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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Nautilus Q1 FY 2016 earnings call. During the presentation, all applicants will be in a listen-only mode. Afterwards we will conduct a question and answer session. (Operator Instructions). As a reminder, this conference is being recorded; Monday, May 9, 2016. I would now like to turn the conference over to Mr. John Mills, Partner at ICR. Please go ahead.

John Mills - Nautilus, Inc. - ICR, IR

Great, thank you. Good afternoon, everyone. Welcome to Nautilus' first quarter 2016 conference call. Participants ethno 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 website at nautilusinc.com on the Investor Relations page. The earnings relates includes reconciliation of the non-GAAP financial measures mentioned in today's call for the most directly-comparable GAAP measure. The remarks in 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 gross margin improvements, factors affecting our future operating results including channel mix and segment margins, long-term growth and profitable targets, anticipated new product introductions, available supply of certain products, planned anticipated results of new product and business development initiatives, and anticipated benefits and costs of the acquisitions of Octane Fitness. 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 annual and quarterly reports filed with the SEC as well as the Safe Harbor statement in today's press release. Nautilus undertakes no objection 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 pertaining to our continuing operations. And with that it is my pleasure to hand the call over to Bruce. Go ahead, Bruce.



Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Thank you, John. Good afternoon, everyone and thank you for joining our call today. I would like to start by providing a general overview of our first quarter results, and then we will 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. I will then close with some summary remarks before we open up the call for questions.

Following a strong year of performance in 2015, we are very pleased to report a solid start to 2016, which highlights continued execution of key initiatives across all aspects of our business, as well as broad-based growth in demand for both our cardio and strength products. In the first quarter total revenue grew by 26%, which came from a healthy and complementary mix of both strong organic business growth and incremental new business from the Octane Fitness acquisition. The organic retail business increased at over 20%, while the direct business increased 10% over the same period prior year.

These are very satisfying growth numbers considering the recent events in the general retail environment and the challenging comparison period we faced in the direct business when revenues were up 46%. Improving gross margins is one of our key initiatives and I am also very pleased to report that our efforts resulted in increases in both the direct and retail segments in the first quarter 2016.

Because of the higher retail sales growth and resulting shift in channel mix, gross margins on a consolidated basis declined by 110 basis points to 54.9%, as we expected. As mentioned in previous calls, because of our very different operating expense structures between the two businesses; so long as each business segment's margins are maintained or growing, fluctuations in channel mix alone should not adversely impact overall bottom-line profitability.

Briefly looking at our bottom line, we continue to see positive improvement with a 10% increase in operating income, and a 15% increase in EBITDA from continuing operations. The underlying operating performance is even stronger, excluding certain noncash purchase accounting entries relating to the recent acquisition of Octane Fitness, which Sid will comment on.

We are very encouraged by the continued strong momentum and outlook in our organic businesses, and remain very excited about the added opportunities that the Octane Fitness platform will provide. Our optimism and outlook is based on careful study of the capabilities inherent in the business, and is reflected in the upward revisions to our targeted long-range financial performance metrics. Sid will provide further details.

With that I would like to turn the call over to Sid to review our financials in more detail.

Sid Nayar - *Nautilus, Inc. - CFO*

Thank you, Bruce. I would like to review the details of our financial results for the first quarter of 2016. As a reminder, this will be the first quarter where we include the financial results of Octane Fitness within our retail channel. Net sales for the first quarter of 2016 totaled \$120.9 million, an increase of 25.7% as compared to the same period in the prior year.

First quarter gross margins increased 110 basis points in the direct segment to 66.3% and were up 790 basis points in the retail segment to 29.9%, when compared to the same quarter last quarter year. Retail margins include the impact of a \$0.7 million noncash inventory step-up charge related to the Octane Fitness acquisition. Excluding this charge, retail gross margins would have been 31.8%.

