

NAUTILUS, INC.  
Form 10-Q  
August 07, 2014

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, 2014

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  
(State or other jurisdiction of  
incorporation or organization)  
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)

94-3002667  
(I.R.S. Employer  
Identification No.)

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

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:

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Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(do not check if a 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, 2014 was 31,278,703 shares.

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NAUTILUS, INC.  
FORM 10-Q  
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2014

PART I

Item 1.	<u>Financial Statements</u>	<u>2</u>
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>14</u>
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>22</u>
Item 4.	<u>Controls and Procedures</u>	<u>22</u>

PART II

Item 1.	Legal Proceedings	<u>23</u>
Item 1A.	<u>Risk Factors</u>	<u>23</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>23</u>
Item 6.	<u>Exhibits</u>	<u>24</u>
	<u>Signature</u>	<u>25</u>

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## NAUTILUS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited and in thousands)

	As of June 30, 2014	December 31, 2013
Assets		
Cash and cash equivalents	\$38,285	\$40,979
Marketable securities	19,050	—
Trade receivables, net of allowances of \$34 and \$53	8,895	25,336
Inventories	23,229	15,824
Prepays and other current assets	5,069	6,927
Income taxes receivable	73	80
Deferred income tax assets	6,204	4,441
Total current assets	100,805	93,587
Property, plant and equipment, net	8,680	8,499
Goodwill	2,746	2,740
Other intangible assets, net	11,595	12,615
Long-term deferred income tax assets	20,899	25,725
Other assets	311	401
Total assets	\$145,036	\$143,567
Liabilities and Shareholders' Equity		
Trade payables	\$31,997	\$37,192
Accrued liabilities	8,122	9,123
Warranty obligations, current portion	2,075	1,610
Total current liabilities	42,194	47,925
Warranty obligations, non-current	—	28
Income taxes payable, non-current	3,533	2,577
Other long-term liabilities	1,232	1,472
Total liabilities	46,959	52,002
Commitments and contingencies (Note 12)		
Shareholders' equity:		
Common stock - no par value, 75,000 shares authorized, 31,278 and 31,162 shares issued and outstanding	7,348	6,769
Retained earnings	90,483	84,552
Accumulated other comprehensive income	246	244
Total shareholders' equity	98,077	91,565
Total liabilities and shareholders' equity	\$145,036	\$143,567

See accompanying Notes to Condensed Consolidated Financial Statements.



NAUTILUS, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited and in thousands, except per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net sales	\$48,546	\$36,242	\$120,450	\$95,456
Cost of sales	23,766	18,913	57,189	47,433
Gross profit	24,780	17,329	63,261	48,023
Operating expenses:				
Selling and marketing	15,690	13,768	37,463	32,394
General and administrative	4,959	3,982	10,762	8,929
Research and development	1,752	1,303	3,655	2,430
Total operating expenses	22,401	19,053	51,880	43,753
Operating income (loss)	2,379	(1,724)	11,381	4,270
Other income (expense):				
Interest income	16	—	24	1
Interest expense	(5)	(6)	(12)	(15)
Other, net	(56)	130	(117)	21
Total other income (expense)	(45)	124	(105)	7
Income (loss) from continuing operations before income taxes	2,334	(1,600)	11,276	4,277
Income tax provision (benefit)	836	(34,268)	4,030	(33,915)
Income from continuing operations	1,498	32,668	7,246	38,192
Discontinued operations:				
Income (loss) from discontinued operations before income taxes	(322)	113	(834)	(261)
Income tax provision (benefit) from discontinued operations	619	(82)	481	(91)
Income (loss) from discontinued operations	(941)	195	(1,315)	(170)
Net income	\$557	\$32,863	\$5,931	\$38,022
Basic income per share from continuing operations	\$0.05	\$1.05	\$0.23	\$1.23
Basic income (loss) per share from discontinued operations	(0.03)	0.01	(0.04)	(0.01)
Basic net income per share <sup>(1)</sup>	\$0.02	\$1.06	\$0.19	\$1.23
Diluted income per share from continuing operations	\$0.05	\$1.04	\$0.23	\$1.22
Diluted income (loss) per share from discontinued operations	(0.03)	0.01	(0.04)	(0.01)
Diluted net income per share	\$0.02	\$1.05	\$0.19	\$1.21
Shares used in per share calculations:				
Basic	31,226	31,058	31,203	31,003
Diluted	31,598	31,430	31,586	31,360

<sup>(1)</sup>May not add due to rounding.

See accompanying Notes to Condensed Consolidated Financial Statements.



NAUTILUS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (Unaudited and in thousands)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net income	\$557	\$32,863	\$5,931	\$38,022
Other comprehensive income (loss):				
Unrealized gain (loss) on marketable securities, net of income tax expense of \$0, \$0, \$0 and \$0	3	—	(10 )	—
Foreign currency translation, net of income tax expense (benefit) of \$(4), \$12, \$1 and \$21	176	(185 )	12	(332 )
Comprehensive income	\$736	\$32,678	\$5,933	\$37,690



See accompanying Notes to Condensed Consolidated Financial Statements.

