax assets	875,000	1,460,000
Total current assets	106,856,000	88,575,000
Property, plant and equipment - net	41,135,000	40,109,000
Trademarks and intangibles - net	49,000	428,000
Other assets	356,000	1,139,000
<b>TOTAL ASSETS</b>	<b>\$ 148,396,000</b>	<b>\$ 130,251,000</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 30,338,000	\$ 28,221,000
Current maturities of long-term debt and capital leases	220,000	528,000
Total current liabilities	30,558,000	28,749,000
Other liabilities:		
Long-term debt, net of current portion	-	3,113,000
Capital leases, net of current portion	530,000	696,000
Deferred tax liabilities	5,970,000	6,907,000
Total liabilities	37,058,000	39,465,000
Stockholders' Equity:		
Preferred stock, \$.001 par value (1,500,000 authorized, no shares issued and outstanding)	-	-
Common stock; par value \$.001 per share; 20,000,000 shares authorized; 15,542,118 and 15,525,955 issued; 13,884,293 and 13,767,380 issued and outstanding	16,000	16,000
Additional paid-in capital	42,285,000	40,191,000
Accumulated other comprehensive income	332,000	553,000
Retained earnings	95,213,000	76,534,000
Less: cost of 1,608,908 shares of common stock in treasury	(26,508,000)	(26,508,000)
Total stockholders' equity	111,338,000	90,786,000

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TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$	148,396,000	\$	130,251,000
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The accompanying notes are an integral part of these consolidated financial statements.

**MEDIFAST, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited)

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2012	
	2013	2012	2013	2012
Revenue	\$ 86,480,000	\$ 90,968,000	\$ 279,595,000	\$ 273,464,000
Cost of sales	21,627,000	22,632,000	69,403,000	68,233,000
Gross Profit	64,853,000	68,336,000	210,192,000	205,231,000
Selling, general, and administration	57,504,000	59,408,000	183,624,000	185,568,000
Income from operations	7,349,000	8,928,000	26,568,000	19,663,000
Other income				
Interest and dividend income, net	167,000	64,000	317,000	226,000
Other income	362,000	(13,000)	581,000	925,000
	529,000	51,000	898,000	1,151,000
Income before income taxes	7,878,000	8,979,000	27,466,000	20,814,000
Provision for income taxes	2,205,000	1,771,000	8,787,000	6,803,000
Net income	\$ 5,673,000	\$ 7,208,000	\$ 18,679,000	\$ 14,011,000
Basic earnings per share	\$ 0.41	\$ 0.53	\$ 1.35	\$ 1.02
Diluted earnings per share	\$ 0.41	\$ 0.52	\$ 1.34	\$ 1.02
Weighted average shares outstanding -				
Basic	13,884,293	13,705,188	13,852,155	13,709,702
Diluted	13,903,412	13,804,212	13,955,217	13,766,013

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

**MEDIFAST, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(Unaudited)

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2012	
	2013	2012	2013	2012
Net income	\$ 5,673,000	\$ 7,208,000	\$ 18,679,000	\$ 14,011,000
Other comprehensive income, net of tax				
Change in unrealized gains/losses on marketable securities:				
Change in fair value of marketable securities, net of tax	304,000	165,000	(4,000)	292,000
Adjustment for net (gains)/losses realized and included in net income, net of tax	(32,000)	(1,000)	(217,000)	(91,000)
Total change in unrealized gains/losses on marketable securities, net of tax	272,000	164,000	(221,000)	201,000
Other comprehensive income	272,000	164,000	(221,000)	201,000
Comprehensive income	\$ 5,945,000	\$ 7,372,000	\$ 18,458,000	\$ 14,212,000

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

**MEDIFAST, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY**  
**Nine Months Ended September 30, 2013**  
**(Unaudited)**

	Number of Shares Issued	Par Value \$0.001 Amount	Additional Paid- In Capital	Retained Earnings	Accumulated other comprehensive income	Treasury Stock	Total
Balance, December 31, 2012	15,525,955	\$ 16,000	\$ 40,191,000	\$ 76,534,000	\$ 553,000	\$ (26,508,000)	\$ 90,786,000
Shares issued to executives	16,163						
Share-based compensation to executives and directors			1,772,000				1,772,000
Share-based compensation tax benefit			322,000				322,000
Net income				18,679,000			18,679,000
Net change in unrealized gain on investments					(221,000)		(221,000)
Balance, September 30, 2013	15,542,118	\$ 16,000	\$ 42,285,000	\$ 95,213,000	\$ 332,000	\$ (26,508,000)	\$ 111,338,000

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



**MEDIFAST, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	Nine Months Ended September 30,	
	2013	2012
Cash flows from operating activities:		
Net income	\$ 18,679,000	\$ 14,011,000
Adjustments to reconcile net income to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	7,912,000	8,219,000
Realized gain on investment securities, net	(337,000)	(4,000)
Share-based compensation	1,772,000	1,816,000
Deferred income taxes	(47,000)	(440,000)
Loss on disposal of fixed assets	85,000	59,000
Changes in assets and liabilities which provided (used) cash:		
Accounts receivable	216,000	(1,255,000)
Inventory	3,353,000	1,690,000
Prepaid expenses and other current assets	1,261,000	(19,000)
Other assets	764,000	219,000
Accounts payable and accrued expenses	2,117,000	10,603,000
Income taxes	(1,682,000)	4,828,000
Net cash provided by operating activities	34,093,000	39,727,000
Cash Flow from Investing Activities:		
Sale of investment securities	7,416,000	7,140,000
Purchase of investment securities	(21,576,000)	(6,802,000)
Purchase of property and equipment	(8,644,000)	(7,435,000)
Net cash used in investing activities	(22,804,000)	(7,097,000)
Cash Flow from Financing Activities:		
Repayment of long-term debt and capital leases	(3,587,000)	(1,297,000)
Decrease in note receivable	19,000	13,000
Excess tax benefits from share-based compensation	322,000	567,000
Purchase of treasury stock	-	(2,764,000)
Net cash used in financing activities	(3,246,000)	(3,481,000)
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	<b>8,043,000</b>	<b>29,149,000</b>
Cash and cash equivalents - beginning of the period	39,937,000	14,262,000
Cash and cash equivalents - end of period	\$ 47,980,000	\$ 43,411,000
Supplemental disclosure of cash flow information:		
Interest paid	\$ 49,000	\$ 93,000
Income taxes paid	\$ 10,143,000	\$ 2,249,000
Supplemental disclosure of non cash activity:		
Capitalized lease additions	\$ -	\$ 104,000

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



**Medifast, Inc. and subsidiaries**

**Notes to Unaudited Condensed Consolidated Financial Statements**

**General**

**1. Basis of Presentation**

The condensed unaudited interim consolidated financial statements included herein have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. The condensed consolidated financial statements and notes are presented as permitted on Form 10-Q and do not contain information included in the Company's annual statements and notes. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

The results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results to be expected for the year ending December 31, 2013 or any other portions thereof. Certain information in footnote disclosures normally included in annual financial statements has been condensed or omitted for the interim periods presented in accordance with the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim consolidated financial statements.

These financial statements do not contain all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, in the opinion of management, all adjustments consisting of normal, recurring adjustments considered necessary for a fair presentation of the financial position and results of operations have been included.

The consolidated balance sheet as of December 31, 2012 is derived from the audited financial statements included in the Company's Annual Report in Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2012 (the 2012 form 10-K), which should be read in conjunction with these consolidated financial statements.

**2. Presentation of Financial Statements**

The Company's condensed consolidated financial statements include the accounts of Medifast, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Certain amounts reported for prior periods have been reclassified to be consistent with the current period presentation. No reclassification in the consolidated financial statements had a material impact on the presentation.

