

---

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

---

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended December 31, 2002

Commission file number 0-15701

---

**NATURAL ALTERNATIVES  
INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**1185 Linda Vista Drive**  
**San Marcos, California 92069**  
(Address of principal executive offices,  
including zip code)

**84-1007839**  
(I.R.S. Employer  
Identification No.)

**(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  No

At February 3, 2003, the registrant had 5,812,421 outstanding shares of common stock, \$.01 par value, net of 272,400 treasury shares.

---

**Part I. Financial Information**  
**Item 1. Financial Statements**

**Natural Alternatives International, Inc.**  
**Consolidated Balance Sheets**  
(Dollars in thousands, except share data)

	December 31, 2002	June 30, 2002
	(Unaudited)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 4,037	\$ 640
Restricted cash	—	1,500
Accounts receivable, net of allowance for doubtful accounts of \$25 at September 30, 2002 and \$105 at June 30, 2002	3,958	3,536
Inventories, net	7,318	7,871
Income tax refund receivable	715	701
Prepaid expenses	761	271
Deposits	106	168
Other current assets	189	165
	<u>17,084</u>	<u>14,852</u>
Property and equipment, net	<u>11,630</u>	<u>12,439</u>
Other assets:		
Related parties notes receivable	50	118
Other noncurrent assets, net	101	101
	<u>151</u>	<u>219</u>
Total assets	<u>\$ 28,865</u>	<u>\$ 27,510</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 3,563	\$ 4,112
Accrued liabilities	858	815
Accrued compensation and employee benefits	533	482
Income taxes payable	145	131
Current portion of long-term debt	567	587
	<u>5,666</u>	<u>6,127</u>
Long-term debt, less current portion	2,672	1,576
Long-term pension liability	158	199
	<u>8,496</u>	<u>7,902</u>
Commitments and contingencies		
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 6,084,821 shares at December 31, 2002 and 6,073,179 shares at June 30, 2002	61	61
Additional paid-in capital	11,437	11,362
Retained earnings	10,174	9,488
Treasury stock, at cost, 272,400 shares at December 31, 2002 and June 30, 2002	(1,303)	(1,303)
	<u>20,369</u>	<u>19,608</u>
Total liabilities and stockholders' equity	<u>\$ 28,865</u>	<u>\$ 27,510</u>

*See accompanying notes to consolidated financial statements.*

**Natural Alternatives International, Inc.**  
**Consolidated Statements Of Operations And Comprehensive Income (Loss)**  
(Dollars in thousands, except share data)  
(Unaudited)

	Three months ended December 31,		Six months ended December 31,	
	2002	2001	2002	2001
Net sales	\$ 13,010	\$ 12,655	\$ 26,146	\$ 22,542
Cost of goods sold	9,958	9,949	19,899	17,812
Gross profit	3,052	2,706	6,247	4,730
Selling, general & administrative expenses	2,797	2,461	5,589	4,915
Income (loss) from operations	255	245	658	(185)
Other income (expense):				
Interest income	21	4	28	7
Interest expense	(70)	(193)	(153)	(351)
Foreign exchange loss	(11)	27	(17)	(37)
Proceeds from vitamin antitrust litigation	—	—	225	—
Other, net	(39)	9	(40)	14
	(99)	(153)	43	(367)
Income (loss) before income taxes	156	92	701	(552)
Provision for income taxes	7	28	15	42
Net income (loss)	\$ 149	\$ 64	\$ 686	\$ (594)
Net income (loss) per common share:				
Basic	\$ 0.03	\$ 0.01	\$ 0.12	\$ (0.10)
Diluted	\$ 0.02	\$ 0.01	\$ 0.11	\$ (0.10)
Weighted average common shares outstanding:				
Basic shares	5,804,267	5,785,606	5,803,566	5,785,606
Diluted shares	6,021,919	5,785,606	5,975,742	5,785,606

*See accompanying notes to consolidated financial statements.*

**Natural Alternatives International, Inc.**  
**Consolidated Statements of Cash Flows**  
**For the Six Months Ended December 31,**  
**(Dollars in thousands)**  
**(Unaudited)**

