

NAUTILUS, INC.
Form 10-Q/A
November 15, 2011

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

FORM 10-Q/A
Amendment No. 1

(Mark One)

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

For the quarterly period ended September 30, 2011

or

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

For the transition period from _____ to _____

Commission file number: 001-31321

NAUTILUS, INC.
(Exact name of Registrant as specified in its
charter)

Washington
(State or other jurisdiction of
incorporation or organization)
16400 S.E. Nautilus Drive
Vancouver, Washington 98683
(Address of principal executive offices, including zip code)
(360) 859-2900
(Registrant's telephone number, including area code)

94-3002667
(I.R.S. Employer
Identification No.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of “accelerated filer, large accelerated filer and smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (do not check if a smaller reporting company)

Smaller reporting company

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

No

The number of shares outstanding of the registrant's common stock as of October 31, 2011 was 30,746,836 shares.

EXPLANATORY NOTE

This amendment on Form 10-Q/A is being filed to amend Nautilus, Inc.'s Quarterly Report on Form 10-Q for the period ended September 30, 2011, filed with the Securities and Exchange Commission on November 9, 2011 (the "Original Filing"). The purpose of the amendment is to correct a typographical error which resulted in the inadvertent omission of several words from a sentence in Management's Discussion and Analysis of Financial Condition and Results of Operation. The error appeared on page 20 of the Original Filing, in the second sentence of the first paragraph under "Retail Business" in "Comparison of Operating Results for the Nine Months Ended September 30, 2011 and 2010."

This amendment corrects the sentence to read as follows:

The decrease in Retail net sales was attributable primarily to a \$3.5 million, or 12.0%, decline in net sales of cardio products owing to (i) a third quarter 2010 sales promotion that was not repeated in 2011, (ii) a shift in the timing of certain customer orders from the third quarter to the fourth quarter of 2011 and (iii) overall soft demand among retailers.

We are not amending any other part of the Original Filing. This Form 10-Q/A speaks as of the date of the Original Filing and does not reflect events that occurred subsequent to the date of the Original Filing.

NAUTILUS, INC.
AMENDMENT NO. 1
TO FORM 10-Q FOR THE
QUARTERLY PERIOD ENDED SEPTEMBER 30, 2011

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PART I. FINANCIAL INFORMATION

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following discussion and analysis is based upon our financial statements as of the dates and for the periods presented in this section. You should read this discussion and analysis in conjunction with the financial statements and notes thereto found in Part I, Item 1 of this Form 10-Q and our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010 (the "2010 Form 10-K"). All references to the third quarters of 2011 and 2010 mean the three-month periods ended September 30, 2011 and 2010, respectively. Unless the context otherwise requires, "Nautilus," "we," "us" and "our" refer to Nautilus, Inc. and its subsidiaries. Unless indicated otherwise, all information regarding our operating results pertains to our continuing operations.

Our results of operations may vary significantly from period-to-period. Our revenues typically fluctuate due to the seasonality of our industry, customer buying patterns, product innovation, the nature and level of competition for health and fitness products, our ability to procure products to meet customer demand, the level of spending on, and effectiveness of, our media and advertising programs and our ability to attract new customers and maintain existing sales relationships. In addition, our revenues are highly susceptible to economic factors, including, among other things, the overall condition of the economy and the availability of consumer credit in both the United States and Canada. Our profit margins may vary in response to the aforementioned factors and our ability to manage product costs. Profit margins may also be affected by fluctuations in the costs or availability of materials used to manufacture our products, product warranty costs, higher or lower fuel prices, and changes in costs of other distribution or manufacturing-related services. Our operating profits or losses may also be affected by the efficiency and effectiveness of our organization. Historically, our operating expenses have been influenced by media costs to produce and air television advertisements of our products, facility costs, operating costs of our information and communications systems, product supply chain management, customer support and new product development activities. In addition, our operating expenses have been affected from time-to-time by asset impairment charges, restructuring charges and other significant unusual or infrequent expenses.

As a result of the above and other factors, our period-to-period operating results may not be indicative of future performance. You should not place undue reliance on our operating results and should consider our prospects in light of the risks, expenses and difficulties typically encountered by us and other companies, both within and outside our industry. We may not be able to successfully address these risks and difficulties and, consequently, we cannot assure you of any future growth or profitability. For more information, see our discussion of Risk Factors located at Part I, Item 1A of our 2010 Form 10-K.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "plan," "expect," "aim," "believe," "project," "intend," "estimate," "will," "should," "could," and other terms of similar meaning typically identify forward-looking statements. The forward-looking statements in this Form 10-Q include, without limitation, anticipated declines in sales of strength products, anticipated sales increases of cardio-oriented products and the expectation that increased sales of the TreadClimber® product line will offset anticipated declines in sales of legacy strength products; potential improvement in consumer credit financing approval rates; the continuance of promotional programs and the impact of such programs on profit margins; our new product development strategies; and our plans for achieving future profitability. Forward-looking statements also include any statements related to our expectations regarding future business and financial performance or conditions, anticipated sales growth across markets, distribution channels and product categories, expenses and gross margins, profits or losses, losses from discontinued operation, settlements of warranty obligations, new product introductions, financing and working capital requirements and resources. These