**3. Recent Accounting Pronouncements**

We have considered all new accounting pronouncements and have concluded that there are no new pronouncements that may have a material impact on our results of operations, financial condition, or cash flows, based on current information.

**4. Revenue Recognition**

Revenue is recognized net of discounts, rebates, promotional adjustments, price adjustments, and estimated returns and upon transfer of title and risk to the customer which primarily occurs at shipping (F.O.B. terms). Upon shipment,

the Company has no further performance obligations and collection is reasonably assured as the majority of sales are paid for prior to shipping. Medifast Weight Control Centers' program fees are recognized over the estimated service period.

#### 5. Inventories

Inventories consist principally of packaged meal replacements held in the Company's warehouses. Inventory is stated at the lower of cost or market, utilizing the first-in, first-out method. The cost of finished goods includes the cost of raw materials, packaging supplies, direct and indirect labor and other indirect manufacturing costs. On a quarterly basis, management reviews inventory for unsalable or obsolete inventory.

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Inventories consisted of the following at September 30, 2013 and December 31, 2012:

	2013	2012
Raw Materials	\$ 5,235,000	\$ 5,685,000
Packaging	730,000	653,000
Non-food Finished Goods	796,000	961,000
Finished Goods	10,936,000	13,857,000
Reserve for Obsolete Inventory	(246,000)	(352,000)
	\$ 17,451,000	\$ 20,804,000

## 6. Intangible Assets

The Company has acquired certain intangible assets, which include: customer lists, trademarks, patents and copyrights. The customer lists are being amortized over a 3-year period based on management's best estimate of the expected useful life. The costs of trademarks, patents and copyrights are amortized over 2 to 7 years based on their estimated useful life.

	As of September 30, 2013		As of December 31, 2012		Weighted-Avg. Amortization Period
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization	
Customer lists	\$ 235,000	\$ 228,000	\$ 235,000	\$ 206,000	3 years
Trademarks, patents, and copyrights	2,437,000	2,395,000	2,437,000	2,038,000	4 years
Total	\$ 2,672,000	\$ 2,623,000	\$ 2,672,000	\$ 2,244,000	

Amortization expense for the three and nine months ended September 30, 2013 and 2012 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Customer lists	\$ 7,000	\$ 20,000	\$ 22,000	\$ 60,000
Trademarks, patents, and copyrights	111,000	132,000	357,000	351,000
Total trademarks and intangibles	\$ 118,000	\$ 152,000	\$ 379,000	\$ 411,000

Amortization expense is included in selling, general and administrative expenses.

## 7. Earnings per Share

Basic earnings per share ("EPS") computations are calculated utilizing the weighted average number of common shares outstanding during the periods presented. Diluted EPS is calculated utilizing the weighted average number of common shares outstanding adjusted for the effect of dilutive common stock equivalents.

The following table sets forth the computation of basic and diluted EPS for the three and nine months ended September 30:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Numerator:				
Net income	\$ 5,673,000	\$ 7,208,000	\$ 18,679,000	\$ 14,011,000
Denominator:				
Weighted average shares of common stock outstanding	13,884,293	13,705,188	13,852,155	13,709,702
Effect of dilutive common stock equivalents	19,119	99,024	103,062	56,311

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Weighted average diluted common shares outstanding	13,903,412	13,804,212	13,955,217	13,766,013
EPS:				
Basic	\$ 0.41	\$ 0.53	\$ 1.35	\$ 1.02
Diluted	\$ 0.41	\$ 0.52	\$ 1.34	\$ 1.02

## 8. Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

## 9. Financial Instruments

Certain financial assets and liabilities are accounted for at fair value, which is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following fair value hierarchy prioritizes the inputs used to measure fair value:

**Level 1** Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

**Level 2** Pricing inputs are other than quoted prices in active markets included in level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies.

**Level 3** Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value from the perspective of a market participant.

The following table represents cash and the available-for-sale securities adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash and cash equivalents or investment securities as of September 30, 2013 and December 31, 2012:



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September 30, 2013							
	Cost	Unrealized Gains	Unrealized Losses	Accrued Interest	Estimated Fair Value	Cash & Cash Equivalents	Investment Securities
Cash	\$ 45,816,000	\$ -	\$ -	\$ -	\$ 45,816,000	\$ 45,816,000	\$ -
Level 1:							
Money Market Accounts	2,164,000	-	-	-	2,164,000	2,164,000	-
Mutual Funds	9,426,000	52,000	(244,000)	-	9,234,000	-	9,234,000
Corporate Equity Securities	4,585,000	668,000	(98,000)	-	5,155,000	-	5,155,000
Government & Agency Securities	7,774,000	83,000	(76,000)	31,000	7,812,000	-	7,812,000
	23,949,000	803,000	(418,000)	31,000	24,365,000	2,164,000	22,201,000
Level 2:							
Municipal Bonds	3,629,000	99,000	-	23,000	3,751,000	-	3,751,000
Corporate Bonds	8,007,000	73,000	(57,000)	53,000	8,076,000	-	8,076,000
	11,636,000	172,000	(57,000)	76,000	11,827,000	-	11,827,000
Total	\$ 81,401,000	\$ 975,000	\$ (475,000)	\$ 107,000	\$ 82,008,000	\$ 47,980,000	\$ 34,028,000

December 31, 2012							
	Cost	Unrealized Gains	Unrealized Losses	Accrued Interest	Estimated Fair Value	Cash & Cash Equivalents	Investment Securities
Cash	\$ 38,977,000	\$ -	\$ -	\$ -	\$ 38,977,000	\$ 38,977,000	\$ -
Level 1:							
Money Market Accounts	960,000	-	-	-	960,000	960,000	-
Mutual Funds	234,000	13,000	(1,000)	-	246,000	-	246,000
Corporate Equity Securities	1,853,000	489,000	(46,000)	-	2,296,000	-	2,296,000
Government & Agency Securities	7,004,000	180,000	(3,000)	34,000	7,215,000	-	7,215,000
	10,051,000	682,000	(50,000)	34,000	10,717,000	960,000	9,757,000

Level 2:

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Municipal Bonds	4,197,000	124,000	(4,000)	27,000	4,344,000	-	4,344,000
Corporate Bonds	5,772,000	136,000	(2,000)	50,000	5,956,000	-	5,956,000
	9,969,000	260,000	(6,000)	77,000	10,300,000	-	10,300,000
Total	\$ 58,997,000	\$ 942,000	\$ (56,000)	\$ 111,000	\$ 59,994,000	\$ 39,937,000	\$ 20,057,000

10. Shared-based Compensation

The Company has issued restricted stock to employees and nonemployee directors generally with terms up to five years. The fair value is equal to the market price of the Company's common stock on the date of grant. Expense for restricted stock is amortized ratably over the vesting period. The following table summarizes the restricted stock activity:

	Shares	Weighed-Average Grant Date Fair Value
Unvested at December 31, 2012	149,667	\$ 8.21
Granted	314,706	25.23
Vested	(151,883)	13.14
Forfeited	-	-
Unvested at September 30, 2013	312,490	\$ 22.95

The total restricted stock awards vested and charged against income during the three months ended September 30, 2013 and 2012 was \$620,000 and \$360,000, respectively and \$2.0 million and \$1.8 million for the nine months ended September 30, 2013 and 2012, respectively. The total income tax benefit recognized in the consolidated statement of income for these restricted stock awards was approximately \$211,000 and \$139,000 for the three months ended September 30, 2013 and 2012, respectively and \$602,000 and \$702,000 for the nine months ended September 30, 2013 and 2012, respectively. The tax benefit recognized in additional paid-in capital upon vesting of restricted stock awards was approximately \$224,000 and \$104,000 for the three months ended September 30, 2013 and 2012, respectively and \$322,000 and 567,000 for the nine months ended September 30, 2013 and 2012, respectively. There was approximately \$7.2 million of total unrecognized compensation cost related to restricted stock awards as of September 30, 2013. The cost is expected to be recognized over a weighted-average period of approximately 4.4 years.

