

NATURAL ALTERNATIVES INTERNATIONAL INC
Form 10-Q
May 15, 2017
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 MARCH 31, 2017

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.)

1535 Faraday Drive

Carlsbad, California 92008

(760) 744-7340

(Address of principal executive offices) (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

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, or an emerging growth company.

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

Emerging Growth Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

As of May 15, 2017, 6,938,352 shares of NAI's common stock were outstanding, net of 1,043,325 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,” “predicts,” “forecasts,” or “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, and other financial items;

• our ability to maintain or increase our patent and trademark licensing revenues;

• our ability to develop market acceptance for and increase sales of new products, develop relationships with new customers and maintain or improve existing customer relationships;

• our ability to protect our intellectual property;

• the outcome of currently pending litigation, regulatory and tax matters, the costs associated with such matters and the effect of such matters on our business and results of operations;

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

• the costs associated with defending and resolving potential new claims, even if such claims are without merit;

• currency exchange rates, their effect on our results of operations, including amounts that may be reclassified as earnings, the availability of foreign exchange facilities, our ability to effectively hedge against foreign exchange risks and the extent to which we may seek to hedge against such risks;

• future levels of our revenue concentration risks;

- sources and availability of raw materials, including the limited number of suppliers of beta-alanine;
- inventories, including the adequacy of raw material and other inventory levels to meet future customer demand and the adequacy and intended use of our facilities;
- manufacturing and distribution channels, product sales and performance, and timing of product shipments;
- current or future customer orders, product returns, and potential product recalls;
- the impact on our business and results of operations and variations in quarterly net sales from seasonal and other factors;
- our ability to operate within the standards set by the U.S. Food and Drug Administration's (FDA) Good Manufacturing Practices (GMP);
- our ability to successfully expand our operations, including outside the United States (U.S.);
- the adequacy of our reserves and allowances;
- the sufficiency of our available cash, cash equivalents, and potential cash flows from operations to fund our current working capital needs and capital expenditures through the next 12 months;
- current and future economic and political conditions;
- the impact of accounting pronouncements and our adoption of certain accounting guidance; 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).

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

| | March 31, 2017 (Unaudited) | June 30, 2016 |
|--|--------------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 22,593 | \$ 19,747 |
| Accounts receivable - less allowance for doubtful accounts of \$21 at March 31, 2017 and \$45 at June 30, 2016 | 7,919 | 13,217 |
| Inventories, net | 15,966 | 20,768 |
| Income tax receivable | 14 | 14 |
| Prepays and other current assets | 2,699 | 2,136 |
| Total current assets | 49,191 | 55,882 |
| Property and equipment, net | 17,788 | 15,167 |
| Deferred income taxes | 2,227 | 2,227 |
| Other noncurrent assets, net | 781 | 899 |
| Total assets | \$ 69,987 | \$ 74,175 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 4,073 | \$ 12,821 |
| Accrued liabilities | 2,367 | 2,242 |
| Accrued compensation and employee benefits | 989 | 2,802 |
| Income taxes payable | 1,207 | 1,340 |
| Total current liabilities | 8,636 | 19,205 |

| | | | | |
|---|-----------|---|-----------|---|
| Other noncurrent liabilities, net | 908 | | 758 | |
| Deferred rent | 530 | | 486 | |
| Total liabilities | 10,074 | | 20,449 | |
| 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 (net of treasury shares) 6,933,352 at March 31, 2017 and 6,868,628 at June 30, 2016 | 79 | | 77 | |
| Additional paid-in capital | 21,933 | | 21,138 | |
| Accumulated other comprehensive loss | (279 |) | (680 |) |
| Retained earnings | 44,254 | | 38,553 | |
| Treasury stock, at cost, 1,043,325 shares at March 31, 2017 and 958,049 at June 30, 2016 | (6,074 |) | (5,362 |) |
| Total stockholders' equity | 59,913 | | 53,726 | |
| Total liabilities and stockholders' equity | \$ 69,987 | | \$ 74,175 | |

See accompanying notes to condensed consolidated financial statements.

NATURAL ALTERNATIVES INTERNATIONAL, INC.

Condensed Consolidated Statements Of Income And Comprehensive Income

(In thousands, except share and per share data)

(Unaudited)

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|--|---------------------------------|-----------|--------------------------------|-----------|
| | 2017 | 2016 | 2017 | 2016 |
| Net sales | \$25,135 | \$30,006 | \$89,761 | \$78,502 |
| Cost of goods sold | 20,017 | 23,549 | 70,479 | 61,643 |
| Gross profit | 5,118 | 6,457 | 19,282 | 16,859 |
| Selling, general and administrative expenses | 4,125 | 3,352 | 11,640 | 9,291 |
| Income from operations | 993 | 3,105 | 7,642 | 7,568 |
| Other income (expense): | | | | |
| Interest income | 109 | 26 | 358 | 82 |
| Interest expense | (1) | 2 | (1) | (1) |
| Foreign exchange (loss) gain | (45) | (137) | 158 | (241) |
| Other, net | (6) | 1,611 | (21) | 1,601 |
| | 57 | 1,502 | 494 | 1,441 |
| Income before income taxes | 1,050 | 4,607 | 8,136 | 9,009 |
| Provision for income taxes | 305 | 1,584 | 2,435 | 2,905 |
| Net income | \$745 | \$3,023 | \$5,701 | \$6,104 |
| Unrealized (loss) gain resulting from change in fair value of derivative instruments, net of tax | (451) | (473) | 401 | (199) |
| Comprehensive income | \$294 | \$2,550 | \$6,102 | \$5,905 |
| Net income per common share: | | | | |
| Basic | \$0.11 | \$0.46 | \$0.87 | \$0.94 |
| Diluted | \$0.11 | \$0.46 | \$0.86 | \$0.92 |
| Weighted average common shares outstanding: | | | | |
| Basic | 6,581,632 | 6,510,902 | 6,569,165 | 6,513,821 |
| Diluted | 6,613,955 | 6,562,577 | 6,648,091 | 6,628,883 |

See accompanying notes to condensed consolidated financial statements.

