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NATURAL HEALTH TRENDS CORP

Form 10-Q

October 30, 2018

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number: 001-36849

NATURAL HEALTH TRENDS CORP.

(Exact name of registrant as specified in its charter)

Delaware 59-2705336

(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

609 Deep Valley Drive

Suite 395

Rolling Hills Estates, California 90274

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (310) 541-0888

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):
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 the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

At October 26, 2018, the number of shares outstanding of the registrant's common stock was 11,376,092 shares.

NATURAL HEALTH TRENDS CORP.
Quarterly Report on Form 10-Q
September 30, 2018

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FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, in particular “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations,” includes “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). When used in this report, the words or phrases “will likely result,” “expect,” “intend,” “will continue,” “anticipate,” “estimate,” “project,” “believe” and similar expressions are intended to identify “forward-looking statements” within the meaning of the Exchange Act. These statements represent our expectations or beliefs concerning, among other things, future revenue, earnings, growth strategies, new products and initiatives, future operations and operating results, and future business and market opportunities.

Forward-looking statements in this report speak only as of the date hereof, and forward-looking statements in documents incorporated by reference speak only as of the date of those documents. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as required by law. We caution and advise readers that these statements are based on certain assumptions that may not be realized and involve risks and uncertainties that could cause actual results to differ materially from the expectations and beliefs contained herein.

For a summary of certain risks related to our business, see “Part I, Item 1A. Risk Factors” in our most recent Annual Report on Form 10-K, as modified by the disclosure set forth in “Part II, Item 1A. Risk Factors” in this report, which includes the following:

- We could be adversely affected by management changes or an inability to attract and retain key management, directors and consultants;
- Because our Hong Kong operations account for a substantial portion of our overall business, and substantially all of our Hong Kong business is derived from the sale of products to members in China, any material adverse change in our business relating to either Hong Kong or China would likely have a material adverse impact on our overall business; Our operations in China are subject to compliance with a myriad of applicable laws and regulations, and any actual or alleged violations of those laws or government actions otherwise directed at us could have a material adverse impact on our business and the value of our company;
- Our failure to maintain and expand our member relationships could adversely affect our business;
- We are currently involved in, and may in the future face, litigation claims and governmental proceedings and inquiries that could harm our business;
- Although our members are independent contractors, improper member actions that violate laws or regulations could harm our business;
- Direct-selling laws and regulations may prohibit or severely restrict our direct sales efforts and cause our revenue and profitability to decline, and regulators could adopt new regulations that harm our business;
- The high level of competition in our industry could adversely affect our business;
- Challenges by third parties to the legality of our business operations could harm our business;
- An increase in the amount of compensation paid to members would reduce profitability;
- Currency exchange rate fluctuations could lower our revenue and net income;
- Changes in tax or duty laws, and unanticipated tax or duty liabilities, could adversely affect our net income;
- Transfer pricing regulations affect our business and results of operations;
- Our products and related activities are subject to extensive government regulation, which could delay, limit or prevent the sale of some of our products in some markets;
- Failure of new products to gain member and market acceptance could harm our business;
- New regulations governing the marketing and sale of nutritional supplements could harm our business;
- Regulations governing the production and marketing of our personal care products could harm our business;

• If we are found not to be in compliance with good manufacturing practices our operations could be harmed;
• Failure to comply with domestic and foreign laws and regulations governing product claims and advertising could harm our business;

- Adverse publicity associated with our products, ingredients or network marketing program, or those of similar companies, could harm our financial condition and operating results;
- We are subject to risks relating to product concentration and lack of revenue diversification;
- We rely on a limited number of independent third parties to manufacture and supply our products;
- Growth may be impeded by the political and economic risks of entering and operating foreign markets; Recently enacted tariffs, other potential changes to tariff and import/export regulations, and ongoing trade disputes between the United States and other jurisdictions, particularly China, may have a negative effect on global economic conditions and our business, financial results and financial condition;
- We may be held responsible for certain taxes or assessments relating to the activities of our members and service providers, which could harm our financial condition and operating results;
- We may be unable to protect or use our intellectual property rights;
- We do not have a comprehensive product liability insurance program and product liability claims could hurt our business;
- Our internal controls and accounting methods may require modification; We identified a material weakness in our internal control over financial reporting. If we do not adequately address this material weakness or if other material weaknesses or significant deficiencies in our internal control over financial reporting are discovered, our financial statements could contain material misstatements and our business, operations and stock price may be adversely affected;
- We rely on and are subject to risks associated with our reliance upon information technology systems;
 - System disruptions or failures, cybersecurity risks, and compromises of data could harm our business;
- Our systems, software and data reside on third-party servers, exposing us to risks that disruption or intrusion of those servers could temporarily or permanently interrupt our access and damage our business;
- Terrorist attacks, acts of war, epidemics or natural disasters may seriously harm our business;
- We may experience substantial negative cash flows, which may have a significant adverse effect on our business and could threaten our solvency; If we experience negative cash flows, we may need to seek additional debt or equity financing, which may not be available on acceptable terms or at all. If available, it could have a highly dilutive effect on the holdings of existing stockholders;
- Disappointing quarterly revenue or operating results could cause the price of our common stock to fall;
- Our common stock is particularly subject to volatility because of the industry in which we operate; Our common stock continues to experience wide fluctuations in trading volumes and prices. This may make it more difficult for holders of our common stock to sell shares when they want and at prices they find attractive; and
- Future sales by us or our existing stockholders could depress the market price of our common stock.

Additional factors that could cause actual results to differ materially from our forward-looking statements are set forth in this report, including under the headings “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and in our financial statements and the related notes.

PART I - FINANCIAL INFORMATION**Item 1. FINANCIAL STATEMENTS****NATURAL HEALTH TRENDS CORP.
CONSOLIDATED BALANCE SHEETS****(In thousands, except share data)**

	September 30, 2018	December 31, 2017
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 132,206	\$ 135,311
Inventories	11,119	8,398
Other current assets	4,918	7,534
Total current assets	148,243	151,243
Property and equipment, net	988	1,149
Goodwill	1,764	1,764
Restricted cash	3,003	3,167
Deferred tax asset	1,435	1,435
Other assets	859	796
Total assets	\$ 156,292	\$ 159,554
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,715	\$ 1,751
Income taxes payable	168	309
Accrued commissions	13,125	11,170
Other accrued expenses	7,341	7,605
Deferred revenue	4,462	4,455
Amounts held in eWallets	14,196	15,152
Other current liabilities	1,906	1,479
Total current liabilities	43,913	41,921
Income taxes payable	16,982	19,052
Deferred tax liability	75	56
Long-term incentive	7,104	7,904
Total liabilities	68,074	68,933
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, \$0.001 par value; 50,000,000 shares authorized; 12,979,414 shares issued at September 30, 2018 and December 31, 2017	13	13
Additional paid-in capital	86,415	86,683
Retained earnings	42,740	44,908
Accumulated other comprehensive loss	(1,202) (413
Treasury stock, at cost; 1,603,322 and 1,637,524 shares at September 30, 2018 and December 31, 2017, respectively	(39,748) (40,570
Total stockholders' equity	88,218	90,621
Total liabilities and stockholders' equity	\$ 156,292	\$ 159,554

See accompanying notes to consolidated financial statements.