forward-looking statements, and others we make from time-to-time, are subject to a number of risks and uncertainties. Many factors could cause actual results to differ materially from those projected in forward-looking statements, including the risks described in Part I, Item 1A, "Risk Factors," in our 2010 Form 10-K as supplemented or modified in our quarterly reports on Form 10-Q. We do not undertake any duty to update forward-looking statements after the date they are made or to conform them to actual results or to changes in circumstances or expectations.

Available Information

We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, available free of charge on our website, www.nautilusinc.com. In addition, our Code of Business Conduct and Ethics, corporate governance policies, and the charters of our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee are available on our corporate website. The information presented on our website is not part of this report.

OVERVIEW

Nautilus is committed to providing innovative, quality solutions to help people achieve a fit and healthy lifestyle. Our principal business activities include designing, developing, sourcing and marketing high-quality cardiovascular and strength fitness products and related accessories for consumer home use, primarily in the United States and Canada. Our products are sold under some of the most recognized brand names in the fitness industry, including Nautilus®, Bowflex®, Schwinn®, Schwinn Fitness™ and Universal®.

We market our products through two distinct distribution channels, Direct and Retail, which we consider to be separate business segments. Our Direct business offers products to consumers through television advertising, the Internet and catalogs. Our Retail business offers our products through a network of third-party retailers with stores and websites located in the United States and internationally.

Net sales for the third quarter ended September 30, 2011 were \$37.4 million, a decrease of \$1.1 million, or 2.8%, as compared to net sales of \$38.5 million for the third quarter of 2010. The decrease in net sales primarily reflected a decline of \$2.4 million, or 14.9%, in our Retail segment compared to the third quarter of 2010. Lower Retail sales were primarily attributable to a 2010 third quarter sales promotion that was not repeated in the third quarter this year, a shift in the timing of certain customer orders and generally soft demand from national retailers. Net sales in our Direct segment for the third quarter of 2011 rose \$1.1 million, or 5.3% compared to the 2010 third quarter, largely due to continued strong demand for our TreadClimbers. This increase was offset in part by comparably lower sales for home gyms and other strength products. Growth in TreadClimber sales continues to be driven by consumer acceptance, more effective media advertising and improving consumer credit approval rates. Based on sales trends observed during the last three quarters, we expect that increased sales of cardio products should more than offset anticipated declines in strength product sales for the full year 2011.

Income from continuing operations was \$0.3 million for the third quarter ended September 30, 2011, compared to a loss from continuing operations of \$2.4 million for the third quarter of 2010. Diluted income per share from continuing operations for the third quarter of 2011 was \$0.01, compared to a diluted loss per share of \$(0.08) for the same quarter of 2010. The significant improvement in results of continuing operations for the third quarter of 2011 was primarily attributable to a 16.8% reduction in operating expenses achieved through more cost efficient media advertising expenditures. Selling and marketing expenses for the third quarter of 2011, as a percent of net sales, declined to 30.8% from 37.3% for the comparable 2010 period.

Net loss for the third quarter ended September 30, 2011 was \$0.1 million, an improvement of \$4.2 million, or 97.9%, over net loss of \$4.3 million for the third quarter of 2010. Basic and diluted net loss per share for the third quarter of 2011 was breakeven \$(0.00), as compared to basic and diluted net loss per share of \$(0.14) for the same quarter of 2010.

During the third quarter of 2011, we continued to allocate a larger portion of our media expenditures toward our TreadClimber product line, compared to 2010, and we expect to direct the majority of such expenditures to this product category and a new product introduction during the remainder of this year. In addition, we began implementing a lower cost Internet-based advertising strategy for our home gyms in 2011, which is designed to capitalize on the extensive product awareness that currently exists among consumers for our Bowflex rod-based home gyms.