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

| | Nine Months Ended | |
|---|------------------------------|-------------|
| | March 31, | |
| | 2017 | 2016 |
| Cash flows from operating activities | | |
| Net income | \$5,701 | \$6,104 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,711 | 1,364 |
| Non-cash compensation | 729 | 463 |
| Pension expense | 149 | 38 |
| Gain on disposal of assets | (23) | (1,848) |
| Deferred taxes | - | 645 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 5,298 | (2,473) |
| Inventories, net | 4,802 | (7,164) |
| Prepays and other assets | 182 | 380 |
| Accounts payable and accrued liabilities | (8,579) | 3,514 |
| Income taxes | (291) | 749 |
| Accrued compensation and employee benefits | (1,813) | 588 |
| Net cash provided by operating activities | 7,866 | 2,360 |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (4,332) | (6,959) |
| Proceeds from sale of property and equipment | 24 | 3,000 |
| Net cash used in investing activities | (4,308) | (3,959) |
| Cash flows from financing activities | | |
| Repurchase of common stock | (712) | (648) |
| Net cash used in financing activities | (712) | (648) |
| Net increase (decrease) in cash and cash equivalents | 2,846 | (2,247) |
| Cash and cash equivalents at beginning of period | 19,747 | 18,551 |
| Cash and cash equivalents at end of period | \$22,593 | \$16,304 |

Supplemental disclosures of cash flow information

Cash paid during the period for:

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| | | |
|--|---------|----------|
| Interest | \$- | \$- |
| Taxes | \$2,761 | \$1,929 |
| Disclosure of non-cash activities: | | |
| Change in unrealized gain (loss) resulting from change in fair value of derivative instruments, net of tax | \$401 | \$(199) |

See accompanying notes to condensed consolidated financial statements.

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 (U.S. GAAP) 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 and nine months ended March 31, 2017 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, 2016 ("2016 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 2016 Annual Report unless otherwise noted below.

Net Income 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 March 31, 2017 | | Nine Months Ended March 31, 2016 | |
|--|--|---------|---|---------|
| Numerator | | | | |
| Net income | \$745 | \$3,023 | \$5,701 | \$6,104 |
| Denominator | | | | |
| Basic weighted average common shares outstanding | 6,582 | 6,511 | 6,569 | 6,514 |

| | | | | |
|--|--------|--------|--------|--------|
| Dilutive effect of stock options | 32 | 52 | 79 | 115 |
| Diluted weighted average common shares outstanding | 6,614 | 6,563 | 6,648 | 6,629 |
| Basic net income per common share | \$0.11 | \$0.46 | \$0.87 | \$0.94 |
| Diluted net income per common share | \$0.11 | \$0.46 | \$0.86 | \$0.92 |

No shares related to stock options were excluded for the three or nine months ended March 31, 2017 and March 31, 2016.

Revenue Recognition

To recognize revenue, four basic criteria must be met: (1) there is evidence that an arrangement exists; (2) delivery has occurred; (3) the fee is fixed or determinable; and (4) collectability is reasonably assured. Revenue from sales transactions where the buyer has the right to return the product is recognized at the time of sale only if (a) the seller's price to the buyer is substantially fixed or determinable at the date of sale; (b) the buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product; (c) the buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product; (d) the buyer acquiring the product for resale has economic substance apart from that provided by the seller; (e) the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer; and (f) the amount of future returns can be reasonably estimated. We recognize revenue upon determination that all criteria for revenue recognition have been met. The criteria are usually met at the time title passes to the customer, which usually occurs upon shipment. Revenue from shipments where title passes upon delivery is deferred until the shipment has been delivered.

We record reductions to gross revenue for estimated returns of private label contract manufacturing products and beta-alanine raw material sales. The estimated returns are based on the trailing six months of private-label contract manufacturing gross sales and our historical experience for both private label contract manufacturing and beta-alanine raw material product returns. However, the estimate for product returns does not reflect the impact of a potential large product recall resulting from product nonconformance or other factors as such events are not predictable nor is the related economic impact estimable.

We currently own certain U.S. patents, and each patent's corresponding foreign patent applications. All of these patents and patent rights relate to the ingredient known as beta-alanine marketed and sold under the CarnoSyn® and SR Carnosyn® trademarks. We recorded royalty and licensing income as a component of revenue in the amount of \$6.6 million during the three months ended March 31, 2017 and \$20.0 million during the nine months ended March 31, 2017. We recorded beta-alanine raw material sales and royalty and licensing income as a component of revenue in the amount of \$5.5 million during the three months ended March 31, 2016 and \$16.1 million during the nine months ended March 31, 2016. These royalty income and raw material sale amounts resulted in royalty expense paid to the original patent holders from whom NAI acquired its patents and its patent rights. We recognized royalty expense as a component of cost of goods sold in the amount of \$233,000 during the three months ended March 31, 2017 and \$799,000 during the nine months ended March 31, 2017. We recognized royalty expense as a component of cost of goods sold in the amount of \$193,000 during the three months ended March 31, 2016 and \$666,000 during the nine months ended March 31, 2016.

Stock-Based Compensation

We have an omnibus incentive plan that was approved by our Board of Directors effective as of October 15, 2009 and approved by our stockholders at the Annual Meeting of Stockholders held on November 30, 2009. Under the plan, we may grant nonqualified and incentive stock options and other stock-based awards to employees, non-employee directors and consultants.

We estimate the fair value of stock option awards at the date of grant 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 we assume to be zero, as we have not paid any cash dividends) and employee exercise behavior. Expected volatilities used in the model are based 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. The fair value of restricted stock shares granted is based on the market price of our common stock on the date of grant. We amortize the estimated fair value of our stock awards to expense over the related vesting periods.

On March 28, 2017, the Board of Directors approved the grant of 140,000 shares of restricted stock to the members of our Board of Directors and certain key members of our management team pursuant to our 2009 Omnibus Incentive Plan. On March 23, 2016, the Board of Directors approved the grant of 130,000 shares of restricted stock to the members of our Board of Directors and certain key members of our management team pursuant to our 2009 Omnibus Incentive Plan. These restricted stock grants will vest over three years and the unvested shares cannot be sold or otherwise transferred and the rights to receive dividends, if declared by our Board of Directors, are forfeitable until the shares become vested.

Our net income included stock based compensation expense of approximately \$223,000 for the three months ended March 31, 2017 and approximately \$729,000 for the nine months ended March 31, 2017. Our net income included stock based compensation expense of approximately \$183,000 for the three months ended March 31, 2016 and approximately \$463,000 for the nine months ended March 31, 2016.

Fair Value of Financial Instruments

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 use 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 independent sources. 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 under 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 use 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 Level 1 assets. 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 March 31, 2017 and June 30, 2016, we did not have any financial assets or liabilities classified as Level 1. We classify derivative forward exchange contracts as Level 2 assets. The fair value of our forward exchange contracts as of March 31, 2017 was a net asset of \$1.1 million. The fair value of our forward exchange contracts as of June 30, 2016 was a net asset of \$250,000. As of March 31, 2017 and June 30, 2016, we did not have any financial assets or liabilities classified as Level 3. We did not transfer any assets or liabilities between Levels during fiscal 2016 or the three and nine month periods ended March 31, 2017.