4

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NAUTILUS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (Unaudited and in thousands)

	Six months ended June 30,	
	2014	2013
Cash flows from operating activities:		
Income from continuing operations	\$7,246	\$38,192
Loss from discontinued operations	(1,315	) (170
Net income	5,931	38,022
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	1,832	1,644
Bad debt expense	32	417
Inventory lower-of-cost-or-market adjustments	863	92
Stock-based compensation expense	520	134
Loss on asset dispositions	—	4
Deferred income taxes, net of valuation allowance	2,851	(34,414
Excess tax deficiency related to stock-based awards	174	—
Changes in operating assets and liabilities:		
Trade receivables, net	16,297	13,082
Inventories	(8,253	) 5,334
Prepays and other current assets	1,938	1,377
Income taxes	372	(34
Trade payables	(5,193	) (16,155
Accrued liabilities, including warranty obligations	(179	) (2,678
Net cash provided by operating activities	17,185	6,825
Cash flows from investing activities:		
Purchase of marketable securities	(19,050	) —
Proceeds from sale of assets of discontinued operations	—	110
Purchases of property, plant and equipment	(987	) (1,941
Net cash used in investing activities	(20,037	) (1,831
Cash flows from financing activities:		
Proceeds from exercise of stock options	234	275
Excess tax deficiency related to stock-based awards	(174	) —
Net cash provided by financing activities	60	275
Effect of exchange rate changes on cash and cash equivalents	98	(106
Increase (decrease) in cash and cash equivalents	(2,694	) 5,163
Cash and cash equivalents:		
Beginning of period	40,979	23,207
End of period	\$38,285	\$28,370
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$12	\$16
Cash paid for income taxes, net	261	188

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, 2013 (the "2013 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 2013 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, 2014 and December 31, 2013, our results of operations and comprehensive income for the three and six months ended June 30, 2014 and 2013 and our cash flows for the six months ended June 30, 2014 and 2013. 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 2014-12

In June 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-12, "Compensation - Stock Compensation (Topic 718)." ASU No. 2014-12 addresses accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. ASU 2014-12 indicates that, in such situations, the performance target should be treated as a performance condition and, accordingly, the performance target should not be reflected in estimating the grant-date fair value of the award. Instead, compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. We do not expect the adoption of ASU 2014-12 to have a material effect on our financial position, results of operations or cash flows.

ASU 2014-09

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers." ASU 2014-09 clarifies the principles for recognizing revenue and develops a common revenue standard for U.S. GAAP and the International Accounting Standards Board that:

- removes inconsistencies and weaknesses in revenue requirements;
- provides a more robust framework for addressing revenue issues;
- improves comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets;
- provides more useful information to users of financial statements through improved disclosure requirements; and
- simplifies the preparation of financial statements by reducing the number of requirements to which an entity must refer.

ASU 2014-09 is effective for annual and interim periods beginning on or after December 15, 2016. While we do not expect the adoption of ASU 2014-09 to have a material effect on our business, we are still evaluating any potential impact that adoption of the ASU may have on our financial position, results of operations or cash flows.

## ASU 2014-08

In April 2014, the FASB issued ASU No. 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360) and Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." ASU 2014-08 amends the definition for what types of asset disposals are to be considered discontinued operations, and amends the required disclosures for discontinued operations and assets held for sale. ASU 2014-08 also enhances the convergence of the FASB's and the International Accounting Standard Board's reporting requirements for discontinued operations. ASU 2014-08 is effective for annual periods beginning on or after December 15, 2014, and interim periods within annual periods beginning on or after December 15, 2015. We do not expect the adoption of ASU 2014-08 to have a material effect on our financial position, results of operations or cash flows.

## ASU 2013-11

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." ASU 2013-11 amends the guidance related to the presentation of unrecognized tax benefits and allows for the reduction of a deferred tax asset for a net operating loss ("NOL") carryforward whenever the NOL or tax credit carryforward would be available to reduce the additional taxable income or tax due if the tax position is disallowed. ASU 2013-11 is effective for annual and interim periods for fiscal years beginning after December 15, 2013. Since ASU 2013-11 relates only to the presentation of unrecognized tax benefits, our adoption of ASU 2013-11 in January 2014 did not have a material effect on our financial position, results of operations or cash flows.

## (2) DISCONTINUED OPERATIONS

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 Discontinued Operations 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 legal and accounting expenses as we work with authorities on final deregistration of certain European entities and product liability expenses associated with product previously sold into the Commercial channel. There was no revenue related to the Commercial business for the year ended December 31, 2013 or the three or six-month periods ended June 30, 2014.

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

	Facilities Leases
Balance, December 31, 2013	\$831
Adjustments	—
Payments	(127 )
Balance, June 30, 2014	\$704

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

## (3) MARKETABLE SECURITIES

We classify our marketable securities as available-for-sale and, accordingly, record them at fair value. Unrealized holding gains and losses are excluded from earnings and are reported net of tax in other comprehensive income until realized. Dividend and interest income is recognized when earned. Realized gains and losses are included in earnings

and are derived using the specific identification method for determining the cost of securities sold.

We periodically evaluate whether declines in fair values of our investments below their cost are "other-than-temporary". This evaluation consists of qualitative and quantitative factors regarding the severity and duration of the unrealized loss, as well as our ability and intent to hold the investment until a forecasted recovery occurs.

**(4) INVENTORIES**

Inventories are carried at the lower of cost or market. Cost is determined using the first-in, first-out method. We periodically review inventory for excess, obsolete and slow moving items and make provisions as necessary to properly reflect inventory value.