	2002	2001
<b>Cash flows from operating activities</b>		
Net income (loss)	\$ 686	\$ (594)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for uncollectible accounts receivable	(80)	(133)
Depreciation and amortization	1,222	1,188
Stock based compensation	51	3
Pension expense, net of contributions	(41)	—
Loss on disposal of asset	4	—
Foreign exchange gains on foreign debt	—	37
Changes in operating assets and liabilities:		
Accounts receivable	(342)	(1,859)
Inventories	553	(399)
Tax refund receivable	(14)	—
Prepaid expenses	(490)	(179)
Other assets	38	(133)
Accounts payable and accrued liabilities	(492)	1,964
Accrued compensation and employee benefits	51	124
Net cash provided by operating activities	<u>1,146</u>	<u>19</u>
<b>Cash flows from investing activities</b>		
Capital expenditures	(526)	(852)
Proceeds from sale of property and equipment	109	16
Repayment of notes receivable	68	—
Issuance of notes receivable	—	(14)
Write-off of investment	—	5
Net cash used in investing activities	<u>(349)</u>	<u>(845)</u>
<b>Cash flows from financing activities</b>		
Net borrowing on lines of credit	—	1,268
Borrowings on long-term debt	2,500	—
Payments on long-term debt	(1,424)	(476)
Decrease in restricted cash	1,500	—
Proceeds from issuance of common stock	24	17
Net cash provided by financing activities	<u>2,600</u>	<u>809</u>
Net increase (decrease) in cash and cash equivalents	3,397	(17)
Cash and cash equivalents at beginning of period	640	499
Cash and cash equivalents at end of period	<u>\$ 4,037</u>	<u>\$ 482</u>
<b>Supplemental disclosures of cash flow information</b>		
Cash paid during the year for interest	<u>\$ 153</u>	<u>\$ 351</u>

*See accompanying notes to consolidated financial statements.*

**NATURAL ALTERNATIVES INTERNATIONAL, INC.**  
**NOTES TO UNAUDITED FINANCIAL STATEMENTS**

**Note 1 – Basis of Presentation and Summary of Significant Accounting Policies**

The consolidated financial statements include the accounts of Natural Alternatives International, Inc. and its wholly owned subsidiary, Natural Alternatives International Europe (“NAIE”), (the “Company”) and have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures herein are adequate to make the information presented not misleading. The Company suggests that these unaudited consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the Company’s latest Annual Report on Form 10-K. In preparing the consolidated financial statements, 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. In the opinion of the Company, all adjustments necessary to present fairly the information in the following unaudited consolidated financial statements of the Company have been included. The results of operations for such interim periods are not necessarily indicative of the results for the full year.

**Inventories**

Inventories are recorded at the lower of cost (first in, first out) or market (net realizable value). Inventories were as follows (dollars in thousands):

	December 31, 2002	June 30, 2002
Raw materials	\$ 4,112	\$ 4,631
Work in progress	1,573	1,754
Finished goods	1,633	1,486
	<u>\$ 7,318</u>	<u>\$ 7,871</u>

**Property and Equipment**

Property and equipment are stated at cost less accumulated depreciation. Property and equipment were as follows (dollars in thousands):

	Life Used for Depreciation	December 31, 2002	June 30, 2002
Land	NA	\$ 393	\$ 393
Building and building improvements	5-39 years	3,288	3,279
Machinery and equipment	3-15 years	15,226	15,517
Office equipment and furniture	5-7 years	4,129	4,054
Vehicles	3 years	197	197
Leasehold improvements	5-39 years	4,415	4,230
Total property and equipment		<u>27,648</u>	<u>27,670</u>
Less accumulated depreciation and amortization		<u>(16,018)</u>	<u>(15,231)</u>
Property and equipment, net		<u>\$ 11,630</u>	<u>\$ 12,439</u>

