

NATURAL ALTERNATIVES INTERNATIONAL INC

Form 10-Q

November 12, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q
QUARTERLY REPORT

pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2009

000-15701

(Commission file number)

NATURAL ALTERNATIVES INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

84-1007839
(IRS Employer Identification No.)

1185 Linda Vista Drive

San Marcos, California 92078
(Address of principal executive offices)

(760) 744-7340
(Registrant's telephone number)

Indicate by check mark whether Natural Alternatives International, Inc. (NAI) (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that NAI was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

☒ Yes ☐ No

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

☐ Yes ☐ No

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

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

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

☐ Yes ☒ No

As of November 10, 2009, 7,068,793 shares of NAI's common stock were outstanding, net of 180,941 treasury shares.

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SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

Certain statements in this report, including information incorporated by reference, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements reflect current views about future events and financial performance based on certain assumptions. They include opinions, forecasts, intentions, plans, goals, projections, guidance, expectations, beliefs or other statements that are not statements of historical fact. Words such as may, will, should, could, would, expects, plans, believes, anticipates, intends, estimates, ap projects, or the negative or other variation of such words, and similar expressions may identify a statement as a forward-looking statement. Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focus and plans, and other characterizations of future events or circumstances, including statements expressing general optimism about future operating results, are forward-looking statements. Forward-looking statements in this report may include statements about:

future financial and operating results, including projections of net sales, revenue, income or loss, net income or loss per share, profit margins, expenditures, liquidity, goodwill valuation and other financial items;

our ability to develop relationships with new customers and maintain or improve existing customer relationships;

development of new products, brands and marketing strategies;

the effect of the discontinuance of Dr. Cherry's television program and our ability to develop a new marketing plan for, and to sustain, our Pathway to Healing® product line;

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

inventories and the adequacy and intended use of our facilities;

current or future customer orders;

the impact on our business and results of operations and variations in quarterly net sales from cost reduction programs, seasonal and other factors;

management's goals and plans for future operations;

our ability to improve operational efficiencies, manage costs and business risks and improve or maintain profitability;

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

personnel;

the outcome of regulatory, tax and litigation matters;

sources and availability of raw materials;

operations outside the United States;

the adequacy of reserves and allowances;

overall industry and market performance;

competition and competitive advantages resulting from our quality commitment;

current and future economic and political conditions;

the impact of accounting pronouncements; and

other assumptions described in this report underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements. Forward-looking statements are subject to certain events, risks, and uncertainties that may be outside of our control. When considering forward-looking statements, you should carefully review the risks, uncertainties and other cautionary statements in this report as they identify certain important factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. These factors include, among others, the risks described under Item 1A of Part II and elsewhere in this report, as well as in other reports and documents we file with the United States Securities and Exchange Commission (SEC).

Unless the context requires otherwise, all references in this report to the Company, NAI, we, our, and us refer to Natural Alternatives International, Inc. and, as applicable, Natural Alternatives International Europe S.A. (NAIE), and our other wholly owned subsidiary.

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

| | September 30, 2009 (Unaudited) | June 30, 2009 |
|---|--------------------------------------|------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 4,483 | \$ 3,995 |
| Certificate of deposit | 699 | 699 |
| Accounts receivable - less allowance for doubtful accounts of \$22 at September 30, 2009 and \$27 at June 30, 2009 | 5,271 | 5,685 |
| Inventories, net | 10,872 | 9,320 |
| Deferred income taxes | 225 | |
| Prepays and other current assets | 1,639 | 1,261 |
| Assets of discontinued operations | 433 | 1,187 |
| Total current assets | 23,622 | 22,147 |
| Property and equipment, net | 14,358 | 14,133 |
| Other noncurrent assets, net | 159 | 159 |
| Total assets | \$ 38,139 | \$ 36,439 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 5,448 | \$ 4,327 |
| Accrued liabilities | 871 | 1,001 |
| Accrued compensation and employee benefits | 937 | 1,164 |
| Income taxes payable | 852 | 490 |
| Current portion of long-term debt | 405 | 669 |
| Liabilities of discontinued operations | 163 | 599 |
| Total current liabilities | 8,676 | 8,250 |
| Long-term debt, less current portion | 559 | 598 |
| Deferred rent | 1,020 | 1,054 |
| Long-term pension liability | 468 | 505 |
| Total liabilities | 10,723 | 10,407 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock; \$.01 par value; 500,000 shares authorized; none issued or outstanding | | |
| Common stock; \$.01 par value; 20,000,000 shares authorized; issued and outstanding 7,249,734 at September 30, 2009 and June 30, 2009 | 71 | 71 |

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| | | |
|---|-----------|-----------|
| Additional paid-in capital | 18,942 | 18,899 |
| Accumulated other comprehensive loss | (565) | (565) |
| Retained earnings | 10,067 | 8,726 |
| Treasury stock, at cost, 180,941 shares at September 30, 2009 and June 30, 2009 | (1,099) | (1,099) |
| Total stockholders' equity | 27,416 | 26,032 |
| Total liabilities and stockholders' equity | \$ 38,139 | \$ 36,439 |

See accompanying notes to condensed consolidated financial statements.

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

| | Three Months Ended September 30, | |
|--|---|-------------|
| | 2009 | 2008 |
| Net sales | \$ 16,961 | \$ 19,526 |
| Cost of goods sold | 13,806 | 17,126 |
| Gross profit | 3,155 | 2,400 |
| Selling, general & administrative expenses | 1,748 | 2,618 |
| Operating income (loss) from continuing operations | 1,407 | (218) |
| Other income (expense): | | |
| Interest income | 5 | 5 |
| Interest expense | (42) | (43) |
| Foreign exchange (loss) gain | 23 | (299) |
| Other, net | 25 | 24 |
| Total other income (expense) | 11 | (313) |
| Income (loss) from continuing operations before income taxes | 1,418 | (531) |
| Provision (benefit) for income taxes | 172 | (182) |
| Income (loss) from continuing operations | 1,246 | (349) |
| Income (loss) from discontinued operations, net of tax | 95 | (1,048) |
| Net income (loss) and comprehensive income (loss) | \$ 1,341 | \$ (1,397) |
| Net income (loss) per common share: | | |
| Basic: | | |
| Continuing operations | \$ 0.18 | \$ (0.05) |
| Discontinued operations | 0.01 | (0.15) |
| Basic net income (loss) per share | \$ 0.19 | \$ (0.20) |
| Diluted: | | |
| Continuing operations | \$ 0.18 | \$ (0.05) |
| Discontinued operations | 0.01 | (0.15) |
| Diluted net income (loss) per share | \$ 0.19 | \$ (0.20) |
| Weighted average common shares outstanding: | | |
| Basic | 7,068,793 | 7,033,213 |
| Diluted | 7,110,810 | 7,033,213 |

See accompanying notes to condensed consolidated financial statements.