On an overall basis total company gross margins for the first quarter 2016 declined by 110 basis points to 54.9% versus the same period prior year. Reflecting channel mix as a result of higher retail sales growth and the previously mentioned noncash charge. Total operating expenses for the first quarter of 2016 as a percentage of net sales increased to 38.9% from 37.7% in the same period last year. Reflecting higher amortization expense related to the Octane Fitness acquisition, as well as increased spending in product development partially offset by lower sales and marketing expenses as a percentage of sales due to the change in channel mix.



Sales and marketing expense for the first quarter of 2016 was \$35.2 million or 29.1% of net sales as compared to 28.4% -- \$28.4 million or 29.5% net sales in the same period last year. The increased dollar amount primarily reflected higher media spending, as well as the inclusion of expenses related to Octane Fitness. As previously stated, improvement in sales and marketing as a percentage of sales relates to the shift in mix to a more retail-rated channel mix.

General and administrative expenses were \$8.2 million or 6.8% of net sales for the first quarter of 2016, which compares to \$5.6 million or 5.8% of net sales in the same period last year. The increased dollar spending in G&A primarily reflects the addition of Octane Fitness, as well as \$0.8 million of higher amortization expense for intangible assets that was also related to the acquisition.

Research and development costs in the first quarter 2016 were \$3.6 million or 3% of net sales compared to \$2.3 million or 2.4% of net sales in the same period last year. The dollar increase reflects our continued investment in the engineering and design resources required to continue to innovate and broaden our product portfolio, coupled with the addition of incremental product development resources related to the Octane Fitness acquisition.

Operating income for the first quarter of 2016 increased to \$19.3 million as compared to \$17.6 million in the same quarter last year. The increase reflects higher net sales and gross margins in both segments, partially offset by higher acquisition-related expenses of \$1.5 million, including the increased amortization expense of \$0.8 million and the inventory step-up charge \$0.7 million. Operating margin for the first quarter of 2016 was 16% compared to 18.3% for the same period last year.

Excluding the \$0.7 million noncash inventory step-up charge referenced previously, operating income for first quarter 2016 was \$20 million, a 13.7% increase over the same quarter in 2015. EBITDA from continued operations in the first quarter of 2016 increased by 14.7% to \$21.1 million versus \$18.4 million for the same quarter of the prior year. Income from continuing operations for the first quarter of 2016 was \$11.6 million or \$0.37 per diluted share as compared to \$10.9 million or had \$0.34 per diluted share for the same period last year.

Excluding the noncash inventory step-up charge, income from continuing operations for the first quarter of 2016 was \$12 million or \$0.38 per diluted share. The effective tax rate for the first quarter of 2016 was 38.3% compared to 38% in the same period last year. Total net income including discontinued operations for the first quarter of 2016 was \$11.4 million or \$0.37 per diluted share, which includes a \$0.1 million loss, net of taxes, from discontinued operations.

This compares to the first quarter last year, where we reported total net income including discontinued operations of \$10.7 million or \$0.34 per diluted share, which included a loss from discontinued operations of \$0.1 million net of taxes. Turning now to our segment results, net sales in the direct business totaled \$81.2 million for the first quarter 2016, \$9.7 million increase over the same quarter last year.

Direct segment sales benefited from continued strong demand for our cardio products, primarily Max Trainer, coupled with a slight uptick in strength product sales. Gross margin for the direct business improved to 66.3% for the first quarter of 2016 compared to 65.2% in the same quarter last year. Gross margin improvement was primarily due to favorable product mix and continued leverage of our supply chain costs.

Operating income for the first quarter of 2016 in our direct business was \$21.1 million compared to \$19.6 million in the same quarter prior year. Operating income benefited from higher net sales and gross margins in the first quarter of 2016. Net sales in our retail segment for the first quarter of 2016 were \$38.8 million, an increase of 82.3% compared to \$21.3 million in the first quarter of last year.

