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NLS - Q3 2015 Nautilus Inc Earnings Call

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PRESENTATION

Operator

Welcome to the Nautilus third-quarter conference call 2015.

(Operator Instructions)

As a reminder, this conference is being recorded Monday, November 2, 2015.

I would now like to turn the conference over to John Mills with ICR. Please go ahead.

John Mills - *IRC - IR*

Great. Thank you. Good afternoon, everyone, and welcome to Nautilus's third-quarter 2015 earnings conference call. Participants on the call from Nautilus are Bruce Cazenave, Chief Executive Officer; Sid Nayar, Chief Financial Officer; and Bill McMahon, Chief Operating Officer. Our earnings release was issued earlier today, and may be downloaded from our site at nautilusinc.com on the Investor Relations page.

Remarks on today's conference call may include forward-looking statements within the meaning of the securities laws. These statements include statements concerning the Company's current or future financial and operating trends, anticipated new product introductions, available supply and maintenance of appropriate inventories of our products, planned and anticipated results of new product and channel development initiatives, expectations concerning future income tax payments, and forecasts related to sales performance, generally and in relation to specific products and markets.

Forward-looking statements are subject to a number of risks and uncertainties, and actual results may differ materially from those statements. For more information about these risks, please refer to our quarterly and annual reports filed with the SEC, as well as the Safe Harbor statement in today's press release. Nautilus undertakes no obligation to update publicly any forward-looking statements to reflect new information, events or circumstances after they were made, or to reflect the occurrence of unanticipated events, unless otherwise indicated. All information and comments regarding our operating results pertain to our continuing operations.

With that, it's my pleasure to turn the call over to Bruce. Go ahead, Bruce.

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Bruce Cazenave - *Nautilus Inc - CEO*

Thank you, John. Good afternoon, everyone, and thank you for joining our call today. I'd like to start by providing a general overview of our third-quarter results, and then we'll turn it over to Sid Nayar to review our financial results in more detail. Bill McMahon will then provide details on each business segment, as well as updates on product activity and introductions. I will then close with some summary remarks before we open up the call for questions.

Our third quarter represents another strong quarter of performance. Third-quarter sales increased 20% overall, when compared to the same period last year, and was driven by significant growth in both our Direct and Retail segments. Increased market penetration in a number of product categories helped generate sales growth of approximately 10% in our Retail business. We believe this to be in excess of twice the pace of industry growth. It is also encouraging that we are beginning to see the positive effects of actions we took earlier this year to improve Retail gross margins. On the Direct side, revenues grew 24% over last year, and this reflects the continued positive momentum of the Max Trainer product line.

I am pleased to report that the action plans and operating principles we deployed throughout our Organization a few years ago continue to generate greater operating leverage. This is evidenced by a 49% increase in operating income and 50% increase in earnings per share this quarter versus the same period last year.

At this time, I'd like to turn it over to Sid Nayar, our Chief Financial Officer, who will provide some additional details on our third-quarter financials. Sid?

Sid Nayar - *Nautilus Inc - CFO*

Thank you, Bruce.

Net sales for the third quarter of 2015 totaled $70.7 million, an increase of 19.7% as compared to the same period in the prior year. Net sales for the nine months ended September 30, 2015, totaled $226.6 million versus $179.5 million for the same prior period, an increase of 26%. Third-quarter gross margins increased 210 basis points in the direct segment to 64.3%, and were down 90 basis points for the Retail segment to 25.6% when compared to the same quarter last year. On an overall basis, total Company gross margins for the third-quarter 2015 improved to 51.2%, up 250 basis points versus the same prior period, primarily reflecting channel mix. Year-to-date 2015 gross margins of 53.3% are 200 basis points better than the same period in the prior year.

Total operating expenses for the third quarter of 2015 as a percentage of net sales increased to 42.2% from 41.5% in the same period last year, reflecting higher spending in sales and marketing, and in product development, partially offset by improved leverage of general and administrative expenses across the higher revenue base. Operating expenses for the nine months ended September 30, 2015, as a percentage of sales improved to 41% as compared to 42.6% for the same prior period. It is important to remember that we measure our improvement in operating expenses as a percent of revenue on an annual basis. Our expenses will fluctuate from quarter to quarter, depending on manufacturers, including investment in media, longer-term marketing initiatives, and new product development spend.