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

| | Three Months Ended September 30, | |
|---|---|-------------|
| | 2009 | 2008 |
| Cash flows from operating activities | | |
| Income (loss) before discontinued operations | \$ 1,246 | \$ (349) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 801 | 789 |
| Reduction of uncollectible accounts receivable | (5) | |
| Non-cash compensation | 43 | 69 |
| Tax benefit from exercise of stock options | | (17) |
| Deferred income taxes | (225) | |
| Pension expense, net of contributions | (37) | 13 |
| Loss on disposal of assets | 1 | 8 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 419 | 2,521 |
| Inventories, net | (1,552) | (1,707) |
| Other assets | (378) | 27 |
| Accounts payable and accrued liabilities | 957 | (878) |
| Income taxes payable | 362 | (871) |
| Accrued compensation and employee benefits | (227) | 249 |
| Net cash provided by (used in) operating activities from continuing operations | 1,405 | (146) |
| Net cash used in operating activities from discontinued operations | (87) | (494) |
| Net cash provided by (used in) operating activities | 1,318 | (640) |
| Cash flows from investing activities | | |
| Capital expenditures | (1,027) | (1,540) |
| Purchase of certificate of deposit | | (699) |
| Net cash used by investing activities from continuing operations | (1,027) | (2,239) |
| Net cash provided by investing activities from discontinued operations, including proceeds from the sale of the legacy RHL business assets and As We Change | 500 | 2,155 |
| Net cash used by investing activities | (527) | (84) |
| Cash flows from financing activities | | |
| Net borrowings on line of credit | | 595 |
| Payments on long-term debt | (303) | (366) |
| Tax benefit from exercise of stock options | | 17 |
| Proceeds from issuance of common stock | | 26 |
| Net cash (used in) provided by financing activities | (303) | 272 |
| Net increase (decrease) in cash and cash equivalents | 488 | (452) |

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| | | |
|--|----------|----------|
| Cash and cash equivalents at beginning of period | 3,995 | 3,518 |
| Cash and cash equivalents at end of period | \$ 4,483 | \$ 3,066 |
| Supplemental disclosures of cash flow information | | |
| Cash paid during the period for: | | |
| Interest | \$ 51 | \$ 49 |
| Taxes | \$ 62 | \$ 60 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(UNAUDITED)****A. Basis of Presentation and Summary of Significant Accounting Policies**

The accompanying interim unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and applicable rules and regulations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In management's opinion, all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows have been included and are of a normal, recurring nature. The results of operations for the three months ended September 30, 2009 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

You should read the financial statements and these notes, which are an integral part of the financial statements, together with our audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2009 (2009 Annual Report). The accounting policies used to prepare the financial statements included in this report are the same as those described in the notes to the consolidated financial statements in our 2009 Annual Report unless otherwise noted below.

Subsequent Events Evaluation

The Company evaluated all events or transactions that occurred after September 30, 2009 up through November 10, 2009, the date these financial statements were issued.

Net Income (Loss) per Common Share

We compute net income per common share using the weighted average number of common shares outstanding during the period, and diluted net income per common share using the additional dilutive effect of all dilutive securities. The dilutive impact of stock options account for the additional weighted average shares of common stock outstanding for our diluted net income per common share computation. We calculated basic and diluted net income per common share as follows (in thousands, except per share data):

| | Three Months Ended September 30, | |
|--|---|-------------|
| | 2009 | 2008 |
| Numerator | | |
| Net income (loss) | \$ 1,341 | \$ (1,397) |
| Denominator | | |
| Basic weighted average common shares outstanding | 7,069 | 7,033 |
| Dilutive effect of stock options | 42 | |
| Diluted weighted average common shares outstanding | 7,111 | 7,033 |
| Basic net income (loss) per common share | \$ 0.19 | \$ (0.20) |
| Diluted net income (loss) per common share | \$ 0.19 | \$ (0.20) |

Shares related to stock options totalling 560,276 for the three months ended September 30, 2009, and 679,500 for the three months ended September 30, 2008, were excluded from the calculation of diluted net income per common share, as the effect of their inclusion would have been anti-dilutive.

Stock-Based Compensation

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We have an equity incentive plan under which we have granted nonqualified and incentive stock options to employees, non-employee directors and consultants. We also had an employee stock purchase plan that was terminated effective as of June 30, 2009.

We estimated the fair value of the stock option awards at the date of grant and employee stock purchase plan shares at the beginning of the offering period using the Black-Scholes option valuation model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions. Black-Scholes uses assumptions related to volatility, the risk-free interest rate, the dividend yield (which is assumed to be zero, as we have not paid any cash dividends) and employee exercise behavior. Expected volatilities used in the model are based mainly on the historical volatility of our stock price. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect in the period of grant. The expected life of stock option grants is derived from historical experience.

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Our net income for the three months ended September 30, 2009 included stock based compensation expense of approximately \$43,000 and our net loss for the three months ended September 30, 2008 included stock based compensation expense of approximately \$69,000.

Fair Value of Financial Instruments

Our financial statements include the following financial instruments: cash and cash equivalents, short-term investments, accounts payable, and accrued expenses. We believe the carrying amounts of these assets and liabilities in the financial statements approximate the fair values of these financial instruments at September 30, 2009 and June 30, 2009. Fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date.

We utilize a three-level hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions about the inputs that market participants would use in pricing the asset or liability and are developed based on the best information available in the circumstances.

The fair value hierarchy is broken down into three levels based on the source of inputs. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. We classify cash, cash equivalents, and marketable securities balances as a Level 1 asset. Fair values determined by Level 2 inputs are based on quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and models for which all significant inputs are observable or can be corroborated, either directly or indirectly by observable market data. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. These include certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs. As of September 30, 2009 and June 30, 2009, we did not have any financial assets or liabilities classified as Level 2 or 3.

Adoption of New Accounting Standards

During the first quarter of 2010, we adopted the new Accounting Standards Codification (ASC) as issued by the Financial Accounting Standards Board (FASB). The ASC has become the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. The ASC is not intended to change or alter existing United States generally accepted accounting principles (GAAP). The adoption of the ASC did not have a material impact on our consolidated financial statements.

B. Discontinued Operations

In an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business, during the fourth quarter of fiscal 2008 we undertook a careful review of our branded products portfolio and operations. As a result, we decided to narrow our branded products focus and portfolio and developed a plan to do so, which included a decision to sell the legacy business of Real Health Laboratories (RHL). On August 4, 2008, RHL sold certain assets related to its catalog and internet business conducted under the name As We Change® to Miles Kimball Company for a cash purchase price of \$2.3 million. We recorded a loss of \$226,000 as a result of this sale and recognized \$221,000 in severance and related payroll costs during fiscal 2009.

On July 29, 2009, we entered into an Asset Purchase Agreement with PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for the sale of substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business. The sale closed on July 31, 2009 for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. NAI provided a guarantee of RHL's indemnity obligations under the Asset Purchase Agreement, which potential liability is capped at the amount of the purchase price paid by the buyers to RHL. We recorded a loss of \$6,000 as a result of this sale during the first quarter of fiscal 2010. RHL has agreed to provide certain transition services and support to the buyers for a period of up to six months and will receive an amount equal to \$9,000 per month for such services. Following the sale of substantially all of the assets of RHL, we changed the name of RHL to Disposition Company, Inc.

As a result of our decision to sell the legacy RHL business, we initiated an operational consolidation program during the first quarter of fiscal 2009 that transitioned the remaining branded products business operations to our corporate offices. This operational consolidation program was substantially complete as of September 30, 2008 and resulted in a charge to discontinued operations of \$823,000 in severance and other business related exit costs during the year ended June 30, 2009.