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NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net sales	\$47,043	\$40,132	\$150,320	\$151,471
Cost of sales	9,926	8,183	30,546	29,221
Gross profit	37,117	31,949	119,774	122,250
Operating expenses:				
Commissions expense	22,001	15,802	67,291	63,842
Selling, general and administrative expenses	7,269	7,633	24,484	24,035
Total operating expenses	29,270	23,435	91,775	87,877
Income from operations	7,847	8,514	27,999	34,373
Other income (expense), net	249	(12)	465	224
Income before income taxes	8,096	8,502	28,464	34,597
Income tax provision	467	1,164	2,988	6,531
Net income	\$7,629	\$7,338	\$25,476	\$28,066
Net income per common share:				
Basic	\$0.67	\$0.65	\$2.25	\$2.50
Diluted	\$0.67	\$0.65	\$2.25	\$2.49
Weighted-average number of common shares outstanding:				
Basic	11,309	11,258	11,298	11,244
Diluted	11,322	11,276	11,307	11,269
Cash dividends declared per common share	\$0.40	\$0.36	\$2.43	\$1.25

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(In thousands)

	Three Months Ended September 30, 2018		2017		Nine Months Ended September 30, 2018		2017	
Net income	\$7,629	\$7,338	\$25,476	\$28,066				
Other comprehensive income (loss), net of tax:								
Foreign currency translation adjustment	(432)	196	(798)	359				
Release of cumulative translation adjustment	—	—	—	(258)				
Net change in foreign currency translation adjustment	(432)	196	(798)	101				
Unrealized gains (losses) on available-for-sale securities	5	(5)	9	(10)				
Comprehensive income	\$7,202	\$7,529	\$24,687	\$28,157				

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

	Nine Months Ended September 30,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$25,476	\$28,066
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	332	414
Stock-based compensation	—	26
Cumulative translation adjustment realized in net income	—	(258)
Changes in assets and liabilities:		
Inventories	(2,828)	590
Other current assets	2,548	1,164
Other assets	(83)	(61)
Accounts payable	967	(1,121)
Income taxes payable	(2,201)	392
Accrued commissions	2,003	(3,143)
Other accrued expenses	314	(5,064)
Deferred revenue	26	(1,364)
Amounts held in eWallets	(930)	(2,856)
Other current liabilities	438	51
Long-term incentive	(800)	(1,498)
Net cash provided by operating activities	25,262	15,338
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(176)	(238)
Net cash used in investing activities	(176)	(238)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Dividends paid	(27,644)	(14,157)
Net cash used in financing activities	(27,644)	(14,157)
Effect of exchange rates on cash, cash equivalents and restricted cash	(711)	218
Net (decrease) increase in cash, cash equivalents and restricted cash	(3,269)	1,161
CASH, CASH EQUIVALENTS AND RESTRICTED CASH, beginning of period	138,478	128,884
CASH, CASH EQUIVALENTS AND RESTRICTED CASH, end of period	\$135,209	\$130,045
SUPPLEMENTAL DISCLOSURES OF OTHER CASH FLOW INFORMATION:		
Issuance of treasury stock for employee awards, net	\$554	\$1,393

See accompanying notes to consolidated financial statements.

NATURAL HEALTH TRENDS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. NATURE OF OPERATIONS, BASIS OF PRESENTATION AND CONSOLIDATION

Nature of Operations

Natural Health Trends Corp., a Delaware corporation (whether or not including its subsidiaries, the “Company”), is an international direct-selling and e-commerce company headquartered in Rolling Hills Estates, California. Subsidiaries controlled by the Company sell personal care, wellness, and “quality of life” products under the “NHT Global” brand.

The Company’s wholly-owned subsidiaries have an active physical presence in the following markets: the Americas, which consists of the United States, Canada, Cayman Islands, Mexico and Peru; Greater China, which consists of Hong Kong, Taiwan and China; Southeast Asia, which consists of Singapore, Malaysia and Vietnam; South Korea; Japan; and Europe. The Company also operates in Russia and Kazakhstan through an engagement with a local service provider.

Basis of Presentation

The unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. As a result, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company’s financial information for the interim periods presented. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company’s 2017 Annual Report on Form 10-K filed with the United States Securities and Exchange Commission (SEC) on March 27, 2018.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and all of its wholly-owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

Reclassification

In accordance with the adoption of Accounting Standards Update (“ASU”) No. 2016-18, *Statement of Cash Flows - Restricted Cash*, the Company has included amounts classified as restricted cash or restricted cash equivalents when reconciling beginning-of-period and end-of-period total cash, cash equivalents and restricted cash amounts, as presented in its consolidated statements of cash flows.

2. ACCOUNTING PRONOUNCEMENTS

In November 2016, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2016-18 that requires amounts generally described as restricted cash or restricted cash equivalents be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The new standard was effective for fiscal years beginning after December 15, 2017, including interim periods

within those fiscal years. The Company adopted the new standard effective January 1, 2018 using the retrospective transition method. Its adoption did not have a material effect on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*, that requires organizations that lease assets, referred to as "lessees", to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases with lease terms of more than 12 months. ASU 2016-02 will also require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases and will include qualitative and quantitative requirements. The new standard will be effective for fiscal years beginning after December 15, 2018, including interim periods within those annual years, and early application is permitted. The Company is currently assessing the impact that this standard will have on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue From Contracts With Customers*, that outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. ASU 2014-09 is based on the principle that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. It also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract. In July 2015, the FASB approved the deferral of the effective date for annual reporting periods beginning after December 15, 2017, including interim reporting periods. The Company adopted the new standard effective January 1, 2018 using the modified retrospective transition method. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements. See Note 3 for additional information.

Other recently issued accounting pronouncements did not or are not believed by management to have a material impact on the Company's present or future financial statements.

3. REVENUE

Revenue Recognition

All revenue is recognized when the performance obligations under a contract are satisfied. Product sales are recognized when the products are shipped and title passes to independent members. Product sales to members are made pursuant to a member agreement that provides for transfer of both title and risk of loss upon the Company's delivery to the carrier that completes delivery to the members, which is commonly referred to as "F.O.B. Shipping Point." The Company's sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return. These contracts are generally short-term in nature.

Actual product returns are recorded as a reduction to net sales. The Company estimates and accrues a reserve for product returns based on its return policies and historical experience. The reserve is based upon the return policy of each country, which varies from 14 days to one year, and their historical return rates, which range from 1% to 7% of sales. Sales returns were 2% for each of the nine months ended September 30, 2018 and 2017, respectively. No material changes in estimates have been recognized during the periods presented. See Note 5 for additional information.

The Company has elected to account for shipping and handling activities performed after title has passed to members as a fulfillment cost, and accrues for the costs of shipping and handling if revenue is recognized before the contractually obligated shipping and handling activities occur. Shipping charges billed to members are included in net sales. Costs associated with shipments are included in cost of sales. Event and training revenue is deferred and recognized as the event or training occurs. Costs of events and member training are included within selling, general and administrative expenses.

Various taxes on the sale of products to members are collected by the Company as an agent and remitted to the respective taxing authority. These taxes are presented on a net basis and recorded as a liability until remitted to the respective taxing authority.

Deferred Revenue

The Company primarily receives payment by credit card at the time members place orders. Amounts received for unshipped product are considered a contract liability and are recorded as deferred revenue. The increase in deferred

revenue for the three months ended September 30, 2018 is primarily due to \$2.3 million of cash payments received for unshipped product during the third quarter offset by \$1.7 million of revenue recognized during the quarter that was included in deferred revenue as of June 30, 2018. See Note 5 for additional information.

Disaggregation of Revenue

The Company sells products to a member network that operates in a seamless manner from market to market, except for the Chinese market where it sells to consumers through an e-commerce retail platform and the Russia and Kazakhstan market where the Company operates through an engagement of a third-party service provider.

