NATURAL ALTERNATIVES INTERNATIONAL INC
Form 10-Q
January 30, 2007
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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, 2006

000-15701

(Commission file number)

NATURAL ALTERNATIVES INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State of incorporation)**	**84-1007839** **(IRS Employer Identification No.)**
1185 Linda Vista Drive	
San Marcos, California 92078 **(Address of principal executive offices)**	**(760) 744-7340** **(Registrant s telephone number)**

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

Indicate by check mark whether NAI is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether NAI is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes x No

As of January 30, 2007, 6,886,482 shares of NAI s common stock were outstanding, net of 70,000 treasury shares.

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SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

Certain statements in this report, including information incorporated by reference, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements reflect current views about future events and financial performance based on certain assumptions. They include opinions, forecasts, intentions, plans, goals, projections, guidance, expectations, beliefs or other statements that are not statements of historical fact. Words such as may, will, should, could, would, expects, plans, believes, anticipates, intends, estimates, ap projects, or the negative or other variation of such words, and similar expressions may identify a statement as a forward-looking statement. Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focus and plans, and other characterizations of future events or circumstances, including statements expressing general optimism about future operating results, are forward-looking statements. Forward-looking statements in this report may include statements about:

- future financial and operating results, including projections of net sales, revenue, income, net income per share, profit margins, expenditures, liquidity and other financial items;
- our ability to develop relationships with new customers and maintain or improve existing customer relationships;
- development of new products, brands and marketing strategies;
- inventories and the adequacy and intended use of our facilities;
- distribution channels, product sales and performance and timing of product shipments;
- current or future customer orders;
- management s goals and plans for future operations;
- our ability to improve operational efficiencies, manage costs and business risks and improve or maintain profitability;
- growth, expansion, diversification and acquisition strategies, the success of such strategies, and the benefits we believe can be derived from such strategies;
- personnel;
- the outcome of regulatory, tax and litigation matters;
- sources and availability of raw materials;

operations outside the United States;

the adequacy of reserves and allowances;

overall industry and market performance;

competition;

current and future economic and political conditions;

the impact of accounting pronouncements; and

other assumptions described in this report underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements. Forward-looking statements are subject to certain events, risks, and uncertainties that may be outside of our control. When considering forward-looking statements, you should carefully review the risks, uncertainties and other cautionary statements in this report as they identify certain important factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. These factors include, among others, the risks described under Item 1A of Part II and elsewhere in this report, as well as in other reports and documents we file with the United States Securities and Exchange Commission (SEC).

Unless the context requires otherwise, all references in this report to the Company, NAI, we, our, and us refer to Natural Alternatives International, Inc. and, as applicable, Natural Alternatives International Europe S.A. (NAIE), Real Health Laboratories, Inc. (RHL) and our other wholly owned subsidiaries.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NATURAL ALTERNATIVES INTERNATIONAL, INC.

Condensed Consolidated Balance Sheets

(In thousands, except share and per share data)

	December 31, 2006 (Unaudited)	June 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 3,212	$ 2,157
Accounts receivable - less allowance for doubtful accounts of $159 at December 31, 2006 and $217 at June 30, 2006	4,689	12,839
Inventories, net	17,521	17,054
Deferred income taxes	1,251	1,059
Other current assets	1,828	1,916
Total current assets	28,501	35,025
Property and equipment, net	15,627	15,943
Goodwill and purchased intangibles, net	11,466	11,303
Other noncurrent assets, net	168	182
Total assets	$ 55,762	$ 62,453
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 5,692	$ 5,221
Accrued liabilities	2,445	2,265
Accrued compensation and employee benefits	1,341	1,964
Line of credit	2,000	9,574
Income taxes payable	477	1,063
Current portion of long-term debt	1,815	1,766
Total current liabilities	13,770	21,853
Long-term debt, less current portion	3,723	4,596
Deferred income taxes	1,260	1,260
Deferred rent	1,248	1,262
Long-term pension liability	220	191
Total liabilities	20,221	29,162
Commitments and contingencies		
Stockholders equity:		
Preferred stock; $0.01 par value; 500,000 shares authorized; none issued or outstanding		

Common stock; $0.01 par value; 20,000,000 shares authorized; issued and outstanding 6,947,182 at December 31, 2006 and 6,685,546 at June 30, 2006	68	67
Additional paid-in capital	16,707	15,331
Accumulated other comprehensive loss	(262)	(276)
Retained earnings	19,403	18,462
Treasury stock, at cost, 70,000 at December 31, 2006 and 61,000 shares at June 30, 2006	(375)	(293)
Total stockholders equity	35,541	33,291
Total liabilities and stockholders equity	$ 55,762	$ 62,453

See accompanying notes to condensed consolidated financial statements.

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NATURAL ALTERNATIVES INTERNATIONAL, INC.

Condensed Consolidated Statements Of Income And Comprehensive Income

(In thousands, except share and per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2006	2005	2006	2005
Net sales	$ 24,049	$ 19,945	$ 49,210	$ 41,845
Cost of goods sold	18,347	15,755	37,993	33,599
Gross profit	5,702	4,190	11,217	8,246
Selling, general & administrative expenses	4,737	3,347	9,420	6,725
Income from operations	965	843	1,797	1,521
Other income (expense):				
Interest income	4	16	5	26
Interest expense	(167)	(83)	(397)	(141)
Foreign exchange gain (loss)	48	(23)	56	(2)
Other, net	(4)	(3)	(13)	(3)
	(119)	(93)	(349)	(120)
Income before income taxes	846	750	1,448	1,401
Provision for income taxes	292	289	507	528
Net income	$ 554	$ 461	$ 941	$ 873
Unrealized gain (loss) resulting from change in fair value of derivative instruments, net of tax	21	(1)	14	(46)
Comprehensive income	$ 575	$ 460	$ 955	$ 827
Net income per common share:				
Basic	$ 0.08	$ 0.07	$ 0.14	$ 0.14
Diluted	$ 0.08	$ 0.07	$ 0.13	$ 0.13
Weighted average common shares outstanding:				
Basic	6,840,314	6,185,816	6,780,240	6,099,603
Diluted	7,184,910	6,485,091	7,189,213	6,477,097

See accompanying notes to condensed consolidated financial statements.

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NATURAL ALTERNATIVES INTERNATIONAL, INC.