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As the plan to dispose of the legacy RHL business met the criteria of accounting for the impairment or disposal of long-lived assets, the current and prior periods presented in this report have been reclassified to reflect the legacy RHL business as discontinued operations.

During the third quarter of fiscal 2009, RHL's wholesale operation experienced a decline in sales activity from one of its largest customers as a result of the discontinuance of certain RHL product lines. Historically these product sales represented a significant portion of RHL's overall annual sales to this customer. Additionally, during this same period we received feedback from multiple parties related to their preliminary interest in acquiring the then remaining RHL operations. Due in part to the expected decline in future RHL sales as noted above and the current depressed worldwide economic conditions, the preliminary purchase price valuations provided by these third parties provided us with an indication that an impairment of the RHL net asset carrying values may exist.

We performed an analysis that compared the fair value of RHL's net assets as indicated by the third party purchase price valuations noted above to the current carrying amounts to determine if an impairment of value was evident. As a result of this analysis, we determined that as of the related measurement date the book value of RHL's net assets exceeded the fair value by approximately \$1.8 million and recorded an impairment charge for this amount to discontinued operations during the third quarter of fiscal 2009.

The following table presents the activity and the reserve balances related to these restructuring programs for the three months ended September 30, 2009 (in thousands):

| | Balance at June 30, 2009 | Charges to Expense | Cash Payments | Balance at September 30, 2009 |
|--|-----------------------------|-----------------------|------------------|----------------------------------|
| Employee termination costs | \$ 19 | \$ 1 | \$ (14) | \$ 6 |
| Lease liabilities and related facility closure costs | 15 | | (6) | 9 |
| Total | \$ 34 | \$ 1 | \$ (20) | \$ 15 |
| Accrued restructuring charges: | | | | |
| Current portion continuing operations | | | | \$ 6 |
| Discontinued operations | | | | 9 |
| Total | | | | \$ 15 |

The following table summarizes the results of the legacy RHL business for the three months ended September 30 (in thousands):

| | 2009 | 2008 |
|---|--------------|-------------------|
| Net sales | \$ 323 | \$ 1,374 |
| Cost of goods sold and operating expenses | 188 | 1,967 |
| Restructuring expenses | 1 | 851 |
| Loss on the sale of As We Change® | | 226 |
| Loss on the sale of remaining Legacy RHL assets | 6 | |
| Other expense (income) | 7 | (1) |
| Income (loss) before income taxes | 121 | (1,669) |
| Income tax provision (benefit) | 26 | (621) |
| Income (loss) from discontinued operations | \$ 95 | \$ (1,048) |

Assets and liabilities of the legacy RHL business included in the condensed consolidated balance sheets are summarized as follows (in thousands):

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| | September 30, 2009 | June 30, 2009 |
|---------------------------------------|-----------------------|------------------|
| Assets | | |
| Cash | \$ 42 | \$ 144 |
| Accounts receivable, net | 389 | 510 |
| Inventory, net | | 286 |
| Other current assets | 2 | 39 |
| Goodwill and intangible assets | | 208 |
| Total assets | \$ 433 | \$ 1,187 |
| Liabilities | | |
| Accrued liabilities | 163 | 599 |
| Total liabilities | 163 | 599 |
| Net assets of discontinued operations | \$ 270 | \$ 588 |

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

| | September 30, 2009 | June 30, 2009 |
|------------------|-----------------------|------------------|
| Raw materials | \$ 7,367 | \$ 6,368 |
| Work in progress | 2,261 | 1,445 |
| Finished goods | 2,240 | 2,287 |
| Reserves | (996) | (780) |
| | \$ 10,872 | \$ 9,320 |

D. Property and Equipment

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

| | Depreciable Life In Years | September 30, 2009 | June 30, 2009 |
|---|------------------------------|-----------------------|------------------|
| Land | N/A | \$ 393 | \$ 393 |
| Building and building improvements | 7 39 | 2,679 | 2,679 |
| Machinery and equipment | 3 12 | 24,678 | 23,681 |
| Office equipment and furniture | 3 5 | 3,396 | 3,419 |
| Vehicles | 3 | 204 | 204 |
| Leasehold improvements | 1 15 | 10,086 | 10,067 |
| Total property and equipment | | 41,436 | 40,443 |
| Less: accumulated depreciation and amortization | | (27,078) | (26,310) |
| Property and equipment, net | | \$ 14,358 | \$ 14,133 |

E. Debt

We have a bank credit facility of \$8.5 million as of September 30, 2009, comprised of a \$7.5 million working capital line of credit and \$964,000 in outstanding term loans. The working capital line of credit has a maturity date of November 1, 2010 and is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has a fluctuating or fixed interest rate as elected by NAI from time to time and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. As of September 30, 2009, the outstanding balances on the term loans consisted of a \$198,000, 15 year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a \$513,000, 10 year term loan due May 2014 with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; and a \$253,000, four year term loan due December 2009, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately \$98,000 plus interest. As of September 30, 2009 and June 30, 2009, our working capital line of credit balance was zero.

On September 30, 2009, we were in compliance with all loan debt covenants.

On September 22, 2006, NAIE, our wholly owned subsidiary, entered into a credit facility to provide it with a credit line of up to CHF 1.3 million, or approximately \$1.3 million, which is the initial maximum aggregate amount that can be outstanding at any one time under the credit facility. This maximum amount was reduced by CHF 160,000, or approximately \$155,000, as of December 31, 2007,

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and was reduced an additional CHF 160,000, or approximately \$155,000, as of December 31, 2008, and will be reduced by an additional CHF 160,000 at the end of each succeeding calendar year. On February 19, 2007, NAIE amended its credit facility to provide that the maximum aggregate amount that may be outstanding under the facility cannot be reduced below CHF 500,000, or approximately \$483,000. As of September 30, 2009, there was no outstanding balance under the credit facility.

Under its credit facility, NAIE may draw amounts either as current account loan credits to its current or future bank accounts or as fixed loans with a maximum term of 24 months. Current account loans will bear interest at the rate of 5% per annum. Fixed loans will bear interest at a rate determined by the parties based on current market conditions and must be repaid pursuant to a repayment schedule established by the parties at the time of the loan. If a fixed loan is repaid early at NAIE's election or in connection with the termination of the credit facility, NAIE will be charged a pre-payment penalty equal to 0.1% of the principal amount of the fixed loan or CHF 1,000 (approximately \$966), whichever is greater. The bank reserves the right to refuse individual requests for an advance under the credit facility, although its exercise of such right will not have the effect of terminating the credit facility as a whole.

The composite interest rate on all of our outstanding debt was 16.31% at September 30, 2009 and 5.75% at September 30, 2008. The composite interest rate includes interest from our term debt, interest from the use of our working capital line of credit, amortization of annual loan fees and loan modification fees, as applicable, divided by the average balance of our outstanding borrowings during the period.

F. Defined Benefit Pension Plan

We sponsor a defined benefit pension plan that provides retirement benefits to employees based generally on years of service and compensation during the last five years before retirement. Effective June 20, 1999, we adopted an amendment to freeze benefit accruals to the participants. We contribute an amount not less than the minimum funding requirements of the Employee Retirement Income Security Act of 1974 nor more than the maximum tax-deductible amount.