COMPARISON OF OPERATING RESULTS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010

The following table compares selected financial information in our condensed consolidated statements of operations for the three months ended September 30, 2011 and 2010 (unaudited and in thousands):

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| | Three months ended September 30, | | Change | | |
|--|----------------------------------|-----------|-----------|---------|----|
| | 2011 | 2010 | \$ | % | |
| Net sales | \$37,402 | \$38,474 | \$(1,072) | (2.8) |)% |
| Cost of sales | 21,605 | 21,856 | (251) | (1.1) |)% |
| Gross margin | 15,797 | 16,618 | (821) | (4.9) |)% |
| Operating expenses: | | | | | |
| Selling and marketing | 11,517 | 14,347 | (2,830) | (19.7) |)% |
| General and administrative | 4,134 | 4,797 | (663) | (13.8) |)% |
| Research and development | 859 | 699 | 160 | 22.9 | % |
| Total operating expenses | 16,510 | 19,843 | (3,333) | (16.8) |)% |
| Operating loss | (713) | (3,225) | 2,512 | 77.9 | % |
| Other income (expense): | | | | | |
| Interest income | 5 | 4 | 1 | 25.0 | % |
| Interest expense | (116) | (9) | (107) | n.m. | |
| Other | (65) | 343 | (408) | n.m. | |
| Total other income (expense) | (176) | 338 | (514) | n.m. | |
| Loss before income taxes | (889) | (2,887) | 1,998 | 69.2 | % |
| Income tax benefit | (1,170) | (489) | (681) | (139.3) |)% |
| Income (loss) from continuing operations | 281 | (2,398) | 2,679 | n.m. | |
| Loss from discontinued operation, net of tax | (373) | (1,908) | 1,535 | 80.5 | % |
| Net loss | \$(92) | \$(4,306) | \$4,214 | 97.9 | % |

The following table compares the net sales and gross margins of our business segments for the three months ended September 30, 2011 and 2010 (unaudited and in thousands):

| | Three months ended September 30, | | Change | | |
|-----------------------|----------------------------------|----------|-----------|--------|--------------|
| | 2011 | 2010 | \$ | % | |
| Net sales: | | | | | |
| Direct | \$22,645 | \$21,504 | \$1,141 | 5.3 | % |
| Retail | 13,710 | 16,118 | (2,408) | (14.9) |)% |
| Royalty income | 1,047 | 852 | 195 | 22.9 | % |
| | \$37,402 | \$38,474 | \$(1,072) | (2.8) |)% |
| Gross margin: | | | | | |
| Direct | \$11,784 | \$11,839 | \$(55) | (0.5) |)% |
| Retail | 2,966 | 3,926 | (960) | (24.4) |)% |
| Royalty income | 1,047 | 853 | 194 | 22.7 | % |
| | \$15,797 | \$16,618 | \$(821) | (4.9) |)% |
| Gross margin percent: | | | | | |
| Direct | 52.0 | % 55.1 | % (310) |) | basis points |
| Retail | 21.6 | % 24.4 | % (280) |) | basis points |

The following table compares the net sales of our major product lines within each business segment for the three months ended September 30, 2011 and 2010 (in thousands):

| | Three months ended | | Change | | |
|----------------------------------|-----------------------|-----------|-----------|---|----------|
| | September 30, 2011 | 2010 | \$ | | % |
| Direct net sales: | | | | | |
| Cardio products ⁽¹⁾ | \$ 16,754 | \$ 11,434 | \$ 5,320 | | 46.5 % |
| Strength products ⁽²⁾ | 5,891 | 10,070 | (4,179 |) | (41.5)% |
| | 22,645 | 21,504 | 1,141 | | 5.3 % |
| Retail net sales: | | | | | |
| Cardio products ⁽¹⁾ | 9,041 | 11,236 | (2,195 |) | (19.5)% |
| Strength products ⁽²⁾ | 4,669 | 4,882 | (213 |) | (4.4)% |
| | 13,710 | 16,118 | (2,408 |) | (14.9)% |
| Royalty income | 1,047 | 852 | 195 | | 22.9 % |
| | \$ 37,402 | \$ 38,474 | \$ (1,072 |) | (2.8)% |

(1) Cardio products include: TreadClimbers, treadmills, exercise bikes and ellipticals.

(2) Strength products include: home gyms, selectorized dumbbells, kettlebell weights, weight benches and accessories.

Direct

Net sales for our Direct business totaled \$22.6 million for the third quarter of 2011, an increase of \$1.1 million, or 5.3%, compared to Direct net sales of \$21.5 million for the third quarter of 2010. The comparative increase in net sales of our Direct business for the third quarter of 2011 reflected a \$5.3 million, or 46.5%, increase in sales of cardio products, driven by continued strong demand for our TreadClimber products. We believe higher comparable Direct net sales underscores broadening product appeal, the effectiveness of our media advertising strategy, as well as improved consumer credit approval rates, discussed below. The increase in sales of cardio products was partially offset by a \$4.2 million, or 41.5%, decline in sales of strength products, primarily due to comparatively lower sales of rod-based home gyms and a product pricing strategy used during the third quarter of 2010 that was not repeated in 2011. The decline in sales of rod-based home gyms was attributable in part to the cessation of television advertising for these products, as television ad spending on this mature product category was generating unsatisfactory returns. We have marketed rod-based home gyms through more cost efficient online media since early 2011. Based on recent sales trends, we expect that increased sales of TreadClimber products will continue to more than offset anticipated declines in home gym sales through our Direct channel for the full year 2011.

