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

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2001

OR

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

Commission file number **0-15701**

NATURAL ALTERNATIVES INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware	**84-1007839**
(State of other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1185 Linda Vista Drive, San Marcos, California 92069
(Address of principal executive offices)
(Zip Code)

(760) 744-7340
(Registrant's telephone number, including area code)

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 [X] No [ ]

5,785,606

(Number of shares of common stock of the registrant outstanding, net of treasury shares held, as of October 5, 2001

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NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART I — FINANCIAL INFORMATION
CONSOLIDATED BALANCE SHEETS

ASSETS

(Amounts in thousands except share data)	September 30 2001	June 30 2001
	(unaudited)	(audited)
Current Assets:		
Cash and cash equivalents	$ 792	$ 499
Accounts receivable — less allowance for doubtful accounts of $416 at September 30, 2001 and $470 at June 30, 2001	3,395	3,331
Inventories (Note 2)	7,059	6,201
Prepaid expenses	628	481
Deposits	353	353
Other current assets	248	172
Total Current Assets	12,475	11,037
Property and equipment, net	13,151	13,478
Related parties notes receivable, less current portion	452	451
Other noncurrent assets, net	102	102
TOTAL ASSETS	$ 26,180	$25,068

See accompanying notes to unaudited financial statements.

NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART I — FINANCIAL INFORMATION
CONSOLIDATED BALANCE SHEETS *(continued)*

LIABILITIES AND STOCKHOLDERS' EQUITY

(Amounts in thousands except share data)	September 30 2001	June 30 2001
	(unaudited)	(audited)
Current Liabilities:		
Accounts payable	$ 4,617	$ 4,149
Accrued compensation and employee benefits	532	320
Lines of credit	1,496	242
Income taxes payable	86	72
Current installments of long-term debt and capital lease	885	889
Total Current Liabilities	7,616	5,672
Long-term debt and capital lease, less current installments (Note 5)	3,386	3,567
Long-term pension liability	230	225
Total Liabilities	11,232	9,464
Stockholders' Equity:		
Preferred stock; $.01 par value; 500,000 shares authorized; none issued or outstanding	—	—
Common stock; $.01 par value; 8,000,000 shares authorized; issued and outstanding 6,048,106 at September 30, 2001 and June 30, 2001, respectively	60	60
Additional paid-in capital	11,310	11,307
Retained earnings	4,951	5,609
Treasury stock, at cost, 262,500 shares	(1,283)	(1,283)
Accumulated other comprehensive loss	(90)	(89)
Total Stockholders' Equity	14,948	15,604
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 26,180	$25,068

See accompanying notes to unaudited financial statements.

NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART I — FINANCIAL INFORMATION
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(unaudited)

(Amounts in thousands except share and per share data)	Three months ended September 30 2001	2000
Net sales	$ 9,887	$ 10,223
Cost of goods sold	7,863	8,418
GROSS PROFIT	2,024	1,805
Selling, general & administrative expenses	2,454	1,222
Loss on abandonment of leased facility	—	308
INCOME (LOSS) FROM OPERATIONS	(430)	275
Other income (expense):		
Interest income	3	31
Interest expense	(158)	(184)
Equity in loss of unconsolidated joint venture	—	(20)
Foreign exchange gain (loss)	(64)	39
Other, net	5	(6)
	(214)	(140)
INCOME (LOSS) BEFORE INCOME TAXES	(644)	135
Provision (benefit) for income taxes	14	(70)
NET INCOME (LOSS)	($658)	$ 205
Unrealized loss on investments	(1)	—
Comprehensive earnings (loss)	($659)	$ 205
NET INCOME (LOSS) PER COMMON SHARE:		
Basic	$ (0.11)	$ 0.04
Diluted	$ (0.11)	$ 0.04
Weighted average common shares outstanding:		
Basic shares	5,785,606	5,761,880
Diluted shares	5,785,606	5,763,890

See accompanying notes to unaudited financial statements

NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART I — FINANCIAL INFORMATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