The components included in the net periodic benefit for the periods ended September 30 were as follows (in thousands):

| | Three Months Ended September 30, | |
|--------------------------------|---|-------------|
| | 2009 | 2008 |
| Interest cost | \$ 21 | \$ 20 |
| Expected return on plan assets | (13) | (7) |
| Net periodic benefit | \$ 8 | \$ 13 |

G. Economic Dependency

We had substantial net sales from continuing operations to certain customers during the periods shown in the following table. The loss of any of these customers, or a significant decline in sales or the growth rate of sales to these customers could have a material adverse impact on our net sales and net income from continuing operations. Net sales from continuing operations to any one customer representing 10% or more of the respective period's total net sales were as follows (dollars in thousands):

| | Three Months Ended September 30, | | | |
|------------|---|---------------------------------|----------------------------------|---------------------------------|
| | 2009 | | 2008 | |
| | Net Sales by Customer | % of Total Net Sales | Net Sales by Customer | % of Total Net Sales |
| Customer 1 | \$ 5,763 | 34% | \$ 5,401 | 28% |
| Customer 2 | 8,457 | 50 | 9,872 | 50 |
| | \$ 14,220 | 84% | \$ 15,273 | 78% |

We buy certain products from a limited number of raw material suppliers. The loss of any of these suppliers could have a material adverse impact on our net sales and net income. Raw material purchases from any one supplier representing 10% or more of the respective period's total

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raw material purchases were as follows (dollars in thousands):

| | Three Months Ended September 30, 2009 | | 2008 | |
|------------|---|--|---|--|
| | Raw Material Purchases by Supplier | % of Total Raw Material Purchases | Raw Material Purchases by Supplier | % of Total Raw Material Purchases |
| Supplier 1 | \$ 1,199 | 16% | \$ 1,768 | 17% |
| Supplier 2 | 944 | 13 | 1,079 | 10 |
| | \$ 2,143 | 29% | \$ 2,847 | 27% |

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Our business consists of two segments, identified as private label contract manufacturing, which primarily provides private label contract manufacturing services to companies that market and distribute nutritional supplements and other health care products, and branded products, which markets and distributes branded nutritional supplements.

In an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business, during the fourth quarter of fiscal 2008 we developed a plan to narrow our branded products focus and portfolio and to sell our legacy RHL business. On August 4, 2008, RHL sold certain assets related to its catalog and internet business conducted under the name As We Change® to Miles Kimball Company for a cash purchase price of \$2.3 million. We recorded a loss of \$226,000 as a result of this sale and recognized \$221,000 in severance and related payroll costs during fiscal 2009.

On July 31, 2009, we sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business to PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. The financial information presented in this report has been reclassified to reflect the legacy RHL business as discontinued operations. We recorded a loss of \$6,000 as a result of this sale.

Following the completion of the sale of substantially all of the assets of RHL, our branded products segment consists primarily of the products sold under our Pathway to Healing product line.

We evaluate performance based on a number of factors. The primary performance measures for each segment are net sales and income or loss from operations before corporate allocations. Operating income or loss for each segment does not include corporate general and administrative expenses, interest expense and other miscellaneous income and expense items. Corporate general and administrative expenses include, but are not limited to: human resources, legal, finance, information technology, and other corporate level related expenses, which are not allocated to either segment. The accounting policies of our segments are the same as those described in Note A above and in the consolidated financial statements included in our 2009 Annual Report.

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

| | Three Months Ended September 30, | |
|---|---|-------------|
| | 2009 | 2008 |
| Net Sales | | |
| Private label contract manufacturing | \$ 16,373 | \$ 18,742 |
| Branded products | 588 | 784 |
| | \$ 16,961 | \$ 19,526 |
| | | |
| | Three Months Ended September 30, | |
| | 2009 | 2008 |
| Income (Loss) from Continuing Operations | | |
| Private label contract manufacturing | \$ 2,516 | \$ 1,468 |
| Branded products | 107 | 50 |
| | | |
| Income from operations of reportable segments | 2,623 | 1,518 |
| Corporate expenses not allocated to segments | (1,216) | (1,736) |
| | \$ 1,407 | \$ (218) |

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| | September 30, 2009 | June 30, 2009 |
|--------------------------------------|-----------------------|------------------|
| Total Assets | | |
| Private label contract manufacturing | \$ 37,317 | \$ 34,774 |
| Branded products | 389 | 478 |
| | \$ 37,706 | \$ 35,252 |

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Our private label contract manufacturing products are sold both in the United States and in markets outside the United States, including Europe, Australia and Asia. Our primary market outside the United States is Europe. Our branded products are sold only in the United States.

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

| | Three Months Ended September 30, | |
|-----------------------------------|-------------------------------------|------------------|
| | 2009 | 2008 |
| United States | \$ 11,120 | \$ 13,193 |
| Markets outside the United States | 5,841 | 6,333 |
| Total net sales | \$ 16,961 | \$ 19,526 |

Products manufactured by NAIE accounted for 53% of net sales in markets outside the United States for the three months ended September 30, 2009, and 55% for the three months ended September 30, 2008. No products manufactured by NAIE were sold in the United States during the three months ended September 30, 2009 and 2008.

Assets and capital expenditures by geographic region, based on the location of the company or subsidiary at which they were located or made, were as follows (in thousands):

| | Long-Lived Assets | | Total Assets | | Capital Expenditures Three Months Ended | |
|---------------|-----------------------|------------------|-----------------------|------------------|--|-----------------------|
| | September 30, 2009 | June 30, 2009 | September 30, 2009 | June 30, 2009 | September 30, 2009 | September 30, 2008 |
| United States | \$ 12,297 | \$ 11,991 | \$ 29,345 | \$ 27,106 | \$ 984 | \$ 1,439 |
| Europe | 2,220 | 2,301 | 8,361 | 8,146 | 43 | 101 |
| | \$ 14,517 | \$ 14,292 | \$ 37,706 | \$ 35,252 | \$ 1,027 | \$ 1,540 |

I. Restructuring Costs

During the year ended June 30, 2009, the continued decline in economic conditions in the United States and the various foreign markets we service negatively impacted our customers' businesses and our operations. As a result, during the second quarter of fiscal 2009 we implemented a cost reduction program that resulted in the elimination of certain personnel and business activities. The cost reduction program is expected to reduce the financial impact of the anticipated reduction in future sales. This program resulted in a charge to our continuing operations of \$558,000 in severance from a reduction in force during the second quarter of fiscal 2009. All payments related to this cost reduction program are expected to be completed within the next twelve months.

The following table presents the activity and the reserve balance related to this restructuring program for the three months ended September 30, 2009 (in thousands):

| | Balance at June 30, 2009 | Charges to Expense | Adjustments | Cash Payments | Balance at September 30, 2009 |
|---|--------------------------------|-----------------------|-------------|------------------|-------------------------------------|
| Employee termination costs recorded to cost of goods sold | \$ | \$ | \$ | \$ | \$ |
| Employee termination costs recorded to selling, general & administrative expenses | 76 | | | (41) | 35 |
| Total | \$ 76 | \$ | \$ | \$ (41) | \$ 35 |

J. Income Taxes

We account for income taxes using the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are

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measured using enacted tax rates, for each of the jurisdictions in which we operate, expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date.