In September 2010, we completed our transition to a new consumer credit program with a new primary third-party financing provider, GE Capital Retail Bank, formerly GE Money Bank ("GE"). Prior to this transition, we had experienced continued declines in consumer credit approval rates by our previous third-party provider of consumer financing. In addition, we added one secondary third-party consumer credit financing provider during 2010 and another in early 2011, both of which offer credit to certain qualified consumers whose credit applications have been declined by GE. As a result, combined consumer credit approvals by our primary and secondary third-party U.S. financing providers increased from 21% in the third quarter of 2010 to 27% in the third quarter of 2011. Management expects combined consumer credit approval rates during the remainder of 2011 to remain at approximately the same level as the third quarter of 2011.

Gross margin for our Direct business was 52.0% of net sales for the third quarter of 2011, a decrease of 310 basis points compared to the third quarter of 2010. The comparative decrease in Direct gross margin percent was attributable primarily to higher freight and warranty expenses, offset in part by improved product margins.

Retail

Net sales for our Retail business totaled \$13.7 million for the third quarter of 2011, a decrease of \$2.4 million, or 14.9%, compared to Retail net sales of \$16.1 million for the third quarter of 2010. The decrease in Retail net sales was attributable primarily to a third quarter 2010 sales promotion that was not repeated in the third quarter this year, as well as a shift in the timing of certain customer orders from the third quarter to the fourth quarter of 2011 and overall soft demand among retailers.

Gross margin for our Retail business was 21.6% of net sales for the third quarter of 2011, a decrease of 280 basis points compared to the third quarter of 2010, primarily due to higher supply chain costs combined with the effect of lower sales volume, partially offset by improved product margins.

Operating Expenses

Operating expenses totaled \$16.5 million for the third quarter of 2011, an improvement of \$3.3 million, or 16.8%, compared to operating expenses of \$19.8 million for the third quarter of 2010. The improvement is principally due to more cost effective media advertising expenditures, combined with a lower general and administrative cost structure, offset in part by higher research and development expenses as we invest in new product development resources and capabilities.

Selling and Marketing

Selling and marketing expenses were \$11.5 million for the third quarter of 2011, a decrease of \$2.8 million, or 19.7%, compared to the third quarter of 2010. Advertising expense for our Direct business was \$5.9 million for the third quarter of 2011, a decline of \$2.5 million, or 29.9%, compared to the third quarter of 2010. The comparative decrease in Direct advertising expense from the prior year period was attributable primarily to the effectiveness of our media advertising, which enabled more efficient spending. Lower comparable Direct advertising expenses were offset in part by higher consumer credit financing costs, as a result of higher credit approval rates and the availability of additional secondary financing providers during the 2011 period as compared to the comparable period in 2010.

General and Administrative

General and administrative expenses were \$4.1 million for the third quarter of 2011, a decrease of \$0.7 million, or 13.8%, compared to the third quarter of 2010, primarily due to lower depreciation, personnel and legal expenses.

Research and Development

Research and development expenses were \$0.9 million for the third quarter of 2011, an increase of \$0.2 million, or 22.9%, compared to the third quarter of 2010. We expect research and development expenses to increase for the full year 2011, as compared to 2010, as we invest in new product development resources and capabilities.

Other Income and Expense

Interest Expense

Interest expense of \$0.1 million for the third quarter of 2011 was incurred in connection with our long-term subordinated notes. We incurred only a nominal amount of interest expense in the third quarter of 2010.

Other Income (Expense)

Other expense was \$0.1 million for the third quarter of 2011, compared to other income of \$0.3 million the third quarter of 2010, primarily due to foreign currency exchange rate fluctuations.

Income Tax Benefit

Income tax benefit was \$1.2 million for the third quarter of 2011, compared to income tax benefit of \$0.5 million for the third quarter of 2010. Our income tax benefit for the third quarter of 2011 was primarily related to the Company's pre-tax loss in the third quarter of 2011. The income tax benefit for the third quarter of 2010 was attributable to an income tax refund claim filed in the period.

Discontinued Operation

Our Commercial business discontinued operation resulted in a loss of \$0.4 million for the third quarter of 2011, compared to a loss of \$1.9 million for the third quarter of 2010, as we completed the disposal of our former Commercial business in April 2011. We may incur additional expenses in future periods in connection with the settlement of contingencies arising from and directly related to the Commercial business prior to its disposal. Loss from discontinued operation for the third quarter of 2011 and 2010 was net of a reduction in the amount of pre-tax disposal loss previously estimated in connection with the divestiture of \$0.3 million and \$0.8 million, respectively.