B. Inventories, net

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

| | March 31, 2017 | June 30, 2016 |
|------------------|-------------------------------|------------------------------|
| Raw materials | \$10,043 | \$14,751 |
| Work in progress | 3,019 | 3,487 |
| Finished goods | 3,014 | 2,832 |
| Reserves | (110) | (302) |
| Inventories, net | \$15,966 | \$20,768 |

C. Property and Equipment, net

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

| | Depreciable Life In Years | March 31, 2017 | June 30, 2016 |
|---|--|-------------------------------|--------------------------|
| Land | N/A | \$1,200 | \$1,200 |
| Building and building improvements | 7 – 39 | 3,675 | 3,324 |
| Machinery and equipment | 3 – 12 | 24,450 | 23,846 |
| Office equipment and furniture | 3 – 5 | 3,749 | 2,994 |
| Vehicles | 3 | 209 | 209 |
| Leasehold improvements | 1 – 15 | 17,008 | 15,261 |
| Total property and equipment | | 50,291 | 46,834 |
| Less: accumulated depreciation and amortization | | (32,503) | (31,667) |
| Property and equipment, net | | \$17,788 | \$15,167 |

D. Accumulated Other Comprehensive (Loss) Income

Accumulated other comprehensive (loss) income (“OCL” and “OCI”) consisted of the following during the three and nine months ended March 31, 2017 and March 31, 2016 (dollars in thousands):

| | Three Months Ended March 31, 2017 | | |
|----------------------------------|---|-----------------------------|--------------|
| | Unrealized Gains | (losses) on Cash | Total |
| | Defined Benefit Pension Plan | Flow Hedges | |
| Beginning balance | \$ (775) | \$ 947 | \$ 172 |
| OCI/OCL before reclassifications | — | (322) | (322) |
| Amounts reclassified from OCI | — | (383) | (383) |
| Tax effect of OCI activity | — | 254 | 254 |
| Net current period OCI/OCL | — | (451) | (451) |
| Ending balance | \$ (775) | \$ 496 | \$ (279) |

| | Nine Months Ended March 31, 2017 | | |
|----------------------------------|---|-----------------------------|--------------|
| | Unrealized Gains | (Losses) on Cash | Total |
| | Defined Benefit Pension Plan | Flow Hedges | |
| Beginning balance | \$ (775) | \$ 95 | \$ (680) |
| OCI/OCL before reclassifications | — | 1,512 | 1,512 |
| Amounts reclassified from OCI | — | (884) | (884) |
| Tax effect of OCI activity | — | (227) | (227) |
| Net current period OCI/OCL | — | 401 | 401 |
| Ending balance | \$ (775) | \$ 496 | \$ (279) |

**Three Months Ended
March 31, 2016**

| | | |
|---|---|--------------|
| Unrealized Gains | | |
| Defined Benefit Pension Plan | (Losses) on Cash Flow Hedges | Total |

| | | | |
|----------------------------------|---------|----------|---------|
| Beginning balance | \$(643) | \$ 151 | \$(492) |
| OCI/OCL before reclassifications | — | (613) | (613) |
| Amounts reclassified from OCI | — | (120) | (120) |
| Tax effect of OCI activity | — | 260 | 260 |
| Net current period OCI/OCL | — | (473) | (473) |
| Ending balance | \$(643) | \$ (322) | \$(965) |

| | Nine Months Ended | | |
|----------------------------------|--------------------------|-------------------------|--------------|
| | March 31, 2016 | | |
| | Unrealized | | |
| | Defined Gains | | |
| | Benefit (Losses) | | Total |
| | Pension Plan | Cash Flow Hedges | |
| Beginning balance | \$(643) | \$ (123) | \$(766) |
| OCI/OCL before reclassifications | — | (131) | (131) |
| Amounts reclassified from OCI | — | (178) | (178) |
| Tax effect of OCI activity | — | 110 | 110 |
| Net current period OCI/OCL | — | (199) | (199) |
| Ending balance | \$(643) | \$ (322) | \$(965) |

During the three months ended March 31, 2017, the amounts reclassified from OCI were comprised of \$278,000 of gains reclassified to net revenues and \$106,000 related to the amortization of forward points reclassified to other income. During the nine months ended March 31, 2017, the amounts reclassified from OCI were comprised of \$549,000 of gains reclassified to net revenues and \$336,000 related to the amortization of forward points reclassified to other income.

During the three months ended March 31, 2016, the amounts reclassified from OCI were comprised of \$118,000 of gains reclassified to net revenues and \$2,000 related to the amortization of forward points reclassified to other income. During the nine months ended March 31, 2016, the amounts reclassified from OCI were comprised of \$125,000 of gains reclassified to net revenues and \$53,000 related to the amortization of forward points reclassified to other income.

E. Debt

On March 28, 2017, we executed an amendment to our credit facility with Wells Fargo Bank, N.A. to extend the maturity date for our working line of credit from January 31, 2019 to February 1, 2020. The Credit Agreement provides us with a credit line of up to \$10.0 million. The line of credit may be used to finance working capital requirements. There was no commitment fee required as part of this amendment. There are no amounts currently drawn under the line of credit.

Under the terms of the Credit Agreement, borrowings are subject to eligibility requirements including maintaining (i) a ratio of total liabilities to tangible net worth of not greater than 1.25 to 1.0 at any time; and (ii) a ratio of total current assets to total current liabilities of not less than 1.75 to 1.0 at each fiscal quarter end. Any amounts outstanding under

the line of credit will bear interest at a fixed or fluctuating interest rate as elected by NAI from time to time; provided, however, that if the outstanding principal amount is less than \$100,000 such amount shall bear interest at the then applicable fluctuating rate of interest. If elected, the fluctuating rate per annum would be equal to 1.25% above the daily one month LIBOR rate as in effect from time to time. If a fixed rate is elected, it would equal a per annum rate of 1.25% above the LIBOR rate in effect on the first day of the applicable fixed rate term. Any amounts outstanding under the line of credit must be paid in full on or before the maturity date. Amounts outstanding that are subject to a fluctuating interest rate may be prepaid at any time without penalty. Amounts outstanding that are subject to a fixed interest rate may be prepaid at any time in minimum amounts of \$100,000, subject to a prepayment fee equal to the sum of the discounted monthly differences for each month from the month of prepayment through the month in which the then applicable fixed rate term matures.

Our obligations under the Credit Agreement are secured by our accounts receivable and other rights to payment, general intangibles, inventory, equipment and fixtures. We also have a foreign exchange facility with Wells Fargo Bank, N.A. in effect until January 31, 2019, and with Bank of America, N.A. in effect until August 15, 2017.

On March 31, 2017, we were in compliance with all of the financial and other covenants required under the Credit agreement.

We did not use our working capital line of credit nor did we have any long-term debt outstanding during the nine months ended March 31, 2017. As of March 31, 2017, we had \$10.0 million available under our credit facilities.