Condensed Consolidated Statements Of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended December 31, 2006	Six Months Ended December 31, 2005
Cash flows from operating activities		
Net income	$ 941	$ 873
Adjustments to reconcile net income to net cash provided by operating activities:		
Reduction for uncollectible accounts receivable	(60)	(43)
Depreciation and amortization	1,687	1,469
Amortization of purchased intangibles	126	21
Non-cash compensation	96	26
Tax benefit from exercise of stock options	(442)	
Pension expense, net of contributions	29	50
Loss on disposal of assets	11	
Changes in operating assets and liabilities (net of effects of business acquisition):		
Accounts receivable	8,210	4,235
Inventories, net	(467)	(1,108)
Other assets	118	(184)
Accounts payable and accrued liabilities	13	(1,434)
Accrued compensation and employee benefits	(625)	(292)
Net cash provided by operating activities	9,637	3,613
Cash flows from investing activities		
Capital expenditures	(1,412)	(716)
Proceeds from sale of equipment	30	
Net cash paid for business acquisition		(5,617)
Net cash used in investing activities	(1,382)	(6,333)
Cash flows from financing activities		
Proceeds from long-term debt		3,800
Payments on long-term debt	(824)	(987)
Net payments on line of credit	(7,574)	
Tax benefit from exercise of stock options	442	
Repurchase of common stock	(82)	
Proceeds from issuance of common stock	838	226
Net cash provided by (used in) financing activities	(7,200)	3,039
Net increase in cash and cash equivalents	1,055	319
Cash and cash equivalents at beginning of period	2,157	1,916
Cash and cash equivalents at end of period	$ 3,212	$ 2,235

Supplemental disclosures of cash flow information

Cash paid during the period for:		
Interest	$ 375	$ 123
Taxes	$ 671	$ 495

See accompanying notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

A. Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

The accompanying interim unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and applicable rules and regulations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In management s opinion, all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows have been included and are of a normal, recurring nature. The results of operations for the three and six months ended December 31, 2006 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

You should read the financial statements and these notes, which are an integral part of the financial statements, together with our audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006 (2006 Annual Report). The accounting policies used to prepare the financial statements included in this report are the same as those described in the notes to the consolidated financial statements in our 2006 Annual Report unless otherwise noted below.

Certain reclassications to prior period information have been made to conform to current presentation. For the three and six months ended December 31, 2006, we reclassified $118,000 and $264,000, respectively, of shipping costs for our private label contract manufacturing sales from net sales to cost of goods sold on the Statements Of Income And Comprehensive Income in accordance with the Financial Accounting Standards Board (FASB) Emerging Issue Task Force (EITF) No. 00-10, Accounting for Shipping and Handling Fees and Costs. Shipping costs of $77,000 for the three months ended December 31, 2005 and $244,000 for the six months ended December 31, 2005, were reclassified to conform to this presentation change.

Net Income per Common Share

We compute net income per common share in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, Earnings Per Share. This statement requires the presentation of basic income per common share, using the weighted average number of common shares outstanding during the period, and diluted net income per common share, using the additional dilutive effect of all dilutive securities. The dilutive impact of stock options account for the additional weighted average shares of common stock outstanding for our diluted net income per common share computation. We calculated basic and diluted net income per common share as follows (in thousands, except per share data):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
Numerator				
Net income	$ 554	$ 461	$ 941	$ 873
Denominator				
Basic weighted average common shares outstanding	6,840	6,186	6,780	6,100
Dilutive effect of stock options	345	299	409	377
Diluted weighted average common shares outstanding	7,185	6,485	7,189	6,477
Basic net income per common share	$ 0.08	$ 0.07	$ 0.14	$ 0.14
Diluted net income per common share	$ 0.08	$ 0.07	$ 0.13	$ 0.13

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Shares related to stock options of 219,000 for the three months ended December 31, 2006, and 122,000 for the six months ended December 31, 2006, were excluded from the calculation of diluted net income per common share, as the effect of their inclusion would have been anti-dilutive.

Shares related to stock options of 697,000 for the three months ended December 31, 2005, and 446,000 for the six months ended December 31, 2005, were excluded from the calculation of diluted net income per common share, as the effect of their inclusion would have been anti-dilutive.

Stock-Based Compensation

We have an equity incentive plan under which we have granted nonqualified and incentive stock options to employees, non-employee directors and consultants. We also have an employee stock purchase plan. Effective July 1, 2005, we adopted the fair value recognition provisions of SFAS No. 123R, Share Based Payment (SFAS 123R), using the modified-prospective-transition method. Under that transition method, compensation cost is recognized (a) for all stock-based awards granted before, but not yet vested as of, July 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock Based Compensation, and (b) for all stock-based awards granted after July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated.

We estimated the fair value of the stock option awards at the date of grant and employee stock purchase plan shares at the beginning of the offering period using the Black-Scholes option valuation model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions. Black-Scholes utilizes assumptions related to volatility, the risk-free interest rate, the dividend yield (which is assumed to be zero, as we have not paid any cash dividends) and employee exercise behavior. Expected volatilities utilized in the model are based mainly on the historical volatility of our stock price and other factors. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect in the period of grant. The expected life of stock option grants is derived from historical and other factors.

Our net income has been reduced by stock based compensation expense of approximately $58,000 for the three months ended December 31, 2006 and $15,000 for the three months ended December 31, 2005. Our net income has been reduced by compensation expense of approximately $96,000 for the six months ended December 31, 2006 and $26,000 for the six months ended December 31, 2005.

B. Acquisition

On December 5, 2005, we acquired Real Health Laboratories, Inc. (RHL), an integrated direct marketer of branded nutritional supplements and other lifestyle products. RHL markets and distributes its own branded products as well as third party branded products, including a variety of high quality nutritional, beauty, skin care, exercise, lifestyle and other personal care products. RHL s operations include in-house creative, catalog design, supply chain management and call center and fulfillment activities.

The aggregate consideration given to the selling stockholders of RHL by NAI in connection with the acquisition was approximately $8.7 million, consisting of cash in the amount of $5.8 million and the issuance of 510,000 shares of NAI s authorized but unissued shares of common stock, $0.01 par value per share. Additionally, NAI assumed $590,000 of RHL s debt, which was repaid at the close of the acquisition, and agreed to pay $35,000 of the legal fees and expenses incurred by RHL and the selling stockholders in connection with the acquisition. At the close of the acquisition, RHL became a wholly owned subsidiary of NAI.

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The RHL acquisition was accounted for as a purchase business combination in accordance with Statement of Financial Accounting Standards No. 141 Business Combinations. Assets acquired and liabilities assumed were recorded at their fair values as of December 5, 2005 based on a preliminary valuation using management s estimates and assumptions and were subject to adjustment as certain preacquisition contingencies had not yet been finalized. In November 2006, the purchase price allocation was completed resulting in an increase of goodwill of approximately $289,000. The adjustment to the purchase price allocation resulted primarily from the finalization of the valuation of a pre-acquisition contingency related to the potential return of product from a rebate program offered by RHL prior to the acquisition date to introduce a new product and develop the RHL brand. During the allocation period, we obtained the necessary post rebate program follow on sales data needed to complete the analysis of the contingency and adjusted the preliminary purchase price allocation accordingly. The final allocation of the purchase price was allocated to the assets acquired and liabilities assumed at December 5, 2005 as follows (in thousands):