(Amounts in thousands)	Three months ended September 30 2001	2000
OPERATING ACTIVITIES:		
Net income (loss)	($658)	$ 205
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:		
Bad debt provision	(54)	—
Depreciation and amortization	593	634
Deferred income taxes	—	(70)
Pension expense, net of contributions	5	(197)
Loss on investments	—	20
Accrued interest — notes receivable	(1)	(23)
Foreign exchange (gains) loss — Swiss franc debt	36	(51)
Changes in operating assets and liabilities:		
Accounts receivable	(10)	(585)
Inventories	(858)	(275)
Prepaid expenses	(147)	(2)
Deposits	—	(112)
Other current assets	(77)	(142)
Accounts payable	468	953
Income taxes payable	14	—
Accrued compensation and employee benefits	212	128
Accrual for loss on lease obligation	—	(50)
Net Cash Provided (Used) by Operating Activities	($477)	$ 433

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(continued)

NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART 1 — FINANCIAL INFORMATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(unaudited)

	Three months ended September 30	
	2001	2000
INVESTING ACTIVITIES:		
Capital expenditures	$ (266)	$ (190)
Net Cash Used in Investing Activities	(266)	(190)
FINANCING ACTIVITIES:		
Net borrowing on lines of credit	1,251	293
Payments on long-term debt and capital lease	(218)	(548)
Stock based compensation	3	—
Net Cash Provided by (Used in) Financing Activities	1,036	(255)
Net Increase (Decrease) in Cash and Cash Equivalents	293	(12)
Cash and Cash Equivalents at Beginning of Period	499	815
Cash and Cash Equivalents at End of Period	$ 792	$ 803
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 158	$ 172
Cash paid (received) during the period for:		
Income taxes	—	—

See accompanying notes to unaudited financial statements.

NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART I — FINANCIAL INFORMATION
NOTES TO UNAUDITED FINANCIAL STATEMENTS

Note 1 — Interim Financial Information

The unaudited consolidated financial statements of Natural Alternatives International, Inc. and subsidiaries (the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States and with Article 10 of the Securities and Exchange Commission’s Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete consolidated financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the Company’s financial information as of and for the three months ended September 30, 2001 and 2000.

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States, management is required to make certain estimates and assumptions that may affect the reported amounts of assets, liabilities, revenues and expenses during the reporting periods. Actual results may differ from such estimates. The consolidated results of operations for the interim periods ended September 30, 2001 and 2000 are not necessarily indicative of the consolidated operating results for the full year. It is suggested that these consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company’s annual report on Form 10-K for the year ended June 30, 2001.

Principles of Consolidation

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

Reclassifications

Certain amounts in prior periods’ consolidated financial statements have been reclassified to conform to the presentation for the period ended September 30, 2001.

Note 2 — Inventories

Inventories are comprised of the following:

(Amounts in thousands)	September 30 2001	June 30 2001
Raw materials	$ 3,135	$2,758
Work in progress	2,239	2,196
Finished goods	1,685	1,247
	$ 7,059	$6,201

Note 3 — Net Income Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share reflects the potential dilution that could occur if stock options or other contracts to issue common stock were exercised or converted into common stock. The computation of diluted net income (loss) per share does not assume exercise or conversion of securities that would have an anti-dilutive effect on net income (loss) per share.

(Amounts in thousands except share data)

	Three Months Ended September 30 2001	2000
Numerator:		
Net income (loss) — Numerator for basic and diluted income (loss) per share — income available to common shareholders	($658)	$ 205
Denominator:		
Denominator for basic income (loss) per share — weighted average shares	5,785,606	5,761,880
Effect of dilutive securities — employee stock options	—	2,010
Denominator for diluted earnings (loss) per share — adjusted weighted average shares with assumed conversions	5,785,606	5,763,890
Basic income (loss) per share	$ (0.11)	$ 0.04
Diluted income (loss) per share	$ (0.11)	$ 0.04

For the three months ended September 30, 2001 and 2000, there were outstanding options to purchase 615,400 and 301,000 shares, respectively, of common stock, that were not included in the computation of diluted net income (loss) per share as their effect would have been anti-dilutive.

Note 4 — Major Customers

The Company had substantial sales to five separate customers during one or more of the periods shown in the following table. The loss of any of these customers could have a material adverse impact on the Company’s revenues and earnings. Sales by customer, representing 5% or more of the respective period’s total net sales, are shown below.