During fiscal 2009, we recorded a valuation allowance against deferred income tax assets of \$1.8 million, representing the amount of our deferred income tax assets in excess of our deferred income tax liabilities. We recorded the valuation allowance because management was unable to conclude, in light of the cumulative loss we have realized related to our US-based operations for the three year period ended June 30, 2009, that realization of the net deferred income tax asset was more likely than not. The valuation allowance recorded during fiscal 2009 primarily related to fiscal 2009 net operating loss carry forwards and changes in other deferred tax items recognized during fiscal 2009. During the three months ended September 30, 2009 we recorded US-based federal tax expense of \$238,000 that was fully offset by a release of a portion of our deferred tax asset valuation allowance during the quarter. In addition, during the three months ended September 30, 2009 we recorded US-based state tax expense from continuing operations of \$104,000 as a result of our inability to carryforward our state net operating losses due to the suspension of carryforwards by the state of California during the current tax year.

As a result of the recognition of these valuation adjustments, we have a \$2.0 million gross deferred tax asset offset by a deferred tax liability of \$272,000 and a valuation allowance of \$1.5 million resulting in a net deferred tax asset of \$225,000 as of September 30, 2009. This valuation allowance did not have any effect on the tax expense and related liability recorded for operating income recognized by our foreign subsidiary during the three months ended September 30, 2009.

We account for uncertain tax positions using the more-likely-than-not recognition threshold. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense. As of September 30, 2009 and June 30, 2009, we have not recorded any tax liabilities for uncertain tax positions.

We are subject to taxation in the United States, Switzerland and various state jurisdictions. Our tax years for the fiscal year ended June 30, 2006 and forward are subject to examination by the United States and state tax authorities and our tax years for the fiscal year ended June 30, 2007 and forward are subject to examination by the Switzerland tax authorities.

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

It is our policy to establish reserves based on management's assessment of exposure for certain positions taken in previously filed tax returns that may become payable upon audit by tax authorities. The tax reserves are analyzed at least annually, generally in the fourth quarter of each year, and adjustments are made as events occur that warrant adjustments to the reserve.

On November 6, 2009, the President signed into law the Worker, Homeownership, and Business Assistance Act of 2009 (the Act). The Act amended Section 172 of the Internal Revenue Code to allow net operating losses realized in either tax year 2008 or 2009 to be carried back up to five years (previously limited to a two-year carryback). The Company is currently assessing the impact the new provision will have on its financial statements.

K. Contingencies

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operations. However, a settlement payment or unfavorable outcome could adversely impact our results of operations. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

As of November 10, 2009, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

On July 31, 2009 RHL sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business to PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for a cash purchase price of \$500,000. As additional compensation, RHL may

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receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. NAI provided a guarantee of RHL's indemnity obligations under the asset purchase agreement, which potential liability is capped at the amount of the purchase price paid by the buyers to RHL.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis is intended to help you understand our financial condition and results of operations for the three months ended September 30, 2009. You should read the following discussion and analysis together with our unaudited condensed consolidated financial statements and the notes to the condensed consolidated financial statements included under Item 1 in this report, as well as the risk factors and other information included in our 2009 Annual Report and other reports and documents we file with the SEC. Our future financial condition and results of operations will vary from our historical financial condition and results of operations described below based on a variety of factors.

Executive Overview

The following overview does not address all of the matters covered in the other sections of this Item 2 or other items in this report or contain all of the information that may be important to our stockholders or the investing public. This overview should be read in conjunction with the other sections of this Item 2 and this report.

Our primary business activity is providing private label contract manufacturing services to companies that market and distribute vitamins, minerals, herbs and other nutritional supplements, as well as other health care products, to consumers both within and outside the United States. Historically, our revenue has been largely dependent on sales to one or two private label contract manufacturing customers and subject to variations in the timing of such customers' orders, which in turn is impacted by such customers' internal marketing programs, supply chain management, entry into new markets and new product introductions, as well as general economic conditions.

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

In an effort to enhance stockholder value, improve working capital and enable us to focus on our core contract manufacturing business, during the fourth quarter of fiscal 2008 we developed a plan to narrow our branded products focus and portfolio and to sell our legacy RHL business. On August 4, 2008 RHL sold certain assets related to its catalog and internet business conducted under the name As We Change® to Miles Kimball Company for a cash purchase price of \$2.3 million. We recorded a loss of \$226,000 as a result of this sale and recognized \$221,000 in severance and related payroll costs during fiscal 2009.

On July 31, 2009, we sold substantially all of the remaining assets of RHL related to its wholesale and direct-to-consumer business to PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. for a cash purchase price of \$500,000. As additional compensation, RHL may receive up to an additional \$500,000 from the buyers as a conditional earn-out if the RHL business acquired by the buyers meets or exceeds certain budgeted profitability criteria during the period August 1, 2009 through July 31, 2010. The financial information presented in this report has been reclassified to reflect the legacy RHL business as discontinued operations. We recorded a loss of \$6,000 as a result of this sale.

As a result of our decision to sell the legacy RHL business, we initiated an operational consolidation program during the first quarter of fiscal 2009 that transitioned the remaining branded products business operations to our corporate offices. This operational consolidation program was substantially complete as of September 30, 2008 and resulted in a charge to discontinued operations of \$823,000 in severance and other business related exit costs during fiscal 2009.

During the first three months of fiscal 2010, our net sales from continuing operations were 13.1% lower than in the first three months of fiscal 2009. Private label contract manufacturing sales declined 12.6% due primarily to lower volumes of existing products in existing markets sold to one of our largest customers and the discontinuance of a relationship with one of our smaller customers. This decline was partially offset by income related to our sublicense agreement for the distribution of Beta-Alanine. Net sales from our branded products declined 25.0% in the first three months of fiscal 2010 as compared to the first three months of fiscal 2009 due to the continued softening of our Pathway to Healing® product line. During fiscal 2010 we intend to further increase our Dr. Cherry marketing and advertising efforts and plan to re-launch the product line in late fiscal 2010 with new formulations, labeling and packaging in an effort to expand our future sales opportunities.

Our revenue concentration risk for our two largest customers increased to 84% as a percentage of our total sales from continuing operations for the first three months of fiscal 2010 compared to 78% in the first three months of fiscal 2009. We expect our contract manufacturing revenue concentration percentage for our two largest customers to remain relatively consistent for the remainder of fiscal 2010.

Beginning in fiscal 2008 and continuing through fiscal 2009, we invested substantial time and incurred substantial costs associated with hiring and training new quality assurance and other manufacturing support personnel, increased testing activity, and documentation and validation processes related to our Good Manufacturing Practices (GMPs) compliance programs. These additional expenses negatively impacted our

operating income from continuing operations during fiscal 2008 and fiscal 2009.

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Although the cost of GMP compliance is significant, we believe the majority of our implementation investment costs have been incurred. Going forward, our commitment to quality and our steadfast support of the FDA mandated GMPs makes us well positioned to operate within the higher standards of the Food and Drug Administration's GMPs and we believe differentiates us from our competitors.

During fiscal 2009, the continued decline in economic conditions in the United States and the various foreign markets we service negatively impacted our customers' businesses and our operations. As a result, during the second quarter of fiscal 2009 we implemented a cost reduction program that resulted in the elimination of certain personnel and business activities. This program resulted in a charge to our continuing operations of \$558,000 during the second quarter of fiscal 2009. During the second half of fiscal 2009, our cost reduction program resulted in a savings of \$3.0 million compared to the cost structure in the comparable prior year period. This cost reduction program reduced our operating overhead costs during the first three months of fiscal 2010 by \$1.3 million and we expect it will further reduce our remaining fiscal 2010 operating overhead by approximately \$2.1 million as compared to fiscal 2009.