## 11. Business Segments

Operating segments are components of an enterprise about which separate financial information is available that is regularly reviewed by the chief operating decision maker about how to allocate resources and in assessing performance. The Company has two reportable operating segments: Medifast, and MWCC and Wholesale. The Medifast reporting segment consists of the following distribution channels: Medifast Direct and Take Shape For Life. The MWCC and Wholesale segment consists of Medifast Corporate and Franchise Weight Control Centers as well as Medifast Wholesale Physicians.

Total assets and operating expense not identified with a specific segment are listed as “Other” and include items such as auditors’ fees, attorney’s fees, stock compensation expense and corporate governance related to NYSE, Sarbanes Oxley and SEC regulations. Evaluation of the performance of operating segments is based on their respective income from operations before taxes. The accounting policies of the segments are the same as those of the Company. The presentation and allocation of assets, liabilities and results of operations may not reflect the actual economic costs of the segments as stand-alone businesses. If a different basis of allocation were utilized, the relative contributions of the segments might differ, but management believes that the relative trends in segments would likely not be impacted.

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The following tables present segment information for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September, 2013			
	Medifast	MWCC & Wholesale	Other	Consolidated
Revenues	\$ 73,324,000	\$ 13,156,000	\$ -	\$ 86,480,000
Cost of Sales	18,120,000	3,507,000	-	21,627,000
Selling, General and Administrative Expense	44,970,000	8,434,000	1,408,000	54,812,000
Depreciation and Amortization	1,939,000	684,000	69,000	2,692,000
Interest(net) and other	(306,000)	3,000	(226,000)	(529,000)
Income before income taxes	\$ 8,601,000	\$ 528,000	\$ (1,251,000)	\$ 7,878,000
Segment Assets	\$ 91,370,000	\$ 12,450,000	\$ 44,576,000	\$ 148,396,000

	Three Months Ended September 30, 2012			
	Medifast	MWCC & Wholesale	Other	Consolidated
Revenues	\$ 76,777,000	\$ 14,191,000	\$ -	\$ 90,968,000
Cost of Sales	18,986,000	3,646,000	-	22,632,000
Selling, General and Administrative Expense	46,118,000	9,311,000	1,012,000	56,441,000
Depreciation and Amortization	2,068,000	841,000	58,000	2,967,000
Interest(net) and other	30,000	5,000	(86,000)	(51,000)
Income before income taxes	\$ 9,575,000	\$ 388,000	\$ (984,000)	\$ 8,979,000
Segment Assets	\$ 82,402,000	\$ 17,362,000	\$ 28,536,000	\$ 128,300,000

	Nine Months Ended September, 2013			
	Medifast	MWCC & Wholesale	Other	Consolidated
Revenues	\$ 238,625,000	\$ 40,970,000	\$ -	\$ 279,595,000
Cost of Sales	58,790,000	10,613,000	-	69,403,000
Selling, General and Administrative Expense	145,028,000	26,058,000	4,626,000	175,712,000
Depreciation and Amortization	5,583,000	2,135,000	194,000	7,912,000
Interest(net) and other	(228,000)	7,000	(677,000)	(898,000)
Income before income taxes	\$ 29,452,000	\$ 2,157,000	\$ (4,143,000)	\$ 27,466,000
Segment Assets	\$ 91,370,000	\$ 12,450,000	\$ 44,576,000	\$ 148,396,000

	Nine Months Ended September 30, 2012			
	Medifast	MWCC & Wholesale	Other	Consolidated
Revenues	\$ 230,550,000	\$ 42,914,000	\$ -	\$ 273,464,000

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Cost of Sales	57,694,000	10,539,000	-	68,233,000
Selling, General and Administrative Expense	138,140,000	31,426,000	7,783,000	177,349,000
Depreciation and Amortization	5,955,000	2,071,000	193,000	8,219,000
Interest(net) and other	76,000	14,000	(1,241,000)	(1,151,000)
Income before income taxes	\$ 28,685,000	\$ (1,136,000)	\$ (6,735,000)	\$ 20,814,000
Segment Assets	\$ 82,402,000	\$ 17,362,000	\$ 28,536,000	\$ 128,300,000

## 12. Contingencies

The Company filed a civil complaint on February 17, 2010 in the U.S. District Court (SD, Cal) against Barry Minkow and the Fraud Discovery Institute, Inc. (collectively, "Minkow"), iBusiness Reporting, and its editor William Lobdell, Tracy Coenen and Sequence, Inc. (collectively, "Coenen"), "Zee Yourself", and Robert L. Fitzpatrick ("FitzPatrick") for Defamation, Market Manipulation and Unfair Business Practices, alleging a scheme of market manipulation of Medifast stock for Defendants' monetary gain, by damaging the business reputation of Medifast and its Take Shape For Life division. Bradley T. MacDonald, former Executive Chairman of Medifast and Company shareholder, joined the lawsuit individually. The lawsuit seeks \$270 million in compensatory damages, punitive damages, and ancillary relief. In March 2011, the District Court granted in part and denied in part certain Anti-SLAPP Motions to Strike (i.e. motions to dismiss) previously filed by all Defendants. The Company has appealed that portion of the District Court's ruling which dismissed its defamation claims against Minkow and Coenen in the 9th Circuit Court of Appeals. Defendant FitzPatrick's motion was denied as to the Company's defamation claim, and FitzPatrick has appealed that portion of the Court's ruling. Both appeals have been fully-briefed and oral argument was held on March 5, 2013. On May 20, 2013, the Court deferred its decision on Medifast and FitzPatrick's appeals pending the determination of a petition for rehearing en banc in another Anti-SLAPP appeal, Tarla Makaeff v. Trump University, LLC, Case No. 11-55016, filed on April 30, 2013. That petition is currently pending before the Ninth Circuit.

On July 20, 2012, Jason Pharmaceuticals, Inc., a wholly-owned subsidiary of the Company, signed a proposed consent decree with the Federal Trade Commission ("FTC"), in response to the FTC's investigation of certain statements in the Company's advertising for its weight-loss programs. On September 17, 2012 the consent decree was entered and approved by the United States District Court for the District of Columbia. The consent decree replaces a previous consent order entered into by Jason Pharmaceuticals, Inc. and the FTC in 1992. The FTC expressed concern that some of the Company's advertising contained claims which were not compatible with current standards for substantiation. Pursuant to the consent decree, the Company agreed to modify certain advertising claims in this regard and agreed to ensure that its clinical studies meet the protocol contained in the consent agreement. The Company paid a civil penalty of \$3.7 million to resolve the FTC's concerns and avoid protracted legal proceedings. The Company accrued for the penalty in the second quarter of 2012 as part of selling, general & administration expenses.

**Item MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS  
2. OF OPERATIONS. FORWARD LOOKING STATEMENTS**

Some of the information presented in this quarterly report constitutes forward-looking statements within the meaning of the private Securities Litigation Reform Act of 1995. Statements that are not historical facts, including statements about management's expectations for fiscal year 2013 and beyond, are forward-looking statements and involve various risks and uncertainties. Although the Company believes that its expectations are based on reasonable assumptions within the bounds of its knowledge, there can be no assurance that actual results will not differ materially from the Company's expectations. The Company cautions investors not to place undue reliance on forward-looking statements which speak only to management's experience on this data.

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and related notes appearing elsewhere herein.

**Critical Accounting Policies and Estimates**

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles. Our significant accounting policies are described in Note 2 of the consolidated financial statements filed on Form 10-K.

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management develops, and changes periodically, these estimates and assumptions based on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Management considers the following accounting estimates to be the most critical in preparing our consolidated financial statements. These critical accounting estimates have been discussed with our Audit Committee.