	Three months ended September 30			
	2001		2000	
(Amounts in thousands) Customer	Sales by Customer	%(a)	Sales by Customer	%(a)
Customer 1	$ 5,119	52%	$ 5,226	51%
Customer 2	1,030	10%	927	9%
Customer 3	794	8%	1,259	12%
Customer 4	(b)	—	616	6%
Customer 5	464	5%	543	5%
	$ 7,407	75%	$ 8,571	83%

(a) Percent of total sales
(b) Sales for period reported were less than 5%

Accounts receivable from these customers totaled $2.9 million and $3.0 million at September 30, 2001 and June 30, 2001, respectively.

Note 5 — Debt

On December 20, 2000, the Company replaced an existing $9.0 million working capital line of credit with $9.35 million in new financing. The new financing consists of a $7.0 million working capital line of credit, a $1.6 million term note, and an additional $750,000 term note facility to be used to finance equipment purchases. The entire credit facility carries an annual interest rate of prime plus 0.5%, for an effective interest rate of 6.50% at September 30, 2001. Borrowings under the line of credit are collateralized by eligible accounts receivable and inventory, as defined in the agreement; proceeds are to be used to support ongoing operating requirements. As of June 30, 2001, the Company was not in compliance with certain financial covenant provisions of the credit agreement.

In October 2001, the Company and the lender amended the credit agreement to provide new debt covenant restrictions and waive default rights and remedies as of June 30, 2001. Under the amended agreement the working capital line of credit was reduced to $2.5 million and the annual interest rate was increased to prime plus 3.5%, which becomes effective October 1, 2001. The entire credit facility, including the term note, now expires on July 1, 2002. The term note is to be repaid in monthly installments of approximately $26,700 with the balance due upon expiration of the agreement on July 1, 2002. As of September 30, 2001, the Company was in compliance with all financial covenant provisions of the amended credit agreement.

As of September 30, 2001, amounts outstanding under the line of credit and the term note were $886,000 and $1.360 million, respectively. The Company expects this line to be refinanced in the normal course of business.

On May 2, 1996, the Company entered into a term note agreement for $1.1 million, secured by a building, at an annual interest rate of 8.25%. The note is due in June 2011 and provides for principal and interest payable in monthly installments of $10,800. As of September 30, 2001 the outstanding amount is $858,000.

NAIE has a line of credit agreement permitting borrowings up to CHF 1.0 million, or approximately $617,000 at September 30, 2001, at an annual interest rate of 5.5%. The line of credit requires minimum annual principal payments of CHF 250,000, or $154,000, due annually on December 31; management expects this line to be renewed in the normal course of business. The agreement contains no financial covenants. As of September 30, 2001, the Company has converted approximately $247,000 of amounts previously borrowed under the line of credit, into various unsecured term notes with maturities from six to twelve months at interest rates ranging from 5.5% to 6.0%. The amount outstanding under the line of credit was approximately $611,000 as of September 30, 2001.

In March 2001, NAIE entered into a capital lease arrangement with a bank for CHF 182,000, or approximately $108,000. The lease provides for monthly payments of approximately $3,000 over its thirty six (36) month term. Proceeds were used to finance capital equipment purchased. Total future minimum payments, net of amounts representing interest, due on this obligation at September 30, 2001 was $94,000.

On November 9, 1999, the Company entered into a term note agreement for $2.5 million, secured by equipment, at an annual interest rate of 9.2%. The note has a five-year term that provides for principal and interest payable in monthly installments of $52,000. As of September 30, 2001 the outstanding amount is $1.712 million.

The composite interest rate on all outstanding debt at September 30, 2001 was 7.34%. This rate would have been 8.51% if the amended credit agreement had been effective as of September 30, 2001.

NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART I — FINANCIAL INFORMATION

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

Certain Forward-Looking Information

Information provided in this Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 that are not historical facts and information. These statements represent the Company's expectations or beliefs, including, but not limited to, statements concerning future financial and operating results, statements concerning industry performance, the Company's operations, economic performance, financial condition, margins and growth in sales of the Company's products, capital expenditures, financing needs, as well as assumptions related to the foregoing. For this purpose, any statements contained in this Quarterly Report that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the generality of the foregoing, words such as "may", "will", "expect", "believe", "anticipate", "intend", "could", "estimate" or "continue" or the negative or other variations thereof or comparable terminology are intended to identify forward-looking statements. These forward-looking statements are based on current expectations and involve various risks and uncertainties that could cause actual results and outcomes for future periods to differ materially from any forward-looking statement or views expressed herein. The Company's financial performance and the forward-looking statements contained herein are further qualified by other risks including but not limited to those set forth herein and in the Company's most recent Form 10-K.