Current assets	$ 1,439
Property and equipment	132
Other assets	120
Goodwill	7,530
Intangibles:	
Distributor relationships	500
Direct consumer relationships	400
Tradenames	3,300
Non-compete agreements	10
Total assets acquired	13,431
Current liabilities	2,451
Deferred tax liability	1,634
Total liabilities assumed	4,085
Net assets acquired	9,346
Cash acquired	(191)
Debt assumed	590
Purchase price and debt assumed, net of cash acquired	$ 9,745

C. Goodwill and Purchased Intangibles

Goodwill and other acquisition-related intangibles as of December 31, 2006 were as follows (dollars in thousands):

	Amortization Life in Years	Gross Amount	Accumulated Amortization	Net Amount
Goodwill	N/A	$ 7,530	$	$ 7,530
Distributor relationships	13	500	(41)	459
Direct consumer relationships	9	400	(48)	352
Tradenames	20	3,300	(179)	3,121
Non-compete agreements	2	10	(6)	4
		$ 11,740	$ (274)	$ 11,466

The estimated future amortization expense of purchased intangible assets as of December 31, 2006 was as follows (in thousands):

Six months ending June 30, 2007	$ 126
Fiscal year 2008	249
Fiscal year 2009	247
Fiscal year 2010	247
Fiscal year 2011	247
Thereafter	2,820
	$ 3,936

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D. Inventories

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

	December 31, 2006	June 30, 2006
Raw materials	$ 8,914	$ 8,461
Work in progress	5,219	5,339
Finished goods	3,388	3,254
	$ 17,521	$ 17,054

E. Property and Equipment

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

	Depreciable Life In Years	December 31, 2006	June 30, 2006
Land	N/A	$ 393	$ 393
Building and building improvements	7 39	2,726	2,721
Machinery and equipment	3 12	20,188	20,208
Office equipment and furniture	3 5	4,271	3,843
Vehicles	3	204	204
Leasehold improvements	1 15	9,680	9,434
Total property and equipment		37,462	36,803
Less: accumulated depreciation and amortization		(21,835)	(20,860)
Property and equipment, net		$ 15,627	$ 15,943

F. Debt

We amended our credit facility on December 1, 2005 and again on March 29, 2006 to increase our working capital line of credit from $8.0 million to $12.0 million, extend the maturity date from November 1, 2006 to November 1, 2007 and modify certain financial covenants. We also obtained an additional $3.8 million term loan on December 5, 2005, to fund, in part, the cash purchase price of the RHL acquisition.

As a result of the amendments and additional term loan, our bank credit facility increased to a total of $20.9 million, comprised of a $12.0 million working capital line of credit and $8.9 million in term loans. The working capital line of credit is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has an interest rate of Prime Rate or LIBOR plus 1.75%, as elected by NAI from time to time, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. The term loans consist of a $1.1 million fifteen year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a $700,000 ten year term loan with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; a $1.8 million four year term loan, secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, at an interest rate of LIBOR plus 2.10%; a $1.5 million five year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%; and the $3.8 million four year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately $138,000 plus interest.

On January 24, 2007, we further amended our credit facility to extend the maturity date for the working capital line of credit from November 1, 2007 to November 1, 2008, and maintain the ratio of total liabilities/tangible net worth covenant at 1.25/1.0 for the remainder of the term of the credit facility.

As of December 31, 2006, the amount outstanding on the working capital line of credit was $2.0 million and the amount outstanding on the term loans was $5.5 million. As of December 31, 2006, we had $5.1 million available under the line of credit, net of a $134,000 outstanding letter of credit issued to our landlord.

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On September 22, 2006, NAIE, our wholly owned subsidiary, entered into a credit facility to provide it with a credit line of up to CHF 1,300,000, or approximately $1.0 million, which is the initial maximum aggregate amount that can be outstanding at any one time under the credit facility. This maximum amount will be reduced by CHF 160,000, or approximately $128,000, at the end of each year beginning on December 31, 2007. As of December 31, 2006, there was no outstanding balance under the credit facility.

The composite interest rate on all of our outstanding debt was 7.84% at December 31, 2006, and 6.36% at December 31, 2005.

G. Defined Benefit Pension Plan

We sponsor a defined benefit pension plan that provides retirement benefits to employees based generally on years of service and compensation during the last five years before retirement. Effective June 20, 1999, our Board of Directors amended the plan to freeze the accrued benefit of each plan member at its then current amount and to no longer allow inactive plan members or other employees to become active members of the plan. We contribute an amount not less than the minimum funding requirements of the Employee Retirement Income Security Act of 1974 nor more than the maximum tax-deductible amount.

The components included in the net periodic benefit for the periods ended December 31 were as follows (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
Interest cost	$ 21	$ 20	$ 42	$ 40
Expected return on plan assets	(27)	(23)	(54)	(46)
Net periodic benefit	$ (6)	$ (3)	$ (12)	$ (6)

H. Economic Dependency

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

	Three Months Ended December 31,				Six Months Ended December 31,			
	2006		2005		2006		2005	
	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales	Net Sales by Customer	% of Total Net Sales
Customer 1	$ 10,095	42%	$ 8,826	44%	$ 20,051	41%	$ 19,158	46%
Customer 2	7,341	31	6,323	32	14,870	30	13,918	33
	$ 17,436	73%	$ 15,149	76%	$ 34,921	71%	$ 33,076	79%

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We buy certain products from a limited number of raw material suppliers. The loss of any of these suppliers could have a material adverse impact on our net sales and net income. Raw material purchases from any one supplier representing 10% or more of the respective period s total raw material purchases were as follows (dollars in thousands):

	Three Months Ended December 31,				Six Months Ended December 31,			
	2006		2005		2006		2005	
	Raw Material Purchases by Supplier	% of Total Raw Material Purchases	Raw Material Purchases by Supplier	% of Total Raw Material Purchases	Raw Material Purchases by Supplier	% of Total Raw Material Purchases	Raw Material Purchases by Supplier	% of Total Raw Material Purchases
Supplier 1	$ 1,112	11%	$ 1,291	18%	$ 2,993	14%	$ 3,510	23%
Supplier 2	1,630	16	(a)	(a)	2,388	11	(a)	(a)
Supplier 3	1,276	12	1,582	22	2,341	11	2,613	17
	$ 4,018	39%	$ 2,873	40%	$ 7,722	36%	$ 6,123	40%

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

I. Segment Information

Before the first quarter of fiscal 2007, our business consisted of two reportable segments, as defined by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, identified as NAI and RHL, which was acquired on December 5, 2005.