COMPARISON OF OPERATING RESULTS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010

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The following table compares selected financial information in our condensed consolidated statements of operations for the nine months ended September 30, 2011 and 2010 (unaudited and in thousands):

| | Nine months ended September 30, | | Change | | |
|--|---------------------------------|------------|-----------|--------|----|
| | 2011 | 2010 | \$ | % | |
| Net sales | \$ 120,427 | \$ 114,760 | \$ 5,667 | 4.9 | % |
| Cost of sales | 68,000 | 61,708 | 6,292 | 10.2 | % |
| Gross margin | 52,427 | 53,052 | (625) | (1.2) |)% |
| Operating expenses: | | | | | |
| Selling and marketing | 38,601 | 47,935 | (9,334) | (19.5) |)% |
| General and administrative | 13,103 | 14,750 | (1,647) | (11.2) |)% |
| Research and development | 2,336 | 2,290 | 46 | 2.0 | % |
| Total operating expenses | 54,040 | 64,975 | (10,935) | (16.8) |)% |
| Operating loss | (1,613) | (11,923) | 10,310 | 86.5 | % |
| Other income (expense): | | | | | |
| Interest income | 14 | 15 | (1) | (6.7) |)% |
| Interest expense | (348) | (9) | (339) | n.m. | |
| Other | 17 | 284 | (267) | (94.0) |)% |
| Total other income (expense) | (317) | 290 | (607) | n.m. | |
| Loss before income taxes | (1,930) | (11,633) | 9,703 | 83.4 | % |
| Income tax (benefit) expense | (1,136) | 130 | (1,266) | n.m. | |
| Loss from continuing operations | (794) | (11,763) | 10,969 | 93.3 | % |
| Loss from discontinued operation, net of tax | (960) | (11,039) | 10,079 | 91.3 | % |
| Net loss | \$(1,754) | \$(22,802) | \$ 21,048 | 92.3 | % |

The following table compares the net sales and gross margins of our business segments for the nine months ended September 30, 2011 and 2010 (unaudited and in thousands):

| | Nine months ended September 30, | | Change | | |
|-----------------------|---------------------------------|------------|----------|--------|--------------|
| | 2011 | 2010 | \$ | % | |
| Net sales: | | | | | |
| Direct | \$ 75,354 | \$ 68,450 | \$ 6,904 | 10.1 | % |
| Retail | 42,090 | 43,869 | (1,779) | (4.1) |)% |
| Royalty income | 2,983 | 2,441 | 542 | 22.2 | % |
| | \$ 120,427 | \$ 114,760 | \$ 5,667 | 4.9 | % |
| Gross margin: | | | | | |
| Direct | \$ 40,037 | \$ 39,352 | \$ 685 | 1.7 | % |
| Retail | 9,407 | 11,256 | (1,849) | (16.4) |)% |
| Royalty income | 2,983 | 2,444 | 539 | 22.1 | % |
| | \$ 52,427 | \$ 53,052 | \$(625) | (1.2) |)% |
| Gross margin percent: | | | | | |
| Direct | 53.1 | % 57.5 | % (440) |) | basis points |
| Retail | 22.4 | % 25.7 | % (330) |) | basis points |

The following table compares the net sales of our major product lines within each business segment for the nine months ended September 30, 2011 and 2010 (in thousands):

| | Nine months ended September 30, | | Change | | |
|----------------------------------|---------------------------------|-----------|----------|--------|---|
| | 2011 | 2010 | \$ | % | |
| Direct net sales: | | | | | |
| Cardio products ⁽¹⁾ | \$52,017 | \$36,879 | \$15,138 | 41.0 | % |
| Strength products ⁽²⁾ | 23,337 | 31,571 | (8,234) | (26.1) | % |
| | 75,354 | 68,450 | 6,904 | 10.1 | % |
| Retail net sales: | | | | | |
| Cardio products ⁽¹⁾ | 25,790 | 29,310 | (3,520) | (12.0) | % |
| Strength products ⁽²⁾ | 16,300 | 14,558 | 1,742 | 12.0 | % |
| | 42,090 | 43,868 | (1,778) | (4.1) | % |
| Royalty income | 2,983 | 2,441 | 542 | 22.2 | % |
| | \$120,427 | \$114,759 | \$5,668 | 4.9 | % |

(1) Cardio products include: TreadClimbers, treadmills, exercise bikes and ellipticals.

(2) Strength products include: home gyms, selectorized dumbbells, kettlebell weights, weight benches and accessories.