RESULTS OF OPERATIONS

First Quarter Fiscal 2002 ("fiscal 2002")
versus First Quarter Fiscal 2001 ("fiscal 2001")

Net sales for the first quarter of fiscal 2002 were $9.9 million a decrease from the same period of fiscal 2001 of $336,000, or 3%. Net sales for fiscal 2002 were comprised of $7.9 million from our private label contract manufacturing business ("core business" or "core products") and $2.0 million from our direct-to-consumer ("DTC") products versus $9.2 million and $1.0, for the same products in fiscal 2001, respectively. Of the core business for fiscal 2002, $1.7 million was produced by our Swiss subsidiary ("NAIE") with our U.S. operations ("NAI") manufacturing the remainder of $6.2 million. NAIE produced approximately $2.0 million of the core business sales in fiscal 2001.

DTC sales for fiscal 2001 were $1.0 million and included only a single product offering. DTC sales during fiscal 2002 included six products and sales increased by $1.0 million.

Total net sales for all core business customers achieving individual volumes of at least 5% of total net sales were $7.4 million (four customers) and $8.6 million (five customers) for fiscal years 2001 and 2000, respectively, a decrease of $1.2 million. Sales, during the first quarter of fiscal 2002, to our largest customer declined slightly to $5.1 million from $5.2 million for fiscal 2001, while sales to our second largest customer increased by a similar amount from $900,000 for fiscal 2001 to $1.0 million in fiscal 2002. Sales to our next three largest customers decreased by $1.2 million during the first quarter of fiscal 2002 versus same quarter of fiscal 2001. The decrease was primarily due to adjustments in order rates by our customer to reduce inventories (third largest customer $465,000) and shift in product mix from vitamins and nutritional supplements to personal care products (fourth largest customer $616,000). Sales volume to our third largest customer is not indicative of expected volumes for entire current fiscal year. The decline in sales to our fourth largest customer is expected to continue.

Gross profit for fiscal 2002 increased to $2.0 million, 20% of net sales, from $1.8 million, or 18% of net sales, for fiscal 2001. In absolute dollars, gross profit attributable to our DTC business increased $650,000, while our core business declined approximately $450,000. The changes, in absolute dollars, were driven for the most part by changes in sales volumes, although core business margins declined by 3% of sales, while DTC's margins increased 4%.

Total material costs, including outside packaging costs, as a percentage of net sales, were 49% ($4.8 million) and 53% ($5.4 million) for fiscal 2002 and 2001, respectively. Material costs for our core products remained comparable in both periods at 55% of sales, while DTC costs decreased in fiscal 2002 to 24% versus 30% for fiscal 2001. The noted improvement is primarily due to increased margins being derived from the five new products introduced during the last 12 months.

Total direct and indirect manufacturing expenses, as a percentage of sales, remained comparable from period-to-period at 29%. In absolute dollars, the expenses decreased $62,000. The reduction was primarily due to a savings achieved in our core business ($146,000), offset by additional fulfillment expenses required to support the DTC business ($84,000). Fulfillment expenses as a percentage of DTC sales increased to approximately 6% in fiscal 2002 versus 4% in fiscal 2001.

Selling, general and administrative expenses (“SG&A”) for fiscal years 2002 and 2001 were $2.5 million (25% of net sales) and $1.5 million (15% of net sales), respectively. The increase of fiscal 2002’s SG&A expenses, as a percentage of net sales, reflects incremental expenditures for consulting ($59,000), legal expense ($273,000), selling and promotional expenses associated with DTC sales increases ($432,000) and separation expenses ($150,000). Legal expense incurred in fiscal 2002 is net of insurance proceeds received from our insurance carriers of $129,000 (See Item 3. Legal Proceedings).

The Company’s loss from operations was $430,000 for fiscal 2002 compared to income of $275,000 for fiscal 2001. The increase in the loss from operations of $705,000 was due primarily to an increase in gross profit of $219,000 offset by the incremental increases in SG&A expenses discussed above.