Sales and marketing expense for the third quarter of 2015 were $21.7 million, or 30.8% of net sales, as compared to $17.1 million, or 28.9% of net sales, in the same period last year, primarily reflecting higher media spending as we continue to invest in generating sales leads for the upcoming fitness season. For the nine months ended September 30, 2015, sales and marketing expenses totaled $70.2 million, or 31% of net sales, compared to $54.5 million, or 30.4% of net sales, for the same period in the prior year, with higher media spending being the main driver.

General and administrative expenses were $5.5 million, or 7.8% of net sales, for the third quarter of 2015, which compares to $5.7 million, or 9.7% of net sales, in the same period last year. The decreased dollar spending in G&A primarily reflects lower spending in legal expenses related to patent enforcement cases versus the prior year. The improvement in G&A as a percentage of net sales highlights favorable operating efficiencies and our ability to leverage the existing operating base as the Business expands. General and administrative expenses for the first nine months of 2015 as a percentage of net sales totaled 6.8% as compared to 9.2% for the same prior period.

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Research and development costs in the third quarter of 2015 were $2.6 million, or 3.6% of net sales, compared to $1.7 million, or 2.8% of net sales, in the same period last year. The dollar increase was driven by higher headcount and consulting expenses reflecting our ongoing commitment to invest in the engineering and design resources required to continue to innovate and broaden our product portfolio. Research and development costs for the first nine months of 2015 as a percentage of sales totaled 3.2% as compared to 3% for the same prior period.

Operating income for the third quarter of 2015 increased 49.2% to $6.4 million, as compared to operating income of $4.3 million in the same quarter of last year. The increase reflects higher net sales and gross margins in the Direct segment, combined with improved operating leverage of general and administrative expenses. Operating margin as a percent of revenue for the third quarter of 2015 improved to 9% compared to 7.2% for the same period last year. For the first nine months of 2015, operating income totaled $27.9 million, or 12.3% of net sales, up 78.3% compared to the same period last year. Income from continuing operations for the third quarter of 2015 was $3.9 million, or $0.12 per diluted share, as compared to $2.7 million, or $0.08 per diluted share, for the same period last year.

The effective tax rate for the third quarter of 2015 was 39.8% compared to 38.5% in the same period last year. Given the Company's US net operating loss carry-forward position, we expect to continue to have limited cash tax payments for the balance of the year. Income from continuing operations for the first nine months of 2015 totaled $17 million, or $0.53 per diluted share, as compared to $9.9 million, or $0.31 per diluted share, for the first nine months of 2014.

Turning now to our segment results, net sales in the Direct business totaled $42.9 million for the third quarter of 2015, a 24.3% increase over the same quarter last year. Direct segment sales benefited from continued strong demand for our cardio products, primarily driven by sales of the Bowflex Max Trainer product line. Gross margin for the Direct business improved to 64.3% for the third quarter of 2015, compared to 62.2% in the same quarter of last year. Gross margin improvement was due to continued leverage of our supply chain costs, and lower reserve requirements reflecting favorable warranty experience trends.

Operating income for the third quarter of 2015 in our Direct business was $5.4 million compared to $4.1 million in the same quarter prior year. Operating income benefited from higher net sales and gross margins in the third quarter of 2015.

Net sales in our Retail segment for the third quarter of 2015 were $25.7 million, an increase of 9.6% compared to $23.5 million in the third quarter of last year. The improvement reflects robust sales of SelectTech dumbbells, coupled with increased placement of the Company's new lineup of cardio products and treadmills launched in the fall of 2014. Gross margins for the Retail business were 25.6% in the third quarter of 2015, as compared to 26.5% for the prior period, primarily driven by unfavorable product and channel mix. As previously disclosed, the Company has implemented plans to continue to improve Retail margins, as evidenced by the sequential increases in the 2015 quarters.

In the third quarter of 2015, operating income for the Retail business totaled $3.2 million, as compared to $3.7 million in the same period of last year. The decrease is attributable to the lower gross margins, higher marketing and merchandising expenses, and increased R&D and IT-related costs allocated to the segment. Our Retail operating margins have been negatively impacted in the short term as we seek to accelerate growth through investments in new product categories and channel development.