The following table sets forth revenue by market for the periods indicated (in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2018		2017		2018		2017	
Americas ¹	\$1,970	4.2 %	\$1,239	3.1 %	\$5,361	3.6 %	\$4,340	2.9 %
Hong Kong ²	41,447	88.1	35,049	87.3	133,681	88.9	135,304	89.3
China	1,698	3.6	1,731	4.3	5,510	3.7	4,732	3.1
Taiwan	935	2.0	1,229	3.1	2,933	1.9	4,116	2.7
South Korea	133	0.3	128	0.3	392	0.3	379	0.3
Japan	51	0.1	29	0.1	160	0.1	89	0.1
Singapore	52	0.1	40	0.1	134	0.1	124	0.1
Malaysia	216	0.5	—	—	316	0.2	—	—
Russia and Kazakhstan	184	0.4	209	0.5	626	0.4	655	0.4
Europe	357	0.7	478	1.2	1,207	0.8	1,732	1.1
Total	\$47,043	100.0%	\$40,132	100.0%	\$150,320	100.0%	\$151,471	100.0%

¹ United States, Canada, Mexico and Peru

² Substantially all of our Hong Kong revenues are derived from the sale of products that are delivered to members in China. See "Item 1A. Risk Factors" in our most recent Annual Report on Form 10-K.

The Company's net sales by product and service are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Product sales	\$44,434	\$37,666	\$142,258	\$143,771
Freight and other	3,365	2,960	10,550	10,775
Less: sales returns (756)	(494)	(2,488)	(3,075)	
Total net sales	\$47,043	\$40,132	\$150,320	\$151,471

Concentration

No single market other than Hong Kong had net sales greater than 10% of total net sales. Sales are made to the Company's members and no single customer accounted for 10% or more of net sales for the three and nine months ended September 30, 2018 and 2017. However, the Company's business model can result in a concentration of sales to several different members and their network of members. Although no single member accounted for 10% or more of net sales, the loss of a key member or that member's network could have an adverse effect on the Company's net sales and financial results.

Arrangements with Multiple Performance Obligations

The Company's contracts with customers may include multiple performance obligations. For such arrangements, the Company allocates revenues to each performance obligation based on its relative standalone selling price. The Company generally determines standalone selling prices based on the prices charged for individual products to similar customers.

Practical Expedients

The Company generally expenses sales commissions when incurred because the amortization period would have been one year or less. These costs are recorded in commissions expense.

The Company does not provide certain disclosures about unsatisfied performance obligations for contracts with an original expected length of one year or less.

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4. NET INCOME PER COMMON SHARE

Diluted net income per common share is determined using the weighted-average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents. The dilutive effect of non-vested restricted stock is reflected by application of the treasury stock method. Under the treasury stock method, the amount of compensation cost for future service that the Company has not yet recognized and the amount of tax benefit that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

The following tables illustrate the computation of basic and diluted net income per common share for the periods indicated (in thousands, except per share data):

	Three Months Ended September 30,					
	2018			2017		
	Income	Shares	Per	Income	Shares	Per
	(Numerator)	(Denominator)	Share	(Numerator)	(Denominator)	Share
			Amount			Amount
Basic net income per common share:						
Net income available to common stockholders	\$7,629	11,309	\$ 0.67	\$7,338	11,258	\$ 0.65
Effect of dilutive securities:						
Non-vested restricted stock	—	13		—	18	
Diluted net income per common share:						
Net income available to common stockholders plus assumed conversions	\$7,629	11,322	\$ 0.67	\$7,338	11,276	\$ 0.65
	Nine Months Ended September 30,					
	2018			2017		
	Income	Shares	Per	Income	Shares	Per
	(Numerator)	(Denominator)	Share	(Numerator)	(Denominator)	Share
			Amount			Amount
Basic net income per common share:						
Net income available to common stockholders	\$25,476	11,298	\$ 2.25	\$28,066	11,244	\$ 2.50
Effect of dilutive securities:						
Non-vested restricted stock	—	9		—	25	
Diluted net income per common share:						
Net income available to common stockholders plus assumed conversions	\$25,476	11,307	\$ 2.25	\$28,066	11,269	\$ 2.49

Certain

Non-vested restricted stock totaling 12,781 and 9,178 shares were not included for the three and nine months ended September 30, 2018, respectively.

5. BALANCE SHEET COMPONENTS

The components of certain balance sheet amounts are as follows (in thousands):

	September 30, December 31,	
	2018	2017
Cash, cash equivalents and restricted cash:		
Cash	\$ 54,709	\$ 61,703
Cash equivalents	77,497	73,608
	132,206	135,311
Restricted cash	3,003	3,167
	\$ 135,209	\$ 138,478
Inventories:		
Finished goods	\$ 10,826	\$ 7,779
Raw materials	370	799
Reserve for obsolescence	(77) (180
	\$ 11,119	\$ 8,398
Other accrued expenses:		
Sales returns	\$ 437	\$ 614
Employee-related expense	5,802	5,568
Warehousing, inventory-related and other	1,102	1,423
	\$ 7,341	\$ 7,605
Deferred revenue:		
Unshipped product	\$ 2,307	\$ 2,411
Auto ship advances	1,801	1,665
Other	354	379
	\$ 4,462	\$ 4,455

6. FAIR VALUE MEASUREMENTS

As of September 30, 2018, cash and cash equivalents include the Company's investments in debt securities, comprising municipal notes and bonds and corporate debt, commercial paper, money market funds and time deposits. The Company considers all highly liquid investments with original maturities of three months or less when purchased and have insignificant interest rate risk to be cash equivalents. Debt securities classified as cash equivalents are required to be accounted for in accordance with the FASB Accounting Standards Codification ("ASC") 320, *Investments - Debt and Equity Securities*. As such, the Company determined its investments in debt securities held at September 30, 2018 should be classified as available-for-sale and are carried at fair value with unrealized gains and losses reported in accumulated other comprehensive income in stockholders' equity. The cost of debt securities is adjusted for amortization of premiums and discounts to maturity. This amortization is included in other income. Realized gains and losses, as well as interest income, are also included in other income. The fair values of securities are based on quoted market prices.

The carrying amounts of the Company's financial instruments, including cash and cash equivalents and accounts payable, approximate fair value because of their short maturities. The carrying amount of the noncurrent restricted cash approximates fair value since, absent the restrictions, the underlying assets would be included in cash and cash equivalents. The Company's cash equivalents are valued based on level 1 inputs which consist of quoted prices in active markets.

Accounting standards permit companies, at their option, to choose to measure many financial instruments and certain other items at fair value. The Company has elected to not fair value existing eligible items.

Available-for-sale investments included in cash equivalents at the end of each period were as follows (in thousands):

	September 30, 2018			December 31, 2017		
	Adjusted Cost	Gross Unrealized Losses	Fair Value	Adjusted Cost	Gross Unrealized Losses	Fair Value
Municipal bonds and notes	\$553	\$ —	\$553	\$13,320	\$ (1)	\$13,319
Corporate debt securities	35,857	(18)	35,839	49,432	(24)	49,408
Financial institution instruments	41,105	—	41,105	10,881	—	10,881
Total available-for-sale investments	\$77,515	\$ (18)	\$77,497	\$73,633	\$ (25)	\$73,608

Financial institution instruments include instruments issued or managed by financial institutions such as money market fund deposits and time deposits.

7. STOCKHOLDERS' EQUITY

Dividends

The following table summarizes the Company's cash dividend activity for the nine months ended September 30, 2018 (in thousands, except per share data):

Declaration Date	Per Share	Amount	Record Date	Payment Date
July 18, 2018 (special)	\$0.25	\$2,844	August 14, 2018	August 24, 2018
July 18, 2018	0.15	1,707	August 14, 2018	August 24, 2018
April 17, 2018 (special)	1.76	20,022	May 15, 2018	May 25, 2018
April 17, 2018	0.14	1,592	May 15, 2018	May 25, 2018
February 6, 2018	0.13	1,479	February 27, 2018	March 9, 2018
	\$2.43	\$27,644		

Declaration and payment of any future dividends on shares of common stock will be at the discretion of the Company's Board of Directors.