Income tax expense for fiscal 2002 was $14,000 and reflects the local Swiss income tax of 4% applied to our Swiss operations, which were profitable for fiscal 2002. The Company benefits from a five-year tax holiday, which applies, at the Swiss federal level, a zero tax rate to pretax income of our Swiss subsidiary. The tax holiday applies to earnings through June 30, 2004. At September 30, 2001, the Company’s U.S generated net deferred tax assets are fully offset by a valuation allowance, resulting in no tax benefit recognized for fiscal 2002. Management will continue to assess the valuation allowance and to the extent it is determined that such allowance is no longer required, the tax benefit of the remaining net deferred tax assets will be recognized in the future. The income tax benefit recognized in fiscal 2001, reflects the increase to the Company’s net deferred tax assets recorded at that time.

The Company recorded a net loss for fiscal 2002 of $658,000 ($0.11 per share) compared to a net income of $205,000 million ($0.04 per share) for fiscal 2001. The change in profitability from fiscal 2001 to fiscal 2002 reflects primarily the favorable increase in gross profit offset by the increases to SG&A expenses as described above.

LIQUIDITY AND CAPITAL RESOURCES

The Company has historically financed its operations through cash flow from operations, its working capital lines of credit facility and equipment financing arrangements.

At September 30, 2001, the Company has cash and cash equivalents of approximately $792,000, a slight increase from $499,000 at June 30, 2001. Net cash provided by financing activities during the first three months of fiscal 2002 amounted to $1.036 million and was used to fund cash used by operations of $477,000 and the acquisition of capital equipment of $266,000.

At September 30, 2001, the Company has access to approximately $3.8 million of funds from existing working capital credit facilities to support future operating requirements. Borrowings outstanding under these facilities as of September 30, 2001 total approximately $1.7 million. The working capital line of credit facilities are subject to eligibility requirements for current accounts receivable and inventory balances. As of September 30, 2001, total excess borrowing capacity based on eligible working capital balances was approximately $2.1 million. One or more of the Company’s loan agreements contain a number of covenants that restrict the operations of the Company. Such restrictions include requiring the Company to comply with specified financial ratios and tests, including minimum tangible net worth requirements, maximum leverage ratios, and minimum net income. As of September 30, 2001, the Company was in compliance with all restrictive covenants of these agreements.

The Company believes its available cash and existing credit facilities should be sufficient to fund near-term operating activities. However, the Company's ability to fund future operations and meet capital requirements will depend on many factors, including but not limited to: the ability to seek additional capital; the effectiveness of the Company's diversified growth strategy; the effectiveness of the expansion of European operations and the ability to establish additional customers or changes to existing customer's business.

RISK FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

In addition to the other information included in this Report, the following factors should be considered in evaluating the Company's business and future prospects. The Company's business and results of operations could be seriously harmed by any of the following risks. In addition, the market price of our common stock could decline due to any of these risks.

Recent Losses; Declining Sales

The Company incurred a net loss of approximately $658,000 for the first three months of fiscal 2002. Sales for the fiscal quarter ended September 30, 2001, declined to approximately $9.9 million, compared to approximately $10.2 million for the same period of fiscal 2001. There can be no assurance management's efforts to reverse these trends will be effective, or if they are, the Company cannot predict the level of profitability or whether the Company will be able to maintain profitability. The Company expects that operating results will fluctuate from period to period as a result of differences in when it incurs expenses and recognizes revenues from product sales. Some of these fluctuations may be significant.

Decline in Stock Price

The Company's stock price has experienced significant volatility at times during the past few years and is currently near historic lows. In view of the Company's recent losses and the fact there can be no assurances of future profitability, there can be no assurance that the stock price will not continue to decline. Market conditions in the vitamin and nutritional supplement industry, such as increased price competition, consolidation, oversupply of vitamin and supplement products, operating results of competitors, adverse publicity and other factors such as customer and product announcements by the Company and operating results which are lower than the expectations of analysts and our investors, may have a continuing adverse affect on the price of the Company's stock.

Reliance on Limited Number of Customers for Majority of Revenue

For the first three months of fiscal 2002, the Company had 4 major customers, which together accounted for approximately 75% of the Company's net sales. The loss of any of these major customers, or any substantial reduction of their purchases from the Company, would have a material adverse impact on the business, operations and financial condition of the Company.

Restrictive Financing Covenants

One or more of the Company's loan agreements contain a number of covenants that restrict the operations of the Company. Such restrictions include requiring the Company to comply with specified financial ratios and tests, including minimum tangible net worth requirements, maximum leverage ratios, and minimum earnings.