Now turning to the consolidated balance sheet, cash and investments totaled $74.7 million as of September 30, 2015, with no debt. This compares to $72.2 million in cash at December 31, 2014, and $41.7 million in cash at September 30, 2014. Inventories were $35.6 million as of September 30, 2015, compared to $24.9 million at December 31, 2014, and $21.3 million at September 30, 2014. The increases in inventory versus year-end 2014, and September 30, 2014, reflected increased stocking levels for high-demand products and the added distribution point.

Trade payables were $38.9 million as of September 30, 2015, compared to $47.6 million at the end of 2014. Capital expenditures totaled $3.6 million for the nine months ended September 30, 2015, with spending primarily on facility infrastructure, product tooling, and IT assets. We anticipate full-year CapEx to be in the range of $5.5 million to $6.5 million. The Company also repurchased $9.6 million of stock during the quarter, bringing total year-to-date purchases to $11.6 million as part of the previously disclosed $15 million buy-back program.

At this time, I would like to turn it over to Bill McMahon, our Chief Operating Officer, who will provide additional insights into our Business and key products. Bill?

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Bill McMahon - *Nautilus Inc - COO*

Thank you, Sid. I'd like to provide additional background on our third-quarter results and the overall position of our Business. Starting with our Direct business, we reported another quarter of strong revenue and operating income growth, largely driven by the Bowflex Max Trainer, which continues to perform extremely well. We anticipate that the Max Trainer product line will continue to drive growth in our Direct segment in the coming quarters. And in order to drive that growth, we plan to continue to prudently and incrementally ramp up media spend. In the last two years, we have had success in driving improved conversion during peak fitness season attributable to these media investments during Q2 and Q3. Given our knowledge of current media market conditions, we feel conditions remain favorable for these investments.

Turning to the Bowflex TreadClimber, as expected, in the third quarter we continued to see some cross shopping between TreadClimber and Max Trainer sales leads, which impacted TreadClimber category sales, as those leads gravitated towards Max. At our annual product showcase event held in New York City in September, we debuted our next generation of TreadClimber products. The TreadClimber is known for offering users a low-impact workout that burns calories extremely efficiently by combining the motions of a treadmill, stepper and elliptical.

The new TC 100 and 200 products feature a major technology facelift. The new TC 200 tracks and stores up to four users' data, and allows them to set, monitor and track their personal fitness goals utilizing the free TreadClimber smart device app, along with integrated Bluetooth connectivity. The app automatically shares data with popular dashboards including Under Armour's MyFitnessPal, Apple's HealthKit, Google Fit, and Bowflex Connect. Both machines include extensive console improvements, as well as design changes that further optimize the TreadClimber experience. The machines continue to have a classic compact design that make them ideal for a home workout.

We're very pleased with the positive response from consumers and the fitness media to our updated TreadClimber products. And we are optimistic that these new offerings will contribute to continue to overall Direct channel growth. Our new TreadClimber models are expected to launch before the end of this year.

Turning to the strength category in our Direct segment, we're pleased to report a second consecutive quarter in which our strength category sales grew year over year. While strength currently represents a fairly small percentage of our Direct category, our market research indicates that consumers are looking for new and innovative ways to incorporate strength-based fitness in their homes, and we are excited about our newest strength product to address this demand.

At our product showcase event, we debuted the new Bowflex 560 SelectTech Dumbbell. These are the first-ever smart dumbbells offering users a fully interactive experience to work out harder and smarter. An integrated and proprietary 3-D trainer features a counter the records reps, weight lifted, and repetition speed, providing users with an audible cue when they complete each rep properly. The 3-D trainer app features a library of video exercises, and wirelessly transfers data from their workouts via Bluetooth smart technology, and automatically syncs data to iOS and Android devices. The dumbbells will be available for purchase with extended weight options to further customize the users' workout experience.

SelectTech 560 is expected to launch in Direct later this quarter and in Retail during 2016. We're very excited about our new and enhanced products in the Direct portfolio. These products offer a more interactive and tailored workout experience than ever before, and complement our existing solutions in order to allow us to offer customers all the tools they need to be stronger and healthier.