**Revenue Recognition:** Revenue is recognized net of discounts, rebates, promotional adjustments, price adjustments, and estimated returns and upon transfer of title and risk to the customer which primarily occurs at shipping (F.O.B. terms). Upon shipment, the Company has no further performance obligations and collection is reasonably assured as the majority of sales are paid for prior to shipping. Medifast Weight Control Centers program fees are recognized over the estimated service period.

**Impairment of Fixed Assets and Intangible Assets:** We continually assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. Judgments regarding the existence of impairment indicators are based on legal factors, market conditions and our operating performance. Future events could cause us to conclude that impairment indicators exist and the carrying values of fixed and intangible assets may be impaired. Any resulting impairment loss would be limited to the value of net fixed and intangible assets.

**Income Taxes:** The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more-likely-than-not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon

examination.

We evaluated our tax positions and determined that we did not have any material uncertain tax positions. Our policy is to recognize interest and penalties accrued on uncertain tax positions as part of income tax expense. For the nine months ended September 30, 2013 and 2012, no material estimated interest or penalties were recognized for the uncertainty of certain tax positions. We file income tax returns in the United States and various states jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local income tax examinations by tax authorities for the years before 2007.

**Reserves for Returns:** We review the reserves for customer returns at each reporting period and adjust them to reflect data available at that time. To estimate reserves for returns, we consider actual return rates in preceding periods. To the extent the estimate of returns changes, we will adjust the reserve, which will impact the amount of product sales revenue recognized in the period of the adjustment. Our estimates for returns have not differed materially from our actual returns. The provisions for estimated returns as of September 30, 2013 and December 31, 2012 were \$514,000 and \$300,000, respectively.

**Operating leases:** Medifast leases retail stores, distribution facilities, and office space under operating leases. Many lease agreements contain tenant improvement allowances, rent holidays, rent escalation clauses and contingent rent provisions. The Company recognizes incentives and minimum rental expenses on a straight-line basis over the terms of the leases. We commence recording rent expense on the date of initial possession, which is generally when we enter the space and begin to make improvements to properties for our intended use. For tenant improvement allowances and rent holidays, we record a deferred rent liability on the consolidated balance sheets and amortize the deferred rent over the terms of the leases as reductions to rent expense on the consolidated statements of income.

For scheduled rent escalation clauses during the lease terms or for rental payments commencing at a date other than the date of initial occupancy, we record minimum rental expenses on a straight-line basis over the terms of the leases on the consolidated statements of income. Several leases provide for contingent rents, which are determined as a percentage of gross sales in excess of specified levels. We record a contingent rent liability on the consolidated balance sheets and the corresponding rent expense when we determine achieving specified levels is probable.



## **Background:**

The Company is engaged in the production, distribution, and sale of weight management products and other consumable health and diet products. The Company's product lines include meal replacements and supplements. Our products and services are sold to weight loss program participants primarily via the internet, telephone, and brick and mortar clinics. Customers of our Health Coaches in the Take Shape For Life person-to-person direct sales channel are directed to order our products through either the internet or through the Company's in-house call center. Our product sales accounted for 96% of our revenues in the first nine months of 2013 and 95% of our revenues in the first nine months of 2012. Program sales in our Medifast Weight Control Center channel accounted for 2% of revenues in the first nine months of 2013 and 3% in the first nine months of 2012. Shipping revenue and other accounted for 2% in the first nine months of 2013 and 2012. Revenue consists primarily of meal replacement food sales. In the first nine months of 2013, revenue increased to \$279.6 million as compared to \$273.5 million in the first nine months of 2012, an increase of \$6.1 million or 2.2%. The Take Shape For Life sales channel accounted for 63.3% of total revenue, Medifast Direct 22.0%, and Medifast Weight Control Centers and Medifast Wholesale Physicians 14.7%.

We review and analyze a number of key operating and financial metrics to manage our business, including revenue to advertising spend, number of active Health Coaches and average monthly revenue generated per health coach in the Take Shape For Life channel, and average same store sales improvement for the Medifast Weight Control Center channel.

## **Overview of the Company**

### **Distribution Channels**

**Medifast Direct** In the direct-to-consumer channel ("Medifast Direct"), customers order Medifast product directly through the Company's website, [www.medifast1.com](http://www.medifast1.com) or our in-house call center. The product is shipped directly to the customer's home. This business is driven by a multi-media customer acquisition strategy that includes both national and regional print, radio, web advertising, direct mail, and television as well as public relations, word of mouth referrals, and social media initiatives. The Medifast Direct division focuses on targeted marketing initiatives and provides customer support through its in-house call center and nutrition support team of registered dietitians to better serve its customers. In addition, Medifast continues to use leading web technology featuring customized meal planning and web community components. MyMedifast is a robust online community which provides a library of support articles, support forums, meal-planning tools, and social media functions. See Note 11, "Business Segments" of the financial statements for a detailed breakout of revenues, profit or loss, and total assets of each of the Company's business segments.

**Take Shape For Life** Take Shape For Life is the personal coaching division of Medifast. The coaching network consists of independent contractor Health Coaches ("Health Coaches"), who are trained to provide coaching and support to clients on Medifast weight-loss programs and is led by its co-founder, a physician with a background in critical care. The role of the Health Coach is to give clients the encouragement and mentoring to assist them to successfully reach a healthy weight. The Take Shape For Life program provides a road map to empower the individual to take control of their health through adopting better long-term habits. Take Shape For Life moves beyond the scope of weight loss to teach clients how to achieve optimal health through the balance of body, mind, and finances. The program uses the high-quality, medically validated products of Medifast that have been proven safe and effective in clinical studies described in our most recent Annual Report on Form 10-K, under "Clinical Research Overview." Health Coaches and their clients follow the principles of the Discover Your Optimal Health book, Habits of Health book, and Habits of Health companion workbook written by the Take Shape For Life co-founder to create a lifelong health optimization program. In addition to the encouragement and support of a Health Coach, clients of Take Shape For Life are offered a bio-network of support including product and program information on our website, weekly medical and general support calls, and access to our registered dietitians.

Program entrants are encouraged to consult with their primary care physician and a Take Shape For Life Health Coach to determine the Medifast program that is right for them. Health Coaches are required to become qualified based upon testing of their knowledge of Medifast products and programs. Our Health Coaches provide coaching and support to their Clients throughout the weight-loss and weight-maintenance process. Most new Health Coaches are introduced to the opportunity by an existing Health Coach. The vast majority of new Health Coaches started as weight-loss clients of a Health Coach, had success on the Medifast program, and became a Health Coach to help others through the weight-loss process. Approximately 20% of active Health Coaches in the Take Shape For Life network are health care providers.

Take Shape For Life Health Coaches are independent contractors who are compensated on product sales referred to the Company. Health Coaches can earn compensation in two ways:

**Commissions:** The primary way a Health Coach is compensated is through earning commissions on product sold. Health Coaches earn commissions by referring product sales through their own replicated website or through the Company's in-house call center. The clients of Health Coaches are responsible for ordering and paying for products, and their order is shipped directly from the Company to the client's home or designated address. Our Health Coaches do not handle payments and are not required to purchase or store products in order to receive a commission. In addition, Health Coaches do not receive a commission on their own personal product orders. Health Coaches pay the same price for products as their clients. The Company pays retail commissions to qualified Health Coaches on a weekly basis.

**Bonuses:** Health Coaches are offered several bonus opportunities, including client support bonuses, certification bonus, team growth bonuses, generation bonuses, elite leadership bonuses, consistency bonuses, client acquisition bonuses, and new Health Coach assist bonuses. The purposes of these bonuses are to reward Health Coaches for successfully referring product sales to the Take Shape For Life network, and to incentivize Health Coaches to further support and develop other Health Coaches within their network. The Company pays bonuses on a monthly basis to qualified Health Coaches.