The Company was not in compliance with certain of these ratios at June 30, 2001, which the lender has agreed to waive through June 30, 2001. As of July 1, 2001, the Company and the lender have amended the credit agreement to provide new debt covenant restrictions under which the Company is compliant. There can be no assurance the Company will be able to comply with the covenants or restrictions contained therein during future quarters. The Company's ability to comply with such covenants and other restrictions may be affected by events beyond its control, including prevailing economic, financial and industry conditions. The breach of any such covenants or restrictions could result in a default under the various loan agreements that would permit the lenders to declare all amounts outstanding thereunder to be immediately due and payable, together with accrued and unpaid interest, and to terminate their commitments to make further extensions of credit. Any such action could have a material adverse impact upon the business operations and financial condition of the Company.

Potential for Increased Competition

The market for the Company's products is highly competitive. The Company competes with other dietary supplement products and over-the-counter pharmaceutical manufacturers. Among other factors, competition among these manufacturers is based upon price. If one or more manufacturers significantly reduce their prices in an effort to gain market share, the Company's business, operations and financial condition could be adversely affected. Many of the Company's competitors, particularly manufacturers of nationally advertised brand name products, are larger and have resources substantially greater than those of the Company. There has been speculation about the potential for increased participation in these markets by major international pharmaceutical companies. In the future, if not already, one or more of these companies could seek to compete more directly with the Company by manufacturing and distributing their own or others' products, or by significantly lowering the prices of existing national brand products. The Company sells substantially all of its supplement products to customers who re-sell and distribute the products. Although the Company does not currently participate significantly in other channels such as health food stores, direct mail, and internet sales, the Company is expanding its operations and its products, and will likely face increased competition in such distribution and sales channels as more vendors and customers utilize them.

Reliance on Limited Number of Suppliers; Availability and Cost of Purchased Materials

The Company purchases certain products it does not manufacture from a limited number of raw material suppliers. No supplier represented more than 10% of total raw material purchases for the fiscal year ended June 30, 2001 and through September 30, 2001. Although the Company currently has supply arrangements with several suppliers of these raw materials, and such materials are generally available from numerous sources, the termination of the supply relationship by any material supplier or an unexpected interruption of supply could materially adversely affect the Company's business, operations and financial condition.

The Company relies on a single supplier to process certain raw materials for a product line of the Company's largest customer. An unexpected interruption of supply of this service would materially adversely affect the Company's business, operations and financial condition.

Effect of Adverse Publicity

The Company's products consist primarily of dietary supplements (vitamins, minerals, herbs and other ingredients). The Company regards these products as safe when taken as suggested by the Company. In addition, various scientific studies have suggested the ingredients in some of the Company's products may involve health benefits. The Company believes the growth in the dietary supplements business of the last several years may, in part, be based on significant media attention and various scientific research suggesting potential health benefits from the consumption of certain vitamin products. The Company is indirectly dependent upon its customers' perception of the overall integrity of its business, as well as the safety and quality of its products and similar products distributed by other companies which may not adhere to the same quality standards as the Company. The business, operations, and financial condition of the Company could be adversely affected if any of the Company's products or any similar products distributed by other companies should prove or be asserted to be harmful to consumers, or should scientific studies provide unfavorable findings regarding the effect of products similar to those produced by the Company.

Exposure to Product Liability Claims

The Company, like other retailers, distributors and manufacturers of products that are ingested, faces a risk of exposure to product liability claims in the event that, among other things, the use of its products allegedly results in injury. The Company maintains product liability insurance coverage, including primary product liability and excess liability coverage. There can be no assurance that product liability insurance will continue to be available at an economically reasonable cost or that the Company's insurance will be adequate to cover any liability the Company incurs in respect to all possible product liability claims. In addition, some of the ingredients included in one or more of the products manufactured by the Company are subject to controversy involving potential negative side effects or questionable health benefits. Some insurers have recently excluded certain of these ingredients from their product liability coverage. Although the Company's product liability insurance does not presently have any such limitations, the Company's insurer could require such exclusions or limitations on coverage in the future. In such event, the Company may have to cease utilizing the ingredients or may have to rely on indemnification or similar arrangements with its customers who wish to continue to include such ingredients in their products. In such an event, the consequential increase in product liability risk or the loss of customers or product lines could have a material adverse impact on the Company's business, operations, and financial condition.