**NATURAL ALTERNATIVES INTERNATIONAL, INC.**  
**NOTES TO UNAUDITED FINANCIAL STATEMENTS**

**Note 1 – Basis of Presentation and Summary of Significant Accounting Policies (Continued)**

**Net Income (Loss) Per Share**

The Company computes net income (loss) per share in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 128, “Earnings Per Share.” This statement requires the presentation of basic net income (loss) per share, using the weighted average number of shares outstanding during the period, and diluted net income (loss) per share, using the additional dilutive effect of all dilutive securities. The dilutive impact of stock options account for the additional weighted average shares of common stock outstanding for the Company’s diluted net income (loss) per share computation. Basic and diluted net income (loss) per share are calculated as follows (dollars in thousands, except per share amounts):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2002	2001	2002	2001
<b>Numerator</b>				
Net income (loss)	\$ 149	\$ 64	\$ 686	\$ (594)
<b>Denominator</b>				
Basic weighted average common shares outstanding	5,804,267	5,785,606	5,803,566	5,785,606
Dilutive effect of stock options	217,652	—	172,176	—
Diluted weighted average common shares outstanding	6,021,919	5,785,606	5,975,742	5,785,606
Basic net income (loss) per share	\$ 0.03	\$ 0.01	\$ 0.12	\$ (0.10)
Diluted net income (loss) per share	\$ 0.02	\$ 0.01	\$ 0.11	\$ (0.10)

For the three and six months ended December 31, 2002, there were outstanding options to purchase 105,000 and 117,500 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.

For the three and six months ended December 31, 2001, there were outstanding options to purchase 580,200 and 506,015 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.

**Recent Accounting Pronouncements**

In June 2002, the Financial Accounting Standards Board (the “FASB”) issued Statement of Financial Accounting Standards Board (“SFAS”) No. 146, “Accounting for Costs Associated with Exit or Disposal Activities,” which addresses significant issues regarding the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. This statement requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. We do not expect the adoption of this statement will have a material impact on our results of operations or financial position.

In December 2002, the FASB issued SFAS No. 148, “Accounting for Stock-Based Compensation — Transition and Disclosure — an amendment of FASB Statement No. 123.” SFAS No. 148 amends SFAS No. 123, “Accounting for Stock-Based Compensation,” to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent

**NATURAL ALTERNATIVES INTERNATIONAL, INC.**  
**NOTES TO UNAUDITED FINANCIAL STATEMENTS**

disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company is required to follow the prescribed format and provide the additional disclosures required by SFAS No. 148 in its annual financial statements for the year ended June 30, 2003 and must also provide the disclosures in its quarterly reports containing condensed financial statements for interim periods beginning with the quarter ended March 31, 2003.

**Note 2 – Economic Dependency**

The Company had substantial sales to two separate customers during the periods shown in the following table. The loss of either of these customers could have a material adverse impact on the Company's sales and earnings. Net sales by customer, representing 10% or more of the respective quarter's total net sales, are shown below (dollars in thousands):

	Three months ended December 31,				Six months ended December 31,			
	2002		2001		2002		2001	
Customer 1	\$5,782	44%	\$ 5,163	41%	\$11,750	45%	\$10,360	46%
Customer 2	3,599	28%	3,200	25%	6,413	24%	4,230	19%
	<u>\$9,381</u>	<u>72%</u>	<u>\$ 8,363</u>	<u>66%</u>	<u>\$18,163</u>	<u>69%</u>	<u>\$14,590</u>	<u>65%</u>

Accounts receivable from these customers totaled \$3.0 million and \$2.5 million at December 31, 2002 and June 30, 2002, respectively.

Direct-to-consumer sales were approximately \$2.4 million and \$1.7 million for the three months ended December 31, 2002 and 2001, respectively, and \$5.0 million and \$3.8 million for the six months ended December 31, 2002 and 2001, respectively.

The Company purchases certain products it does not manufacture from a limited number of raw material suppliers. The Company had substantial purchases from five separate suppliers during the periods shown in the following table. The loss of any of these suppliers could have a material adverse impact on the Company's sales and earnings.