F. Economic Dependency

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

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|------------|-------------------------------------|------------------------------|------------------------------------|------------------------------|
| | 2017 | 2016 | 2017 | 2016 |
| | Net Sales by Customer | Net Sales by Customer | Net Sales by Customer | Net Sales by Customer |
| Customer 1 | \$11,046 | \$ 13,023 | \$43,198 | \$ 31,714 |
| Customer 2 | (a) | 3,367 | (a) | 9,705 |
| Customer 3 | (a) | 3,196 | (a) | (a) |
| | \$11,046 | \$ 19,586 | \$43,198 | \$ 41,419 |

- (a) Sales were less than 10% of the respective period's total private revenues.

We buy certain products, including beta-alanine, 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 raw material purchases were as follows (dollars in thousands):

| | Three Months Ended March 31, | | | Nine Months Ended March 31, | | |
|------------|---|--|---|---|--|------|
| | 2017 | 2016 | | 2017 | 2016 | |
| | Raw Material Purchases by Supplier | % of Total Raw Material Purchases | | Raw Material Purchases by Supplier | % of Total Raw Material Purchases | |
| Supplier 1 | \$1,683 | 16 | % | (a) | (a) | (a) |
| Supplier 2 | 1,646 | 16 | | (a) | (a) | (a) |
| Supplier 3 | 1,317 | 13 | | (a) | (a) | (a) |
| | \$4,646 | 45 | % | (a) | (a) | (a) |

(a) Purchases were less than 10% of the respective period's total raw material purchases.

G. Segment Information

Our business consists of two segments for financial reporting purposes. The two segments are identified as (i) private label contract manufacturing, which primarily relates to the provision of private label contract manufacturing services to companies that market and distribute nutritional supplements and other health care products, and (ii) patent and trademark licensing, which primarily includes direct raw material sales and royalty income from our license and supply agreements associated with the sale and use of beta-alanine under our CarnoSyn® trade name.

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, corporate legal, finance, information technology, and other corporate level related expenses, which are not allocated to any 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 2016 Annual Report.

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

| | Three Months Ended March 31, 2017 | | Nine Months Ended March 31, 2017 | |
|---|--|------------------------------|---|-------------|
| | 2016 | 2016 | 2016 | 2016 |
| Net Sales | | | | |
| Private label contract manufacturing | \$18,544 | \$24,493 | \$69,787 | \$62,377 |
| Patent and trademark licensing | 6,591 | 5,513 | 19,974 | 16,125 |
| | \$25,135 | \$30,006 | \$89,761 | \$78,502 |
| | | | | |
| | Three Months Ended March 31, 2017 | | Nine Months Ended March 31, 2017 | |
| | 2016 | 2016 | 2016 | 2016 |
| Income from Operations | | | | |
| Private label contract manufacturing | \$749 | \$2,915 | \$6,182 | \$7,518 |
| Patent and trademark licensing | 1,786 | 1,750 | 6,026 | 4,440 |
| Income from operations of reportable segments | 2,535 | 4,665 | 12,208 | 11,958 |
| Corporate expenses not allocated to segments | (1,542) | (1,560) | (4,566) | (4,390) |
| | \$993 | \$3,105 | \$7,642 | \$7,568 |
| | | | | |
| | March 31, 2017 | June 30, 2016 | | |
| Total Assets | | | | |
| Private label contract manufacturing | \$58,867 | \$66,375 | | |
| Patent and trademark licensing | 11,120 | 7,800 | | |
| | \$69,987 | \$74,175 | | |

Our private label contract manufacturing products are sold both in the U.S. and in markets outside the U.S., including Europe, Australia, Asia, Canada, Mexico, and South Africa. Our primary market outside the U.S. is Europe. Our patent and trademark licensing activities are primarily based in the U.S. and our branded products were only sold in

the U.S.

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

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|-----------------------------------|---|-------------|--|-------------|
| | 2017 | 2016 | 2017 | 2016 |
| Net Sales | | | | |
| United States | \$14,605 | \$13,374 | \$43,484 | \$38,665 |
| Markets outside the United States | 10,530 | 16,632 | 46,277 | 39,837 |
| | \$25,135 | \$30,006 | \$89,761 | \$78,502 |

Products manufactured by NAIE accounted for approximately 62% of consolidated net sales in markets outside the U.S. for the three months ended March 31, 2017 and 57% for the three months ended March 31, 2016. Products manufactured by NAIE accounted for 55% of consolidated net sales in markets outside the U.S. for the nine months ended March 31, 2017 and 67% for the nine months ended March 31, 2016. No products manufactured by NAIE were sold in the U.S. during the nine months ended March 31, 2017 and 2016.

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 Nine Months Ended | |
|---------------|-------------------------------|------------------------------|-------------------------------|------------------------------|---|-------------------------------|
| | March 31, 2017 | June 30, 2016 | March 31, 2017 | June 30, 2016 | March 31, 2017 | March 31, 2016 |
| United States | \$10,827 | \$9,678 | \$45,599 | \$49,755 | \$2,090 | \$5,004 |
| Europe | 6,961 | 5,489 | 24,388 | 24,420 | 2,242 | 1,955 |
| | \$17,788 | \$15,167 | \$69,987 | \$74,175 | \$4,332 | \$6,959 |

H. Income Taxes

The effective tax rate for the three months ended March 31, 2017 was an expense of 29.0% and the effective tax rate for the nine months ended March 31, 2017 was an expense of 29.9%. The rate differs from the U.S. federal statutory rate of 34% primarily due to the favorable impact of foreign earnings taxed at less than the U.S. statutory rate.

To determine our quarterly provision for income taxes, we use an estimated annual effective tax rate, which is based on expected annual income, statutory tax rates and tax planning opportunities available in the various jurisdictions to which we are subject. Certain significant or unusual items are separately recognized in the quarter in which they occur and can be a source of variability in the effective tax rate from quarter to quarter. There were no significant discrete items for the three and nine months ended March 31, 2017. We recognize interest and penalties related to uncertain tax positions, if any, as an income tax expense.

We record valuation allowances to reduce our deferred tax assets to an amount that we believe is more likely than not to be realized. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary

differences become deductible. During the three and nine months ended March 31, 2017, there was no change to our valuation allowance.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are 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 income in the period that includes the enactment date.

We are subject to taxation in the U.S., Switzerland and various state jurisdictions. Our tax years for the fiscal year ended June 30, 2013 and forward are subject to examination by the U.S. tax authorities and our years for the fiscal year ended June 30, 2008 and forward are subject to examination by the state tax authorities. Our tax years for the fiscal year ended June 30, 2015 and forward are subject to examination by the Swiss 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. Currently 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 quarterly and adjustments are made as events occur that we believe warrant adjustments to the reserves. There were no adjustments to reserves in the nine months ended March 31, 2017.