Inventories consisted of the following (in thousands):

	As of	
	June 30, 2014	December 31, 2013
Finished goods	\$ 21,919	\$ 14,259
Parts and components	1,310	1,565
Total inventories	\$ 23,229	\$ 15,824

**(5) PROPERTY, PLANT AND EQUIPMENT**

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

	Estimated Useful Life (in years)	As of June 30, 2014	December 31, 2013
Leasehold improvements	5 to 20	\$ 2,870	\$ 2,869
Computer software and equipment	3 to 7	40,172	35,554
Machinery and equipment	3 to 5	5,818	5,648
Furniture and fixtures	5	711	688
Work in progress	N/A	394	4,281
Total cost		49,965	49,040
Accumulated depreciation		(41,285)	(40,541)
Total property, plant and equipment, net		\$ 8,680	\$ 8,499

**(6) GOODWILL AND OTHER INTANGIBLE ASSETS****Goodwill**

All goodwill is assigned to our Direct reporting segment. The rollforward of goodwill was as follows (in thousands):

Balance, January 1, 2013	\$ 2,940
Currency exchange rate adjustment	(200)
Balance, December 31, 2013	2,740
Currency exchange rate adjustment	6
Balance, June 30, 2014	\$ 2,746

**Other Intangible Assets**

Other intangible assets consisted of the following (in thousands):

	Estimated Useful Life (in years)	As of June 30, 2014	December 31, 2013
Other intangible assets:			
Indefinite-lived trademarks	N/A	\$ 9,052	\$ 9,052
Patents	8 to 16	18,154	18,154
		27,206	27,206
Accumulated amortization - patents		(15,611)	(14,591)
Other intangible assets, net		\$ 11,595	\$ 12,615





Amortization expense was as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Patent amortization	\$ 510	\$ 512	\$ 1,020	\$ 1,025

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

Remainder of 2014	\$ 1,020
2015	828
2016	430
2017	143
2018	65
Thereafter	57
	\$ 2,543

#### (7) ACCRUED LIABILITIES

Accrued liabilities consisted of the following (in thousands):

	As of	
	June 30, 2014	December 31, 2013
Payroll and related liabilities	\$ 3,014	\$ 4,244
Other	5,108	4,879
Total accrued liabilities	\$ 8,122	\$ 9,123

#### (8) FAIR VALUE MEASUREMENTS

Factors used in determining the fair value of financial assets and liabilities are summarized into three broad categories:

Level 1 - observable inputs such as quoted prices (unadjusted) in active liquid markets for identical securities as of the reporting date;

Level 2 - other significant directly or indirectly observable inputs, including quoted prices for similar securities, interest rates, prepayment speeds and credit risk; or observable market prices in markets with insufficient volume and/or infrequent transactions; and

Level 3 - significant inputs that are generally unobservable inputs for which there is little or no market data available, including our own assumptions in determining fair value.

Assets measured at fair value on a recurring basis were as follows (in thousands):

	June 30, 2014			
	Level 1	Level 2	Level 3	Total
<b>Cash Equivalents</b>				
Money market funds	\$ 1,965	\$—	\$—	\$ 1,965
Commercial paper	—	9,498	—	9,498
Variable-rate demand notes	—	8,000	—	8,000
Total Cash Equivalents	1,965	17,498	—	19,463
<b>Available for Sale Securities</b>				
Certificates of deposit	—	4,165	—	4,165
Corporate bonds	—	7,888	—	7,888
Commercial paper	—	6,997	—	6,997
Total Available for Sale Securities	—	19,050	—	19,050
Total assets measured at fair value	\$ 1,965	\$ 36,548	\$—	\$ 38,513

The company recognizes transfers between levels at the actual date of the event or change in circumstance that caused the transfer. There were no transfers between levels during the six months ended June 30, 2014.

We classify our marketable securities as available-for-sale and, accordingly, record them at fair value based on quoted market prices. The factors or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities. Unrealized holding gains and losses are excluded from earnings and are reported net of tax in other comprehensive income until realized. During the first six months of 2014 and 2013, we did not record any other-than-temporary impairments on our financial assets required to be measured at fair value on a nonrecurring basis.

We recognize or disclose the fair value of certain assets, such as non-financial assets, primarily Property, Plant and Equipment, Goodwill, Other Intangible Assets and certain other long-lived assets in connection with impairment evaluations. All of our nonrecurring valuations use significant unobservable inputs and therefore fall under Level 3 of the fair value hierarchy. We did not perform any valuations on assets or liabilities that are valued at fair value on a nonrecurring basis during the first six months of 2014 or during all of 2013 except for the Goodwill and indefinite-lived trade names impairment evaluation that was prepared effective October 1, 2013.

The carrying value of Cash and Cash Equivalents, Trade Receivables, Prepaids and Other Current Assets, Trade Payables and Accrued Liabilities approximates their fair values due to the short-term nature of their maturities.

## (9) 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 ended June 30,	
	2014	2013
Balance, beginning of period	\$1,638	\$2,492
Accruals	1,318	718
Adjustments	—	(186)
Payments	(881)	(862)
Balance, end of period	\$2,075	\$2,162

#### (10) INCOME PER SHARE

Basic per share amounts were computed using the weighted average number of common shares outstanding. Diluted per share amounts were calculated using the number of basic weighted average shares outstanding 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 per share were as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Shares used to calculate basic income per share	31,226	31,058	31,203	31,003
Dilutive effect of outstanding options, performance stock units and restricted stock units	372	372	383	357
Shares used to calculate diluted income per share	31,598	31,430	31,586	31,360

The weighted average numbers of shares outstanding listed in the table below were anti-dilutive and excluded from the computation of diluted income 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 months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Stock options	271	307	282	306
Performance stock units	151	75	84	88

#### (11) SEGMENT AND ENTERPRISE-WIDE 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, Cash and Cash Equivalents, Marketable Securities, Prepaids and Other Current Assets, Deferred Income Tax Assets, Other Assets, and capital expenditures.