Effective July 1, 2006, we changed our reporting segments to reflect the structure of our internal organization after the integration of previously outsourced fulfillment and call center activities for our Dr. Cherry Pathway to Healing® product line into RHL s existing operations. The new reportable segments are as follows:

- Private label contract manufacturing, in which we primarily provide manufacturing services to companies that market and distribute nutritional supplements and other health care products; and
- Branded products, in which we market and distribute branded nutritional supplements and other lifestyle products in the following distribution channels:
  - Direct-to-consumer marketing programs, under which we develop, manufacture and market our own products and work with nationally recognized physicians to develop brand name products that reflect their individual approaches to restoring, maintaining or improving health. These products are sold through a variety of distribution channels, including television programs, print media and the internet. The Dr. Cherry Pathway to Healing® product line is sold under a direct-to-consumer marketing program;
  - Food, Drug and Mass Market (FDM) retail channel in which we sell the Real Health® Laboratories nutritional supplement product line; and
  - As We Change (AWC) catalog, a lifestyle catalog geared towards women between the ages of 45 and 65, in which we sell our own branded products as well as third party products. The quarterly print catalog offers a variety of high quality nutritional, beauty, skin care, exercise, lifestyle and other personal care products.

We evaluate performance based on a number of factors, the primary performance measures for each segment being net sales and income or loss from operations (prior to corporate allocations). Operating income or loss for each segment does not include corporate general and administrative expenses, interest expense and other miscellaneous income and expense items. Corporate general and administrative expenses include, but are not limited to: human resources, legal, finance, information technology, and various other corporate level related expenses, which are not allocated to either segment. The accounting policies of our segments are the same as those described in the summary of significant accounting policies in Note A to the consolidated financial statements included in our 2006 Annual Report.

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Our operating results by business segment shown below for the three and six months ended December 31, 2005 have been restated to reflect our new reporting segments, with the exception of the information on total assets as we believe it would be impractical to restate such information. Accordingly, the total asset information is provided only for our new reporting segments as of December 31, 2006. Our operating results by business segment were as follows (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
Net Sales				
Private label contract manufacturing	$ 20,147	$ 17,440	$ 41,117	$ 37,314
Branded products	3,902	2,505	8,093	4,531
	$ 24,049	$ 19,945	$ 49,210	$ 41,845

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
Income from Operations				
Private label contract manufacturing	$ 3,004	$ 1,969	$ 5,722	$ 4,106
Branded products	10	381	218	648
Income from operations of reportable segments	3,014	2,350	5,940	4,754
Corporate expenses not allocated to segments	(2,049)	(1,507)	(4,143)	(3,233)
	$ 965	$ 843	$ 1,797	$ 1,521

	December 31,
	2006
Total Assets	
Private label contract manufacturing	$ 41,074
Branded products	14,688
	$ 55,762

Our private label contract manufacturing products are sold both in the United States and in markets outside the United States, including Europe, Australia and Japan. Our primary market outside the United States is Europe. Our branded products are sold in the United States.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
United States	$ 18,564	$ 14,801	$ 39,006	$ 31,931
Markets Outside the United States	5,485	5,144	10,204	9,914
Total Net Sales	$ 24,049	$ 19,945	$ 49,210	$ 41,845

Products manufactured by NAIE accounted for approximately 40% of net sales in markets outside the United States for the three months ended December 31, 2006, and 47% for the three months ended December 31, 2005. NAIE accounted for 45% of net sales in markets outside the United States for the six months ended December 31, 2006, and 48% for the six months ended December 31, 2005. No products manufactured by NAIE were sold in the United States during the six months ended December 31, 2006 and 2005.

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Assets and capital expenditures by geographic region, based on the location of the company or subsidiary at which they were located or made, were as follows (in thousands):

	Long-Lived Assets		Total Assets		Capital Expenditures Six Months Ended	
	December 31, 2006	June 30, 2006	December 31, 2006	June 30, 2006	December 31, 2006	December 31, 2005
United States	$ 27,013	$ 27,735	$ 50,584	$ 57,661	$ 707	$ 581
Europe	1,771	1,202	5,178	4,792	705	135
	$ 28,784	$ 28,937	$ 55,762	$ 62,453	$ 1,412	$ 716

J. Contingencies

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operation. However, a settlement payment or unfavorable outcome could adversely impact our results of operation. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

As of January 30, 2007, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

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

The following discussion and analysis is intended to help you understand our financial condition and results of operations for the three and six months ended December 31, 2006. You should read the following discussion and analysis together with our unaudited condensed consolidated financial statements and the notes to the condensed consolidated financial statements included under Item 1 in this report, as well as the risk factors and other information included in our 2006 Annual Report and other reports and documents we file with the SEC. Our future financial condition and results of operations will vary from our historical financial condition and results of operations described below.

Executive Overview

The following overview does not address all of the matters covered in the other sections of this Item 2 or other items in this report or contain all of the information that may be important to our stockholders or the investing public. This overview should be read in conjunction with the other sections of this Item 2 and this report.

Our primary business activity has been to provide private label contract manufacturing services to companies that market and distribute vitamins, minerals, herbs and other nutritional supplements, as well as other health care products, to consumers both within and outside the United States. Historically, our revenue has been largely dependent on sales to one or two private label contract manufacturing customers and subject to variations in the timing of such customers orders, which in turn is impacted by such customers internal marketing programs, supply chain management, entry into new markets and new product introductions.

A cornerstone of our business strategy is to achieve long-term growth and diversify our sales. We have sought and expect to continue to seek to diversify our sales both by developing relationships with additional, quality-oriented, private label contract manufacturing customers and developing and growing our own line of branded products. To that end, during fiscal 2006, we established relationships with two new private label contract manufacturing customers, and completed our acquisition of RHL, an integrated direct marketer of its own and third party branded nutritional supplements and other lifestyle products.

During the first six months of fiscal 2007, we achieved an 18% increase in our net sales over the comparable period last year. While we are pleased with our revenue growth, we also believe the source of the growth is important in the context of our overall business strategy. We saw sales from our branded products contribute approximately half of the 18% growth we achieved, primarily as a result of our acquisition of RHL, and saw sales to new private label contract manufacturing relationships established in fiscal 2006 contribute to an increase in our overall private label contract manufacturing sales. As a result, net sales to our two largest private label contract manufacturing customers as a percentage of our total net sales decreased to 71% from 79% in the comparable six month period last year.

We completed our integration of previously outsourced call center activities for our Dr. Cherry Pathway to Healing® product line into RHL s existing operation during the first quarter of fiscal 2007. While we expect to realize cost savings from the integration of previously outsourced activities, we anticipate any future savings will be invested in further expanding and marketing our branded products.

Income from operations increased 18% over the comparable six month period last year primarily due to incremental sales in our private label contract manufacturing business. The increase in income from operations of 18% over the comparable six month period was partially offset by additional interest expense relating to the acquisition of RHL and carrying costs of accounts receivable and inventory for one of the new private label contract manufacturing customers.

We believe our acquisition of RHL marked a significant advance in our efforts to achieve long-term growth and diversify our net sales by developing our own branded products sales and expanding our distribution channels. In addition to the cost savings we hope to achieve through our integration efforts and the elimination of duplicative costs, we also hope to achieve benefits related to the leading branded products in the FDM retail channel, the additional expertise in the direct marketing and retail channels, and the access to additional direct marketing and mass-market channels for our products and concepts that we acquired in the acquisition.