I. Treasury Stock

On June 2, 2011, the Board of Directors authorized the repurchase of up to \$2.0 million of our common stock. On February 6, 2015, the Board of Directors authorized a \$1.0 million increase to our stock repurchase plan bringing the total authorized repurchase amount to \$3.0 million. On May 11, 2015, the Board of Directors authorized a \$2.0 million increase to our stock repurchase plan bringing the total authorized repurchase amount to \$5.0 million. On March 28, 2017, the Board of Directors authorized a \$2.0 million increase to our stock repurchase plan bringing the total authorized repurchase amount to \$7.0 million. When we do so we may purchase the shares in open market or privately negotiated transactions.

During the nine months ended March 31, 2017, we purchased 39,547 shares under this plan at a weighted average cost of \$8.74 per share and a total cost of \$345,000 including commissions and fees. During the nine months ended March 31, 2016, we purchased 52,603 shares under this plan at a weighted average cost of \$6.26 per share and a total cost of \$329,000 including commissions and fees.

During the nine months ended March 31, 2017, we acquired 38,729 shares from employees in connection with restricted stock that vested during the year. During the nine months ended March 31, 2016, we acquired 27,195 shares from employees in connection with restricted stock that vested during the year. These shares were returned to the Company by the related employees and in return the Company paid each employee's required tax withholding. The valuation of the shares acquired and thereby the amount of shares returned to the Company was calculated based on the closing price on the date the shares vested.

Unvested restricted stock grants that are forfeited are returned to treasury stock. During the nine months ended March 31, 2017, employees forfeited 7,000 shares of unvested restricted stock grants. During the nine months ended March 31, 2016, employees forfeited 2,667 shares of unvested restricted stock grants.

J. Derivatives and Hedging

We are exposed to gains and losses resulting from fluctuations in foreign currency exchange rates relating to forecasted product sales denominated in foreign currencies and transactions of NAIE, our foreign subsidiary. As part of our overall strategy to manage the level of exposure to the risk of fluctuations in foreign currency exchange rates, we may use foreign exchange contracts in the form of forward contracts. To the extent we enter into such contracts, there can be no guarantee any such contracts will be effective hedges against our foreign currency exchange risk.

As of March 31, 2017, we had forward contracts designated as cash flow hedges primarily to protect against the foreign exchange risks inherent in our forecasted sales of products at prices denominated in currencies other than the U.S. Dollar. These contracts are expected to be settled through February 2018. For derivative instruments that are designated and qualify as cash flow hedges, we record the effective portion of the gain or loss on the derivative in accumulated other comprehensive income (“OCI”) as a separate component of stockholders’ equity and subsequently reclassify these amounts into earnings in the period during which the hedged transaction is recognized in earnings.

For foreign currency contracts designated as cash flow hedges, hedge effectiveness is measured using the spot rate. Changes in the spot-forward differential are excluded from the test of hedge effectiveness and are recorded currently in earnings as interest expense. We measure effectiveness by comparing the cumulative change in the hedge contract with the cumulative change in the hedged item. During the three months ended March 31, 2017, we recorded a \$97,000 gain related to the ineffective portion of our hedging instruments to other income. During the nine months ended March 31, 2017, we recorded a \$189,000 gain related to the ineffective portion of our hedging instruments to other income. We did not have any losses or gains related to the ineffective portion of our hedging instruments during the three and nine months ended March 31, 2016. No hedging relationships were terminated as a result of ineffective hedging or forecasted transactions no longer probable of occurring for foreign currency forward contracts. We monitor the probability of forecasted transactions as part of the hedge effectiveness testing on a quarterly basis.

As of March 31, 2017, the notional amounts of our foreign exchange contracts designated as cash flow hedges were approximately \$23.1 million (EUR 20.4 million). As of March 31, 2017, a net gain of approximately \$776,000 related to derivative instruments designated as cash flow hedges was recorded in OCI. It is expected that a majority of the OCI balance will be reclassified into earnings in the next 12 months along with the earnings effects of the related forecasted transactions.

As of March 31, 2017, the fair value of our cash flow hedges was a net asset of \$1.1 million, which was classified as prepaids and other current assets in our Condensed Consolidated Balance Sheets. During the three months ended March 31, 2017 we recognized \$322,000 of losses in OCI and reclassified \$278,000 of gains from OCI to revenue. During the nine months ended March 31, 2017 we recognized \$1.5 million of gains in OCI and reclassified \$549,000 of gains from OCI to revenue. As of June 30, 2016, \$226,000 of the fair value of our cash flow hedges was classified in prepaids and other current assets in our Consolidated Balance Sheets. During the three months ended March 31, 2016 we recognized \$118,000 of gains in OCI and reclassified \$2,000 of gains from OCI to revenue. During the nine months ended March 31, 2016 we recognized \$125,000 of gains in OCI and reclassified \$53,000 of gains from OCI to revenue.

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 operation. However, a settlement payment or unfavorable outcome could adversely impact our results of operation. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes we do not expect.

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 and nine months ended March 31, 2017. 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 2016 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. You should read this overview 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 U.S. 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, new product introductions, the demand for such customers' products, and general industry and economic conditions. Our revenue also includes raw material sales, royalty and licensing revenue generated from our patent estate pursuant to license and supply agreements with third parties for the distribution and use of the ingredient known as beta-alanine sold under our CarnoSyn® trademarks.

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, and commercializing our patent estate through sales of beta-alanine under our Carnosyn® and SR Carnosyn® trade names, contract manufacturing, and licensing agreements.

On March 29, 2017 we received a Notice of Allowance from the U.S. Patent and Trademark Office related to a new patent application directed to a broad range of improved methods of beta-alanine intake. These 28 allowed patent claims target such benefits as delaying muscle fatigue, increasing anaerobic capacity, increasing muscle strength and increasing muscle endurance. This patent when issued will not only become part of our global portfolio covering our CarnoSyn® beta-alanine and SR CarnoSyn® products, but more importantly, we believe it significantly lengthens the

patent coverage around our instant release CarnoSyn® beta-alanine to 2023. Following this Notice of Allowance we intend to seek a significant number of additional patent claims to further broaden our intellectual property protection.

During the first nine months of fiscal 2017, our net sales were 14% higher than in the first nine months of fiscal 2016. Private label contract manufacturing sales increased 12% due primarily to the sale of higher volumes of existing products to existing customers and new products sales to existing customers. Our sales for the first nine months of fiscal 2017 were favorably impacted due to the timing and shipments of orders and new product launches. Revenue concentration risk for our largest private label contract manufacturing customer as a percent of total net sales increased to 48% for the first nine months of fiscal 2017 compared to 40% in the first nine months of fiscal 2016.