Client Support bonuses are paid to Health Coaches who have at least 1,200 in frontline product sales to either Clients or personally sponsored Health Coaches. These are incremental bonuses based on the Health Coach frontline product sales performance.

- o Certification bonus is paid to Health Coaches who have purchased the COPE online certification course, completed the course work and passed a final examination. This bonus is earned on all frontline product sales starting in the month certification status is obtained.
- o Team growth bonuses are paid to Health Coaches who have at least five ordering clients per month and who have generated over \$1,200 in group product sales per month. Monthly growth bonuses are incremental bonuses that enable Health Coaches to earn income on product orders placed by clients and/or Health Coach Teams within their network.
- o Generation bonuses are paid to Health Coaches who qualify as Executive Director and have one or more Health Coaches in their business who have achieved the rank of Executive Director. An Executive Director is a Health Coach who has obtained 5 Qualifying Points. Qualifying Points are earned for every \$1,200 in frontline product sales generated or every qualified Senior Coach Team. . A Senior Coach is a Health Coach who generates at least \$1,200 a month in group product sales from a combination of at least five personally enrolled, ordering Clients, and/or Health Coaches, Health Coach teams, or a combination of both.
- o Elite leadership bonuses are paid to Health Coaches who qualify as Executive Director and have three or more Health Coaches in their business who have achieved the rank of Executive Director.
- o Consistency bonuses are paid to Health Coaches who are Certified and maintain frontline product sales and/or qualified Senior Coach Team performance with order consistency month after month. Health Coaches who generate at least \$2,000 or more in frontline product sales for three consecutive months are paid a Health Coach consistency bonus. Certified Health Coaches who maintain at least \$6,000 in frontline product sales, at least \$15,000 in group product sales, and qualify 5 Senior Coach teams for three consecutive months are paid a Fully Integrated Business Coach Consistency Bonus.
- o Client acquisition bonuses are paid to new Health Coaches who develop five Clients and generate \$1,000 in frontline product sales within their first 30 calendar days in Take Shape For Life program.
- o The assist bonuses are paid to Health Coaches who assist a newly sponsored Health Coach attain the Client acquisition bonus.

Health Coaches do not earn a commission or bonus when they recruit a new Health Coach into the Take Shape For Life network. Fees paid by new Health Coaches for start-up materials are at the Company's approximate cost and no commissions are paid thereon.

Take Shape For Life is a member of the Direct Selling Association (the "DSA"), a national trade association representing over 200 direct selling companies doing business in the United States. To become a member of the DSA, Take Shape For Life, like other active DSA member companies, underwent a comprehensive and rigorous one-year company review by DSA legal staff that included a detailed analysis of its company business-plan materials. This review is designed to ensure that a company's business practices do not contravene DSA's Code of Ethics. Compliance with the requirements of the Code of Ethics is paramount to becoming and remaining a member in good standing of DSA. Accordingly, we believe membership in DSA by Take Shape For Life demonstrates its commitment to the highest standards of ethics and a pledge not to engage in any deceptive, unlawful, or unethical business practices. Among those Code of Ethics proscriptions are pyramid schemes or endless chain schemes as defined by federal, state, or local laws. Moreover, Take Shape For Life, like other DSA member companies in good standing, has pledged to

provide consumers with accurate and truthful information regarding the price, grade, quality, and performance of the products Take Shape For Life markets. See Note 11, "Business Segments" of the financial statements for a detailed breakout of revenues, profit or loss, and total assets of each of the Company's business segments.

**Medifast Weight Control Centers** Medifast Weight Control Centers is the brick and mortar clinic channel of Medifast with affiliate-owned locations in Pennsylvania, New Jersey, Delaware, Texas, Florida, Maryland, North Carolina and Virginia. Jason Properties, LLC, a subsidiary of Medifast, Inc., had a total of 83 Medifast Weight Control Centers in operation at quarter-end. Medifast Weight Control Centers offer a high-touch model including comprehensive Medifast programs for weight loss and maintenance, customized client counseling, an InBody<sup>TM</sup> body composition analysis, and monitoring with a BodyGem<sup>TM</sup> indirect calorimeter that determines resting metabolic rates. Medifast Weight Control Centers conduct local advertising including radio, print, television and web initiatives. The Centers also benefit from the enterprise brand advertising which encourages walk-ins and referrals from its customers and other Medifast business channels.

In 2008, Medifast Franchise Systems, Inc. ("MFSI"), a subsidiary of Medifast, began offering the Center model as a franchise opportunity. MFSI currently has franchised centers located in Alabama, Arizona, California, Louisiana, Minnesota, Wisconsin, Maryland and Pennsylvania. As of September 30, 2013, 36 franchise locations were in operation.

MFSI currently offers the Medifast Weight Control Center franchise opportunity in all states under a registered (where required) franchise disclosure document (FDD). The MFSI Franchise Agreement requires franchisees to develop a minimum of three Medifast Weight Control Centers within a defined geographic area in the time frame set forth in the Development Agreement between Medifast and the franchisee.

MFSI's franchise strategy depends on our franchisees' active involvement in, and management of, Medifast Weight Control Center operations. Candidates are reviewed for appropriate operational experience and financial stability, including specific net worth and liquidity requirements. Upon execution of the Franchise Agreement and Development Agreement, franchisees are required to promptly select sites for the Centers which are subject to MFSI's approval.

A franchisee's initial fee includes the franchise fee for the first Center to be developed and a non-refundable deposit for the second and third Centers to be developed, and covers the cost of MFSI resources provided for, among other things, the training of franchisees and their staff, and approval of the proposed territory for development. If a franchisee desires to open more than three centers in the designated territory, there is an additional fee charged for each additional Center to be developed. MFSI provides initial investment estimates in the FDD and cautions applicants considering the franchise opportunity that their actual expenses may vary from the estimates given. Required legal disclosures are provided and the applicant may not sign the Agreements until the applicant has had 14 days to consider the FDD.

Prior to the opening of each Medifast Weight Control Center franchise established under the Franchise and Development Agreements, MFSI will do the following:

- i. designate the Center's Protected Territory.
- ii. review for approval the sites selected by the Franchisee for the Center.
- iii. review for approval the lease governing the location where the Center is to be located.
- iv. provide the franchisee with standard plans and specifications for the build-out of the Center along with a list of equipment and improvements which the franchisee is required to purchase and install.
- v. provide an initial training program.
- vi. provide the franchisee on-site assistance and guidance for approximately three to five days during or close to the opening of the Center.
- vii. provide the franchisee with online access to a password-protected, electronic version of the Medifast Weight Control Centers® Franchise Operations Manuals.

MFSI may, in certain limited circumstances, provide products at a discounted price. MFSI may, in certain circumstances guarantee a franchisee's notes, leases or other obligations. MFSI does not offer direct or indirect financing.

While MFSI does not currently have a purchase option included in its franchise agreement, it does have the right of first refusal to acquire a Center if the franchisee wishes to sell a Center.

See Note 11, "Business Segments" of the financial statements for a detailed breakout of revenues, profit or loss, and total assets of each of the Company's business segments.

**Medifast Wholesale Physicians-** Medifast physicians have been implementing the Medifast Program within their practices since 1980. These physicians carry an inventory of wholesale Medifast products and resell them to patients. They also provide appropriate medical monitoring, testing, and support for patients on the Medifast Program. Medifast products and programs have been recommended by over 20,000 doctors since 1980.

The Company offers an in-house support program to assist the physicians, their staff and their patients. We enable them with on boarding materials, marketing assets and appropriate training modules to help their practice support patients to achieve their weight loss goals. Physicians have access to registered dietitians who provide program support and advice via a toll-free telephone help line, by email, and online chats. See Note 11, "Business Segments" of the financial statements for a detailed breakout of revenues, profit or loss, and total assets of each of the Company's business segments.