Direct

Net sales for our Direct business totaled \$75.4 million for the nine months ended September 30, 2011, an increase of \$6.9 million, or 10.1%, compared to \$68.5 million for the nine months ended September 30, 2010. The comparative increase in net sales in our Direct business for the first nine months of 2011 over 2010 reflected a \$15.1 million, or 41.0%, increase in sales of cardio products, particularly the TreadClimber product category. We believe higher Direct net sales demonstrates broadening product appeal and the effectiveness of our media advertising strategy, as well as improved consumer credit approval rates. The increase in sales of cardio products was partially offset by an \$8.2 million, or 26.1%, comparative decline in sales of strength products, primarily due to lower sales of rod-based home gyms in the 2011 period. The decline in sales of rod-based home gyms is attributable in part to the cessation of television advertising for these products, as television ad spending on this mature product category was generating unsatisfactory returns. We have marketed rod-based home gyms through more cost efficient online media since early 2011. Based on recent sales trends, we expect that increased sales of TreadClimber products will continue to more than offset anticipated declines in home gym sales through our Direct channel for the full year 2011.

In September 2010, we completed our transition to a new consumer credit program with a new primary third-party financing provider, GE Capital Retail Bank, formerly GE Money Bank ("GE"). Prior to this transition, we had experienced continued declines in consumer credit approval rates by our previous third-party provider of consumer financing. In addition, we added one secondary third-party consumer credit financing provider during the third quarter of 2010 and another in early 2011, both of which offer credit to certain qualified consumers whose credit applications have been declined by GE. As a result, combined consumer credit approvals by our primary and secondary U.S. third-party financing providers increased from 14% in the first nine months of 2010 to 24% in the first nine months of 2011.

Gross margin for our Direct business was 53.1% of net sales for the nine months ended September 30, 2011, a decrease of 440 basis points compared to the nine months ended September 30, 2010. The comparative decrease in Direct gross margin percent was attributable primarily to higher freight and warranty expense, as well as to lower product margins.

Retail Business

Net sales for our Retail business totaled \$42.1 million for the nine months ended September 30, 2011, a decrease of \$1.8 million, or 4.1%, compared to Retail net sales of \$43.9 million for the nine months ended September 30, 2010. The decrease in Retail net sales was attributable primarily to a \$3.5 million, or 12.0%, decline in net sales of cardio products owing to (i) a third quarter 2010 sales promotion that was not repeated in 2011, (ii) a shift in the timing of certain customer orders from the third quarter to the fourth quarter of 2011 and (iii) overall soft demand among retailers. The decline in the cardio category was offset in part by a comparative increase in Retail net sales of strength products, driven largely by growth among our e-commerce Retail customers.

Gross margin for our Retail business was 22.4% of net sales for the nine months ended September 30, 2011, a decrease of 330

basis points compared to the nine months ended September 30, 2010, primarily due to higher supply chain management costs and its relative effect when combined with lower sales volume.

Operating Expenses

Operating expenses totaled \$54.0 million for the nine months ended September 30, 2011, an improvement of \$10.9 million, or 16.8%, compared to operating expenses of \$65.0 million for the nine months ended September 30, 2010, principally due to a \$9.3 million, or 19.5%, reduction in selling and marketing expenses. The reduction was achieved primarily through more effective media advertising, which enabled more efficient spending. A \$1.6 million, or 11.2%, reduction in general and administrative expenses compared to the prior year period also contributed to lower comparative total operating expenses for the nine-month period ended September 30, 2011.

Selling and Marketing

Selling and marketing expenses were \$38.6 million for the nine months ended September 30, 2011, a decrease of \$9.3 million, or 19.5%, compared to the nine months ended September 30, 2010. Advertising expenses for our Direct business were \$20.0 million for the first nine months of 2011, a decrease of \$11.1 million, or 35.6%, compared to the first nine months of 2010. The comparative decrease in Direct advertising expenses was primarily attributable to management's decision in early 2011 to shift advertising away from the mature home-gym category and to increase the media investment in our TreadClimber product line. Since early 2011, we have marketed home gyms through more cost efficient online media. Lower comparable Direct advertising expenses were offset in part by higher consumer credit financing costs, as a result of sequentially improving consumer credit approval rates, and the availability of additional secondary consumer financing providers in 2011, as compared to 2010.

General and Administrative

General and administrative expenses were \$13.1 million for the nine months ended September 30, 2011, a decrease of \$1.6 million, or 11.2%, compared to the nine months ended September 30, 2010, primarily due to reduced depreciation, personnel and legal expenses.

Research and Development

Research and development expenses were \$2.3 million for the nine months ended September 30, 2011, an increase of 2.0% compared to the nine months ended September 30, 2010. We expect research and development expenses to increase for the full year 2011, compared to 2010, as we invest in new product development resources and capabilities.

Other Income and Expense

Interest Expense

Interest expense was \$0.3 million for the nine months ended September 30, 2011 in connection with our long-term subordinated notes, which were issued in September 2010. We incurred only a nominal amount of interest expense in the nine months ended September 30, 2010.

Other Income (Expense)

Other expense was insignificant for the nine months ended September 30, 2011, compared to other income of \$0.3 million the nine months ended September 30, 2010, which was primarily due to foreign currency exchange rate

fluctuations.