Raw material purchases, representing 10% or more of the respective quarter's raw material purchases, are shown below (dollars in thousands):

	Three months ended December 31,				Six months ended December 31,			
	2002		2001		2002		2001	
Supplier 1	\$1,628	34%	\$ (a)	—	\$3,163	32%	\$ (a)	—
Supplier 2	601	13%	(a)	—	1,108	11%	(a)	—
Supplier 3	(a)	—	1,774	39%	(a)	—	2,713	31%
Supplier 4	(a)	—	442	10%	(a)	—	877	10%
Supplier 5	(a)	—	435	10%	(a)	—	841	10%
	<u>\$2,229</u>	<u>47%</u>	<u>\$2,651</u>	<u>59%</u>	<u>\$4,271</u>	<u>43%</u>	<u>\$4,431</u>	<u>51%</u>

(a) Purchases were less than 10% of total raw material purchases

Accounts payable to suppliers representing 10% or more of raw material purchases for the quarter ended December 31, 2002, was \$575,000 and \$426,000 at December 31, 2002 and June 30, 2002, respectively.

**NATURAL ALTERNATIVES INTERNATIONAL, INC.**  
**NOTES TO UNAUDITED FINANCIAL STATEMENTS**

**Note 3 – Segment Information**

The Company's information by geographic area was as follows (dollars in thousands):

	Net Sales for the Three months ended December 31,		Net Sales for the Six months ended December 31,	
	2002	2001	2002	2001
United States	\$ 11,112	\$ 10,808	\$ 22,339	\$ 18,985
International	1,898	1,847	3,807	3,557
	<u>\$ 13,010</u>	<u>\$ 12,655</u>	<u>\$ 26,146</u>	<u>\$ 22,542</u>

	Long Lived Assets		Total Assets	
	December 31, 2002	June 30, 2002	December 31, 2002	June 30, 2002
United States	\$ 10,927	\$ 11,450	\$ 25,391	\$ 24,290
International	1,392	1,527	3,474	3,220
	<u>\$ 12,319</u>	<u>\$ 12,977</u>	<u>\$ 28,865</u>	<u>\$ 27,510</u>

**Note 4 – Financial Condition**

On October 31, 2002, the Company entered into a new \$6.5 million two-year credit facility. The facility is comprised of a \$4 million working capital line of credit and a \$2.5 million term loan. The working capital line of credit is subject to eligibility requirements for current accounts receivable and inventory balances. The interest rate on the line of credit and term loan is prime plus 0.5%. As of December 31, 2002, the outstanding amount on the line of credit was zero. The term loan provides for principal and interest payable in monthly installments of \$47,000 with a final balloon payment of \$1.6 million on the second anniversary of the loan agreement. As of December 31, 2002 the outstanding amount was \$2.5 million.

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 December 31, 2002, the outstanding amount was \$781,000.

The composite interest rate on all outstanding debt at December 31, 2002 and 2001 was 6.84% and 8.55%, respectively.

**Note 5 – Contingencies**

The Company was a plaintiff in an antitrust lawsuit against several manufacturers of vitamins and other raw materials purchased by the Company. Other similarly situated companies filed a number of similar lawsuits against some or all of the same manufacturers. The Company's lawsuit was consolidated with some of the others and captioned *In re: Vitamin Antitrust Litigation*, and was pending in U.S. District Court in Washington D.C. A final settlement payment of \$225,000 was received by the Company and is included in proceeds from vitamin antitrust litigation in the accompanying statement of operations for the six months ended December 31, 2002. All of its claims under the *Vitamin Antitrust Litigation* were settled.

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. 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.

### Critical Accounting Policies and Estimates

The Company's discussion and analysis of its financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates the estimates including those related to bad debts and inventories. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The Company believes the following critical accounting policies affect the more significant judgments and estimates used in the preparation of the consolidated financial statements:

**Allowance for Doubtful Accounts** – the Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowance may be required.

**Reserve for Inventory** – the Company records valuation reserves on its inventory for estimated excess and obsolete inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future product demand and market conditions. If future product demand or market conditions are less favorable than those projected by management, additional inventory reserves may be required.

**Depreciation of Long-Lived Assets** – the Company assigns useful lives for long-lived assets based on periodic studies of actual asset lives and the intended use for those assets. Any change in these asset lives would be reported in the statement of operations as soon as any change in estimate is determined.