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

	Three months ended June 30,	
	2014	2013
Net sales:		
Direct	\$32,355	\$25,314
Retail	15,039	10,175
Unallocated royalty income	1,152	753
Consolidated net sales	\$48,546	\$36,242
Contribution:		
Direct	\$3,889	\$508
Retail	1,325	140
Unallocated royalty income	1,152	753
Consolidated contribution	\$6,366	\$1,401
Reconciliation of consolidated contribution to income from continuing operations:		
Consolidated contribution	\$6,366	\$1,401
Amounts not directly related to segments:		
Operating expenses	(3,987	) (3,125
Other income (expense), net	(45	) 124
Income tax (expense) benefit	(836	) 34,268
Income from continuing operations	\$1,498	\$32,668
	Six months ended June 30,	
	2014	2013
Net sales:		
Direct	\$83,091	\$67,949
Retail	35,142	25,309
Unallocated royalty income	2,217	2,198
Consolidated net sales	\$120,450	\$95,456
Contribution:		
Direct	\$14,242	\$7,217
Retail	3,834	2,100
Unallocated royalty income	2,217	2,198
Consolidated contribution	\$20,293	\$11,515
Reconciliation of consolidated contribution to income from continuing operations:		
Consolidated contribution	\$20,293	\$11,515
Amounts not directly related to segments:		
Operating expenses	(8,912	) (7,245
Other income (expense), net	(105	) 7
Income tax (expense) benefit	(4,030	) 33,915
Income from continuing operations	\$7,246	\$38,192

There was no material change in the allocation of assets by segment during the first six months of 2014 and, accordingly, assets by segment are not presented.

For the three and six months ended June 30, 2014, Amazon.com accounted for 10.9% and 10.3%, respectively, of our total Net Sales. No customer represented 10.0% or more of our total Net Sales in the three or six months ended June

30, 2013.

12

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## (12) COMMITMENTS AND CONTINGENCIES

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

As of June 30, 2014, we had approximately \$0.7 million in standby letters of credit with certain vendors with expiration dates through April 2015.

We have long lead times for inventory purchases and, therefore, must secure factory capacity from our vendors in advance. As of June 30, 2014, we had approximately \$19.5 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, 2014.

### Legal Matters

In 2004, we were sued in the Southern District of New York by BioSig Instruments, Inc. for alleged patent infringement in connection with our incorporation of heart rate monitors into certain cardio products. No significant activity in the litigation occurred until 2008. In 2012, the United States District Court granted summary judgment to us on grounds that BioSig's patents were invalid as a matter of law. BioSig appealed the grant of summary judgment and, in April 2013, the United States Court of Appeals for the Federal Circuit reversed the District Court's decision on summary judgment and remanded the case to the District Court for further proceedings. On January 10, 2014, the U.S. Supreme Court granted our petition for a writ of certiorari to address the legal standard applied by the Federal Circuit in determining whether the patents may be valid under applicable law. The case was argued before the Supreme Court on April 28, 2014. By decision dated June 2, 2014, the Supreme Court unanimously reversed the Federal Circuit and held that its standard of when a patent may be "indefinite" was incorrect. The case will return to the Federal Circuit for further proceedings. We do not believe that our use of heart rate monitors utilized or purchased from third parties, and otherwise, infringe the BioSig patents.

In addition to the matter described above, from time to time we are subject to litigation, claims and assessments that arise in the ordinary course of business, including disputes that may arise from intellectual property related matters. Management believes that any liability resulting from such additional matters will not have a material adverse effect on our financial position, results of operations or cash flows.

We record expenses for litigation and loss contingencies when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. When a loss contingency is not both probable and estimable, we do not establish an accrued liability. However, if the loss (or an additional loss in excess of the accrual) is at least a



reasonable possibility and material, then we disclose an estimate of the possible loss or range of loss, if such estimate can be made, or disclose that an estimate cannot be made.

Litigation and jury verdicts are, to some degree, inherently unpredictable, and although we have determined that a loss is not probable in connection with any current legal proceeding at this time, it is reasonably possible that a loss may be incurred in connection with proceedings to which we are a party. Assessment of whether incurrence of a loss is probable, or a reasonable possibility, in connection with a particular proceeding, and estimation of the loss, or a range of loss, involves complex judgments and numerous uncertainties. Management is unable to estimate a range of reasonably possible losses related to litigation in its early stages, especially when the damages sought are indeterminate, or the legal and factual basis for the relevant claims have not been developed with specificity.

We regularly monitor our estimated exposure to these contingencies and, as additional information becomes known, may change our estimates accordingly. We evaluate, on a quarterly basis, developments in legal proceedings, investigations or claims that could

affect the amount of any accrual, as well as any developments that would make a loss probable or reasonably possible, and whether the amount of a probable or reasonably possible loss is estimable. Among other factors, we evaluate the advice of internal and external counsel, the outcomes from similar litigation, current status of the lawsuits (including settlement initiatives), legislative developments and other factors. Due to the numerous variables associated with these judgments and assumptions, both the precision and reliability of the resulting estimates of the related loss contingencies are subject to substantial uncertainties.

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

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, 2013 (the "2013 Form 10-K"). All references to the second quarter and first six months of 2014 and 2013 mean the three or six-month periods ended June 30, 2014 and 2013, 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 distribute advertisements of our products on television, the Internet and other media, 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 2013 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," "should," "could," 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; expectations for increased Research and Development expenses; the amount expected to be spent on capital projects in 2014; 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, the anticipated outcome of litigation to which we are a party, 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 2013 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.

## 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®, Bowflex®, Schwinn®, Schwinn Fitness™ and Universal

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 2014 were \$120.5 million, an increase of \$25.0 million, or 26.2%, as compared to Net Sales of \$95.5 million for the first six months of 2013. Net sales of our Direct segment increased \$15.1 million, or 22.3%, in the first six months of 2014, compared to the first six months of 2013, primarily due to increased consumer demand for our cardio products, especially the recently released Bowflex® MAX Trainer™, which started shipping in January 2014. Net sales of our Retail segment increased by \$9.8 million, or 38.9%, in the first six months of 2014, compared to the first six months of 2013, primarily due to strong retailer sell-through of our new line up of cardio products.