Income Tax Expense

Income tax benefit was \$1.1 million for the nine months ended September 30, 2011, compared to income tax expense of \$0.1 million for the nine months ended September 30, 2010. Our income tax benefit for the first nine months of 2011 was primarily related to the Company's pre-tax loss generated in the United States. Income tax expense for the first nine months of 2010 was attributable to taxable income generated outside of the United States.

Discontinued Operation

Our Commercial business discontinued operation resulted in a loss of \$1.0 million for the nine months ended September 30,

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2011, compared to a loss of \$11.0 million for the nine months ended September 30, 2010, as we completed the disposal of our former Commercial business in early 2011. We may incur additional expenses in future periods in connection with the settlement of contingencies arising from and directly related to the Commercial business prior to its disposal. Loss from discontinued operation in the first nine months of 2011 and 2010 was net of a reduction in the amount of pre-tax disposal loss previously estimated in connection with the divestiture of \$0.9 million and \$3.2 million, respectively.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2011, we had \$11.5 million of cash and cash equivalents, compared to \$14.3 million as of December 31, 2010. Cash used in operating activities was \$1.6 million for the nine months ended September 30, 2011, compared to \$9.4 million for the nine months ended September 30, 2010. The improvement in net cash used in operating activities for the first nine months of 2011, compared to the first nine months of 2010, was primarily due to the reduction of losses from both our continuing operations and our discontinued Commercial business. The cash flow effect of such losses in the first nine months of 2010 was partially offset by income tax refunds of \$12.6 million received during that period. Management believes that sufficient funds will be available to meet our expected cash needs for at least the next twelve months based upon cash on hand and anticipated cash flows from operations.

Cash provided by the reduction of trade receivables was \$8.0 million for the nine months ended September 30, 2011, compared to \$13.5 million for the nine months ended September 30, 2010. The comparatively higher reduction in receivables during the 2010 nine-month period reflects the collection of outstanding accounts receivables of our discontinued Commercial business. Similarly, cash used in reducing trade payables was \$6.7 million for the nine months ended September 30, 2011, compared to \$18.5 million for the nine months ended September 30, 2010, primarily due to the settlement of outstanding trade payables of our discontinued Commercial business during the prior year period. We used \$3.1 million in cash during the nine months ended September 30, 2011 to improve our inventory in-stock condition in order to meet our future sales expectations.

Trade receivables were \$11.5 million as of September 30, 2011, compared to \$19.6 million at the end of 2010, reflecting seasonally lower activity with our Retail business customers, combined with a modest improvement in days sales outstanding ("DSO") in receivables. Trade payables decreased to \$17.8 million as of September 30, 2011, compared to \$24.5 million at December 31, 2010, due to a seasonally lower overall level of business activity between the fourth quarter of 2010 and the 2011 third quarter.

Cash used in investing activities of \$0.7 million for the nine months ended September 30, 2011 consisted of \$2.1 million used for the development of new computer software and purchases of tooling for new cardio products, partially offset by \$1.0 million in proceeds from the sale of portions of our discontinued Commercial business. Cash provided by investing activities of \$11.2 million for the nine months ended September 30, 2010 included \$6.9 million in proceeds from the sale of portions of our discontinued Commercial business and a \$4.4 million net decrease in the amount of restricted cash collateralizing our then-outstanding letters of credit. We do not expect cash provided by the sale of our discontinued Commercial business to be material in future periods.

Cash provided by financing activities during the nine months ended September 30, 2010 was primarily attributable to a note purchase agreement with the Company's former largest shareholder. For more information, see "Financing Arrangements."

Financing Arrangements

We have a Loan and Security Agreement (the "Loan Agreement") with Bank of the West, which provides a revolving secured credit line of up to \$15.0 million. The amount available for borrowings varies based upon the total amount of

eligible accounts receivable and inventory as of the end of the preceding month. The Loan Agreement is available for working capital, standby letters of credit and general corporate purposes through August 31, 2012, assuming we satisfy certain terms and conditions at the time borrowings are requested. The interest rate on future borrowings, if any, under the Loan Agreement will be based on the bank's Base Rate plus 150 to 225 basis points or LIBOR plus 225 to 325 basis points and our financial condition at the time we elect to borrow. The Loan Agreement includes a fee for the unused portion of the credit facility, which will vary depending on our borrowing base availability.

The Loan Agreement is collateralized by substantially all of our assets and contains customary covenants, including minimum current ratio, minimum liquidity, minimum EBITDA (defined as "earnings before interest, taxes, depreciation and amortization") and limitations on capital expenditures, mergers and acquisitions, indebtedness, liens, dispositions, dividends and investments. The Loan Agreement also contains customary events of default. Upon an event of default, the lender would have the option of accelerating all obligations under the Loan Agreement. Standby letters of credit under the Loan Agreement

are treated as a reduction of our available borrowing base.