During the first nine months of fiscal 2017, CarnoSyn® beta-alanine revenue increased 24% to \$20.0 million as compared to \$16.1 million for the first nine months of fiscal 2016. The increase in CarnoSyn® beta-alanine revenue was primarily due to the addition of new customers and increased material shipments to existing customers.

On an annualized basis, we continue to expect our consolidated fiscal 2017 revenue growth percentage to be approximately 5% to 10% due to reductions in contract manufacturing orders and customer forecasts from Australia, Asia, and Europe. A majority of this expected decline occurred in our third fiscal quarter ending March 31, 2017. We expect a smaller decline in our fourth fiscal quarter. We believe this international revenue decline will reverse during fiscal 2018. With respect to our CarnoSyn® beta-alanine business, we expect our current sales levels to continue for the balance of this fiscal year and the foreseeable future as we continue to expand our research, our patent estate and our client base.

To protect our CarnoSyn® business and its underlying patent estate, we incurred litigation, patent compliance, and new patent application expenses of approximately \$3.0 million during the first nine months of fiscal 2017 and \$1.3 million during the comparable period of fiscal 2016. The increase in these legal expenses on a year over year basis is primarily due to our efforts to enforce compliance with our existing patents, fees and expenses related to new patent applications and to protect our trade name in the marketplace against parties who are using it without our consent.

We describe our efforts to protect our patent estate in more detail under Item 1 of Part II of our 2016 Annual Report. Our ability to maintain or further increase our beta-alanine royalty and licensing revenue will depend in large part on our ability to enforce compliance of our instant release CarnoSyn® patents, maintain our patent rights and develop a market for our sustained release form of beta-alanine marketed under our SR Carnosyn® trademark.

During the remainder of fiscal 2017, 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;

Expanding the commercialization of our beta-alanine patent estate through raw material sales, developing a market for our sustained release form of beta-alanine marketed under our SR Carnosyn® trademark, new contract manufacturing opportunities, license agreements and protecting our proprietary rights;

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

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 2016 Annual Report and recent accounting pronouncements are discussed under Item A to our Notes to Condensed Consolidated Financial Statements contained in this Quarterly Report. There have been no significant changes to these policies or pronouncements during the nine months ended March 31, 2017 other than as listed under Item A to our Notes to Condensed Consolidated Financial Statement contained in this Quarterly Report.

Results of Operations

The results of our operations for the three- and nine-month periods ended March 31 were as follows (dollars in thousands):

| | Three Months Ended March 31, | | | Nine Months Ended March 31, | | | | |
|--|---------------------------------|----------|-------------|--------------------------------|----------|-------------|------|---|
| | 2017 | 2016 | % Change | 2016 | 2016 | % Change | | |
| Private label contract manufacturing | \$18,544 | \$24,493 | -24 | % | \$69,787 | \$62,377 | 12 | % |
| Patent and trademark licensing | 6,591 | 5,513 | 20 | % | 19,974 | 16,125 | 24 | % |
| Total net sales | 25,135 | 30,006 | -16 | % | 89,761 | 78,502 | 14 | % |
| Cost of goods sold | 20,017 | 23,549 | -15 | % | 70,479 | 61,643 | 14 | % |
| Gross profit | 5,118 | 6,457 | -21 | % | 19,282 | 16,859 | 14 | % |
| Gross profit % | 20.4 | % | 21.5 | % | 21.5 | % | 21.5 | % |
| Selling, general & administrative expenses | 4,125 | 3,352 | 23 | % | 11,640 | 9,291 | 25 | % |
| % of net sales | 16.4 | % | 11.2 | % | 13.0 | % | 11.8 | % |
| Income from operations | 993 | 3,105 | -68 | % | 7,642 | 7,568 | 1 | % |
| % of net sales | 4.0 | % | 10.3 | % | 8.5 | % | 9.6 | % |
| Other income, net | 57 | 1,502 | -96 | % | 494 | 1,441 | -66 | % |
| Income before income taxes | 1,050 | 4,607 | -77 | % | 8,136 | 9,009 | -10 | % |
| % of net sales | 4.2 | % | 15.4 | % | 9.1 | % | 11.5 | % |
| Income tax expense | 305 | 1,584 | -81 | % | 2,435 | 2,905 | -16 | % |
| Net income | \$745 | \$3,023 | -75 | % | \$5,701 | \$6,104 | -7 | % |
| % of net sales | 3.0 | % | 10.1 | % | 6.4 | % | 7.8 | % |

Private label contract manufacturing net sales decreased 24% during the three months ended March 31, 2017 and increased 12% during the nine months ended March 31, 2017, compared to the same periods in prior year. The decrease in the three months ended March 31, 2017 is primarily due to reductions in orders related to the Asian and European markets. The increase during the first nine months of fiscal 2017 is primarily due to the sale of higher volumes of existing products to existing customers and new products sales to existing customers.

Net sales from our patent and trademark licensing segment increased 20% during the three months ended March 31, 2017 and 24% during the nine months ended March 31, 2017, compared to the same periods in the prior year. These increases were primarily the result of growth in our customer base and increased material shipments.

The change in gross profit margin between the three and nine month periods ended March 31, 2017 was as follows:

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------------------|----|----------------------------------|----|
| Contract manufacturing ⁽¹⁾ | (5.6 |)% | (2.4 |)% |
| Patent and trademark licensing ⁽²⁾ | 4.5 | | 2.4 | |
| Total change in gross profit margin | (1.1 |)% | 0.0 | % |

Private label contract manufacturing gross profit margin as a percentage of consolidated net sales decreased 5.6 percentage points during the three months ended March 31, 2017 and decreased 2.4 percentage points during the nine months ended March 31, 2017 as compared to the comparable prior year periods. The decrease during the three months ended March 31, 2017 is primarily due to shift in product sales mix and increased per unit manufacturing costs. The decrease during the nine months ended March 31, 2017 is primarily due to a nominal increase in labor and overhead costs as a percentage of net revenues.

Patent and trademark licensing gross profit margin as a percentage of consolidated net sales increased 4.5 percentage points during the three months ended March 31, 2017 and increased 2.4 percentage points during the nine months ended March 31, 2017 as compared to the comparable prior year periods. These increases were primarily due to increased revenues and decreased supply chain costs.

Selling, general and administrative expenses increased \$0.8 million, or 23%, during the third quarter of fiscal 2017 as compared to the comparable prior year period. During the first nine months of fiscal 2017, selling, general, and administrative expenses increased \$2.4 million, or 25%, as compared to comparable prior year period. These increases were primarily due to increased litigation and patent compliance expenses and increased compensation costs associated with the growth in sales. The increase in expenses associated with our patent and trademark licensing segment are primarily associated with our efforts to enforce compliance with our patents related to instant release CarnoSyn®, new patent applications, and to protect our trade name in the marketplace against parties who are using them without our consent.