Risks Associated with International Markets

The Company's growth may be dependent in part upon its ability to expand its operations and those of its customers into new markets, including international markets. For the period ended June 30, 2001 and 2000, the percentage of the Company's net sales to customers in international markets was approximately 29% and 32%, respectively. NAIE operates a manufacturing facility in Switzerland, which is intended to facilitate an increase in sales of the Company's products overseas and which contributed approximately 18% and 8% of the Company's net sales for the fiscal years ended June 30, 2001 and 2000, respectively. The Company may experience difficulty expanding in international markets due to regulatory barriers, the necessity of adapting to new regulatory systems, and problems related to entering new markets with different cultural bases and political systems. Operating in international markets exposes the Company to certain risks, including, among other things, (1) changes in or interpretations of foreign import, currency transfer and other restrictions and regulations that among other things may limit the Company's ability to sell certain products or repatriate profits to the United States, (2) exposure to currency fluctuations, (3) the potential imposition of trade or foreign exchange restrictions or increased tariffs, and (4) economic and political instability. As the Company continues to expand its international operations, these and other risks associated with international operations are likely to increase.

Government Regulation

The manufacturing, processing, formulation, packaging, labeling and advertising of the Company's products are subject to regulation by one or more federal agencies, including the United States Food and Drug Administration ("FDA"), the Federal Trade Commission ("FTC"), the Consumer Product Safety Commission, the United States Department of Agriculture, the United States Postal Service, the United States Environmental Protection Agency, and the Occupational Safety and Health Administration. The Company's activities are also regulated by various agencies of the states and localities in which the Company's products are sold. In particular, the FDA regulates the safety, labeling and distribution of dietary supplements, including vitamins, minerals, herbs, food, and over-the-counter and prescription drugs and cosmetics. In addition, the FTC has overlapping jurisdiction with the FDA to regulate the labeling, promotion and advertising of vitamins, over-the-counter drugs, cosmetics and foods.

The Dietary Supplement Health and Education Act of 1994 ("DSHEA") was enacted on October 25, 1994. DSHEA amends the Federal Food, Drug and Cosmetic Act by defining dietary supplements, which include vitamins, minerals, nutritional supplements and herbs as a new category of food separate from conventional food. DSHEA provides a regulatory framework to ensure safe, quality dietary supplements and the dissemination of accurate information about such products. Under DSHEA, the FDA is generally prohibited from regulating the active ingredients in dietary supplements as drugs unless product claims, such as claims that a product may heal, mitigate, cure or prevent an illness, disease or malady, trigger drug status.

DSHEA provides for specific nutritional labeling requirements for dietary supplements. DSHEA permits substantiated, truthful and non-misleading statements of nutritional support to be made in labeling, such as statements describing general well being resulting from consumption of a dietary ingredient or the role of a nutrient or dietary ingredient in affecting or maintaining a structure or function of the body. The Company anticipates the FDA will finalize manufacturing process regulations that are specific to dietary supplements and require at least some of the quality control provisions applicable to drugs. The Company currently manufactures its vitamins and nutritional supplement products in compliance with the food good manufacturing processes.

The FDA is developing additional regulations to implement DSHEA. Labeling regulations may require expanded or different labeling for the Company's vitamin and nutritional products. The Company cannot determine what effect such regulations, when fully implemented, will have on its business in the future. Such regulations could, among other things, require the recall, reformulation or discontinuance of certain products, additional record keeping, warnings, notification procedures and expanded documentation of the properties of certain products or scientific substantiation regarding ingredients, product claims, safety or efficacy. Failure to comply with applicable FDA requirements could result in sanctions being imposed on the Company or the manufacturers of its products, including warning letters, fines, product recalls and seizures.

Governmental regulations in foreign countries where the Company plans to commence or expand sales may prevent or delay entry into a market or prevent or delay the introduction, or require the reformulation of, certain of the Company's products. In addition, the Company cannot predict whether new domestic or foreign legislation regulating its activities will be enacted. Such new legislation could have a material adverse effect on the business, operations and financial condition of the Company.

Failure to Attract and Retain Management Could Harm Our Ability to Achieve Profitability

The Company's success is dependent in large part upon its continued ability to identify, hire, retain, and motivate highly skilled management employees. Competition for these employees is intense, and the Company may not be able to hire additional qualified personnel in a timely manner and on reasonable terms. The majority of the Company's current corporate officers began their employment with the Company in fiscal years 2000 and 2001. The inability of the Company to retain competent professional management could adversely effect our ability to execute our business strategy.