**Overview of Financial Results**

	Three Months Ended September 30,				
	2013	2012	\$ Change	% Change	
Revenue	\$ 86,480,000	\$ 90,968,000	\$ (4,488,000)	-5	%
Cost of sales	21,627,000	22,632,000	(1,005,000)	-4	%
Gross Profit	64,853,000	68,336,000	(3,483,000)	-5	%
Selling, general, and administrative costs	57,504,000	59,408,000	(1,904,000)	-3	%
Income from operations	7,349,000	8,928,000	(1,579,000)	-18	%
Other income					
Interest income, net	167,000	64,000	103,000	161	%
Other expense	362,000	(13,000)	375,000	-2885	%
	529,000	51,000	478,000	937	%
Income before provision for income taxes	7,878,000	8,979,000	(1,101,000)	-12	%
Provision for income tax expense	2,205,000	1,771,000	434,000	25	%
Net income	\$ 5,673,000	\$ 7,208,000	\$ (1,535,000)	-21	%
% of revenue					
Gross Profit	75.0	%	75.1	%	
Selling, general, and administrative costs	66.5	%	65.3	%	
Income from Operations	8.5	%	9.8	%	

	Nine Months Ended September 30,				
	2013	2012	\$ Change	% Change	
Revenue	\$ 279,595,000	\$ 273,464,000	\$ 6,131,000	2	%
Cost of sales	69,403,000	68,233,000	1,170,000	2	%
Gross Profit	210,192,000	205,231,000	4,961,000	2	%
Selling, general, and administrative costs	183,624,000	185,568,000	(1,944,000)	-1	%
Income from operations	26,568,000	19,663,000	6,905,000	35	%
Other income					
Interest income, net	317,000	226,000	91,000	40	%
Other expense	581,000	925,000	(344,000)	-37	%
	898,000	1,151,000	(253,000)	-22	%
	27,466,000	20,814,000	6,652,000	32	%

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Income before provision for income taxes					
Provision for income tax expense	8,787,000	6,803,000	1,984,000	29	%
Net income	\$ 18,679,000	\$ 14,011,000	\$ 4,668,000	33	%
%					
%					
Gross Profit	75.2	%	75.0	%	
Selling, general, and administrative costs	65.7	%	67.9	%	
Income from Operations	9.5	%	7.2	%	

Revenue: Revenue decreased 5% and increased 2% to \$86.5 million and \$279.6 million for the three and nine months ended September 30, 2013, respectively, as compared to \$91.0 million and \$273.5 million for the three and nine months ended September 30, 2012. For the three months ended September 30, 2013, the Take Shape for Life sales channel accounted for 65.0% of total revenue, the Medifast Direct channel accounted for 19.8% of total revenue and the Medifast Weight Control Centers and Medifast Wholesale Physicians 15.2%. For the nine months ended September 30, 2013, the Take Shape for Life sales channel accounted for 63.3% of total revenue, the Medifast Direct channel accounted for 22.0% of total revenue and the Medifast Weight Control Centers and Medifast Wholesale Physicians 14.7%. In the third quarter of 2013, the Company's revenue to spend ratio was 15.8-to-1 versus 12.3-to-1 in the third quarter of 2012. Total advertising spend was \$5.5 million in the third quarter of 2013 versus \$7.4 million in the third quarter of 2012, a decrease of \$1.9 million or 26%. The year to date revenue to spend ratio for 2013 was 11.9-to-1 compared to 10.4-to-1 for 2012. Total advertising spend year to date 2013 was \$23.5 million and \$26.3 million year to date 2012.

For the three months ended September 30, 2013, Take Shape For Life revenue increased 1% to \$56.2 million compared to \$55.6 million in 2012, and increased 8% for the nine months ended September 30, 2013 to \$177.0 million compared to \$164.3 million in 2012. Growth in revenue for Take Shape For Life was driven by pricing resulting from our improved discount structure. The number of active Health Coaches at the end of the third quarter of 2013 increased to 11,700 compared with 10,800 during the period a year ago, an increase of 8.3%. Active Health Coaches are defined as Health Coaches receiving income from a product sale in the last month of the quarter. The average revenue per health coach per month decreased from \$1,660 for the nine months ended September 30, 2012 to \$1,650 for the nine months ended September 30, 2013.

The Medifast Direct Sales division revenue decreased 19% to \$17.1 million for the three months ended September 30, 2013 and 7% to \$61.6 million for the nine months ended September 30, 2013 compared to the same periods for 2012. Revenues in this channel are driven primarily by targeted customer advertising on-line, across local radio, via email and direct mail campaigns, and by highlighting customer successes in large national publications and on television. The decrease in revenue was primarily caused by a more challenging consumer discretionary spending environment and reduction in advertising spending. For the remainder of 2013, we will continue to monitor all elements of our advertising mix to improve near term demand generation and profitability for the Medifast Direct sales division.

The Medifast Weight Control Centers and Medifast Wholesale Physicians experienced revenue decline of 7% in the third quarter of 2013 and 4% year to date as compared to the same periods in 2012. Three corporate centers were closed during the quarter, leaving eighty-three corporate and thirty-six franchise centers in operation. Same store sales for centers open greater than one year decreased by 18% and 15% for the three and nine months ended September 30, 2013 compared to 2012. As previously discussed in prior quarters of 2013, the Company's focus to improve profitability by creating operational efficiency, optimizing staffing, and managing expenses including advertising spend contributed to the decrease in same store sales and overall revenues. There were 83 centers in the comparative same-store-sales base at September 30, 2013.

**Costs of Sales:** Cost of sales decreased \$1.0 million and increased \$1.2 million for the three and nine months ended September 30, 2013 to \$21.6 million and \$69.4 million compared to the same periods in 2012. As a percentage of sales, gross margin decreased to 75.0% from 75.1% in Q3 2013 versus the prior year. The decrease in gross margin verses the third quarter of 2012 was the result of higher shipping costs in the third quarter of 2013. The gross margin increased to 75.2% for the nine months ending September 30, 2013 as compared to 75.0% for the nine months ending September 30, 2012. The increase in gross margin for the nine months ending September 30, 2013 is the result of offering fewer customer discounts and increasing customer prices, partially offset by increased commodity and shipping costs.

**Selling, General and Administrative Costs:** Selling, general and administrative expenses were \$57.5 million for the third quarter of 2013 compared to \$59.4 million in the third quarter of 2012. As a percentage of sales, selling, general and administrative expenses increased to 66.5% versus 65.3% in the third quarter of 2012. For the nine months ended September 30, 2013, selling, general, and administrative expenses were \$183.6 million versus \$185.6 million the year prior, and decreased to 65.7% as a percentage of sales compared to 67.9% for the year prior. Take Shape For Life commission expense, which is variable based upon product sales, decreased by approximately \$0.4 million and increased by approximately \$5.2 million as TSFL sales grew 1% and 8% for the three and nine months ended September 30, 2013 as compared to same periods in 2012. Take Shape For Life Health Coaches are independent contractors that are paid commissions on product sales referred to the Company. Health Coaches earn commissions by referring product sales through their own replicated website or through the Company's in-house call center. The clients of Health Coaches are responsible for order and payment of product and their order is shipped directly to their home or designated address. Health Coaches are not required to purchase product in order to receive a commission. In addition, Health Coaches do not receive a commission on their personal product orders.

Salaries and benefits increased by approximately \$0.4 million in the third quarter of 2013 compared to last year and decreased by \$1.3 million for the nine months ended September 30, 2013 compared to last year. The decrease for the nine months ending September 30, 2013 verses last year was driven by the 2012 restructuring efforts and continued optimization of staffing levels at the Medifast Weight Control Centers and Corporate. The savings were partially offset by the hiring of and increased salaries for key technical and executive positions.