On July 20, 2011, we entered into a Third Amendment (the “Amendment”) of the Loan Agreement. The effect of the Amendment was generally to ease the restrictiveness of certain provisions by increasing our borrowing availability, raising the limitation on our capital expenditures and reducing interest rates applicable to any outstanding amounts. The Amendment, dated effective June 30, 2011, increases the amount of eligible accounts receivable for calculating the borrowing base. Specifically, the Amendment (i) permits up to 40% of total accounts receivable included in the borrowing base to consist of receivables of a specific customer, an increase from the prior limitation of 25%; and (ii) permits accounts receivable of certain customers granted extended payment terms to be included in the borrowing base, subject to certain conditions and limitations. In addition, Bank of the West agreed to increase the limitation on our capital expenditures permitted in any one calendar year from \$1,500,000 to \$3,000,000, and to reduce the interest rate margins applied to amounts outstanding under the Loan Agreement.

As of September 30, 2011, we had no outstanding borrowings and \$3.2 million in standby letters of credit issued under the Loan Agreement. As of September 30, 2011, we were in compliance with the financial covenants of the Loan Agreement.

On September 3, 2010, we entered into a Note Purchase Agreement (the “Purchase Agreement”) with certain entities (collectively, the “Sherborne Purchasers”) under common control of Sherborne Investors GP, LLC and its affiliates (collectively “Sherborne”). Sherborne was formerly our largest shareholder and is controlled by Edward J. Bramson, our former Chairman and Chief Executive Officer, and Craig L. McKibben, a former member of our Board of Directors. Pursuant to the Purchase Agreement, we issued to the Sherborne Purchasers \$6,096,996 in aggregate principal amount at maturity of our Increasing Rate Senior Discount Notes due December 31, 2012 (the “Notes”). The Notes have an original principal amount totaling \$5,000,000 and mature on December 31, 2012. The then-outstanding principal amount of the Notes accretes value at rates equal to 2.5% per annum from September 3, 2010 through February 28, 2011; 6.0% per annum from March 1, 2011 through August 31, 2011; 9.5% per annum from September 1, 2011 through February 29, 2012; 13.0% per annum from March 1, 2012 through August 31, 2012; and 14.5% per annum thereafter. If all the Notes are paid at maturity, the effective rate of interest over the term of the Purchase Agreement would be approximately 8.7% per annum. Prepayment of amounts due under the Notes is permitted under the Purchase Agreement, subject to certain restrictions in both the Purchase Agreement and the Loan Agreement.

On July 19, 2011, beneficial interest in the Notes was assigned by the Sherborne Purchasers pro-rata to their respective investors in the manner permitted by the Purchase Agreement. Such assignment was made in connection with the resignation, of Messrs. Bramson and McKibben from their respective positions with Nautilus on May 26, 2011, and the subsequent pro-rata distribution by certain Sherborne-affiliated entities to their respective investors of the common stock of the Company owned by such entities.

The Notes are subordinated to the Loan Agreement. The Purchase Agreement includes certain negative covenants, including restrictions on the incurrence of additional indebtedness, liens, liquidation of assets, capital expenditures, payment of dividends, changes in our business operations and change of control transactions. The Purchase Agreement includes customary events of default, including nonpayment, insolvency, breach of warranty or covenant, cross-default of the Loan Agreement, material adverse changes and other events. Upon the occurrence of an event of default all outstanding obligations under the Notes may be declared due and payable. The accretion rate of the Notes may be increased by 2% per annum during the continuance of an event of default.

Commitments and Contingencies

For a description of our commitments and contingencies, refer to Note 11 to our condensed consolidated financial statements in Item 1 of this Form 10-Q.

Seasonality

We expect sales of fitness equipment products to vary seasonally. Sales are typically strongest in the first and fourth quarters of a calendar year and are generally weakest in the second quarter. During the spring and summer months, consumers tend to be more involved in outdoor activities, including exercise, which may affect sales of fitness equipment used indoors. This seasonality can have a significant effect on our operating results, inventory levels and working capital requirements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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Our critical accounting policies have not changed from those discussed in our 2010 Form 10-K.

PART II. OTHER INFORMATION

Item 6. Exhibits

The following exhibits are filed herewith.

| Exhibit No. | Description |
|-------------|--|
| 31.1 | Certification of Principal Executive Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification of Principal Financial Officer pursuant to Rule 13a-14 (a) of the Securities Exchange Act of 1934, as amended. |

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.

NAUTILUS, INC.

Date: November 14, 2011

By: /S/ Michael D. Mulholland
Michael D. Mulholland
Chief Financial Officer
(Principal Financial Officer and for the Registrant)