Stock Repurchases

On January 12, 2016, the Board of Directors authorized an increase to the Company's stock repurchase program first approved on July 28, 2015 from \$15.0 million to \$70.0 million. Repurchases are expected to be executed to the extent that the Company's earnings and cash-on-hand allow, and will be made in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act. For all or a portion of the authorized repurchase amount, the Company may enter into one or more plans that are compliant with Rule 10b5-1 of the Exchange Act that are designed to facilitate these purchases. The stock repurchase program does not require the Company to acquire a specific number of shares, and may be suspended from time to time or discontinued. As of September 30, 2018, \$32.0 million of the \$70.0 million stock repurchase program approved on July 28, 2015 and increased on January 12, 2016 remained available for future purchases, inclusive of related estimated income tax.

Restricted Stock

No stock-based compensation was recognized for the three or nine months ended September 30, 2018. Stock-based compensation expense totaled \$8,600 and \$25,900 for the three and nine months ended September 30, 2017,

respectively.

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At the Company's annual meeting of stockholders held on April 7, 2016, the Company's stockholders approved the Natural Health Trends Corp. 2016 Equity Incentive Plan (the "2016 Plan") to replace its 2007 Equity Incentive Plan. The 2016 Plan allows for the grant of various equity awards including incentive stock options, non-statutory options, stock, stock units, stock appreciation rights and other similar equity-based awards to the Company's employees, officers, non-employee directors, contractors, consultants and advisors of the Company. Up to 2,500,000 shares of the Company's common stock (subject to adjustment under certain circumstances) may be issued pursuant to awards granted. At September 30, 2018, 2,359,671 shares remained available for issuance under the 2016 Plan.

On February 1, 2018, the Company granted 34,202 shares of restricted common stock under the 2016 Plan to certain employees for the purpose of further aligning their interest with those of its stockholders and settling fiscal 2017 performance incentives totaling \$554,000. The shares vest on a quarterly basis over the next three years and are subject to forfeiture in the event of their termination of service to the Company under specified circumstances.

The following table summarizes the Company's restricted stock activity under the 2016 Plan:

	Shares	Wtd. Avg. Price at Date of Issuance
Nonvested at December 31, 2017	58,032	\$ 28.59
Granted	34,202	16.19
Vested	(35,061)	26.31
Nonvested at September 30, 2018	57,173	22.57

Accumulated Other Comprehensive Loss

The changes in accumulated other comprehensive loss by component for the first nine months of 2018 were as follows (in thousands):

	Foreign Currency Translation Adjustment	Unrealized Gains/(Losses) on Available-For-Sale Investments	Total
Balance, December 31, 2017	\$ (386)	\$ (27)	\$(413)
Other comprehensive income (loss)	(798)	9	(789)
Balance, September 30, 2018	\$ (1,184)	\$ (18)	\$(1,202)

8. INCOME TAXES

The effective income tax rate for the three and nine months ended September 30, 2018 was significantly impacted by recording the effect of the Tax Cuts and Jobs Act (the "Tax Act"), enacted on December 22, 2017 by the U.S. government. The Tax Act makes broad and complex changes to the Internal Revenue Code of 1986, as amended, including, but not limited to, reducing the maximum U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018 and providing for new Global Intangible Low-Taxed Income ("GILTI") tax rules. In addition, the Tax Act requires a one-time repatriation tax on certain un-repatriated earnings of foreign subsidiaries at a rate of 15.5% tax on post-1986 foreign earnings held in cash and an 8% rate on all other post-1986 earnings, which is payable over eight years beginning with 8% of the liability due with the filing of the year ended December 31, 2017 federal tax return that was due and paid in the second quarter of 2018.

On December 22, 2017, the Securities and Exchange Commission staff issued Staff Accounting Bulletin No. 118 (“SAB 118”), which provides guidance on accounting for tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, *Income Taxes*. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate to be included in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provision of the tax laws that were in effect immediately before the enactment of the Tax Act. While the Company was able to make reasonable estimates of the impact of the reduction in the corporate income tax rate and the deemed repatriation transition tax, the final impact of the Tax Act slightly differed from these estimates, due to, among other things, changes in the Company’s interpretations and assumptions, and additional guidance issued by the Internal Revenue Service. The Company has recorded a benefit of \$496,000 against income tax expense as a discrete item in the three months ended September 30, 2018 to reflect the final calculations, as reflected on the Company’s income tax returns filed during the third quarter. Further adjustments, if any, through the fourth quarter of 2018 will be included as an adjustment to income tax expense.

Effective January 1, 2018, the Company is subject to the new GILTI tax rules. GILTI is the excess income of foreign subsidiaries over a 10% routine return on tangible assets. After a 50% deduction, GILTI is subject to the 21% corporate tax rate. Due to the complexity of the GILTI tax rules, the Company continues to evaluate this provision of the Tax Act and the application of ASC 740. Under U.S. GAAP, the Company is allowed to make an accounting policy choice of either treating taxes due on future U.S. inclusions in taxable income related to GILTI as a current period expense when incurred (the “period cost method”) or factoring such amounts into the Company’s measurement of its deferred taxes (the “deferred method”). Although the Company has not elected an accounting policy, it has recorded a provisional amount of the GILTI tax as a current period expense for 2018. The impact of GILTI as a component of the effective tax rate for the nine months ended September 30, 2018 was approximately 8.2%, or \$2.3 million, net of foreign tax credits attributed to GILTI. The provisional amount of the GILTI tax during the third quarter of 2018 resulted in a slight increase as a component of the effective tax rate from 8% in the second quarter of 2018. The Company will determine the appropriate accounting policy for its structure and record any necessary adjustments within the measurement period.

As a result of capital return activities, the Company determined that a portion of its current undistributed foreign earnings are no longer deemed reinvested indefinitely by its non-U.S. subsidiaries. For state income tax purposes, the Company will continue to periodically reassess the needs of its foreign subsidiaries and update its indefinite reinvestment assertion as necessary. Due to the adoption of a territorial tax regime upon the enactment of the Tax Act, any foreign source portion of a qualified dividend received by a 10% U.S. corporate shareholder is exempt from U.S. federal tax, therefore resulting in any future repatriation having a minimal effect on the Company’s effective tax rate. To the extent that additional foreign earnings are not deemed permanently reinvested, the Company expects to recognize additional income tax provision at the applicable U.S. state corporate tax rate(s). As of September 30, 2018, the Company has accrued tax liabilities for earnings that it plans to repatriate out of accumulated earnings in future periods for state tax purposes only. All undistributed earnings in excess of 50% of current earnings on an annual basis are intended to be reinvested indefinitely as of September 30, 2018.

The Company and its subsidiaries file tax returns in the United States, California, New Jersey and Texas and various foreign jurisdictions. For federal income tax purposes, fiscal years 2007 through 2016 remain open for examination by tax authorities as a result of net operating loss carryovers from older years being used to offset income in recent tax years. The Company is no longer subject to state income tax examinations for years prior to 2012. The Company was notified that it has been selected for audit by the Internal Revenue Service for the tax year ended December 31, 2016. No other jurisdictions are currently examining any income tax returns of the Company or its subsidiaries.

9. COMMITMENTS AND CONTINGENCIES

Shareholder Derivative Claims

In February 2016, a purported shareholder derivative complaint was filed in the Superior Court of the State of California, County of Los Angeles: *Zhou v. Sharng*. In March 2016, a purported shareholder derivative complaint was filed in the United States District Court for the Central District of California: *Kleinfeldt v. Sharng*. On November 10, 2017, the parties to both the *Zhou* and *Kleinfeldt* actions entered into a Memorandum of Understanding (“MOU”) to resolve both actions, subject to the negotiation of a written settlement agreement and approval by the federal court in the *Kleinfeldt* matter. On July 16, 2018, the court granted final approval of the settlement and entered judgment in the *Kleinfeldt* matter. In exchange for full releases, the settlement required the Company to implement certain corporate governance reforms and included an award of \$250,000 in attorneys’ fees to plaintiffs’ counsel, all of which was fully funded by the Company’s insurers. On August 9, 2018, plaintiff filed a request to voluntarily dismiss the *Zhou* action, which was entered by the court on August 30, 2018.