Turning now to our Retail business, Retail customer response to our recent product launches as measured by gains in doors and SKU placement has continued to be positive, and we believe our growth is outpacing industry trends. In the third quarter, we experienced solid domestic partner growth across a variety of categories, including key modalities such as treadmills, ellipticals and select rise weights.

While our domestic growth in doors and placements remains on a strong growth trend, we've experienced some challenges this year in our international markets. The issues are macro level in nature, and involve currency and economic conditions unique to various regions versus any specific issue with our products or support. We certainly understand that we are not the only US-based company facing these obstacles, but growth outside of North America remains one of our key plus growth drivers. A significant positive sign for future growth in international sales has been the initial performance of our Max Trainer product within the Retail channel outside of North America. We are seeing strong acceptance of Max Trainer early in its international deployment cycle, and we're optimistic that its success in the US can translate to multiple global markets. Despite

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the international market conditions, with our current knowledge of retailer orders and plans, we anticipate continued positive growth in our Retail segment through this fitness season, driven by growth in doors and SKUs domestically, and continued deployment of Max Trainer internationally.

To augment our Retail channel cardio offerings, we introduced our new Schwinn Airdyne Pro fitness bike at our New York City product showcase event. These bikes leverage the iconic Schwinn Airdyne technology; its legacy is built around the power of unlimited wind resistance, and takes the technology to the next level, revolutionizing the stationary bike. The AD pro is designed to withstand the rigors of high-intensity training by the most demanding athlete. In addition, Schwinn Airdyne technology blends seamlessly with custom interval training programs to offer users of all levels uniquely challenging workouts, with metrics like watts, calories, time and distance. This product is just launched, and it retails for $999.

As a final note on our Retail segment, I'd like to comment on our gross margins. As Sid stated, Retail gross margins declined 90 basis points from the same quarter in prior year. That said, Retail margins continue to improve sequentially quarter over quarter -- in this case, 210 basis points over Q2, and 360 basis points over our low point in Q1.

We are intensely focused on returning to a margin improvement path in the Retail segment, and these efforts are driving an improving trend. We feel this trend will continue into Q4 and next year. Sequential improvement in margins is a positive sign, but we still have more work to do to reach our goal of year-over-year margin improvement. We continue to close the gap.

I'd also like to briefly discuss our current inventory position. At the end of Q3, we owned $35.6 million in finished goods and parts. This includes finished goods inventory in transit to our warehouses for our peak fitness season. Long-time observers of our Company will note that this level is significantly higher than prior year Q3 inventories of $21.3 million. The primary drivers in inventory level change are our current and anticipated higher revenue levels and associated safety stock with two distribution centers, the introduction of new product lines such as our retail treadmills, as well as our successful efforts to drive improvement in Max Trainer product availability. We continue to manage inventory closely, and we feel we are well positioned for sales this fitness season.

In summary, we're optimistic about our Business as we enter peak fitness selling season. With our new innovative products combined with the strong momentum of Bowflex Max Trainer, we're well positioned for continued growth. Looking forward, our team remains focused on further product innovation, positioning Nautilus to solidify its position as the leader in home fitness.

And with that I'd like to turn the call back over to Bruce for his final comments. Bruce?

Bruce Cazenave - *Nautilus Inc - CEO*

Thank you, Bill.

I'd like to make a few final comments before opening up the call for questions. As we begin the final quarter of 2015, we are well positioned to end the year on a strong note, delivering another year of robust top- and bottom-line growth. The front end of our business model, namely the product development, marketing and sales areas, are giving us good reason to be optimistic about future growth, while the supply chain operations and support areas continue to find service improvements and efficiencies.

Innovation at Nautilus goes beyond just developing engaging new products. It extends into all areas as our teams keep challenging themselves to raise the bar on speed, quality, cost and service. I'm extremely proud and thankful to our team for their ongoing hard work in making so many good things happen.

That concludes our prepared remarks. Now I'd like to open up the call for questions. Operator?

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Frank Camma, Sidoti.

Frank Camma - *Sidoti - Analyst*

Good afternoon, guys. Can you help us out with, maybe I missed it, but obviously the royalty income, you tipped us off that was -- you were going to have an adjustment there. Could you tell us what -- how much of that was a catch-up so we can get to what a more normalized rate would be?