The changes in other income, net for both the three and nine month periods ended March 31, 2017, as compared to the same periods in the prior year, primarily relate to the sale of our domestic corporate headquarters in San Marcos, CA during the third quarter of fiscal 2017, which resulted in a one-time pre-tax gain of \$1.6 million.

Our income tax expense decreased \$1.3 million during the third quarter of fiscal 2017 and \$0.5 million during the nine months ended March 31, 2017 as compared to the same periods in fiscal 2016. The decrease during the three months ended March 31, 2017 is primarily related to approximately \$0.6 million of tax expense related to the sale of our domestic headquarters recorded in the third quarter of fiscal 2016 and lower pre-tax income in the third quarter of fiscal 2017 as compared to the same period in fiscal 2016. The decrease during the first nine months of fiscal 2017 as compared to the same period in fiscal 2016 primarily relates to approximately \$0.6 million of tax expense related to the sale of our domestic headquarters partially offset by increased tax expense on pre-tax income before the impact of the gain recorded on the sale of our corporate headquarters in San Marcos, CA in fiscal 2016.

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 \$7.9 million for the nine months ended March 31, 2017, compared to \$2.4 million provided by operating activities in the comparable period in the prior year.

At March 31, 2017, changes in accounts receivable, consisting primarily of amounts due from our private label contract manufacturing customers and our patent and trademark licensing activities, provided \$5.3 million in cash compared to using \$2.5 million in the comparable period in the prior year. The increase in cash provided by accounts receivable during the nine months ended March 31, 2017, was primarily due to increased sales and the timing and collection of sales year over year. Days sales outstanding was 32 days as of March 31, 2017, compared to 39 days as of March 31, 2016.

At March 31, 2017, changes in inventory provided \$4.8 million in cash compared to \$7.2 million of cash used in the comparable prior year period. The change in cash activity from inventory during the nine months ended March 31, 2017 was primarily related to the conversion of private label contract manufacturing inventory into sales during the first nine months of fiscal 2017 versus inventory growth during the first nine months of fiscal 2017 related to private label contract manufacturing growth. Changes in accounts payable and accrued liabilities used \$8.6 million in cash during the nine months ended March 31, 2017 compared to providing \$3.5 million during the nine months ended March 31, 2016. The change in cash flow activity related to accounts payable and accrued liabilities is primarily due to the timing of inventory receipts and payments.

NAIE provided approximately \$4.3 million of our operating cash flow in the nine months ended March 31, 2017. As of March 31, 2017, NAIE's undistributed retained earnings were considered indefinitely reinvested.

Cash used in investing activities during the nine months ended March 31, 2017 was \$4.3 million as compared to \$4.0 million used during the nine months ended March 31, 2016. Capital expenditures decreased to \$4.3 million during the nine months ended March 31, 2017 compared to \$7.0 million in the comparable period in the prior year. Capital expenditures during both periods included purchases of manufacturing equipment used in our Vista, California and Manno, Switzerland facilities while capital expenditures during the nine months ended March 31, 2016 also included the purchase of our new corporate headquarters located in Carlsbad, CA following the sale of our former headquarters located in San Marcos, CA. The capital expenditures during the first nine months of fiscal 2016 were partially offset by proceeds from the sale of equipment and sale of our former headquarters of \$3.0 million as compared to \$24,000 in the first nine months of fiscal 2016.

Cash used in financing activities for the nine months periods ending March 31, 2017 and March 31, 2016 related to share purchases of our common stock as part of our share repurchase program.

We did not have any consolidated debt as of either March 31, 2017 or June 30, 2016.

On March 28, 2017, we executed an amendment to our credit facility with Wells Fargo Bank, N.A. to extend the maturity date for our working line of credit from January 31, 2019 to February 1, 2020. The Credit Agreement provides us with a credit line of up to \$10.0 million. The line of credit may be used to finance working capital requirements. There was no commitment fee required as part of this amendment. There are no amounts currently drawn under the line of credit.

Under the terms of the Credit Agreement, borrowings are subject to eligibility requirements including maintaining (i) a ratio of total liabilities to tangible net worth of not greater than 1.25 to 1.0 at any time; and (ii) a ratio of total current assets to total current liabilities of not less than 1.75 to 1.0 at each fiscal quarter end. Any amounts outstanding under the line of credit will bear interest at a fixed or fluctuating interest rate as elected by NAI from time to time; provided, however, that if the outstanding principal amount is less than \$100,000 such amount shall bear interest at the then applicable fluctuating rate of interest. If elected, the fluctuating rate per annum would be equal to 1.25% above the daily one month LIBOR rate as in effect from time to time. If a fixed rate is elected, it would equal a per annum rate of 1.25% above the LIBOR rate in effect on the first day of the applicable fixed rate term. Any amounts outstanding under the line of credit must be paid in full on or before January 31, 2020. Amounts outstanding that are subject to a fluctuating interest rate may be prepaid at any time without penalty. Amounts outstanding that are subject to a fixed interest rate may be prepaid at any time in minimum amounts of \$100,000, subject to a prepayment fee equal to the sum of the discounted monthly differences for each month from the month of prepayment through the month in which the then applicable fixed rate term matures.

Our obligations under the Credit Agreement are secured by our accounts receivable and other rights to payment, general intangibles, inventory, equipment and fixtures. We also have a foreign exchange facility with Wells Fargo Bank, N.A. in effect until January 31, 2019, and with Bank of America, N.A. in effect until August 15, 2017.

On March 31, 2017, we were in compliance with all of the financial and other covenants required under the Credit agreement.

As of March 31, 2017, we had \$22.6 million in cash and cash equivalents and \$10.0 million available under our credit facilities. We believe our available cash, cash equivalents and potential cash flows from operations will be sufficient to fund our current working capital needs and capital expenditures through at least the next 12 months.

Off-Balance Sheet Arrangements

As of March 31, 2017, we did not have any 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 1 of this report. Other than those pronouncements, we are not aware of any other pronouncements that materially affect our financial position or results of operations.

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 (principal executive officer) and Chief Financial Officer (principal financial and accounting officer), evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2017. 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 March 31, 2017.

There were no changes to our internal control over financial reporting during the quarterly period ended March 31, 2017 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

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 intellectual property, product liability, employment, 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 we do not expect.

As of May 12, 2017, except as described below, neither NAI nor its subsidiary were a party to any material pending legal proceeding nor was any of our property the subject of any material pending legal proceeding. We are currently involved in several matters in the ordinary course of our business, each of which is related to enforcing our intellectual property rights. Some of these matters are summarized below.