Centralized Location of Manufacturing Operations

The Company currently manufactures the vast majority of its products at its manufacturing facilities in San Marcos, California. Accordingly, any event resulting in the slowdown or stoppage of the Company's manufacturing operations or distribution facilities in San Marcos could have a material adverse affect on the Company. The Company maintains business interruption insurance. There can be no assurance, however, that such insurance will continue to be available at a reasonable cost or, if available, will be adequate to cover any losses that may be incurred from an interruption in the Company's manufacturing and distribution operations.

Concentration of Ownership; Certain Anti-Takeover Considerations

The Company's directors and executive officers beneficially own in excess of 22.9% of the outstanding Common Stock as of June 30, 2001 and September 30, 2001. Accordingly, these shareholders will continue to have the ability to substantially influence the management, policies, and business operations of the Company. The Company's Board of Directors has the authority to approve the issuance of 500,000 shares of preferred stock and to fix the rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the Company's shareholders. The rights of the holders of Common Stock will be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future. Certain provisions of Delaware law, as well as the issuance of preferred stock, and other "anti-takeover" provisions in the Company's Articles and Bylaws, could delay or inhibit the removal of incumbent directors and could delay, defer, make more difficult or prevent a merger, tender offer or proxy content, or any change in control involving the Company, as well as the removal of management, even if such events would be beneficial to the interests of the Company's shareholders, and may limit the price certain investors may be willing to pay in the future for shares of Common Stock.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risks from adverse changes in interest rates, and foreign exchange rates affecting the return on our investments and the cost of our debt. The Company does not use derivative financial instruments to reduce the impact of changes in interest or foreign exchange rates.

At September 30, 2001, the Company's cash equivalents consisted of financial instruments with original maturities of three months or less.

The Company's debt as of September 30, 2001 totaled $5.8 million and was comprised of fixed rate loans of $3.6 million and variable rate loans of $2.2 million. The average composite interest rates at September 30, 2001 for fixed rate and variable rate loans were 7.9% and 6.5%, respectively.

The Company's wholly owned Swiss subsidiary has a line of credit and a capital lease denominated in Swiss Francs. The balance of borrowing under these agreements was CHF 1.6 million at September 30, 2001 ($952,000). The interest rate applied to these obligations is fixed, but the Company is exposed to movements in the exchange rate between the Swiss Franc and the U.S. Dollar. On September 30, 2001, the Swiss Franc closed at 1.62 to 1 U.S. dollar. The same rate was 1.79 Swiss Francs to 1 U.S. dollar at June 30, 2001. Foreign exchange loss for the first three months of fiscal 2002 was $64,000.

An immediate adverse change of one hundred basis points in interest rates would increase interest expense on an annual basis by $22,000. A 10% adverse change to the Swiss Franc exchange rate would decrease earnings by $87,000.

NATURAL ALTERNATIVES INTERNATIONAL, INC.
PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is a party to a lawsuit filed in January 2000 by its former President, Director and Chief Financial Officer, William P. Spencer. The Parties have mutually resolved their disputes with each other and have dismissed all pending claims against one another and have entered into a confidential settlement agreement.

The Company is a plaintiff in an anti-trust lawsuit against several manufacturers of vitamins and other raw materials purchased by the Company. Other similarly situated companies have filed a number of similar lawsuits against some or all of the same manufacturers. The Company's lawsuit has been consolidated with some of the others and is captioned *In re: Vitamin Antitrust Litigation*, and is pending in U.S. District Court in Washington D.C. One or more consumer class actions have also been filed against some or all of the same defendants, and at least one of these is presently in a settlement process. The Company brought its own action to insure it understood what actually occurred. To date the Company has received $416,000 in settlement payments from certain defendants. There can be no assurance the claims will be resolved, or, if they are, that it will result in a material benefit to the Company.

The Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with its legal counsel, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or liquidity.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS BY THE COMPANY ON ITS SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits: None

(b) No reports on Form 8-K were filed during the quarter for which this report is filed.

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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 ALTERNATIVES INTERNATIONAL, INC.

/s/ Randell Weaver	Date: November 12, 2001

Randell Weaver
Chief Financial Officer