Following the completion of the sale of substantially all of the assets of RHL, our branded products segment consists primarily of the products sold under our Pathway to Healing® product line. Beginning in April 2007, Dr. Cherry ceased airing his weekly television program, which had served as the primary customer acquisition vehicle in marketing the Pathway to Healing® product line. While sales of the product line have been primarily generated by continuity orders from long-standing repeat customers, the loss of the television program has had a negative impact on our ability to acquire new customers and retain existing customers. During fiscal 2009, we revamped our Dr. Cherry website and increased our direct-to-consumer marketing and advertising efforts. These activities helped reduce the decline in our Dr. Cherry sales volumes during the second half of fiscal 2009. During the remainder of fiscal 2010, we intend to further increase our Dr. Cherry marketing and advertising efforts and continue working with Dr. Cherry to evaluate alternative sales growth initiatives to support the product line.

During the remainder of fiscal 2010, we plan to continue to focus on:

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

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

Commercializing our licensed patent estate through contract manufacturing, royalties and sublicense agreements and protecting our proprietary rights; and

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

Looking forward, as a result of continued uncertain near-term economic conditions, we expect net sales during the second quarter of fiscal 2010 to be relatively consistent with the comparable prior year period. The anticipated future lower operating overhead costs associated with our cost reduction program and favorable foreign currency fluctuations are expected to result in net operating income from continuing operations during the second quarter of fiscal 2010, although at a reduced level from our first quarter 2010 results given our anticipated product sales mix and working capital initiatives.

Critical Accounting Policies and Estimates

The preparation of our financial statements requires that we make estimates and assumptions that affect the amounts reported in our financial statements and their accompanying notes. We have identified certain policies that we believe are important to the portrayal of our financial condition and results of operations. These policies require the application of significant judgment by our management. We base our estimates on our historical experience, industry standards, and various other assumptions that we believe are reasonable under the circumstances. Actual results could differ from these estimates under different assumptions or conditions. An adverse effect on our financial condition, changes in financial condition, and results of operations could occur if circumstances change that alter the various assumptions or conditions used in such estimates or assumptions.

Our critical accounting policies are discussed under Item 7 of our 2009 Annual Report. There have been no significant changes to these policies during the three months ended September 30, 2009.

Table of Contents**Results of Operations**

The results of our operations for the three months ended September 30 were as follows (in thousands):

| | Three Months Ended September 30, 2009 | | September 30, 2008 | | Increase (Decrease) | |
|--|---|--------|-----------------------|--------|---------------------|---------|
| Private label contract manufacturing | \$ 16,373 | 96.5% | \$ 18,742 | 96.0% | \$ (2,369) | (12.6)% |
| Branded products | 588 | 3.5% | 784 | 4.0% | (196) | (25.0)% |
| Total net sales | 16,961 | 100.0% | 19,526 | 100.0% | (2,565) | (13.1)% |
| Cost of goods sold | 13,806 | 81.4% | 17,126 | 87.7% | (3,320) | (19.4)% |
| Gross profit | 3,155 | 18.6% | 2,400 | 12.3% | 755 | 31.5% |
| Selling, general & administrative expenses | 1,748 | 10.3% | 2,618 | 13.4% | (870) | (33.2)% |
| Operating income (loss) from continuing operations | 1,407 | 8.3% | (218) | (1.1)% | 1,625 | 745.4% |
| Other (income) expenses, net | (11) | (0.1)% | 313 | 1.6% | 324 | 103.5% |
| Income (loss) from continuing operations before income taxes | 1,418 | 8.4% | (531) | (2.7)% | 1,949 | 367.0% |
| Income tax expense (benefit) | 172 | 1.0% | (182) | (0.9)% | 354 | 194.5% |
| Income (loss) from continuing operations | 1,246 | 7.3% | (349) | (1.8)% | 1,595 | 457.0% |
| Income (loss) from discontinued operations, net of tax | 95 | 0.6% | (1,048) | (5.4)% | 1,143 | 109.1% |
| Net income (loss) | \$ 1,341 | 7.9% | \$ (1,397) | (7.2)% | \$ 2,738 | 196.0% |

The percentage decrease in private label contract manufacturing net sales was primarily attributed to the following:

| | |
|--|-------|
| Mannatech, Incorporated ⁽¹⁾ | 2% |
| NSA International, Inc. ⁽²⁾ | (8) |
| Other customers ⁽³⁾ | (7) |
| Total | (13)% |

- 1 Net sales to Mannatech, Incorporated increased primarily as a result of higher volumes of established and new products in existing markets along with a shift in sales mix to higher priced products.
- 2 The decrease in net sales to NSA International, Inc. included a decrease in international sales of 11.6% and a decline in domestic sales of 15.8%. These sales declines were due to lower consumer demand and NSA's inventory management program.
- 3 The decrease in net sales to other customers was primarily related to the discontinuance of a customer relationship and timing of shipments during the first quarter of fiscal 2010 as compared to the prior year offset by royalty income related to our sub-license agreement for the distribution of Beta-Alanine.

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Net sales from our continuing branded products segment decreased 25% during the the first quarter of fiscal 2010 due primarily to the continuing softening of the Pathway to Healing product line following the cessation of Dr. Cherry's weekly television program in April 2007, which had served as the primary acquisition vehicle in marketing the Pathway to Healing® product line.

Gross profit margin from continuing operations increased 6.3 percentage points primarily due to the following:

| | |
|---------------------------------------|-------|
| Contract manufacturing: | |
| Shift in sales mix | 1.8% |
| Incremental overhead expenses | 1.4 |
| Incremental direct and indirect labor | 3.7 |
| Branded products operations | (0.6) |
| Total | 6.3% |

Private label contract manufacturing gross profit margin increased 7.6 percentage points to 18.0% in the first quarter of fiscal 2010 compared to 10.4% in the first quarter of fiscal 2009. The increase in gross profit as a percentage of sales was primarily due to a decrease in material cost as a percentage of sales and decreases in operational labor and overhead costs due to our cost reduction programs implemented in fiscal 2009.

Branded products gross profit margin decreased 24.1 percentage points to 34.5% in the first quarter of fiscal 2010 from 58.6% in the first quarter of fiscal 2009 due primarily to increased material costs and sales discounts and returns.

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Selling, general and administrative expenses from continuing operations decreased \$870,000, or 33.2%, during the first quarter of fiscal 2010 as compared to the same period in the prior fiscal year primarily due to a reduction in compensation associated with reduced headcount, decreased outside services expenses and reduced direct-to-consumer operating costs primarily associated with lower marketing and advertising expenses, employee compensation costs and call center and fulfillment expenses as a result of the sale of substantially all of the assets of RHL.

Other income, net increased \$324,000 during the first quarter of fiscal 2010 as compared to the same period in the prior fiscal year primarily due to favorable foreign currency exchange activity associated with the strengthening of the Euro.