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During the remainder of fiscal 2007, we plan to continue to focus on:

Leveraging our state of the art, certified facilities to increase the value of the goods and services we provide to our highly valued private label contract manufacturing customers, and assist us in developing relationships with additional quality oriented customers;

Implementing focused initiatives to market our own branded products through RHL s distribution channels;

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

Identifying and evaluating additional acquisition opportunities that could increase product lines, expand distribution channels, enhance manufacturing capabilities or reduce risk associated with a variety of factors.

Looking forward, while there can be no assurance we will be able to continue to diversify our sales, that our new customer relationships will generate future sales or that we will realize all of the benefits we hope to realize from our RHL acquisition, we remain optimistic and expect to continue our long-term trend of annual revenue growth. However, we anticipate quarterly revenue fluctuations due to, among other things, the timing of customer orders and other factors.

Critical Accounting Policies and Estimates

The preparation of our financial statements requires that we make estimates and assumptions that affect the amounts reported in our financial statements and their accompanying notes. We have identified certain policies that we believe are important to the portrayal of our financial condition and results of operations. These policies require the application of significant judgment by our management. We base our estimates on our historical experience, industry standards, and various other assumptions that we believe are reasonable under the circumstances. Actual results could differ from these estimates under different assumptions or conditions. An adverse effect on our financial condition, changes in financial condition, and results of operations could occur if circumstances change that alter the various assumptions or conditions used in such estimates or assumptions.

Our critical accounting policies are discussed under Item 7 of our 2006 Annual Report. There have been no significant changes to these policies during the six months ended December 31, 2006.

Results of Operations

The results of our operations for the periods ended December 31 were as follows (in thousands, except per share amounts):

	Three Months Ended December 31,			Six Months Ended December 31,		
	2006	2005	Change	2006	2005	Change
Private label contract manufacturing	$ 20,147	$ 17,440	16%	$ 41,117	$ 37,314	10%
Branded products	3,902	2,505	56	8,093	4,531	79
Total net sales	24,049	19,945	21	49,210	41,845	18
Cost of goods sold	18,347	15,755	16	37,993	33,599	13
Gross profit	5,702	4,190	36	11,217	8,246	36
Gross profit %	23.7%	21.0%		22.8%	19.7%	
Selling, general & administrative expenses	4,737	3,347	42	9,420	6,725	40
% of net sales	19.7%	16.8%		19.1%	16.1%	
Income from operations	965	843	14	1,797	1,521	18

% of net sales		4.0%		4.2%			3.7%		3.6%	
Other expense, net		119		93	28		349		120	191
Income before taxes		846		750	13		1,448		1,401	3
% of net sales		3.5%		3.8%			2.9%		3.3%	
Net income	$	554	$	461	20	$	941	$	873	8
% of net sales		2.3%		2.3%			1.9%		2.1%	
Diluted net income per common share	$	0.08	$	0.07	14%	$	0.13	$	0.13	%

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The percentage increase in private label contract manufacturing net sales was primarily attributed to the following for the periods ended December 31:

	Three Months Ended	Six Months Ended
Arbonne International	3%[1]	6%[1]
Shaklee Corporation	5[2]	4[2]
Mannatech, Incorporated	6[3]	3[3]
NSA International, Inc.	6[4]	2[5]
Impact of foreign exchange rates	1	1
Other customers	(5)	(6)
Total	16%	10%

1 During fiscal 2006, we established a relationship with Arbonne International primarily for initial shipments of a single new product. During the first quarter of fiscal 2007, we had residual sales from the initial order of approximately $1.5 million.

2 During fiscal 2006, we established a relationship with Shaklee Corporation.

3 Net sales to Mannatech, Incorporated increased primarily as a result of higher volumes of established products in existing markets contributing eleven percentage points of net sales growth for the three month period and six percentage points of net sales growth for the six month period, partially offset by a shift in sales mix to lower priced products.

4 An increase in net sales to NSA International, Inc. over the comparable quarter last year resulted primarily from higher volumes of established products in existing markets, which contributed four percentage points of the net sales growth and higher average price per unit which contributed two percentage points of the net sales growth.

5 An increase in net sales to NSA International, Inc. over the comparable period last year resulted primarily from higher average price per unit.

The percentage increase in net sales of our branded products was primarily attributed to the acquisition of RHL on December 5, 2005.

Gross profit margin increased 2.7 percentage points from the comparable quarter and 3.1 percentage points from the comparable six month period last year. The change in gross profit margin was primarily due to the following for the periods ended December 31:

	Three Months Ended	Six Months Ended
RHL operations	2.1%	3.2%
Shift in sales mix	0.9	0.8
Reduced overhead expenses	1.2	0.1
Incremental inventory reserves	(0.7)	(0.4)
Incremental direct and indirect labor	(0.5)	(0.3)
Other	(0.3)	(0.3)
Total	2.7%	3.1%

Selling, general and administrative expenses increased $1.4 million, or 42%, from the comparable quarter last year and $2.7 million, or 40%, from the comparable year to date period last year. The increase is primarily attributed to incremental selling, general and administrative expenses for our branded products segment of $1.3 million for the three months and $3.1 million for the six months ended December 31, 2006 as a result of the RHL acquisition.

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Other expense, net increased $26,000 from the comparable quarter and $229,000 from the comparable year to date period last year primarily due to an increase in interest expense of $84,000 over the comparable quarter and $256,000 over the comparable year to date period last year, partially offset by a decrease in foreign exchange loss of $71,000 from the comparable quarter and $58,000 from the comparable year to date period last year due to the strengthening of the Euro and the related impact on the translation of Euro denominated cash and receivables. The increase in interest expense was primarily due to an additional $3.8 million term loan obtained in December 2005 to partially fund the RHL acquisition; an increase in our weighted average interest rate on our variable rate debt; and an incremental utilization of our line of credit to fund the carrying costs of accounts receivable and inventory for one of our new private label contract manufacturing customers.

Liquidity and Capital Resources

Our primary sources of liquidity and capital resources are cash flows provided by operating activities and the availability of borrowings under our credit facility. Net cash provided by operating activities was $9.6 million for the six months ended December 31, 2006 compared to $3.6 million in the comparable year to date period in the prior year.

At December 31, 2006, changes in accounts receivable, consisting primarily of amounts due from our private label contract manufacturing customers, provided $8.2 million in cash during the six months ended December 31, 2006 compared to $4.2 million in the comparable year to date period in the prior year. Cash provided by accounts receivable in the six months ended December 31, 2006 and 2005 was due to the collection of receivables from fourth quarter sales, which in each case represented then record quarterly sales. Days sales outstanding was 33 days as of December 31, 2006 compared to 38 days as of December 31, 2005.

Approximately $1.6 million of our operating cash flow was generated by NAIE in the six months ended December 31, 2006. As of December 31, 2006, NAIE s undistributed retained earnings were considered indefinitely reinvested.