Sales and marketing expense decreased by \$2.3 million in the third quarter of 2013 compared to last year and \$4.0 million for the nine months ended September 30, 2013 compared to last year. The decrease is the result of lower advertising spend. The Company continues to balance marketing expenses to result in increased sales and a strong bottom line.

Office expenses decreased \$0.1 million and \$4.1 million for the three and nine months ended September 30, 2013, respectively in comparison to the same periods in 2012. The large year to date decrease in expense is primarily due to the Federal Trade Commission settlement (FTC) for \$3.7 million that was accrued in the second quarter of 2012. A decrease in accounting and consulting fees also attributed to the favorable change in expense year-over-year. Other expenses consisting primarily of depreciation, credit card processing fees, and licenses and fees increased by \$0.6 million and \$2.7 million for the three and nine months ended September 30, 2013. The most significant driver of this change was the continued focus on our investment in improving our infrastructure to support growth. As disclosed in



the first quarter, the Company also began accruing a sales tax liability in Q4 2012 that is contributing to both the quarter and year to date increase in other expenses.

**Income taxes:** In the third quarter of 2013, the Company recorded \$2.2 million in income tax expense, an effective rate of 28.0%, compared to \$1.8 million in income tax expense, an effective rate of 19.7% in the third quarter of 2012. The increase for the third quarter versus the third quarter of 2012 is due to the state restructuring that took place in 2012 which took advantage of the Maryland Singles Sales factor apportionment methodology. For the nine months ended September 30, 2013, the Company recorded income tax expense of \$8.8 million, an effective tax rate of 32.0%, compared to income tax expense of \$6.8 million, an effective tax rate of 32.7% for the nine months ended September 30, 2012. The decrease in the effective tax rate for the nine months ended September 30, 2013 was the result of the FTC settlement discussed above, state tax restructuring and apportionment, as well as benefiting from newly enacted research and development credits effective January 1, 2013 applicable retroactively to 2012 activity. The Company anticipates a full year tax rate of approximately 33-34% in 2013.

**Net income:** Net income was \$5.7 million in the third quarter of 2013 compared to \$7.2 million in the third quarter of 2012, a decrease of \$1.5 million. Pre-tax profit as a percent of sales increased to 9.1% in the third quarter of 2013 compared to 9.9% in the third quarter of 2012. Net income for the nine months ended September 30, 2013 was \$18.7 million compared to \$14.0 million in the same period of 2012, an increase of \$4.7 million. Pre-tax profit as a percent of sales increased to 9.8% for the period compared to 7.6% for 2012. The Federal Trade Commission settlement of \$3.7 million accrual and the \$0.4 million accelerated compensation for the Executive Chairman of the Board in the second quarter of 2012 accounted for a significant portion of the increased profitability. These items were partially offset by a \$0.8 million gain from a key man insurance proceeds in the second quarter of 2012 and also the decrease in customer discounts and increased customer pricing implemented in 2013. The nine month increase in profitability was also the result of the MWCC and Wholesale segment income (loss) before taxes increasing from a loss of \$1.1 million in 2012 to a profit of \$2.2 million in 2013. The segment benefited from savings related to the staffing re-alignment completed in the first quarter of 2012, continued staffing optimization and a reduction in advertising spend as a percentage of sales for each corporate center. This improvement in profit is partially offset by the increase in other expenses for depreciation, licenses and fees, and accrued sales tax discussed above.

### **Non-GAAP Financial Measures**

In addition to providing results that are determined in accordance with generally accepted accounting principles in the United States, referred to as GAAP, the Company has provided certain financial measures that are not in accordance with GAAP. The Company's non-GAAP financial measures of adjusted net income and adjusted diluted earnings per share exclude the charge the Company incurred in relation to the non-tax deductible FTC settlement in the second quarter of 2012. This charge was a unique event, not directly related to the Company's normal operations, the Company believes these non-GAAP financial measures may help investors better understand and compare our operating results and trends by eliminating this component.

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The Federal Trade Commission (FTC) settlement for \$3.7 million was first disclosed in the second quarter of 2012 and was finalized and signed on July 20, 2012. Pursuant to the settlement, the Company agreed to modify certain advertising claims and agreed to ensure that its clinical studies meet the protocol contained in the consent agreement.

The reconciliations of these non-GAAP financial measures are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Income from operations	\$ 7,349,000	\$ 8,928,000	\$ 26,568,000	\$ 19,663,000
FTC Settlement Expense	-	-	-	3,700,000
Adjusted Income from operations	\$ 7,349,000	\$ 8,928,000	\$ 26,568,000	\$ 23,363,000

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	\$ 5,673,000	\$ 7,208,000	\$ 18,679,000	\$ 14,011,000
FTC Settlement Expense	-	-	-	3,700,000
Adjusted Net Income	\$ 5,673,000	\$ 7,208,000	\$ 18,679,000	\$ 17,711,000
Diluted earnings per share	\$ 0.41	\$ 0.52	\$ 1.34	\$ 1.02
Impact for adjustments	-	-	-	0.27
Adjusted diluted earnings per share	\$ 0.41	\$ 0.52	\$ 1.34	\$ 1.29

The weighted-average diluted shares outstanding used in the calculation of these non-GAAP financial measures are the same as the weighted-average shares outstanding used in the calculation of the reported per share amounts.

Weighted average shares outstanding -

Basic	13,884,293	13,705,188	13,852,155	13,709,702
Diluted	13,903,412	13,804,212	13,955,217	13,766,013

Excluding the impact of the \$3.7 million expense for the anticipated FTC settlement recognized during 2012, income from operations for the nine months ended September 30, 2013 increased \$3.2 million to \$26.6 million from adjusted income from operations of \$23.4 million in 2012. For the nine months ended September 30, 2013, net income increased to \$18.7 million compared to adjusted net income of \$17.7 million for the same period in 2012. The FTC settlement was non-deductible for tax purposes and resulted in an effective tax rate of 32.7% for the nine months ended September 30, 2012. Adjusted diluted earnings per share for the nine months ended September 30, 2013 are \$1.34 compared to diluted earnings per share of \$1.29 for the same period in 2012.

**SEGMENT RESULTS OF OPERATIONS**

Segments	Net Sales by Segment for the three months ended September 30,					
	2013			2012		
	Sales	% of Total		Sales	% of Total	
Medifast	\$ 73,324,000	85	%	\$ 76,777,000	84	%
MWCC and Wholesale	13,156,000	15	%	14,191,000	16	%
Total Sales	\$ 86,480,000	100	%	\$ 90,968,000	100	%

Segments	Net Sales by Segment for the nine months ended September 30,					
	2013			2012		
	Sales	% of Total		Sales	% of Total	
Medifast	\$ 238,625,000	85	%	\$ 230,550,000	84	%
MWCC and Wholesale	40,970,000	15	%	42,914,000	16	%
Total Sales	\$ 279,595,000	100	%	\$ 273,464,000	100	%

Medifast Segment: The Medifast segment consists of the sales from Medifast Direct Marketing and Take Shape For Life. As this represents the majority of our business, this is discussed in the Overview of Financial Results above.

The MWCC and Wholesale segment consists of the sales of Medifast Corporate and Franchise Weight Control Centers as well as Medifast Wholesale Physicians. Sales decreased \$1.0 million, or 7.3%, in the third quarter of 2013 as compared to 2012 and \$1.9 million, or 4.5% for the nine months ended September 30, 2013 compared to the year prior. The decrease in sales for the periods was driven by the Company's focus to improve profitability by creating operational efficiency, optimizing staffing, and managing expenses including advertising spend. At September 30, 2013, Medifast Weight Control Centers were operating in eighty-three corporate locations and thirty-six franchise locations.