Other Claims

The Company is currently involved in a legal matter with one of its vendors and an outside party. Per the royalty agreement with the vendor, the Company believes that it is fully indemnified in the event of an unfavorable outcome and any potential settlement costs related to the matter would be fully covered by the Company’s vendor.

10. RELATED PARTY TRANSACTIONS

In February 2013, the Company entered into a Royalty Agreement and License with Broady Health Sciences, L.L.C., a Texas limited liability company, (“BHS”) regarding the manufacture and sale of a product called *ReStor*TM. George K. Broady, a director of the Company and beneficial owner of more than 5% of its outstanding common stock, is owner of BHS. Under the agreement, the Company agreed to pay BHS a royalty based on a price per unit in return for the right to manufacture (or have manufactured), market, import, export and sell this product worldwide, with certain rights being exclusive outside the United States. Such royalties were \$72,000 and \$61,000 for the three months ended September 30, 2018 and 2017, respectively, and \$248,000 and \$238,000 for the nine months ended September 30, 2018 and 2017, respectively. The Company is not required to purchase any product under the agreement, and the agreement may be terminated at any time on 120 days’ notice or, under certain circumstances, with no notice. Otherwise, the agreement terminates March 31, 2020.

11. SUBSEQUENT EVENT

On October 21, 2018, the Board of Directors declared a quarterly cash dividend of \$0.16 and a special cash dividend of \$0.18 on each share of common stock outstanding. Such dividends are payable on November 23, 2018 to stockholders of record on November 13, 2018. Declaration and payment of any future dividends on shares of common stock will be at the discretion of the Company’s Board of Directors.

Item 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Business Overview

We are an international direct-selling and e-commerce company. Subsidiaries controlled by us sell personal care, wellness, and “quality of life” products under the “NHT Global” brand. Our wholly-owned subsidiaries have an active physical presence in the following markets: the Americas, which consists of the United States, Canada, Cayman Islands, Mexico and Peru; Greater China, which consists of Hong Kong, Taiwan and China; Southeast Asia, which consists of Singapore, Malaysia and Vietnam; South Korea; Japan; and Europe. We also operate through an engagement of a third-party service provider in Russia and Kazakhstan.

Our member network operates in a seamless manner from market to market, except for our China market where we sell to consumers through an e-commerce platform, and our Russia and Kazakhstan market where our engagement of a third-party service provider results in a different economic structure than in our other markets. Otherwise, we believe that all of our other operating segments are similar in the nature of the products sold, the product acquisition process, the types of customers products are sold to, the methods used to distribute the products, and the nature of the regulatory environment. There is no separate segment manager who is held accountable by our chief operating decision-makers, or anyone else, for operations, operating results and planning for the China market or the Russia and Kazakhstan market on a stand-alone basis, and neither market is material for the periods presented. As such, we consider ourselves to be in a single reporting segment and operating unit structure.

As of September 30, 2018, we were conducting business through 97,160 active members, compared to 93,000 three months ago and 99,690 a year ago. We consider a member “active” if they have placed at least one product order with us during the preceding year. Our priority is to focus our resources in our most promising markets, which we consider to be Greater China and countries where our existing members have the connections to recruit prospects and sell our products, such as Southeast Asia and Europe. We also invested some resources in Mexico and Peru last year.

We generate approximately 96% of our net sales from subsidiaries located outside the Americas, with sales of our Hong Kong subsidiary representing 88% of net sales in the latest fiscal quarter. Because of the size of our foreign operations, operating results can be impacted negatively or positively by factors such as foreign currency fluctuations, and economic, political and business conditions around the world. In addition, our business is subject to various laws and regulations, in particular regulations related to direct selling activities that create uncertain risks for our business, including improper claims or activities by our members and potential inability to obtain necessary product registrations. For further information regarding some of the risks associated with the conduct of our business in China, see generally in “Part I, Item 1A, Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, and more specifically under the captions “Risk Factors - Because our Hong Kong operations account for a substantial portion of our overall business...” and “Risk Factors - Our operations in China are subject to compliance with a myriad of applicable laws and regulations...”, and in “Part II, Item 1A, Risk Factors” in this report.

China has been and continues to be our most important business development project. We operate an e-commerce direct selling model in Hong Kong that generates revenue derived from the sale of products to members in Hong Kong and elsewhere, including China. Substantially all of our Hong Kong revenues are derived from the sale of products that are delivered to members in China. Through a separate Chinese entity, we operate an e-commerce retail platform in China. We believe that neither of these activities requires a direct selling license in China, which we do not currently hold. We have previously sought to obtain a direct selling license, and in August 2015 initiated the process for submitting a new preliminary application for a direct selling license in China. If we are able to obtain a direct selling license in China, we believe that the incentives inherent in the direct selling model in China would incrementally benefit our existing business. We do not expect that any increased sales in China derived from obtaining

a direct selling license would initially be material and, in any event may be partially offset by the higher fixed costs associated with the establishment and maintenance of required service centers, branch offices, manufacturing facilities, certification programs and other legal requirements. We are unable to predict whether and when we will be successful in obtaining a direct selling license to operate in China, and if we are successful, when we will be permitted to conduct direct selling operations and whether such operations would be profitable.

To date, the recently enacted tariffs and trade dispute between the United States and China have not materially impacted our business, although they may have negatively impacted the value of the Chinese yuan, which has in turn negatively affected our Hong Kong revenues because the prices at which our Chinese members can purchase our products have effectively increased. In the event the trade disputes between the United States and China continue or intensify, our business could be negatively impacted in the future. For more information, see Part II, Item 1A. Risk Factors - "Recently enacted tariffs, other potential changes to tariff and import/export regulations, and ongoing trade disputes between the United States and other jurisdictions, particularly China, may have a negative effect on global economic conditions and our business, financial results and financial condition."

Income Statement Presentation

We mainly derive revenue from sales of products. Substantially all of our product sales are to independent members at published wholesale prices. Product sales are recognized when the products are shipped and title passes to independent members, which generally is upon our delivery to the carrier that completes delivery to the members. We estimate and accrue a reserve for product returns based on our return policies and historical experience. We bill members for shipping charges and recognize the freight revenue in net sales. We have elected to account for shipping and handling activities performed after title has passed to members as a fulfillment cost, and accrue for the costs of shipping and handling if revenue is recognized before the contractually obligated shipping and handling activities occur. Event and training revenue is deferred and recognized as the event or training occurs.

Cost of sales consists primarily of products purchased from third-party manufacturers, freight cost for transporting products to our foreign subsidiaries and shipping products to members, import duties, packing materials, product royalties, costs of promotional materials sold to our members at or near cost, and provisions for slow moving or obsolete inventories. Cost of sales also includes purchasing costs, receiving costs, inspection costs and warehousing costs.

Member commissions are our most significant expense and are classified as an operating expense. Under our compensation plan, members are paid weekly commissions by our subsidiary in which they are enrolled, generally in their home country currency, for product purchases by their down-line member network across all geographic markets. Our China subsidiary maintains an e-commerce retail platform and does not pay commissions. This "seamless" compensation plan enables a member located in one country to enroll other members located in other countries where we are authorized to conduct our business. Currently, there are basically two ways in which our members can earn income:

- through commissions paid on the accumulated bonus volume from product purchases made by their down-line members and customers; and

- through retail profits on sales of products purchased by members at wholesale prices and resold at retail prices (in some markets, sales are for personal consumption only and income may not be earned through retail profits).