Capital expenditures were $1.4 million during the six months ended December 31, 2006 compared to $716,000 in the comparable year to date period in the prior year. Capital expenditures during the six months ended December 31, 2006 were primarily for manufacturing equipment in our Vista, California and Manno, Switzerland facilities and call center computer software and hardware for our RHL facility.

Our consolidated debt decreased to $7.5 million at December 31, 2006 from $15.9 million at June 30, 2006 primarily due to payments made on our outstanding working capital line of credit.

We have a bank credit facility of $20.9 million, comprised of a $12.0 million working capital line of credit and $8.9 million in term loans. The working capital line of credit is secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, has an interest rate of Prime Rate or LIBOR plus 1.75%, as elected by NAI from time to time, and borrowings are subject to eligibility requirements for current accounts receivable and inventory balances. The term loans consist of a $1.1 million fifteen year term loan due June 2011, secured by our San Marcos building, at an interest rate of 8.25%; a $700,000 ten year term loan with a twenty year amortization, secured by our San Marcos building, at an interest rate of LIBOR plus 2.25%; a $1.8 million four year term loan, secured by our accounts receivable and other rights to payment, general intangibles, inventory and equipment, at an interest rate of LIBOR plus 2.10%; a $1.5 million five year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%; and a $3.8 million four year term loan, secured by equipment, at an interest rate of LIBOR plus 2.10%. Monthly payments on the term loans are approximately $138,000 plus interest.

We amended our credit facility on December 1, 2005 and again on March 29, 2006 to increase our working capital line of credit from $8.0 million to $12.0 million, extend the maturity date and modify certain financial covenants. The amendments included (i) an increase in our ratio of total liabilities/tangible net worth covenant from 1.25/1.0 to 1.75/1.0 through June 30, 2006 (the ratio returns to 1.25/1.0 from July 1, 2006 through June 30, 2007 and to 1.0/1.0 thereafter); (ii) a limit on capital expenditures of $5,500,000 for fiscal years 2006 and 2007; (iii) an extension of the maturity date for the working capital line of credit from November 1, 2006 to November 1, 2007; (iv) an increase in our ability to incur additional aggregate annual operating lease expenses from $100,000 to $500,000 without prior approval from the lender; (v) an increase in our ability to create specific indebtedness other than with our current lender from $0 to $1,000,000; (vi) replacement of the EBITDA coverage ratio with a fixed charge coverage ratio (aggregate of net profit after taxes, depreciation and amortization expenses and net contributions/aggregate current maturity of long-term debt and capitalized lease payments) not less than 1.25/1.0 as of each fiscal quarter end; (vii) an increase in borrowings against eligible inventory from $3.0 million to $6.0 million, provided the outstanding borrowings shall not at any time exceed eligible accounts receivable; (viii) a change in permissible accounts receivable concentration to allow up to 35% for a new customer acceptable to the lender; and (ix) a change in the calculation of the fixed charge coverage ratio (aggregate of net profit after taxes, depreciation and amortization expenses and net contributions/aggregate current maturity of long-term debt and capitalized lease payments) to a rolling 4-quarter basis from each fiscal quarter end.

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On January 24, 2007, we further amended our credit facility to extend the maturity date for the working capital line of credit from November 1, 2007 to November 1, 2008, and maintain the ratio of total liabilities/tangible net worth covenant at 1.25/1.0 for the remainder of the term of the credit facility.

As of December 31, 2006 the amount outstanding on the working capital line of credit was $2.0 million and the amount outstanding on the term loans was $5.5 million.

On September 22, 2006, NAIE, our wholly owned subsidiary, entered into a credit facility to provide it with a credit line of up to CHF 1,300,000, or approximately $1.0 million, which is the initial maximum aggregate amount that can be outstanding at any one time under the credit facility. This maximum amount will be reduced by CHF 160,000, or approximately $128,000, at the end of each year beginning on December 31, 2007. As of December 31, 2006, there was no outstanding balance under the credit facility.

Under the credit facility, NAIE may draw amounts either as current account loan credits to its current or future bank accounts or as fixed loans with a maximum term of 24 months. Current account loans will bear interest at the rate of 5% per annum. Fixed loans will bear interest at a rate determined by the parties based on current market conditions and must be repaid pursuant to a repayment schedule established by the parties at the time of the loan. In the event that a fixed loan is repaid early at NAIE s election or in connection with the termination of the credit facility, NAIE will be charged a pre-payment penalty equal to 0.1% of the principal amount of the fixed loan or CHF 1,000 (approximately $800), whichever is greater. The bank reserves the right to refuse individual requests for an advance under the credit facility, although its exercise of such right will not have the effect of terminating the credit facility as a whole.

On July 7, 2005, we purchased 12 option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The 12 options expired monthly beginning January 2006 and ending December 2006. The option contracts had a notional amount of $7.0 million, a weighted average strike price of $1.16, and a purchase price of $152,000. The risk of loss associated with the options was limited to the purchase price paid for the option contracts.

On April 6, 2006, we purchased seven option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The seven options expire monthly beginning January 2007 and ending July 2007. The option contracts had a notional amount of $4.9 million, a weighted average strike price of $1.16, and a purchase price of $62,000. The risk of loss associated with the options is limited to the purchase price paid for the option contracts.

On July 6, 2006, we sold the then unexpired options purchased on July 7, 2005 and April 6, 2006 for $13,000. The proceeds were used to purchase 12 option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The 12 options expire monthly beginning August 2006 and ending July 2007. The option contracts had a notional amount of $8.9 million, a weighted average strike price of $1.24, and a purchase price of $103,000. The risk of loss associated with the options is limited to the purchase price paid for the option contracts. As of December 31, 2006, five of the options had expired. The unrealized losses at the time of sale associated with the remaining options sold as of December 31, 2006 were $49,000 and will be recognized in cost of goods sold under the original monthly option contract expiration dates.

On January 18, 2007, we purchased three option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The three options expire monthly beginning August 2007 and ending October 2007. The option contracts had a notional amount of $1.9 million, a weighted average strike price of $1.24, and a purchase price of $12,000. The risk of loss associated with the options is limited to the purchase price paid for the option contracts.

There were no other derivative financial instruments at December 31, 2006.

As of December 31, 2006, we had $3.2 million in cash and cash equivalents and $5.1 million available under our line of credit, net of $134,000 outstanding letter of credit issued to our landlord. We believe our available cash, cash equivalents and potential cash flows from operations will be sufficient to fund our current working capital needs, capital expenditures and debt payments through at least the next 12 months.