Our income tax expense from continuing operations increased \$354,000, or 194.5%, during the first quarter of fiscal 2010 as compared to the same period in the prior fiscal year primarily due to the corresponding increase in our income from continuing operations. As a result, the tax expense from continuing operations for the current fiscal quarter included expense from our foreign subsidiary at a statutory tax rate of 20% and state tax expense from our US-based income from operations. No net federal tax expense was recognized in the current fiscal quarter for our US-base income from operations as it was offset by a release of our net deferred tax asset valuation allowance.

Liquidity and Capital Resources

Our primary sources of liquidity and capital resources are cash flows provided by operating activities and the availability of borrowings under our credit facility. Net cash provided by operating activities was \$1.3 million for the three months ended September 30, 2009 compared to net cash used by operating activities of \$640,000 in the comparable quarter last year.

At September 30, 2009, changes in accounts receivable, consisting primarily of amounts due from our private label contract manufacturing customers, provided \$419,000 in cash during the three months ended September 30, 2009 compared to \$2.5 million of cash provided in the comparable prior year quarter. The decrease in cash provided by accounts receivable during the quarter ended September 30, 2009 was the result of lower sales as compared to the comparable prior year quarter. Days sales outstanding from continuing operations was 30 days during the three months ended September 30, 2009 compared to 24 days in the comparable quarter last year.

Approximately \$588,000 of our operating cash flow was generated by NAIE in the three months ended September 30, 2009. As of September 30, 2009, NAIE's undistributed retained earnings were considered indefinitely reinvested.

Cash used in investing activities in the three months ended September 30, 2009 was \$527,000 compared to \$84,000 in the comparable quarter last year. Capital expenditures were \$1.0 million during the three months ended September 30, 2009 compared to \$1.5 million in the comparable quarter last year. Capital expenditures for both years were primarily for manufacturing equipment in our Vista, California and Manno, Switzerland facilities. Additionally, during the three months ended September 30, 2009, we received \$500,000 in proceeds related to the sale of the remaining assets of legacy RHL business as compared to \$2.2 million in proceeds related to the sale of our As We Change business in the comparable quarter last year.

Our consolidated debt decreased to \$964,000 at September 30, 2009 from \$1.3 million at June 30, 2009 primarily due to payments on our term loans.

We have a bank credit facility of \$8.5 million as of June 30, 2010, comprised of a \$7.5 million working capital line of credit and \$964,000 in outstanding term loans. The working capital line of credit is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has a fluctuating or fixed interest rate as elected by NAI from time to time and described in more detail below, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. As of September 30, 2009, the outstanding balances on the term loans consisted of a \$198,000, 15 year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a \$513,000, 10 year term loan due May 2014 with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; and a \$253,000, four year term loan due December 2009, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately \$98,000 plus interest. As of September 30, 2009 and June 30, 2009, our working capital line of credit balance was zero.

On September 30, 2009, we were in compliance with all loan debt covenants.

On September 22, 2006, NAIE, our wholly owned subsidiary, entered into a credit facility to provide it with a credit line of up to CHF 1.3 million, or approximately \$1.3 million, which is the initial maximum aggregate amount that can be outstanding at any one time under the credit facility. This maximum amount was reduced by CHF 160,000, or approximately \$155,000, as of December 31, 2007, and was reduced an additional CHF 160,000, or approximately \$155,000, as of December 31, 2008, and will be reduced by an

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additional CHF 160,000 at the end of each succeeding calendar year. On February 19, 2007, NAIE amended its credit facility to provide that the maximum aggregate amount that may be outstanding under the facility cannot be reduced below CHF 500,000, or approximately \$483,000. As of September 30, 2009, there was no outstanding balance under the credit facility.

Under its credit facility, NAIE may draw amounts either as current account loan credits to its current or future bank accounts or as fixed loans with a maximum term of 24 months. Current account loans will bear interest at the rate of 5% per annum. Fixed loans will bear interest at a rate determined by the parties based on current market conditions and must be repaid pursuant to a repayment schedule established by the parties at the time of the loan. If a fixed loan is repaid early at NAIE's election or in connection with the termination of the credit facility, NAIE will be charged a pre-payment penalty equal to 0.1% of the principal amount of the fixed loan or CHF 1,000 (approximately \$966), whichever is greater. The bank reserves the right to refuse individual requests for an advance under the credit facility, although its exercise of such right will not have the effect of terminating the credit facility as a whole.

As of September 30, 2009, we had \$4.5 million in cash and cash equivalents, a \$699,000 certificate of deposit and \$4.6 million available under our working line of credit. We believe our available cash, cash equivalents and potential cash flows from operations will be sufficient to fund our current working capital needs, capital expenditures and debt payments through at least the next 12 months.

Off-Balance Sheet Arrangements

As of September 30, 2009, we did not have any significant off-balance sheet debt nor did we have any transactions, arrangements, obligations (including contingent obligations) or other relationships with any unconsolidated entities or other persons that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses material to investors.

Recent Accounting Pronouncements

Recent accounting pronouncements are discussed in the notes to our consolidated financial statements included under Item 8 of our 2009 Annual Report. During the first quarter of 2010, we adopted the new Accounting Standards Codification (ASC) as issued by the Financial Accounting Standards Board (FASB). The ASC has become the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. The ASC is not intended to change or alter existing United States generally accepted accounting principles (GAAP). The adoption of the ASC did not have a material impact on our consolidated financial statements.

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ITEM 4. CONTROLS AND PROCEDURES

We maintain certain disclosure controls and procedures as defined under the Securities Exchange Act of 1934. They are designed to help ensure that material information is: (1) gathered and communicated to our management, including our principal executive and financial officers, in a manner that allows for timely decisions regarding required disclosures; and (2) recorded, processed, summarized, reported and filed with the SEC as required under the Securities Exchange Act of 1934 and within the time periods specified by the SEC. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2009. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective for their intended purpose described above as of September 30, 2009.

There were no changes to our internal control over financial reporting during the quarterly period ended September 30, 2009 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operations. However, a settlement payment or unfavorable outcome could adversely impact our results of operations. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

As of November 10, 2009, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described under Item 1A of our 2009 Annual Report, as well as the other information in our 2009 Annual Report, this report and other reports and documents we file with the SEC, when evaluating our business and future prospects. If any of the identified risks actually occur, our business, financial condition and results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you could lose all or a portion of the value of your investment in our common stock.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

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

EXHIBIT INDEX

| Exhibit Number | Description | Incorporated By Reference To |
|----------------|--|---|
| 3(i) | Amended and Restated Certificate of Incorporation of Natural Alternatives International, Inc. filed with the Delaware Secretary of State on January 14, 2005 | Exhibit 3(i) of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005 |
| 3(ii) | Amended and Restated By-laws of Natural Alternatives International, Inc. dated as of February 9, 2009 | Exhibit 3(ii) of NAI's Current Report on Form 8-K dated February 9, 2009, filed with the commission on February 13, 2009 |
| 4(i) | Form of NAI's Common Stock Certificate | Exhibit 4(i) of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005 |
| 10.1 | 1999 Omnibus Equity Incentive Plan as adopted effective May 10, 1999, amended effective January 30, 2004, and further amended effective December 3, 2004* | Exhibit 10.1 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005 |
| 10.2 | Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and Mark A. LeDoux* | Exhibit 10.6 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004 |
| 10.3 | Amended and Restated Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Dr. Reginald B. Cherry | Exhibit 10.11 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004 |
| 10.4 | Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc. | Exhibit 10.12 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004 |
| 10.5 | First Amendment to Exclusive License Agreement effective as of December 10, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc. | Exhibit 10.3 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005 |
| 10.6 | Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company (lease reference date June 12, 2003) | Exhibit 10.10 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, filed with the commission on November 5, 2003 |
| 10.7 | Credit Agreement dated as of May 1, 2004 by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.11 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004, filed with the commission on May 17, 2004 |
| 10.8 | First Amendment to Credit Agreement dated as of February 1, 2005 by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.1 of NAI's Current Report on Form 8-K dated February 1, 2005, filed with the commission on February 7, 2005 |
| 10.9 | Form of Indemnification Agreement entered into between NAI and each of its directors | Exhibit 10.15 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004 |
| 10.10 | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation) | Exhibit 10.19 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, filed with the commission on May 13, 2005 |
| 10.11 | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated July 25, 2003 (English translation) | Exhibit 10.19 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on |