Sid Nayar - *Nautilus Inc - CFO*

Sure, Frank. This is Sid. The Q1, Q2 catch-up was approximately $1 million.

Frank Camma - *Sidoti - Analyst*

Okay. And when we look forward, is there any significant -- when do some of those patents roll off so that's that would be -- is that a cliff or does this --

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Sid Nayar - *Nautilus Inc - CFO*

Yes. So it is a cliff, essentially. As we go into 2016 -- as we had anticipated rolling off those in January of 2015 but they were extended through January of 2016.

Frank Camma - *Sidoti - Analyst*

January of 2016? Okay. And could you talk about -- I think I understand it but on the Dumbbells, so obviously, there was nothing in the quarter as far as the 560s right?

Sid Nayar - *Nautilus Inc - CFO*

Correct.

Frank Camma - *Sidoti - Analyst*

Okay. But it did affect your inventory levels? So some of that inventory is actual 560s that you're going to launch in a direct segment or not?

Bill McMahon - *Nautilus Inc - COO*

We generally don't disclose inventory level by product, but generally new products along the way have some amount of inventory associated with them.

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Frank Camma - *Sidoti - Analyst*

The reason why I ask is I think I had the timing wrong. I thought you were launching the 560s in both channels this quarter, but you said that you're not launching in the retail channel until next year. Is that right?

Bill McMahon - *Nautilus Inc - COO*

Right. We would anticipate early next year on that.

Frank Camma - *Sidoti - Analyst*

Early next year? Was that a change or was that always the case?

Bill McMahon - *Nautilus Inc - COO*

It's the nature of the way we're going to launch in retail, but the timing matters so we want to go with direct first.

Frank Camma - *Sidoti - Analyst*

Okay. I assume that would be a good type of holiday gift, right? So is that to take advantage of the better margins on the direct segment?

Bill McMahon - *Nautilus Inc - COO*

Also, so we can get more direct feedback on how the product's doing early on.

Frank Camma - *Sidoti - Analyst*

Okay. And just a couple questions on your advertising. You obviously -- I wasn't really surprised that you continue to ramp that up. I was surprised by the comment on the increased promotional required for the retail side. Can you explain that? I wasn't sure if I understood that.

Bill McMahon - *Nautilus Inc - COO*

We are investing some dollars, not major, but some contributing dollars towards some retail tests that we're trying this fall. And based on the outcome of those, we'll have more to say about those tests probably in the Q1 results earnings call.

Frank Camma - *Sidoti - Analyst*

Okay. And just a final question I have is if we look at the retail numbers, you had -- you still had 10% growth off of a pretty difficult comp last year. I don't know if there's anything you could tell us about if you're looking forward to the fourth quarter? You're coming up against a much easier comp obviously. Is there anything you could say about that?

Bill McMahon - *Nautilus Inc - COO*

I'd say that we're very confident in our retail channel direction. And we want to continue to grow revenue pace as well as improve the margins as we talked about.

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Frank Camma - *Sidoti - Analyst*

Okay. Great. Thanks, guys.

Operator

Rommel Dionisio, Wunderlich Securities.

Rommel Dionisio - *Wunderlich Securities - Analyst*

Thank you, good afternoon. You guys have talked about some increased investment in marketing expense especially to drive that strong momentum with the Max Trainer. Have you guys launched any top of line products for that line? And also for some high-end products and some of the other areas, could you talk about some of the mix of how you spend those marketing dollars, if you've -- it seems like you're tailing towards more affluent consumer? I wonder if you could give us a little more granularity in terms of how you intend to spend those dollars to capture that higher end consumer? Thanks.

Bill McMahon - *Nautilus Inc - COO*

Hi Rommel, Bill here. Our media strategy is looking to drive the best possible demographic to match our price points. So we do that in a variety of ways. We do have a mix between traditional television advertising, but we're also pretty significant players in the digital realm, whether that be social, search, or any of the other mechanisms of display in emerging technologies.

So you're correct in assuming that we do target demographics. That might be networks, it might just be we measure performance and say that worked pretty well, let's do more of that. So our team is constantly analyzing results and looking to apply our dollars to the best possible outcome outlet.

Rommel Dionisio - *Wunderlich Securities - Analyst*

Okay. Thanks very much, Bill. Congratulations on the quarter as well.