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Off-Balance Sheet Arrangements

We do not have any off-balance sheet debt nor do we have any transactions, arrangements, obligations (including contingent obligations) or other relationships with any unconsolidated entities or other persons that may have a material current or future effect on our financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for our fiscal year beginning July 1, 2008. We are currently evaluating the impact of SFAS 157.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158. Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158). SFAS 158 requires employers to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare and other postretirement plans in their financial statements. The provisions of SFAS 158 are effective as of the end of the fiscal year ending June 30, 2007. We are currently evaluating the impact of SFAS 158

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 requires public companies to quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in quantifying a misstatement as material, when all relevant quantitative and qualitative factors are considered. The guidance in SAB 108 is effective for the fiscal year ending June 30, 2007. We are currently evaluating the impact of SAB 108

Additional recent accounting pronouncements are discussed under Item 7 of our 2006 Annual Report. As of December 31, 2006, other than the pronouncements described above and the pronouncements discussed in our 2006 Annual Report, we are not aware of any other pronouncements that materially affect our financial position or results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk, which is the potential loss arising from adverse changes in market rates and prices, such as foreign currency exchange and interest rates. We generally do not enter into derivatives or other financial instruments for trading or speculative purposes. We may, however, enter into financial instruments to try to manage and reduce the impact of changes in foreign currency exchange rates. We cannot predict with any certainty our future exposure to fluctuations in foreign currency exchange and interest rates or other market risks or the impact, if any, such fluctuations may have on our future business, product pricing, consolidated financial condition, results of operations or cash flows. The actual impact of any fluctuations in foreign currency exchange or interest rates may differ significantly from those discussed below.

Interest Rates

At December 31, 2006, we had fixed rate debt of $475,000 and variable rate debt of approximately $7.0 million. The interest rates on our variable rate debt range from LIBOR plus 1.75% to LIBOR plus 2.25%. As of December 31, 2006, the weighted average effective interest rate on our variable rate debt was 7.90%. An immediate one hundred basis point (1.0%) increase in the interest rate on our variable rate debt, holding other variables constant, would have increased our interest expense by $49,000 for the six months ended December 31, 2006. Interest rates have been at or near historic lows in recent years but have been increasing during the past year. There can be no guarantee that interest rates will not rise further. Any increase in interest rates may adversely affect our results of operations and financial condition.

Foreign Currencies

To the extent our business continues to expand outside the United States, an increasing share of our net sales and cost of sales may be transacted in currencies other than the United States dollar. Accounting practices require that our non-United States

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dollar-denominated transactions be converted to United States dollars for reporting purposes. Consequently, our reported net earnings may be significantly affected by fluctuations in currency exchange rates. When the United States dollar strengthens against currencies in which products are sold or weakens against currencies in which we incur costs, net sales and costs could be adversely affected.

Our main exchange rate exposures are with the Swiss Franc and the Euro against the United States dollar. This is due to NAIE s operations in Switzerland and the payment in Euros by our largest customer for finished goods. Additionally, we pay our NAIE employees and certain operating expenses in Swiss Francs. We may enter into forward exchange contracts, foreign currency borrowings and option contracts to hedge our foreign currency risk. Our goal in seeking to manage foreign currency risk is to provide reasonable certainty to the functional currency value of foreign currency cash flows and to help stabilize the value of non-United States dollar-denominated earnings.

On July 7, 2005, we purchased 12 option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The 12 options expired monthly beginning January 2006 and ending December 2006. The option contracts had a notional amount of $7.0 million, a weighted average strike price of $1.16, and a purchase price of $152,000. The risk of loss associated with the options was limited to the purchase price paid for the option contracts.

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On January 18, 2007, we purchased three option contracts designated and effective as cash flow hedges to protect against the foreign currency exchange risk inherent in a portion of our forecasted transactions denominated in Euros. The three options expire monthly beginning August 2007 and ending October 2007. The option contracts had a notional amount of $1.9 million, a weighted average strike price of $1.24, and a purchase price of $12,000. The risk of loss associated with the options is limited to the purchase price paid for the option contracts.

On December 31, 2006, the Swiss Franc closed at 1.22 to 1.00 United States dollar and the Euro closed at 0.76 to 1.00 United States dollar. A 10% adverse change to the exchange rates between the Swiss Franc and the Euro against the United States dollar, holding other variables constant, would have decreased our net income for the six months ended December 31, 2006 by $201,000.

ITEM 4. CONTROLS AND PROCEDURES

We maintain certain disclosure controls and procedures. They are designed to help ensure that material information is: (1) gathered and communicated to our management, including our principal executive and financial officers, on a timely basis; and (2) recorded, processed, summarized, reported and filed with the SEC as required under the Securities Exchange Act of 1934.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2006. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective for their intended purpose described above. There were no changes to our internal controls during the quarterly period ended December 31, 2006 that have materially affected, or that are reasonably likely to materially affect, our internal controls.

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we become involved in various investigations, claims and legal proceedings that arise in the ordinary course of our business. These matters may relate to product liability, employment, intellectual property, tax, regulation, contract or other matters. The resolution of these matters as they arise will be subject to various uncertainties and, even if such claims are without merit, could result in the expenditure of significant financial and managerial resources. While unfavorable outcomes are possible, based on available information, we generally do not believe the resolution of these matters will result in a material adverse effect on our business, consolidated financial condition, or results of operation. However, a settlement payment or unfavorable outcome could adversely impact our results of operation. Our evaluation of the likely impact of these actions could change in the future and we could have unfavorable outcomes that we do not expect.

As of January 30, 2007, neither NAI nor its subsidiaries were a party to any material pending legal proceeding nor was any of their property the subject of any material pending legal proceeding.

ITEM 1A. RISK FACTORS

You should carefully consider the other risks described under Item 1A of our 2006 Annual Report, as well as the other information in our 2006 Annual Report, this report and other reports and documents we file with the SEC, when evaluating our business and future prospects. If any of the identified risks actually occur, our business, financial condition and results of operations could be seriously harmed. In that event, the market price of our common stock could decline and you could lose all or a portion of the value of your investment in our common stock.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

Our annual meeting of stockholders was held on December 1, 2006. The following table sets forth the matters voted upon at the meeting and the results of the voting on each matter voted upon:

Matter Voted Upon	Votes For	Withheld	Votes Against	Abstentions	Broker Non-Votes
Election of two Class I directors to serve until the next annual meeting of stockholders held to elect Class I directors and until their respective successors are elected and qualified:					
Joe E. Davis	5,952,518	14,456			
Mark A. LeDoux	5,963,343	3,631			
Ratification of the selection of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending June 30, 2007	5,963,145		21,780	1,659	

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In accordance with the terms set forth in the proxy statement related to the solicitation of proxies for use at the annual meeting, an abstention from voting was used for the purpose of establishing a quorum, and was considered a vote against a proposal. A broker non-vote was also used for the purpose of establishing a quorum, but was not otherwise counted in the voting process. The named directors and the above matter were each approved by the stockholders at the annual meeting.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