Gross Profit for the first six months of 2014 was \$63.3 million, an increase of \$15.2 million, or 31.7%, as compared to Gross Profit of \$48.0 million for the first six months of 2013. The increase in Gross Profit dollars and percent was primarily due to the increase in Net Sales and improved product mix. Operating Expenses for the first six months of 2014 were \$51.9 million, an increase of \$8.1 million, or 18.6%, as compared to Operating Expenses of \$43.8 million for the first six months of 2013. The growth in Operating Expenses was primarily related to increases in Selling and Marketing expenses. Operating Income for the first six months of 2014 was \$11.4 million, an increase of \$7.1 million, or 166.5%, as compared to Operating Income of \$4.3 million for the first six months of 2013. The improvement in our operating results for the first six months of 2014 compared to the first six months of 2013 was driven primarily by higher Net Sales and Gross Profit in both the Retail and Direct channels.

Income from Continuing Operations was \$7.2 million for the first six months of 2014, or \$0.23 per diluted share, compared to Income From Continuing Operations of \$38.2 million, or \$1.22 per diluted share, for the first six months of 2013. Net income for the first six months of 2014 was \$5.9 million, compared to net income of \$38.0 million for the first six months of 2013. Net income per diluted share was \$0.19 for the first six months of 2014, compared to \$1.21 per diluted share for the first six months of 2013. Income from Continuing Operations and Net Income in the first six months of 2013 included a \$34.3 million, or \$1.09 per diluted share, tax benefit related to the reversal of our deferred tax asset valuation allowance.

## Discontinued Operations

Results from discontinued operations relate to the disposal of our former Commercial business, which was completed in April 2011. We reached substantial completion of asset liquidation at December 31, 2012. Although there was no revenue related to the Commercial business in either the 2014 or the 2013 periods, we continue to have legal and accounting expenses as we work with authorities on final deregistration of each entity and product liability expenses associated with product previously sold into the Commercial channel.



## Results of Operations

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

	Three months ended June 30,		Change		
	2014	2013	\$	%	
Net sales	\$48,546	\$36,242	\$12,304	33.9	%
Cost of sales	23,766	18,913	4,853	25.7	%
Gross profit	24,780	17,329	7,451	43.0	%
Operating expenses:					
Selling and marketing	15,690	13,768	1,922	14.0	%
General and administrative	4,959	3,982	977	24.5	%
Research and development	1,752	1,303	449	34.5	%
Total operating expenses	22,401	19,053	3,348	17.6	%
Operating income (loss)	2,379	(1,724)	4,103	238.0	%
Other income (expense):					
Interest income	16	—	16		
Interest expense	(5)	(6)	1		
Other	(56)	130	(186)		
Total other income (expense), net	(45)	124	(169)		
Income (loss) from continuing operations before income taxes	2,334	(1,600)	3,934		
Income tax expense (benefit)	836	(34,268)	35,104		
Income from continuing operations	1,498	32,668	(31,170)		
Income (loss) from discontinued operations, net of income taxes	(941)	195	(1,136)		
Net income	\$557	\$32,863	\$(32,306)		
	Six months ended June 30,		Change		
	2014	2013	\$	%	
Net sales	\$120,450	\$95,456	\$24,994	26.2	%
Cost of sales	57,189	47,433	9,756	20.6	%
Gross profit	63,261	48,023	15,238	31.7	%
Operating expenses:					
Selling and marketing	37,463	32,394	5,069	15.6	%
General and administrative	10,762	8,929	1,833	20.5	%
Research and development	3,655	2,430	1,225	50.4	%
Total operating expenses	51,880	43,753	8,127	18.6	%
Operating income	11,381	4,270	7,111	166.5	%
Other income (expense):					
Interest income	24	1	23		
Interest expense	(12)	(15)	3		
Other	(117)	21	(138)		
Total other income (expense), net	(105)	7	(112)		
Income from continuing operations before income taxes	11,276	4,277	6,999		
Income tax expense (benefit)	4,030	(33,915)	37,945		
Income from continuing operations	7,246	38,192	(30,946)		
Loss from discontinued operations, net of income taxes	(1,315)	(170)	(1,145)		
Net income	\$5,931	\$38,022	\$(32,091)		



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

	Three months ended June 30,		Change		
	2014	2013	\$	%	
Net sales:					
Direct	\$32,355	\$25,314	\$7,041	27.8	%
Retail	15,039	10,175	4,864	47.8	%
Royalty income	1,152	753	399	53.0	%
	\$48,546	\$36,242	\$12,304	33.9	%
Cost of sales:					
Direct	\$12,389	\$10,721	\$1,668	15.6	%
Retail	11,377	8,192	3,185	38.9	%
Royalty income	—	—	—		
	\$23,766	\$18,913	\$4,853	25.7	%
Gross profit:					
Direct	\$19,966	\$14,593	\$5,373	36.8	%
Retail	3,662	1,983	1,679	84.7	%
Royalty income	1,152	753	399	53.0	%
	\$24,780	\$17,329	\$7,451	43.0	%
Gross margin:					
Direct	61.7	% 57.6	% 410		basis points
Retail	24.4	% 19.5	% 490		basis points
	Six months ended June 30,		Change		
	2014	2013	\$	%	
Net sales:					
Direct	\$83,091	\$67,949	\$15,142	22.3	%
Retail	35,142	25,309	9,833	38.9	%
Royalty income	2,217	2,198	19	0.9	%
	\$120,450	\$95,456	\$24,994	26.2	%
Cost of sales:					
Direct	\$30,807	\$27,879	\$2,928	10.5	%
Retail	26,382	19,554	6,828	34.9	%
Royalty income	—	—	—		
	\$57,189	\$47,433	\$9,756	20.6	%
Gross profit:					
Direct	\$52,284	\$40,070	\$12,214	30.5	%
Retail	8,760	5,755	3,005	52.2	%
Royalty income	2,217	2,198	19	0.9	%
	\$63,261	\$48,023	\$15,238	31.7	%
Gross margin:					
Direct	62.9	% 59.0	% 390		basis points
Retail	24.9	% 22.7	% 220		basis points