Operator

(Operator Instructions)

Andrew Burns, D.A. Davidson.

Andrew Burns - *D.A. Davidson - Analyst*

Good afternoon. Congratulations on the quarter. Sorry if I missed it, but credit approval rate in the quarter, is that something you could share and perhaps an update on the mix in terms of the financing versus credit card?

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Bill McMahon - *Nautilus Inc - COO*

Hi Andrew, Bill again here. Credit in the quarter was -- combined credit approval rate was 47.8% which was improved over 40.3% last year same quarter. And our mix of payments remains roughly the same. We're still seeing strong growth across the board in both financed and credit card payments. So it still remains around 50/50.

Andrew Burns - *D.A. Davidson - Analyst*

Great. Thanks. And just in terms of the R&D spend, how to think about that going forward, it's been an investment year, but where that should shake out in 2016 and beyond in terms of a percent of sales target would be helpful.

Sid Nayar - *Nautilus Inc - CFO*

Sure, Andrew. This is Sid. As you indicated this year has been an investment in R&D. I think what we've laid out is we think getting it to about just over 3% of revenues would be our long-term target, and again at that point you would potentially plateau out from a dollar perspective. So as revenues continued to grow from that point potentially you could see some leverage, but that would be our goal is to get it to that just about that 3% and we're on track, certainly with the 2015 numbers.

Andrew Burns - *D.A. Davidson - Analyst*

Okay. Thanks. And in the release, highlighted on the retail side, some softness in Canada, was that the bulk of the international commentary on the call or were there other markets that were additionally feeling pressure?

Sid Nayar - *Nautilus Inc - CFO*

Again for Q3, obviously, Canada was the primary driver, but I think Bill's comment to international is really more where we've been for the nine months on a year-to-date basis. We saw the softness starting in international markets, probably in Q3 of last year.

So year over year, it was probably not off as much, just when you look just at the international channel alone. But Canada was specifically off and we think some of the currency issues and the economy issues in Canada are reflective of that.

Andrew Burns - *D.A. Davidson - Analyst*

Thanks. And last question, plans on the buyback? You're mostly through that -- the $15 million authorization continuing to generate substantial cash plans for buyback as a part of your cash deployment strategy going forward? Thanks.

Sid Nayar - *Nautilus Inc - CFO*

And what I'd say, Andrew, as always we laid out our priorities and the buyback is clearly one of the priorities that we have. And an additional buyback authorization is one option that's on the table at this point.

Andrew Burns - *D.A. Davidson - Analyst*

Thanks and good luck.

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Operator

(Operator Instructions)

Lee Giordano, Sterne Agee.

Lee Giordano - *Sterne Agee - Analyst*

Thanks, good evening everybody. I had a question on the retail side of the Business. What do you feel is the long-term opportunity to expand into the specialty retail channel and to increase your average price points on some of those higher end products that you're talking about? Maybe you could talk about that a little bit? Thank you.

Bill McMahon - *Nautilus Inc - COO*

Hi Lee, Bill again. We definitely believe that there is a long-term plus growth driver possibility for us to move into specialty fitness. We also believe that there's still higher price points in traditional sporting goods retail that we have not yet hit. We'd like to explore all potential profitable price points in retail and/or specialty and part of our product development investment continues to be towards driving that in the future.

Sid Nayar - *Nautilus Inc - CFO*

I would say the AD Pros.

Bill McMahon - *Nautilus Inc - COO*

And Sid makes a good point. AD Pro would be our first real effort into specialty here with professional grade product.

Lee Giordano - *Sterne Agee - Analyst*

Great. Thank you.

Operator

We have no more questions at this time. I'll turn the conference back to you.

Bruce Cazenave - *Nautilus Inc - CEO*

Thanks to all today for your time and interest in Nautilus. We have a couple of non-deal marketing road trips planned this quarter, and also we'll be attending the ICR conference in January. Given the narrower than usual time span between the conference and year end, it is unlikely that we will preannounce preliminary Q4 results at this conference.

We hope to see some of you at these events. In any case we look forward to providing another update on our Business on our year-end call next year. Thanks again to all, and I hope you all have a great rest of the day. Thank you.

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Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line.

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