**Accounting for Income Taxes** – the Company is required to estimate income taxes in each of the jurisdictions in which it operates. This process involves estimating actual current tax exposure for the Company together with assessing temporary differences resulting from differing treatment of items, such as property, plant and equipment depreciation, for tax and financial reporting purposes. Actual income taxes could vary from these estimates due to future changes in income tax law or results from final tax exam reviews. At

December 31, 2002, the Company assessed the need for a valuation allowance on its deferred tax assets. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Based upon the historical operating losses and the uncertainty regarding sufficient near term taxable income, management believes that this evidence creates sufficient uncertainty regarding the realizability of the net deferred tax assets. Therefore, a full valuation allowance is recorded at December 31, 2002. Should the Company determine that it would be able to realize all or part of its net deferred tax assets in the future, an adjustment to the deferred tax assets would be recorded to operations in the period such determination was made.

## **RESULTS OF OPERATIONS**

### **Second Quarter Fiscal 2003 (“fiscal 2003”) versus Second Quarter Fiscal 2002 (“fiscal 2002”)**

Consolidated net sales increased 3% to \$13.0 million for the second quarter of fiscal 2003 from \$12.7 million for the second quarter of fiscal 2002. The consolidated net sales growth resulted primarily from a \$692,000 or 40% increase in direct-to-consumer sales. The growth in direct-to-consumer sales to \$2.4 million for the second quarter of fiscal 2003 from \$1.7 million for the second quarter of fiscal 2002 is primarily due to seven additional product offerings. Contract manufacturing sales decreased slightly to \$10.6 million for the second quarter of fiscal 2003 from \$10.9 million for the same period of the prior year. NAIE contract manufacturing net sales remained consistent at \$1.9 million for the second quarter of fiscal 2003 compared to \$1.8 million for the second quarter of fiscal 2002.

Gross profit margin was 23.5% for the second quarter of fiscal 2003 compared to 21.4% for the second quarter of fiscal 2002. The increase in gross profit margin is primarily due to improvement in fixed cost leverage resulting from additional sales volumes, combined with a decrease in the material cost as a percent of net sales to 52% for the second quarter of fiscal 2003 from 54% for the second quarter of fiscal 2002. The decrease in material cost as a percent of net sales was primarily due to lower pricing from our primary vendors.

Selling, general and administrative expenses (“SG&A”) increased 14% to \$2.8 million for the second quarter of fiscal 2003 from \$2.5 million for the second quarter of fiscal 2002. The increase of \$336,000 is primarily due to increases in direct-to-consumer fulfillment costs of \$110,000 associated with incremental orders, sales and executive personnel costs of \$180,000, insurance premiums of \$90,000, research and development personnel costs of \$110,000, partially offset by a \$150,000 reduction in legal costs.

The Company recorded income from operations of \$255,000 for the second quarter of fiscal 2003 compared to \$245,000 for the second quarter of fiscal 2002. The increase in income from operations of \$10,000 was due primarily to improved gross margin on higher net sales, partially offset by the incremental SG&A expenses discussed above.

### **First Six Months of Fiscal 2003 (“fiscal 2003”) versus First Six Months of Fiscal 2002 (“fiscal 2002”)**

Consolidated net sales increased 16% to \$26.1 million for the six months ended December 31, 2002 from \$22.5 million for the six months ended December 31, 2001. The consolidated net sales growth resulted primarily from a \$2.3 million or 12% increase in contract manufacturing sales and a \$1.3 million or 34% growth in direct-to-consumer sales. The growth in contract manufacturing sales to \$21.1 million for the six months ended December 31, 2002 from \$18.8 million for the six months ended December 31, 2001 is primarily due to new products sold to existing major contract manufacturing customers. The growth in direct-to-consumer sales to \$5.0 million for the six months ended December 31, 2002 from \$3.8 million for the six months ended December 31, 2001 is primarily due to seven additional product offerings. NAIE contract manufacturing net sales were \$3.8 million for the six months ended December 31, 2002 compared to \$3.6 million for the six months ended December 31, 2001.