The following tables compare the Net Sales of our major product lines within each business segment (in thousands):

	Three months ended June 30,		Change		
	2014	2013	\$	%	
Direct net sales:					
Cardio products <sup>(1)</sup>	\$29,384	\$20,461	\$8,923	43.6	%
Strength products <sup>(2)</sup>	2,971	4,853	(1,882)	(38.8)	)%
	32,355	25,314	7,041	27.8	%
Retail net sales:					
Cardio products <sup>(1)</sup>	8,529	3,447	5,082	147.4	%
Strength products <sup>(2)</sup>	6,510	6,728	(218)	(3.2)	)%
	15,039	10,175	4,864	47.8	%
Royalty income	1,152	753	399	53.0	%
	\$48,546	\$36,242	\$12,304	33.9	%

<sup>(1)</sup> Cardio products include: TreadClimber®, MAX Trainer™, treadmills, exercise bikes, ellipticals, CoreBody Reformer®, Bowflex Boost™ and DVDs.

<sup>(2)</sup> Strength products include: home gyms, selectorized dumbbells, kettlebell weights, UpperCut™ and accessories.

	Six months ended June 30,		Change		
	2014	2013	\$	%	
Direct net sales:					
Cardio products <sup>(1)</sup>	\$75,247	\$56,104	\$19,143	34.1	%
Strength products <sup>(2)</sup>	7,844	11,845	(4,001)	(33.8)	)%
	83,091	67,949	15,142	22.3	%
Retail net sales:					
Cardio products <sup>(1)</sup>	20,905	10,345	10,560	102.1	%
Strength products <sup>(2)</sup>	14,237	14,964	(727)	(4.9)	)%
	35,142	25,309	9,833	38.9	%
Royalty income	2,217	2,198	19	0.9	%
	\$120,450	\$95,456	\$24,994	26.2	%

<sup>(1)</sup> Cardio products include: TreadClimber®, MAX Trainer™, treadmills, exercise bikes, ellipticals, CoreBody Reformer®, Bowflex Boost™ and DVDs.

<sup>(2)</sup> Strength products include: home gyms, selectorized dumbbells, kettlebell weights, UpperCut™ and accessories.

#### Direct

The 27.8% and the 22.3% increase, respectively, in Direct Net Sales in the three and six-month periods of 2014 compared to the same periods of 2013 were primarily related to the increases in sales of our cardio products, especially the recently released Bowflex® MAX Trainer™, which started shipping in January 2014. The business also benefited from higher U.S. consumer credit approval rates.

Combined consumer credit approvals by our primary and secondary U.S. third-party financing providers for the three and six-month periods ended June 30, 2014 increased to 38.8% and 40.4%, respectively, compared to 33.8% and 34.6%, respectively, in the same periods of 2013. We attribute the increases to our media strategy focused on driving quality consumer leads and an expanded lender base.

The increases in Direct Net Sales of cardio products in the three and six-month periods of 2014 compared to the same periods of 2013 were partially offset by declines in Direct Net Sales of strength products, primarily due to lower sales

of rod-based home gyms. The declines were attributable, in part, to the reduction of advertising for these products over time, as management determined that television advertising spending on this mature product category was generating suboptimal returns. We continue

18

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to market and sell rod-based home gyms through more cost-efficient online media, and sales of these products have shifted to the Retail segment.

The increases in Cost of Sales of our Direct business in the three and six-month periods of 2014 compared to the same periods of 2013 were almost entirely related to growth in Direct Net Sales.

The 410 and 390 basis point increase, respectively, in the gross margin of our Direct business for the three and six-month periods of 2014 compared to the same periods of 2013 were primarily due to improved product mix coupled with higher sales volume.

#### Retail

The 47.8% and 38.9% increase, respectively, in Retail Net Sales in the three and six-month periods of 2014 compared to the same periods of 2013 were driven by increased sales of the new line up of cardio products launched in September 2013.

The increases in Retail Cost of Sales for the three and six-month periods of 2014 compared to the same periods of 2013 were due to the increase in Retail Net Sales.

The 490 and 220 basis point improvement, respectively, in Retail gross margin in the three and six-month periods of 2014 compared to the same periods of 2013 were primarily due to greater absorption of fixed supply chain costs with the higher sales volume.

#### Selling and Marketing

Dollars in thousands	Three months ended June 30,		Change	
	2014	2013	\$	%
Selling and Marketing	\$15,690	\$13,768	\$1,922	14.0%
As % of Net Sales	32.3%	38.0%		
Dollars in thousands	Six months ended June 30,		Change	
	2014	2013	\$	%
Selling and Marketing	\$37,463	\$32,394	\$5,069	15.6%
As % of Net Sales	31.1%	33.9%		

The increases in Selling and Marketing expense in the three and six-month periods of 2014 compared to the same periods of 2013 were primarily due to higher production costs for creative media of less than \$0.1 million and \$1.0 million, respectively, increases in media advertising of \$0.9 million and \$1.6 million, respectively, and incremental variable selling expenses of \$0.7 million and \$1.6 million, respectively.

Selling and Marketing as a percentage of Net Sales is affected by the mix of Direct sales compared to Retail sales. Increasing Retail sales as a percentage of total Net Sales reduces the percentage of Selling and Marketing as a percentage of Net Sales and vice versa.