Each of our products is designated a specified number of bonus volume points. Commissions are based on total personal and group bonus volume points per weekly sales period. Bonus volume points are essentially a percentage of a product's wholesale price. As the member's business expands from successfully enrolling other members who in turn expand their own businesses by selling product to other members, the member receives higher commissions from purchases made by an expanding down-line network. In some of our markets, to be eligible to receive commissions, a member may be required to make nominal monthly or other periodic purchases of our products. Certain of our subsidiaries do not require these nominal purchases for a member to be eligible to receive commissions. In determining commissions, the number of levels of down-line members included within the member's commissionable group increases as the number of memberships directly below the member increases.

Under our current compensation plan, certain of our commission payouts may be limited to a hard cap dollar amount per week or a specific percentage of total product sales. In some markets, commissions may be further limited. In some markets, we also pay certain bonuses on purchases by up to three generations of personally enrolled members, as well as bonuses on commissions earned by up to three generations of personally enrolled members. Members can also earn additional income, trips and other prizes in specific time-limited promotions and contests we hold from time to time. Member commissions are dependent on the sales mix and, for the first nine months of 2018 and 2017, represented 45% and 42%, respectively, of net sales. Occasionally, we make modifications and enhancements to our compensation plan to help motivate members, which can have an impact on member commissions. We may also enter into performance-based agreements for business or market development, which can result in additional compensation to specific members.

Selling, general and administrative expenses consist of administrative compensation and benefits, travel, credit card fees and assessments, professional fees, certain occupancy costs, and other corporate administrative expenses (including stock-based compensation). In addition, this category includes selling, marketing, and promotion expenses (including the costs of member training events and conventions that are designed to increase both product awareness and member recruitment). Because our various member conventions are not always held at the same time each year, interim period comparisons will be impacted accordingly.

The functional currency of our international subsidiaries is generally their local currency. Local currency assets and liabilities are translated at the rates of exchange on the balance sheet date, and local currency revenues and expenses are translated at average rates of exchange during the period. Equity accounts are translated at historical rates. The resulting translation adjustments are recorded directly into accumulated other comprehensive income.

Sales by our foreign subsidiaries are generally transacted in the respective local currencies and are translated into U.S. dollars using average rates of exchange for each monthly accounting period to which they relate. Most of our product purchases from third-party manufacturers are transacted in U.S. dollars. Consequently, our sales and net earnings are affected by changes in currency exchange rates, with sales and earnings generally increasing with a weakening U.S. dollar and decreasing with a strengthening U.S. dollar.

Results of Operations

The following table sets forth our operating results as a percentage of net sales for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	21.1	20.4	20.3	19.3
Gross profit	78.9	79.6	79.7	80.7
Operating expenses:				
Commissions expense	46.8	39.4	44.8	42.1
Selling, general and administrative expenses	15.4	19.0	16.3	15.9
Total operating expenses	62.2	58.4	61.1	58.0
Income from operations	16.7	21.2	18.6	22.7
Other income (expense), net	0.5	—	0.3	0.1
Income before income taxes	17.2	21.2	18.9	22.8
Income tax provision	1.0	2.9	2.0	4.3
Net income	16.2 %	18.3 %	16.9 %	18.5 %

Net Sales

The following table sets forth revenue by market for the periods indicated (in thousands):

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2018		2017		%	2018		2017		%
Americas ¹	\$1,970	4.2	\$1,239	3.1		%	\$5,361	3.6	\$4,340	
Hong Kong ²	41,447	88.1	35,049	87.3		133,681	88.9	135,304	89.3	
China	1,698	3.6	1,731	4.3		5,510	3.7	4,732	3.1	
Taiwan	935	2.0	1,229	3.1		2,933	1.9	4,116	2.7	
South Korea	133	0.3	128	0.3		392	0.3	379	0.3	
Japan	51	0.1	29	0.1		160	0.1	89	0.1	
Singapore	52	0.1	40	0.1		134	0.1	124	0.1	
Malaysia	216	0.5	—	—		316	0.2	—	—	
Russia and Kazakhstan	184	0.4	209	0.5		626	0.4	655	0.4	
Europe	357	0.7	478	1.2		1,207	0.8	1,732	1.1	
Total	\$47,043	100.0%	\$40,132	100.0%		\$150,320	100.0%	\$151,471	100.0%	

¹ *United States, Canada, Mexico and Peru*

² *Substantially all of our Hong Kong revenues are derived from the sale of products that are delivered to members in China. See "Item 1A. Risk Factors" in our most recent Annual Report on Form 10-K.*

Net sales were \$47.0 million for the three months ended September 30, 2018 compared with \$40.1 million for the comparable period a year ago, an increase of \$6.9 million, or 17%. Hong Kong net sales, substantially all of which were shipped to members residing in China, increased \$6.4 million, or 18%, over the comparable period a year ago. Our revenue in the third quarter increased year-over-year as a result of our effective marketing programs and was further fueled by our Ambassador Academy in Hong Kong.

Outside of our Hong Kong business, net sales increased \$513,000, or 10%, over the comparable three month period a year ago, driven largely by a 59% increase in our Americas business, partially offset by a 24% decrease in Taiwan. The \$731,000 net sales increase in our Americas business was primarily due to product sales of Airelle®, our new age-defying skincare system which was launched in June 2018, and increased order volume from our Peruvian business which began accepting orders in June 2017.

Net sales were \$150.3 million for the nine months ended September 30, 2018 compared with \$151.5 million for the comparable period a year ago, a decrease of \$1.2 million, or 1%. Hong Kong net sales, substantially all of which were shipped to members residing in China, decreased \$1.6 million, or 1%, over the comparable period a year ago. Hong Kong experienced a decrease of 2,900 active members, or 3%, from September 30, 2017 to September 30, 2018, which contributed to the decrease in product sales volume.

Outside of our Hong Kong business, net sales for the nine months ended September 30, 2018 increased \$472,000, or 3%, over the comparable nine month period a year ago, driven largely by a 24% increase in our Americas business and a 16% increase in China e-commerce business, partially offset by a 29% decrease in Taiwan.

As of September 30, 2018, deferred revenue was \$4.5 million, which primarily consisted of \$2.3 million pertaining to unshipped product orders and \$1.8 million pertaining to auto ship advances.

Gross Profit

Gross profit was 78.9% of net sales for the three months ended September 30, 2018 compared with 79.6% of net sales for the three months ended September 30, 2017. The gross profit margin percentage decrease was primarily attributable to Noni promotions in Hong Kong in September and higher freight costs partially due to the shipment of free promotional items.

Gross profit was 79.7% of net sales for the nine months ended September 30, 2018 compared with 80.7% of net sales for the nine months ended September 30, 2017. The gross profit margin percentage decrease was primarily due to lower event revenue and product promotions in our China e-commerce business, the Noni promotions in September and higher freight costs.

Commissions

Commissions were 46.8% of net sales for the three months ended September 30, 2018, compared with 39.4% of net sales for the three months ended September 30, 2017, and 44.8% of net sales for the nine months ended September 30, 2018, compared with 42.1% for the comparable period a year ago. The increase as a percentage of net sales for the three and nine month periods ended September 30, 2018 primarily resulted from higher estimated costs for on-going cash and other incentive programs.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$7.3 million for the three months ended September 30, 2018 compared with \$7.6 million in the same period a year ago. For the nine months ended September 30, 2018, selling, general and administrative expenses were \$24.5 million compared with \$24.0 million for the comparable period a year ago. Selling, general and administrative expenses decreased by 5% during the 2018 three-month period as compared to the 2017 period mainly due to decreases in employee-related costs, partially offset by an increase in credit card fees and assessments. Selling, general and administrative expenses increased by 2% during the 2018 nine-month period as compared to the 2017 period mainly due to increases in employee-related costs, partially offset by decreases in professional fees.