Gross profit margin was 23.9% for the six months ended December 31, 2002 compared to 21.0% for the six months ended December 31, 2001. The increase in gross profit margin is primarily due to improvement in fixed cost leverage resulting from additional sales

---

volumes. Material cost as a percent of net sales remained consistent at 52% for the six months ended quarter of fiscal 2003 and fiscal 2002.

Selling, general and administrative expenses ("SG&A") increased 14% to \$5.6 million for the six months ended December 31, 2002 from \$4.9 million for the six months ended December 31, 2001. The increase of \$674,000 is primarily due to increases in direct-to-consumer fulfillment costs of \$303,000 associated with incremental orders, sales and executive personnel costs of \$300,000, research and development personnel costs of \$150,000, insurance premiums of \$100,000, information systems costs of \$100,000, clinical study costs of \$90,000, partially offset by a \$350,000 reduction in legal costs, and \$150,000 reduction in employee separation expenses incurred in the prior year. Overall, SG&A decreased as a percentage of net sales to 21.4% for the six months ended December 31, 2002 from 21.8% in the comparable period last year.

The Company recorded income from operations of \$658,000 for the six months ended December 31, 2002 compared to a loss from operations of (\$185,000) for the six months ended December 31, 2001. The increase in income from operations was due primarily to improved gross margin on higher net sales, partially offset by the incremental SG&A expenses discussed above.

Proceeds from vitamin antitrust litigation for the six months ended December 31, 2002 includes receipt of the final settlement payment of \$225,000 from the *Vitamin Antitrust Litigation*.

## **LIQUIDITY AND CAPITAL RESOURCES**

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

At December 31, 2002, the Company had cash and working capital of \$4.0 million and \$11.4 million, respectively, compared to \$640,000 and \$8.7 million, respectively, at June 30, 2002. The improvement in working capital is primarily due to the \$1.1 million of cash flow from operations generated during the six months ended December 31, 2002 and \$1.3 million from re-financing the credit facility.

On October 31, 2002, the Company entered into a new \$6.5 million two-year credit facility. The facility is comprised of a \$4 million working capital line of credit and a \$2.5 million term loan. The working capital line of credit is subject to eligibility requirements for current accounts receivable and inventory balances. The interest rate on the line of credit and term loan is prime plus 0.5%. The new facility replaced the \$2.5 million line of credit that expired on October 31, 2002, and refinanced the \$1.2 million outstanding term note. The new working capital line of credit provided a \$1.3 million increase in the Company's cash position, freed up \$1.5 million of cash previously restricted as collateral for the prior line of credit and provided an additional \$1.5 million of borrowing capacity.

The Company believes that its available cash and existing credit facility 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: continued profitability from operations, maintaining adequate financing, the effectiveness of the Company's diversified growth strategy, the effectiveness of the expansion of European operations, the ability to establish additional customers and changes to existing customers' 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 Operating Income; Increasing Sales**

The Company's income from operations increased to \$658,000 for the six months ended December 31, 2002, compared to a loss from operations of (\$185,000) for the six months ended December 31, 2001.

---

Sales for the second quarter of fiscal 2003 increased to \$13.0 million, compared to \$12.7 million for the second quarter of fiscal 2002. There can be no assurance that increases in income from operations will continue or that the Company will have net income from operations and not a net loss in future periods. The Company expects operating results may further 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.

**Reliance on Limited Number of Customers**

For the six months ended December 31, 2002, the Company had two major customers, which together accounted for approximately 69% of the Company's net sales. The loss of either 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.

**Reliance on a Key Personality**

For the six months ended December 31, 2002, the Company's DTC product line was approximately 19% of the Company's net sales. DTC products are marketed with a key personality through a variety of distribution channels including weekly television programming, internet and a monthly newsletter. The inability of the key personality to fulfill his current role, or the reduction of television or other media exposure could have a material adverse impact on 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, including direct mail and internet sales, and will likely face increased competition in such distribution and sales channels as more vendors and customers utilize them.