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 June 30,		Change	
	2014	2013	\$	%
Media advertising	\$8,182	\$7,310	\$872	11.9%
Dollars in thousands	Six months ended June 30,		Change	
	2014	2013	\$	%
Media advertising	\$18,849	\$17,274	\$1,575	9.1%

The increases in media advertising in the three and six-month periods of 2014 compared to the same periods of 2013 were primarily to drive incremental sales in the Direct business, and to support the media launch of the Bowflex® MAX Trainer™.

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General and Administrative

Dollars in thousands	Three months ended June 30,		Change	
	2014	2013	\$	%
General and Administrative	\$4,959	\$3,982	\$977	24.5%
As % of Net Sales	10.2%	11.0%		
Dollars in thousands	Six months ended June 30,		Change	
	2014	2013	\$	%
General and Administrative	\$10,762	\$8,929	\$1,833	20.5%
As % of Net Sales	8.9%	9.4%		

The increases in General and Administrative in the three and six-month periods of 2014 compared to the same periods of 2013 were due to higher spending on intellectual property registration and legal fees of patent enforcement cases in the 2014 periods of \$0.3 million and \$0.5 million, respectively. Additionally, incentive compensation increased by \$0.3 million and \$0.5 million, respectively, and software license fees increased by \$0.1 million and \$0.3 million, respectively.

The decreases as a percentage of Net Sales in the three and six-month periods of 2014 compared to the same periods of 2013 were primarily due to the increases in Net Sales.

Research and Development

Dollars in thousands	Three months ended June 30,		Change	
	2014	2013	\$	%
Research and Development	\$1,752	\$1,303	\$449	34.5%
As % of Net Sales	3.6%	3.6%		
Dollars in thousands	Six months ended June 30,		Change	
	2014	2013	\$	%
Research and Development	\$3,655	\$2,430	\$1,225	50.4%
As % of Net Sales	3.0%	2.5%		

The increases in Research and Development in the three and six-month periods of 2014 compared to the same periods of 2013 were primarily due to our continued investment in resources required to innovate and broaden our product portfolio.

Other Income (Expense)

Other Income (Expense) primarily relates to the effect of exchange rate fluctuations between the U.S. and Canada.

Income Tax Provision

Dollars in thousands	Three months ended June 30,		Change	
	2014	2013	\$	%
Income Tax Provision (Benefit)	\$836	\$(34,268)	\$35,104	n/m
Effective tax rate	35.8%	n/m		
Dollars in thousands	Six months ended June 30,		Change	
	2014	2013	\$	%
Income Tax Provision (Benefit)	\$4,030	\$(33,915)	\$37,945	n/m

Effective tax rate	35.7%	n/m
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n/m - Not meaningful

Income Tax Provision from continuing operations for the three and six-month periods ended June 30, 2014 was primarily related to our profitable U.S. and Canadian operations. Income Tax Benefit from continuing operations for the three and six-month periods of 2013 was attributable to a partial release of U.S domestic valuation allowance.

Further, in the second quarter of 2014, we recorded \$0.6 million of income tax expense in discontinued operations, which was attributable to the tax liability associated with an uncertain tax position in a certain foreign jurisdiction. Although there have been

20

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no material changes to our discontinued foreign operations since December 31, 2013, we continue to evaluate our tax positions as we undergo complex and lengthy tax audits as part of the customary deregistration process in order to liquidate the remainder of the entities.

## LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2014, we had \$38.3 million of Cash and Cash Equivalents and \$19.1 million of Marketable Securities, compared to \$41.0 million of Cash and Cash Equivalents and zero Marketable Securities as of December 31, 2013. Cash provided by operating activities was \$17.2 million for the six months ended June 30, 2014, compared to cash provided by operating activities of \$6.8 million for the six months ended June 30, 2013. We expect our Cash, Cash Equivalents and Marketable Securities at June 30, 2014, 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, 2014.

The increase in cash flows from operating activities was primarily due to the changes in our operating assets and liabilities as discussed below, as well as the decrease in Deferred Income Tax Assets due to the utilization of net operating losses.

Trade Receivables decreased \$16.4 million to \$8.9 million as of June 30, 2014, compared to \$25.3 million as of December 31, 2013, due to seasonally lower revenue. Days sales outstanding ("DSO") at June 30, 2014 were 15.4 days compared to 19.9 days as of December 31, 2013 and 20.2 days as of June 30, 2013. The decrease in DSO at June 30, 2014 compared to December 31, 2013 was due to a higher percentage of our Net Sales being derived from our Direct segment, which generally has a lower DSO than the Retail segment. The decrease in DSO at June 30, 2014 compared to June 30, 2013 was also due to improved collections from Retail customers.

Prepaid and Other Current Assets decreased \$1.8 million to \$5.1 million as of June 30, 2014 compared to \$6.9 million as of December 31, 2013, primarily due to seasonality of the business and royalty payments received from licensees during the first quarter of 2014 for 2013 sales, as well as releasing certain prepaid marketing costs for the recently launched Bowflex® MAX Trainer™.

Inventories increased \$7.4 million to \$23.2 million as of June 30, 2014, compared to \$15.8 million as of December 31, 2013, due to several factors, including pre-buying to allow for production disruption related to a planned factory expansion by a supplier, the potential for work stoppage at certain West Coast ports, and alignment of inventory for a new distribution center that is planned to open in the next quarter. Inventories as of June 30, 2014 compared to June 30, 2013 increased by \$9.9 million, due to the above reasons, as well as the increase in Net Sales.

Trade Payables decreased \$5.2 million to \$32.0 million as of June 30, 2014, compared to \$37.2 million as of December 31, 2013, primarily due to seasonality of the business and vendor payments made in the first quarter of 2014 that related to 2013 inventory purchases.