Income Taxes

An income tax provision of \$0.5 million and \$1.2 million was recognized during the three month periods ended September 30, 2018 and 2017, respectively and \$3.0 million and \$6.5 million during the nine month periods ended September 30, 2018 and 2017, respectively. The effective tax rate for the three and nine month periods ended September 30, 2018 is less than each of the comparable periods a year ago due primarily to the enactment of the Tax Cuts and Jobs Act (the "Tax Act") on December 22, 2017 by the U.S. government, which was effective for taxable years beginning on or after January 1, 2018. The Tax Act reduced the maximum U.S. federal corporate income tax rate from 35% to 21%. The primary impact of the Tax Act on the three and nine months ended September 30, 2018 was the inclusion of the tax effects of Global Intangible Low-Taxed Income ("GILTI"). GILTI is the excess income of foreign subsidiaries over a 10% routine return on tangible assets. After a 50% deduction, GILTI is subject to the 21% corporate tax rate. The impact of GILTI as a component of the effective tax rate for the nine months ended September 30, 2018 was approximately 8.2%, or \$2.3 million, net of foreign tax credits attributed to GILTI. The provisional amount of the GILTI tax during the third quarter of 2018 resulted in a slight increase as a component of the effective tax rate from 8% in the second quarter of 2018. Additionally, a benefit of \$496,000 was recognized as a discrete item during the three months ended September 30, 2018 primarily resulting from the finalization of the deemed repatriation transition tax reported on the federal income tax return filed for the year ended December 31, 2017.

Liquidity and Capital Resources

At September 30, 2018, our cash and cash equivalents totaled \$132.2 million. Total cash and cash equivalents decreased by \$3.1 million from December 31, 2017 to September 30, 2018, primarily due to \$27.6 million in dividends paid, including the \$20.0 million special dividend our Board of Directors declared and paid as a result of an evaluation of the Tax Act, partially offset by an increase in cash from operations during the nine months ended

September 30, 2018. We consider all highly liquid investments with original maturities of three months or less, when purchased, to be cash equivalents. As of September 30, 2018, we had \$77.5 million in available-for-sale investments classified as cash equivalents. In addition, cash and cash equivalents included \$10.0 million held in banks located within China subject to foreign currency controls.

As of September 30, 2018, the ratio of current assets to current liabilities was 3.38 to 1.00 and we had \$104.3 million of working capital. Working capital as of September 30, 2018 decreased \$5.0 million compared to our working capital as of December 31, 2017, due primarily to the decrease in cash and cash equivalents during the nine months ended September 30, 2018 as stated above and an increase in accrued commissions of \$2.0 million during the same period.

Cash provided by operations was \$25.3 million for the first nine months of 2018 compared with \$15.3 million in the comparable period of 2017. The increase in operating cash flows resulted primarily from lower commissions, employee-related costs and eWallet balances paid during 2018, partially offset by an increase in inventories and inventory-related deposits as we build up our inventory in Greater China to enhance our ability to navigate the challenging and uncertain international trade environment and our first installment payment of the one-time repatriation tax required under the Tax Act.

Cash flows used in investing activities totaled \$176,000 during the first nine months of 2018 and consisted primarily of buildout costs in our Hong Kong and California offices and capitalizable software development costs. Cash flows used in investing activities totaled \$238,000 during the first nine months of 2017 and consisted primarily of capitalizable software development costs and buildout costs for our expansion into Peru and Vietnam.

Cash flows used in financing activities during the first nine months of 2018 consisted solely of the following dividend payments (in thousands, except per share amounts):

Declaration Date	Per Share	Amount	Record Date	Payment Date
July 18, 2018 (special)	\$0.25	\$2,844	August 14, 2018	August 24, 2018
July 18, 2018	0.15	1,707	August 14, 2018	August 24, 2018
April 17, 2018 (special)	1.76	20,022	May 15, 2018	May 25, 2018
April 17, 2018	0.14	1,592	May 15, 2018	May 25, 2018
February 6, 2018	0.13	1,479	February 27, 2018	March 9, 2018
	\$2.43	\$27,644		

On October 21, 2018, the Board of Directors declared a quarterly cash dividend of \$0.16 and a special cash dividend of \$0.18 on each share of common stock outstanding. Such dividends are payable on November 23, 2018 to stockholders of record on November 13, 2018. Declaration and payment of any future dividends on shares of common stock will be at the discretion of the Company's Board of Directors.

Cash flows used in financing activities during the first nine months of 2017 consisted solely of dividend payments totaling \$14.2 million.

We believe that our existing internal liquidity, supported by cash on hand and cash flows from operations should be adequate to fund normal business operations and address our financial commitments for the foreseeable future.

We do not have any significant unused sources of liquid assets. If necessary, we may attempt to generate more funding from the capital markets, but currently we do not believe that will be necessary.

Our priority is to focus our resources on investing in our most important markets, which we consider to be Greater China and countries where our existing members may have the connections to recruit prospects and sell our products, such as Southeast Asia and Europe. We will continue to invest in our Mainland China entity for such purposes as establishing China-based manufacturing capabilities, increasing public awareness of our brand and our products, sourcing more Chinese-made products, building a chain of service stations, opening additional Healthy Lifestyle Centers or branch offices, adding local staffing and other requirements for a China direct selling license application. We also invested some resources in Mexico and Peru last year.

Critical Accounting Policies and Estimates

A summary of our significant accounting policies is provided in Note 1 of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data" of our Annual Report on Form 10-K filed with

the United States Securities and Exchange Commission (SEC) on March 27, 2018. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. The process of determining significant estimates is fact specific and takes into account historical experience and current and expected economic conditions. To the extent that there are material differences between the estimates and actual results, future results of operations will be affected.

Critical accounting policies and estimates are defined as both those that are material to the portrayal of our financial condition and results of operations and as those that require management's most subjective judgments. Management believes our critical accounting policies and estimates are those related to revenue recognition, as well as those used in the determination of liabilities related to member commissions and income taxes.

Revenue Recognition. All revenue is recognized when the performance obligations under a contract are satisfied. Product sales are recognized when the products are shipped and title passes to independent members. Product sales to members are made pursuant to a member agreement that provides for transfer of both title and risk of loss upon our delivery to the carrier that completes delivery to the members, which is commonly referred to as "F.O.B. Shipping Point." We primarily receive payment by credit card at the time members place orders. Our sales arrangements do not contain right of inspection or customer acceptance provisions other than general rights of return. Amounts received for unshipped product are recorded as deferred revenue. Such amounts totaled \$2.3 million and \$2.4 million at September 30, 2018 and December 31, 2017, respectively. Shipping charges billed to members are included in net sales. Costs associated with shipments are included in cost of sales. Event and training revenue is deferred and recognized as the event or training occurs.

Additionally, deferred revenue includes advances for auto ship orders. In certain markets, when a member's cumulative commission income reaches a certain threshold, a percentage of the member's weekly commission is held back as an advance and applied to an auto ship order once the accumulated amount of the advances is sufficient to pay for the pre-selected auto ship package of the member. Such advances were \$1.8 million and \$1.7 million at September 30, 2018 and December 31, 2017, respectively.

Commissions. Independent members earn commissions based on total personal and group bonus volume points per weekly sales period. Each of our products are designated a specified number of bonus volume points, which is essentially a percentage of the product's wholesale price. We accrue commissions when earned and as the related revenue is recognized and pay commissions on product sales generally two weeks following the end of the weekly sales period.

Independent members may also earn incentives based on meeting certain qualifications during a designated incentive period, which may range from several weeks to up to a year. For each individual incentive, we estimate the total number of qualifiers as well as the expected per qualifier cost and accrue all costs associated with incentives throughout the qualification period. We regularly review and update, if necessary, the estimates of both qualifiers and cost as more information is obtained during the qualification period. Any resulting change in total cost is recognized over the remaining qualification period. Accrued commissions, including the estimated cost of our international recognition incentive program and other supplemental programs, totaled \$13.1 million and \$11.2 million at September 30, 2018 and December 31, 2017, respectively.