In 2011, NAI filed a lawsuit against Woodbolt Distribution, LLC, also known as Cellucor (“Woodbolt”), and both NAI and Woodbolt filed additional lawsuits and countersuits against each other. NAI and Woodbolt subsequently settled all of the lawsuits between them, but not before the United States Patent and Trademark Office (“USPTO”) at Woodbolt’s request rejected the claims of two NAI patents. The rulings rejecting the claims of two NAI patents was subsequently confirmed by the Patent Trial and Appeal Board (PTAB) at the USPTO. NAI has filed a Notice of Appeal with the U.S. Court of Appeals for the Federal Circuit requesting that certain findings of the PTAB’s be reversed. Both NAI patents rejected by the USPTO expire in August 2017.

On September 18, 2015, the Company filed a complaint against Creative Compounds, Inc., alleging various claims including (1) violation of Section 43 of the Lanham Act, (2) violation of California's Unfair Competition Law, (3) violation of California's False Advertising Law, (4) Trade Libel and Business Disparagement and (5) Intentional Interference with Prospective Economic Advantage. A trial date is currently set for October 3, 2017. On August 24, 2016, the Company filed a separate complaint against Creative Compounds, Inc., alleging infringement of U.S. patent 7,825,084. On October 5, 2016, Creative filed its answer and counterclaims. On January 19, 2017, the Company filed a Motion to Amend the Complaint, to add allegations of infringement of U.S. patents 5,965,596, 7,504,376, 8,993,610 and 8,470,865, and additional parties, Core Supplement Technology, Inc., Honey Badger LLC, and Myopharma, Inc. The Court granted the Company’s motion. On May 2, 2017, the Court issued a revised scheduling order and set a trial date for July 31, 2018.

On July 1, 2016, the Company filed a complaint in U.S. District Court for the Southern District of California against Cenegenics, LLC, alleging infringement of U.S. patents 7,504,376 and 7,825,084. On August 3, 2016, the Company filed an amended complaint to assert infringement of the same patents against Cenegenics' contract manufacturer, Atlantic-Pro Nutrients d/b/a Xymogen, LLC. Subsequently the Company and defendants resolved their disputes and entered into settlement and license agreements, and the case was dismissed.

On July 6, 2016, the Company filed a complaint against Allmax Nutrition, Inc. in U.S. District Court for the Southern District of California, alleging (1) infringement of U.S. patents 5,965,596, 6,172,098, 7,825,084 and RE 45,947, (2) violation of Section 32 of the Lanham Act, and (3) copyright infringement. On October 19, 2016, the Company filed an amended complaint adding HBS International Corp., Allmax's exclusive distributor, as a co-defendant. On May 2, 2017, the Court issued a scheduling order setting a trial date for July 31, 2018.

On August 2, 2016, the Company filed a complaint against Muscle Sports Products, LLC in U.S. District Court for the Southern District of California, alleging infringement of its CarnoSyn® and CarnoSyn Beta Alanine® trademarks. Subsequently the Company and defendant resolved their disputes and entered into settlement and license agreements, and the case was dismissed.

On September 15, 2016, the Company filed a complaint against Arnet Pharmaceutical Corporation in the U.S. District Court for the Southern District of California alleging Breach of Contract. On May 2, 2017, the Court issued a scheduling order setting a trial date for July 31, 2018.

On September 16, 2016, the Company filed a complaint against Hi-Tech Pharmaceuticals, Inc. d/b/a ALR Industries, APS Nutrition, Innovative Laboratories, Formutech Nutrition, LG Sciences and Sports 1 in U.S. District Court for the Southern District of California, alleging (1) infringement of U.S. patents 5,965,596, 7,825,084, 8,993,610 and RE 45,947, (2) violation of Section 32 of the Lanham Act and (3) breach of contract. On May 2, 2017, the Court issued a scheduling order setting a trial date for July 31, 2018.

Although we believe our claims in the above litigation matters are valid, there is no assurance we will prevail in these litigation matters or in proceedings we may initiate or that our litigation expenses will not be greater than anticipated.

ITEM 1A. RISK FACTORS

When evaluating our business and future prospects you should carefully consider the risks described under Item 1A of our 2016 Annual Report, as well as the other information in our 2016 Annual Report, this report and other reports and documents we file with the SEC. 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 our stockholders could lose all or a portion of the value of their investment in our common stock.

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

During the quarter ended March 31, 2017, we repurchased 39,547 shares of our common stock at a total cost of \$345,000 (including commissions and transaction fees) as set forth below:

| <u>Period</u> | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ¹ | (d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs (as of March 31, 2017) |
|--|--|--|--|--|
| | | | | |
| January 1, 2017 to January 31, 2017 | — | — | — | — |

| | | | | |
|---------------------|--------|---------|--------|--------------|
| February 1, 2017 to | — | — | — | — |
| February 29, 2017 | | | | |
| March 1, 2017 to | | | | |
| | 39,547 | \$ 8.74 | 39,547 | \$ 2,844,000 |
| March 31, 2017 | | | | |
| Total | 39,547 | | 39,547 | \$ 2,844,000 |

1. On June 3, 2011, we announced a plan to repurchase up to \$2 million in shares of our common stock.
2. On February 6, 2015, the Board of Directors authorized a \$1 million increase to our stock repurchase plan bringing the total authorized repurchase amount to \$3 million.
3. On May 11, 2015, the Board of Directors authorized a \$2 million increase to our stock repurchase plan bringing the total authorized repurchase amount to \$5 million.
4. On March 28, 2017, the Board of Directors authorized a \$2 million increase to our stock repurchase plan bringing the total authorized repurchase amount to \$7 million.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

| 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 | Second Amendment to the Credit agreement by and between NAI and the Wells Fargo Bank N.A. effective as of March 28, 2017 | Filed herewith |
| 10.2 | Revolving Line of Credit Note made by NAI for the benefit of Wells Fargo Bank N.A. dated March 28, 2017 in the amount of \$10,000,000 | Filed herewith |
| 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 |
| 101.INS | XBRL Instance Document | Filed herewith |
| 101.SCH | XBRL Taxonomy Extension Schema Document | Filed herewith |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document | Filed herewith |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document | Filed herewith |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document | Filed herewith |

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document Filed herewith

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SIGNATURES

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

Date: May 15, 2017

NATURAL ALTERNATIVES INTERNATIONAL, INC.

By: /s/ Mark A. LeDoux
Mark A. LeDoux, Chief Executive
Officer
(principal executive officer)

By: /s/ Michael E. Fortin
Michael E. Fortin, Chief Financial
Officer
(principal financial and accounting
officer)