Accrued Liabilities decreased \$1.0 million to \$8.1 million as of June 30, 2014 compared to \$9.1 million as of December 31, 2013, primarily due to incentive compensation payments made in the first quarter of 2014 that related to 2013 performance.

Cash used in investing activities of \$20.0 million for the first six months of 2014 was primarily related to the purchase of \$19.1 million of marketable securities during the period. Additionally, \$1.0 million in capital expenditures was incurred during the period for implementation of new software and hardware information system upgrades and new product tooling equipment. We anticipate spending between \$3.3 million to \$3.8 million in 2014 for capital projects.

## 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 1.65% as of June 30, 2014. 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, 2014, we had no outstanding borrowings and \$0.7 million in standby letters of credit issued under the Loan Agreement. As of June 30, 2014, we were in compliance with the financial covenants of the Loan Agreement and approximately \$15.0 million was available for borrowing.

#### Commitments and Contingencies

For a description of our commitments and contingencies, refer to Note 12 to our Condensed Consolidated Financial Statements in Item 1 of this Form 10-Q.

#### Off-Balance Sheet Arrangements

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 our 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 indemnifications vary from contract to contract, and generally a maximum obligation is not stated. We hold insurance policies that mitigate potential losses arising from certain types of indemnifications. Because we are unable to estimate our potential obligation, and because management does not expect these obligations to have a material adverse effect on our consolidated financial position, results of operations or cash flows, no liabilities are recorded at June 30, 2014.

#### 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, 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 2013 Form 10-K.

#### 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 Equivalents and Marketable Securities. As of June 30, 2014, we held cash equivalents of \$19.5 million and marketable securities of \$19.1 million. Given that cash equivalents mature within three months or less from the date of purchase and marketable securities mature within twelve months 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.

#### 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 our Chief 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 Chief Financial Officer, have 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

Other than discussed below, there were no changes in our internal control over financial reporting that occurred during the three months ended June 30, 2014, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

During the quarter ended June 30, 2014, we completed the implementation of a new enterprise resource planning ("ERP") system, which covers all of our significant processes including, but not limited to, revenue and invoicing, purchasing, accounts payable, accounts receivable and general ledger reporting. We believe this new ERP system and related processes enhance our internal control over financial reporting. We may make modifications and upgrades to the ERP system in the future to further enhance our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

In 2004, we were sued in the Southern District of New York by BioSig Instruments, Inc. for alleged patent infringement in connection with our incorporation of heart rate monitors into certain cardio products. No significant activity in the litigation occurred until 2008. In 2012, the United States District Court granted summary judgment to us on grounds that BioSig's patents were invalid as a matter of law. BioSig appealed the grant of summary judgment and, in April 2013, the United States Court of Appeals for the Federal Circuit reversed the District Court's decision on summary judgment and remanded the case to the District Court for further proceedings. On January 10, 2014, the U.S. Supreme Court granted our petition for a writ of certiorari to address the legal standard applied by the Federal Circuit in determining whether the patents may be valid under applicable law. The case was argued before the Supreme Court on April 28, 2014. By decision dated June 2, 2014, the Supreme Court unanimously reversed the Federal Circuit and held that its standard of when a patent may be "indefinite" was incorrect. The case will return to the Federal Circuit for further proceedings. We do not believe that our use of heart rate monitors utilized or purchased from third parties, and otherwise, infringe the BioSig patents.

In addition to the matter described above, from time to time we are subject to litigation, claims and assessments that arise in the ordinary course of business, including disputes that may arise from intellectual property related matters. Management believes that any liability resulting from such additional matters will not have a material adverse effect on our financial position, results of operations or cash flows.

### Item 1A. Risk Factors

We operate in an environment that involves a number of risks and uncertainties. The risks and uncertainties described in our 2013 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 2013 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 2013 Form 10-K.

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

#### Issuer Purchases of Equity Securities

The following table provides information about our repurchases of our equity securities during the second quarter ended June 30, 2014:

Period	(a)	(b)	(c)	(d)
		Average	Total Number of Shares (or Units) Purchased as Part	Maximum Number (or Approximate Dollar Value) of Shares (or

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	Total Number of Shares (or Units) Purchased <sup>(1)</sup>	Price Paid per Share (or Unit)	of Publicly Announced Plans or Programs	Units) that May Yet Be Purchased Under the Plans or Programs
April 1 - April 30	1,688	\$8.33	—	—
May 1 - May 31	1,996	10.83	—	—
June 1 - June 30	1,998	11.09	—	—
Total	5,682	10.18	—	—

<sup>(1)</sup> Consists of shares withheld from the vesting portion of a restricted stock unit award granted to Bruce M. Cazenave, our Chief Executive Officer. We will withhold from 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:

Exhibit No.	Description
10.1	First Lease Modification Agreement, dated June 19, 2014, to the Office Lease by and between Nautilus, Inc. and Columbia Tech Center, L.L.C. dated July 25, 2011.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial statements from Nautilus, Inc.'s quarterly report on Form 10-Q for the three months ended June 30, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets (unaudited), (ii) Condensed Consolidated Statements of Operations (unaudited), (iii) Condensed Consolidated Statements of Comprehensive Income (unaudited), (iv) Condensed Consolidated Statements of Cash Flows (unaudited) and (v) Notes to Condensed Consolidated Financial Statements (unaudited).

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.

NAUTILUS, INC.

August 7, 2014

By: /S/ Bruce M. Cazenave  
Bruce M. Cazenave  
Chief Executive Officer  
(Principal Executive Officer)

NAUTILUS, INC.

August 7, 2014

By: /S/ Sidharth Nayar  
Sidharth Nayar  
Chief Financial Officer  
(Principal Financial and Accounting Officer)