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September 8, 2005

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|-------|---|---|
| 10.12 | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated June 8, 2004 (English translation) | Exhibit 10.20 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005 |
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| Exhibit Number | Description | Incorporated By Reference To |
|-----------------------|--|---|
| 10.13 | Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated February 7, 2005 (English translation) | Exhibit 10.21 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005 |
| 10.14 | License Agreement effective as of April 28, 1997 by and among Roger Harris, Mark Dunnett and NAI | Exhibit 10.22 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005 |
| 10.15 | Amendment to License Agreement effective as of March 17, 2001 by and among Roger Harris, Mark Dunnett and NAI | Exhibit 10.23 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005 |
| 10.16 | Amendment effective as of September 15, 2005 to Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation) | Exhibit 10.24 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, filed with the commission on November 4, 2005 |
| 10.17 | Promissory Note made by NAI for the benefit of Wells Fargo Equipment Finance, Inc. in the amount of \$3,800,000 | Exhibit 10.5 of NAI's Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005 |
| 10.18 | Second Amendment to Credit Agreement dated as of December 1, 2005 by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.30 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006 |
| 10.19 | Exclusive License Agreement by and between NAI and Richard Linchitz, M.D. effective as of August 23, 2005 | Exhibit 10.32 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006 |
| 10.20 | First Amendment to Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company, effective December 21, 2004 | Exhibit 10.34 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006 |
| 10.21 | Second Amendment to Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company, effective January 13, 2006 | Exhibit 10.35 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006 |
| 10.22 | Third Amendment to Credit Agreement dated as of March 15, 2006 by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.35 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006, filed with the commission on May 9, 2006 |
| 10.23 | Loan Agreement between NAIE and Credit Suisse dated as of September 22, 2006, including general conditions (portions of the Loan Agreement have been omitted pursuant to a request for confidential treatment) | Exhibit 10.36 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2006, filed with the commission on November 1, 2006 |
| 10.24 | Fourth Amendment to Credit Agreement dated as of November 1, 2006, and entered into on January 24, 2007, by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.37 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2006, filed with the commission on January 30, 2007 |
| 10.25 | Sublease Contract for facilities in Manno, Switzerland, between NAIE and Vertime SA effective as of April 1, 2007 (portions of the Sublease Contract have been omitted pursuant to a request for confidential treatment) (English translation) | Exhibit 10.39 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006, filed with the commission on May 14, 2007 |

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| Exhibit Number | Description | Incorporated By Reference To |
|-----------------------|--|--|
| 10.26 | Second Amendment to License Agreement Amending The First Amendment Dated March 17, 2001 to License Agreement Dated April 28, 1997 by and among Roger Harris, Mark Dunnett and NAI dated as of March 26, 2007 | Exhibit 10.40 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007, filed with the commission on May 14, 2007 |
| 10.27 | First Amendment to Loan Agreement between NAIE and Credit Suisse dated as of February 19, 2007 | Exhibit 10.41 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007, filed with the commission on May 14, 2007 |
| 10.28 | Consulting Agreement effective as of July 1, 2007, by and between Dr. John A. Wise and NAI | Exhibit 10.44 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2007, filed with the commission on October 15, 2007. |
| 10.29 | Fifth Amendment to Credit Agreement dated as of November 1, 2007, and entered into on December 18, 2007, by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.40 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2007, filed with the commission on February 8, 2008 |
| 10.30 | Employment Agreement effective as of February 11, 2008, by and between NAI and Kenneth Wolf* | Exhibit 10.1 of NAI's Current Report on Form 8-K dated February 11, 2008, filed with the commission on February 14, 2008 |
| 10.31 | Asset Purchase Agreement by and between RHL and Miles Kimball Company dated August 4, 2008 | Exhibit 10.1 of NAI's Current Report on Form 8-K dated August 4, 2008, filed with the commission on August 8, 2008 |
| 10.32 | Revolving Line of Credit Note made by NAI for the benefit of Wells Fargo Bank, National Association in the amount of \$7,500,000 (with Addendum) | Exhibit 10.40 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009 |
| 10.33 | Sixth Amendment to Credit Agreement dated as of November 1, 2008, by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.41 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009 |
| 10.34 | Separation Agreement and General Release of Claims by and between Disposition Company, Inc. (fka Real Health Laboratories, Inc.) and John Dullea effective as of December 26, 2008 | Exhibit 10.42 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009 |
| 10.35 | Separation Agreement and General Release of Claims by and between NAI and Randell Weaver effective as of March 13, 2009 | Exhibit 10.43 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009 |
| 10.36 | Agreement to Sublicense by and between NAI and Compound Solutions, Inc. dated as of March 3, 2009 | Exhibit 10.44 of NAI's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2009, filed with the commission on May 13, 2009 |
| 10.37 | Separation Agreement and General Release of Claims by and between NAI and Alvin McCurdy effective as of July 9, 2009 | Exhibit 10.37 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2009, filed with the commission on September 28, 2009. |
| 10.38 | Seventh Amendment to Credit Agreement dated as of June 1, 2009, by and between NAI and Wells Fargo Bank, National Association | Exhibit 10.38 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2009, filed with the commission on September 28, 2009. |
| 10.39 | First Modification to Promissory Note dated as of June 1, 2009, by and between NAI and Wells Fargo Bank, National Association (with Amended and Restated Addendum) | Exhibit 10.39 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2009, filed with the commission on September 28, 2009. |

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| Exhibit Number | Description | Incorporated By Reference To |
|-----------------------|--|---|
| 10.40 | Third Amendment to License Agreement by and among Roger Harris, Mark Dunnett, Kenny Johansson and NAI effective as of March 3, 2009 | Exhibit 10.40 of NAI's Annual Report on Form 10-K for the fiscal year ended June 30, 2009, filed with the commission on September 28, 2009. |
| 10.41 | Asset Purchase Agreement by and among NAI, Disposition Company, Inc. (fka Real Health Laboratories, Inc.), PharmaCare US Inc. and PharmaCare Laboratories Pty Ltd. dated July 29, 2009 | Exhibit 10.1 of NAI's Current Report on Form 8-K dated July 29, 2009, filed with the commission on August 4, 2009 |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer | Filed herewith |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer | Filed herewith |
| 32 | Section 1350 Certification | Filed herewith |

* Indicates management contract or compensatory plan or arrangement.

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SIGNATURES

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

Date: November 10, 2009

NATURAL ALTERNATIVES INTERNATIONAL,
INC.

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

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