Segments	Income Before Income Taxes by Segment for the three months ended September 30,					
	2013			2012		
	Profit	% of Total		Profit	% of Total	
Medifast	\$ 8,601,000	109	%	\$ 9,575,000	107	%
MWCC and Wholesale	528,000	7	%	388,000	4	%
All Other	(1,251,000)	-16	%	(984,000)	-11	%
Income before income taxes	\$ 7,878,000	100	%	\$ 8,979,000	100	%

Segments	Income Before Income Taxes by Segment for the nine months ended September 30,					
	2013			2012		
	Profit	% of Total		Profit	% of Total	
Medifast	\$ 29,452,000	107	%	\$ 28,685,000	138	%
MWCC and Wholesale	2,157,000	8	%	(1,136,000)	-5	%
All Other	(4,143,000)	-14	%	(6,735,000)	-31	%
Income before income taxes	\$ 27,466,000	100	%	\$ 20,814,000	100	%

Medifast Segment: The Medifast reporting segment consists of the activity of Medifast Direct Marketing and Take Shape For Life. This represents the majority of our business and is discussed in the Overview of the Financial Results section above. See Note 11, "Business Segments" of the financial statements for a detailed breakout of expenses.

MWCC and Wholesale Segment: Profitability of this segment increased \$0.1 million in the third quarter of 2013 compared to the third quarter of 2012 and \$3.3 million in the first nine months of 2013 compared to the first nine months of 2012. The increase for both periods was the result of savings from the staffing re-alignment completed in the first quarter of 2012, continued efforts to optimize staffing levels following the restructuring, increased success of franchise centers, and reduced advertising spend as a percentage of sales for each corporate center.

The Company had eighty-three corporate centers and thirty-six franchise centers in operation as of September 30, 2013 compared to eighty-eight and thirty-two, respectively in 2012.

All Other Segment: The All other segment consists of corporate expenses related to the parent Company operations. Year-over-year parent company expenses decreased by \$2.6 million for the three and nine months ended September 30, 2013 compared to 2012. Corporate expenses include items such as auditors' fees, attorney's fees, stock compensation expense and corporate governance related to NYSE, Sarbanes Oxley, and SEC regulations. The \$3.7 million FTC settlement accrual and \$0.4 million accelerated compensation for the Executive Chairman of the Board in the second quarter of 2012 were the largest drivers of the decrease in expenses and were partially offset by a \$0.8 million gain associated with a key man life insurance proceed in the same quarter. See footnote 11, "Business Segments", for additional detail.

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

Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest rates and a decline in the stock market. The Company does not enter into derivatives, foreign exchange transactions or other financial instruments for trading or speculative purposes. The Company paid off our outstanding debt during the first quarter of 2013, eliminating our current exposure to interest rate risk. However, we have an undrawn and unsecured revolving line of credit for \$5,000,000, should we choose to draw on this line of credit in the future we would be subject to market risk due to changing interest rates.

We are exposed to market risk related to changes in interest rates and market pricing impacting our investment portfolio. Our current investment policy is to maintain an investment portfolio consisting mainly of U.S. money market and high-grade corporate securities, directly or through managed funds. Our cash is deposited in and invested through highly rated financial institutions in North America. Our marketable securities are subject to interest rate risk and market pricing risk and will fall in value if market interest rates increase or if market pricing decreases. If market interest rates were to increase and market pricing were to decrease immediately and uniformly by 10% from levels at September 30, 2013, we estimate that the fair value of our investment portfolio would decline by an immaterial amount and therefore we would not expect our operating results or cash flows to be affected to any significant degree by the effect of a change in market conditions on our investments.

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

Management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of September 30, 2013. Our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported accurately and on a timely basis. Based on this evaluation performed in accordance with the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, our management concluded that the Company's internal control over financial reporting was effective as of September 30, 2013.

### **Changes in Internal Control over Financial Reporting:**

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended September 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **Part II Other Information**

## **Item 1. Legal Proceedings**

The Company filed a civil complaint on February 17, 2010 in the U.S. District Court (SD, Cal) against Barry Minkow and the Fraud Discovery Institute, Inc. (collectively, "Minkow"), iBusiness Reporting, and its editor William Lobdell, Tracy Coenen and Sequence, Inc. (collectively, "Coenen"), "Zee Yourself", and Robert L. Fitzpatrick ("FitzPatrick") for Defamation, Market Manipulation and Unfair Business Practices, alleging a scheme of market manipulation of Medifast stock for Defendants' monetary gain, by damaging the business reputation of Medifast and its Take Shape For Life division. Bradley T. MacDonald, former Executive Chairman of Medifast and Company shareholder, joined the lawsuit individually. The lawsuit seeks \$270 million in compensatory damages, punitive damages, and ancillary relief. In March 2011, the District Court granted in part and denied in part certain Anti-SLAPP Motions to Strike (i.e. motions to dismiss) previously filed by all Defendants. The Company has appealed that portion of the District Court's ruling which dismissed its defamation claims against Minkow and Coenen in the 9th Circuit Court of Appeals. Defendant FitzPatrick's motion was denied as to the Company's defamation claim, and FitzPatrick has appealed that portion of the Court's ruling. Both appeals have been fully-briefed and oral argument was held on March 5, 2013. On May 20, 2013, the Court deferred its decision on Medifast and FitzPatrick's appeals pending the determination of a petition for rehearing en banc in another Anti-SLAPP appeal, Tarla Makaeff v. Trump University, LLC, Case No. 11-55016, filed on April 30, 2013. That petition is currently pending before the Ninth Circuit.

In addition to the above matter, the Company is, from time to time, subject to a variety of litigation and similar proceedings incidental to its business. Based upon the Company's experience, current information and applicable law, it does not believe that these proceedings and claims will have a material adverse effect on its results of operations, financial position or liquidity.

## **Item 1A. Risk Factors**

Information about risk factors for the nine months ended September 30, 2013, does not differ materially from those in set forth in Part I, Item 1A, of our Annual Report on Form 10-K for the year ended December 31, 2012.

**Item 5. Other Information**

On May 29, 2012, Board of Directors of Medifast, Inc. authorized the repurchase of up to 1,000,000 shares of the Company's common stock. The authorization remains open for a period of 24 months ending on May 29, 2014. This authorization is in addition to the previously reported share repurchase authorizations on May 18, 2011 and on July 21, 2011.

Stock repurchases under this program may be made by brokers through open market and privately negotiated transactions at times and in such amounts as management shall deem appropriate pursuant to Rule 10b-18 of the Exchange Act. The timing and actual number of shares which may be repurchased will depend on a variety of factors including price, corporate authorization provisions, above noted regulatory requirements, and other market conditions.

We are not obligated to purchase any shares. Subject to applicable securities laws repurchases may be made at such times and in such amounts, as our management deems appropriate. The share repurchase program may be discontinued or terminated at any time and we have not established a date for completion of the share repurchase program. The repurchases will be funded from our available cash.

There are 1,125,000 remaining authorized shares that may be repurchased.

No stock repurchases were made during the nine months ended September 30, 2013.

**SIGNATURES**

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

**Medifast, Inc.**

BY: /S/ MICHAEL C. MACDONALD

November 12, 2013

Michael C. MacDonald

Executive Chairman of the Board and Chief Executive Officer

(principal executive officer )

BY: /S/ TIMOTHY G. ROBINSON November 12, 2013

Timothy G. Robinson

Chief Financial Officer

(principal financial officer)



Index to Exhibits

Exhibit Number Description of Exhibit

- |      |   |
|------|---|
| 3.1  | Certificate of Incorporation of the Company and amendments thereto.*  |
| 3.2  | By-Laws of the Company-Amended.*  |
| 31.1 | Certification of Chief Executive Officer pursuant to Item 601(b)(31) of Regulation S-K, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Item 601(b)(31) of Regulation S-K, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                               |

\* Filed as an exhibit to and incorporated by reference to the Annual report on Form 10-K filed with the Securities and Exchange Commission on March 31, 2010.