**Availability of Line of Credit**

Effective October 31, 2002, the Company entered into a new \$6.5 million two-year credit facility. The liquidity provided by a line of credit is an important component of a sound financial management plan. Failure to maintain the loan covenants required to allow the Company continuing access to this new line of credit could materially impair the Company's ability to fund growth in operations or meet other working capital needs in the future.

**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. For the six months ended December 31, 2002, the Company had two major suppliers, which together accounted for 43% of raw material purchases. No other supplier represented more than 10% of total raw material purchases for the six months ended December 31, 2002. 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.

#### **Decline in Stock Price**

The Company's stock price has experienced volatility, during the past few years. In view of the Company's recent results and the fact there can be no assurances of future profitability, there can be no assurance that the stock price will not 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 or operating results which are lower than the expectations of analysts and our investors, may have an adverse effect on the price of the Company's stock.

#### **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 that 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. The cost of such coverage has increased dramatically in the last year and the availability of adequate insurance coverage has decreased. There can be no assurance that adequate 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. The Company's product liability insurance includes certain exclusions and limitations, the Company's insurer could expand 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 six months ended December 31, 2002 and 2001, the percentage of the Company's net sales to customers in international markets was approximately 25.9% and 27.7%, 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 14.6% and 15.8% of the Company's net sales for the six months ended December 31, 2002 and 2001, 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, (4) economic and political instability, and (5) the impact of various government's regulations and the enforcement thereof. 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 Maintain 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 2002 and 2001. The inability of the Company to retain competent professional management could adversely affect 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 Southern California. Accordingly, any event resulting in the slowdown or stoppage of the Company's manufacturing operations or distribution facilities in Southern California could have a material adverse effect 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 24.5% of the outstanding common stock as of December 31, 2002. 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 contest, 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 December 31, 2002 the Company's cash equivalents consisted of financial instruments with original maturities of three months or less.

The Company's debt as of December 31, 2002 totaled \$3.2 million and was comprised of fixed rate loans of \$781,000 and variable rate loans of \$2.5 million. The average composite interest rates at December 31, 2002 for fixed rate and variable rate loans were 8.25% and 4.75%, respectively.

### **Item 4. Controls and Procedures**

The Company's Chief Executive Officer and Chief Financial Officer believe the Company's disclosure controls and procedures, as defined in Securities Exchange Act Rules 13a-14 and 15d-14, are effective. This conclusion was reached after an evaluation of these controls and procedures as of December 31, 2002.

We are not aware of any significant changes in the Company's internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses, or in other factors that could significantly affect these controls after December 31, 2002.

---

**Part II. Other Information**

**ITEM 1. LEGAL PROCEEDINGS**

The Company was a plaintiff in an antitrust lawsuit against several manufacturers of vitamins and other raw materials purchased by the Company. Other similarly situated companies filed a number of similar lawsuits against some or all of the same manufacturers. The Company's lawsuit was consolidated with some of the others and captioned *In re: Vitamin Antitrust Litigation*, and was pending in U.S. District Court in Washington D.C. A final settlement payment of \$225,000 was received by the Company and is included in proceeds from vitamin antitrust litigation in the accompanying statement of operations for the six months ended December 31, 2002. All of its claims under the *Vitamin Antitrust Litigation* were settled.

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.

**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.**

By: /s/ John R. Reaves

Date: February 4, 2003

\_\_\_\_\_  
John R. Reaves  
Chief Financial Officer



---

### Certifications

I, Mark A. LeDoux, Chief Executive Officer of Natural Alternatives International, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Natural Alternatives International, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a. Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within that entity, particularly during the period in which this quarterly report is being prepared;
  - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and audit committee of registrant's board of directors:
  - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: February 4, 2003

/s/ Mark A. LeDoux

---

Mark A. LeDoux  
Chief Executive Officer

---

### Certifications

I, John R. Reaves, Chief Financial Officer of Natural Alternatives International, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Natural Alternatives International, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a. Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within that entity, particularly during the period in which this quarterly report is being prepared;
  - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and audit committee of registrant's board of directors:
  - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: February 4, 2003

/s/ John R. Reaves

---

John R. Reaves  
Chief Financial Officer