EXHIBIT INDEX

Exhibit Number	Description	Incorporated By Reference To
3(i)	Amended and Restated Certificate of Incorporation of Natural Alternatives International, Inc. filed with the Delaware Secretary of State on January 14, 2005	Exhibit 3(i) of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005
3(ii)	By-laws of Natural Alternatives International, Inc. dated as of December 21, 1990	NAI s Registration Statement on Form S-1 (File No. 33-44292) filed with the commission on December 21, 1992
4(i)	Form of NAI s Common Stock Certificate	Exhibit 4(i) of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.1	1999 Omnibus Equity Incentive Plan as adopted effective May 10, 1999, amended effective January 30, 2004, and further amended effective December 3, 2004*	Exhibit 10.1 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005
10.2	1999 Employee Stock Purchase Plan as adopted effective October 18, 1999	Exhibit B of NAI s definitive Proxy Statement filed with the commission on October 21, 1999
10.3	Management Incentive Plan*	Exhibit 10.3 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, filed with the commission on November 5, 2003
10.4	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and Randell Weaver*	Exhibit 10.5 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.5	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and Mark A. LeDoux*	Exhibit 10.6 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.6	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and John Wise*	Exhibit 10.7 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004

10.7	Amended and Restated Employment Agreement dated as of January 30, 2004, by and between NAI and John Reaves*	Exhibit 10.8 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.8	Amended and Restated Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Dr. Reginald B. Cherry	Exhibit 10.11 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.9	Exclusive License Agreement effective as of September 1, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc.	Exhibit 10.12 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.10	First Amendment to Exclusive License Agreement effective as of December 10, 2004 by and among NAI and Reginald B. Cherry Ministries, Inc.	Exhibit 10.3 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the commission on February 14, 2005
10.11	Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company (lease reference date June 12, 2003)	Exhibit 10.10 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, filed with the commission on November 5, 2003
10.12	Credit Agreement dated as of May 1, 2004 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.11 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004, filed with the commission on May 17, 2004
10.13	First Amendment to Credit Agreement dated as of February 1, 2005 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.1 of NAI s Current Report on Form 8-K dated February 1, 2005, filed with the commission on February 7, 2005
10.14	Form of Indemnification Agreement entered into between NAI and each of its directors	Exhibit 10.15 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the commission on September 14, 2004
10.15	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation)	Exhibit 10.19 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, filed with the commission on May 13, 2005
10.16	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated July 25, 2003 (English translation)	Exhibit 10.19 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.17	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated June 8, 2004 (English translation)	Exhibit 10.20 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.18	Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated February 7, 2005 (English translation)	Exhibit 10.21 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005

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10.19	License Agreement effective as of April 28, 1997 by and among Roger Harris, Mark Dunnett and NAI	Exhibit 10.22 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.20	Amendment to License Agreement effective as of March 17, 2001 by and among Roger Harris, Mark Dunnett and NAI	Exhibit 10.23 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the commission on September 8, 2005
10.21	Amendment effective as of September 15, 2005 to Lease of Facilities in Manno, Switzerland between NAIE and Mr. Silvio Tarchini dated May 9, 2005 (English translation)	Exhibit 10.24 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, filed with the commission on November 4, 2005
10.22	Stock Purchase Agreement effective as of December 5, 2005, by and among NAI and William H. Bunten II and/or Elizabeth W. Bunten, as the trustees of The Bunten Family Trust dated April 14, 2001, John F. Dullea and Carolyn A. Dullea, as the trustees of The John F. and Carolyn A. Dullea Trust dated June 20, 2001, Lincoln Fish, and Michael L. Irwin, as trustee of The Michael L. Irwin Trust u/t/a June 25, 1991	Exhibit 10.1 of NAI s Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005
10.23	Form of Lock-Up Agreement effective as of December 5, 2005 entered into between NAI and each Selling Stockholder	Exhibit 10.2 of NAI s Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005
10.24	Employment Agreement effective as of December 5, 2005, by and between RHL and John F. Dullea*	Exhibit 10.3 of NAI s Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005
10.25	Lease of RHL Facilities in San Diego, California between RHL and Lessor dated February 5, 2003	Exhibit 10.4 of NAI s Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005
10.26	Promissory Note made by NAI for the benefit of Wells Fargo Equipment Finance, Inc. in the amount of $3,800,000	Exhibit 10.5 of NAI s Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005
10.27	Patent License Agreement by and between Unither Pharma, Inc. and RHL dated May 1, 2002	Exhibit 10.6 of NAI s Current Report on Form 8-K dated December 5, 2005, filed with the commission on December 9, 2005
10.28	Second Amendment to Credit Agreement dated as of December 1, 2005 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.30 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.29	Exclusive License Agreement by and between NAI and Richard Linchitz, M.D. effective as of August 23, 2005	Exhibit 10.32 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.30	Letter amendment to Lease of RHL Facilities in San Diego, California between RHL and Lessor dated January 10, 2006	Exhibit 10.33 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006

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10.31	First Amendment to Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company, effective December 21, 2004	Exhibit 10.34 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.32	Second Amendment to Lease of Facilities in Vista, California between NAI and Calwest Industrial Properties, LLC, a California limited liability company, effective January 13, 2006	Exhibit 10.35 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005, filed with the commission on February 14, 2006
10.33	Third Amendment to Credit Agreement dated as of March 15, 2006 by and between NAI and Wells Fargo Bank, National Association	Exhibit 10.35 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006, filed with the commission on May 9, 2006
10.34	Standard Sublease Multi-Tenant by and between J. Gelt Corporation dba Casa Pacifica and RHL (lease reference date March 6, 2006)	Exhibit 10.37 of NAI s Annual Report on Form 10-K for the fiscal year ended June 30, 2006, filed with the commission on September 18, 2006
10.35	Loan Agreement between NAIE and Credit Suisse dated as of September 22, 2006, including general conditions (portions of the Loan Agreement have been omitted pursuant to a request for confidential treatment)	Exhibit 10.36 of NAI s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2006, filed with the commission on November 1, 2006
10.36	Employment Agreement effective as of November 20, 2006, by and between NAI and Alvin McCurdy*	Exhibit 10.1 of NAI s Current Report on Form 8-K dated November 20, 2006, filed with the commission on November 21, 2006
10.37	Fourth Amendment to Credit Agreement dated as of November 1, 2006, and entered into on January 24, 2007, by and between NAI and Wells Fargo Bank, National Association	Filed herewith
10.38	Revolving Line of Credit Note (as revised) made by NAI for the benefit of Wells Fargo Bank, National Association in the amount of $12,000,000	Filed herewith
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer	Filed herewith
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer	Filed herewith
32	Section 1350 Certification	Filed herewith

* Indicates management contract or compensatory plan or arrangement.

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SIGNATURES

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

Date: January 30, 2007

NATURAL ALTERNATIVES INTERNATIONAL, INC.

By: /s/ John R. Reaves
John R. Reaves, Chief Financial Officer

Mr. Reaves is the principal financial officer of Natural Alternatives International, Inc. and has been duly authorized to sign on its behalf.