Income Taxes. Deferred income taxes are recognized for differences between the financial reporting and tax bases of assets and liabilities at enacted statutory rates for the years in which the temporary differences are expected to be recovered or settled. We evaluate the probability of realizing the future benefits of any of our deferred tax assets and record a valuation allowance when we believe a portion or all of our deferred tax assets may not be realized. Deferred tax expense or benefit is a result of changes in deferred tax assets and liabilities. Based on the technical merits of our tax position, tax benefits may be recognized if we determine it is more likely than not that our position will be sustained on examination by tax authorities. The complex nature of these estimates requires us to anticipate the likely application of tax law and make judgments on the largest benefit that has a greater than fifty percent likelihood of being realized prior to the completion and filing of tax returns for such periods. As of September 30, 2018, we no longer have a valuation allowance against our U.S. deferred tax assets. We maintain a valuation allowance in certain foreign jurisdictions with an overall tax loss. The valuation allowance will be reduced at such time as management believes it is more likely than not that the deferred tax assets will be realized. Any reductions in the valuation

allowance will reduce future income tax provision.

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Provision for income taxes depends on the statutory tax rates in each of the jurisdictions in which we operate. As a result of capital return activities, we determined that a portion of our current undistributed foreign earnings are no longer deemed reinvested indefinitely by our non-U.S. subsidiaries. For state income tax purposes, we will continue to periodically reassess the needs of our foreign subsidiaries and update our indefinite reinvestment assertion as necessary. The Tax Act, enacted on December 22, 2017 by the U.S. government, requires a one-time repatriation tax on certain un-repatriated earnings of foreign subsidiaries at a rate of 15.5% tax on post-1986 foreign earnings held in cash and an 8% rate on all other post-1986 earnings. Due to the adoption of a territorial tax regime, any foreign source portion of a qualified dividend received by a 10% U.S. corporate shareholder is exempt from U.S. federal tax, therefore resulting in any future repatriation having a minimal effect on our effective tax rate. To the extent that additional foreign earnings are not deemed permanently reinvested, we expect to recognize additional income tax provision at the applicable U.S. state corporate tax rate(s). As of September 30, 2018, we have accrued tax liabilities for earnings that we plan to repatriate out of accumulated earnings in future periods for state tax purposes only. All undistributed earnings in excess of 50% of current earnings on an annual basis are intended to be reinvested indefinitely as of September 30, 2018.

We estimate what our effective tax rate will be for the full fiscal year at each interim reporting period and record a quarterly tax provision based on that estimated effective tax rate. Throughout the year that estimated rate may change based on variations in our business, changes in our corporate structure, changes in the geographic mix and amount of income, applicable tax laws and regulations, communications with tax authorities, as well as our estimated and actual level of annual pre-tax income. We adjust our income tax provision in the reporting period in which the change in our estimated rate occurs so that the year-to-date provision is consistent with the anticipated annual tax rate. Our effective tax rate projected for the year ending December 31, 2018, without the effect of discrete items, is 12.2%, which differs from the year ended December 31, 2017 primarily as a result of the Tax Act.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable under smaller reporting company disclosure rules.

Item 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Management, with the participation of the Company's principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2018. The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, the principal executive officer and principal financial officer concluded that, due to a material weakness in internal control over financial reporting described in Part II, Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2017, our disclosure controls and procedures were not effective as of September 30, 2018.

Changes in Internal Control over Financial Reporting

Other than with respect to the remediation efforts discussed below, there were no changes in internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2018 that have materially affected, or

are reasonably likely to materially affect, internal control over financial reporting.

Remediation Efforts to Address Material Weakness

Management, with oversight from the Audit Committee, implemented a plan intended to remediate the material weakness related to our proprietary web-based system and strengthen our internal control environment. The remediation plan included the enhancement of controls to ensure that the system change management log is adequately backed up, secured and sufficiently maintained, as well as the periodic review and testing of user access rights and permissions.

During the third quarter of 2018, we completed the enhancement of our controls related to the backup of our proprietary web-based system change management logs and have sufficiently tested those controls. We also sufficiently tested and documented the programming changes completed during the second quarter of 2018 regarding certain user access rights and permissions that were not previously provisioned. Programming changes to further enhance user access rights and permissions were completed during September 2018, and monthly reviews related to these enhancements are expected to continue through year end. As such, we expect that the remediation of this material weakness will be fully complete during 2018.

We will develop additional controls and procedures for continued improvement in our control environment, including compensating review controls for our proprietary web-based system, as deemed necessary.

PART II — OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Shareholder Derivative Claims

In February 2016, a purported shareholder derivative complaint was filed in the Superior Court of the State of California, County of Los Angeles: *Zhou v. Sharng*. In March 2016, a purported shareholder derivative complaint was filed in the United States District Court for the Central District of California: *Kleinfeldt v. Sharng*. On November 10, 2017, the parties to both the *Zhou* and *Kleinfeldt* actions entered into a Memorandum of Understanding (“MOU”) to resolve both actions, subject to the negotiation of a written settlement agreement and approval by the federal court in the *Kleinfeldt* matter. On July 16, 2018, the court granted final approval of the settlement and entered judgment in the *Kleinfeldt* matter. In exchange for full releases, the settlement required us to implement certain corporate governance reforms and included an award of \$250,000 in attorneys’ fees to plaintiffs’ counsel, all of which was fully funded by our insurers. On August 9, 2018, plaintiff filed a request to voluntarily dismiss the *Zhou* action, which was entered by the court on August 30, 2018.

Item 1A. RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties, including those described in Part I, Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, which could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common stock. There have been no material changes to our risk factors since our Annual Report on Form 10-K for the year ended December 31, 2017, except that we (1) previously deleted the risk factor captioned “We are currently being sued in three lawsuits alleging, among other things, that we made materially false and misleading statements regarding the legality of our business operations in China” and (2) are now adding the following risk factor:

Recently enacted tariffs, other potential changes to tariff and import/export regulations, and ongoing trade disputes between the United States and other jurisdictions, particularly China, may have a negative effect on global economic conditions and our business, financial results and financial condition.

The United States recently proposed and enacted tariffs on certain items. Further, there have been ongoing discussions and activities regarding changes to other U.S. trade policies and treaties. In response, a number of our markets, including China, are threatening to impose tariffs on U.S. imports, or have already implemented tariffs on U.S. imports or otherwise imposed non-tariff barriers in response to these U.S. actions. These developments may have a material adverse effect on global economic conditions and the stability of global financial markets, and they may significantly reduce global trade and, in particular, trade between China and the United States. Any of these factors could depress economic activity, create anti-American consumer sentiment, restrict our access to suppliers or customers and have a material adverse effect on our business, financial condition and results of operations. In addition, any actions by non-U.S. markets to implement further trade policy changes, including limiting foreign investment or trade, increasing regulatory scrutiny or taking other actions which impact U.S. companies' ability to obtain necessary licenses or approvals could negatively impact our business.

These tariffs and other policy changes have just recently been announced and are subject to a number of uncertainties as they are implemented, including future adjustments and changes in the countries excluded from such tariffs. The ultimate reaction of other countries, and the individuals in each of these countries, and the impact of these tariffs or other actions on the United States, China, the global economy and our business, financial condition and results of operations, cannot be predicted at this time.

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

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

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Item 5. OTHER INFORMATION

None.

Item 6. EXHIBITS

Exhibit

Number Exhibit Description

31.1 Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certifications of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101.INS *Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document*

101.SCH *XBRL Taxonomy Extension Schema*

101.CAL *XBRL Taxonomy Extension Calculation*

101.DEF *XBRL Taxonomy Extension Definition*

101.LAB *XBRL Taxonomy Extension Labels*

101.PRE *XBRL Taxonomy Extension Presentation*

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SIGNATURES

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

NATURAL HEALTH TRENDS CORP.

Date: October 30, 2018 /s/ Timothy S. Davidson

Timothy S. Davidson

Senior Vice President and Chief Financial Officer

(Principal Financial Officer)

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