The improvement in retail net sales reflects strong double-digit growth across both the cardio and strength components of the organic retail business, coupled with improved international sales year over year. While the addition of Octane Fitness also added incremental sales to the retail category, the dealer/consumer portion within the segment dictation some headwinds from slower retail traffic and inventory rebalancing relative to the prior year.

Gross margins for the retail business improved by 790 basis points to 29.9% in the first quarter of 2016, that is compared to 22% for the prior period. Retail gross margins include the impact of the previously mentioned \$0.7 million purchase price inventory step-up charge related to Octane Fitness acquisition. Excluding this charge, retail gross margins would have been 31.8% up, 980 basis points versus prior year gross margin of 22%. Retail

margin improvement can be attributed to improved product mix, better leveraging of supply chain costs; as well as inclusion of Octane Fitness products, which generate higher gross margins.

In the first quarter of 2016 operating income for the retail business totaled \$3.9 million as compared to \$1.5 million in the same period of last year. The increase is attributable to the higher revenue and gross margins.

Now turning to the consolidated balance sheet. Cash and investments totaled \$72.8 million as of March 31, 2016, with \$76 million of debt. This compares to \$60.8 million in cash and debt of \$80 million at December 31, 2015. Inventories were \$36.8 million as of March 31, 2016, compared to \$42.7 million at December 31, 2015; and \$20 million at March 31, 2015.

The decrease in inventory versus year end 2015 relates to the seasonality of the business, while the increase in inventory compared to March 31, 2015, primarily reflects the addition of Octane Fitness. Trade payables were \$38.5 million as of March 31, 2016, compared to \$61.7 million at the end of 2015. Capital expenditures totaled \$0.8 million for the three months ended March 31, 2016, which is pending primarily on product tooling and IT assets.

We anticipate full year Capex to be in the range of \$7 million to \$8 million.

Finally, I wanted to provide an update to our long-term operating metrics, which we last revised approximately a year and a half ago. As a reminder, these metrics are intended to reflect Management's assessment of the businesses' annualized growth capability over three- to five-year horizon. We have left the revenue growth target unchanged at 10% to 12% per year.

We continue to target operating income growth to exceed revenue growth. We have increased our targeted range for operating income as a percent of revenue from a range of 9%-13% to a new range of 11%-15%. We have added a range for EBITDA from continuing operations as a percent of revenue of 13%-17%, to better reflect the post-acquisition environment that includes higher amortization and interest expense.

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?

Bill McMahon - Nautilus, Inc. - COO

Thank you, Sid. Good afternoon, everyone. I would like to provide additional background on our recent results and the overall position of our business. Starting with the direct segment, we reported another quarter of strong revenue and operating income growth. We are pleased with this growth given the challenging year over year comparisons in which revenues increased 46% in Q1 of 2015 versus the same period in 2014.

Direct segment sales primarily benefited from continued increase consumer demand for our cardio products, especially the Bowflex Max Trainer. In addition, we saw growth in strength sales due to improved performance in home gyms.

As Sid outlined we reported strong direct channel operating income, driven primarily by higher sales and improved gross profit margins coupled with leveraging operating expenses over higher sales. To get more details specifically on Max Trainer, sales of the Max Trainer product continued on a very strong growth trajectory in the first quarter. This trajectory continues to exceed our internal expectations and the historical performance of the direct channel products from the past.

Sales and margins were further fueled by the introduction of the Max Trainer M7 model during Q1. M7 sales also exceeded our projections in terms of mix, and we are currently working to ramp up M7 production volume to reduce the current lead time for a new purchase. Meanwhile, TreadClimber sales have been assisted by the new TC100 and TC200 models we launched in Q2 2015. However, sales were still on a post-peak declining path. We attribute this to the age of the product category, now approaching 12 years, and the continued strong trend in Max Trainer growth.

We feel walking as a category is a large and profitable category and our product road map includes plans to address this trend in the long-term. Additionally, we continue to see a modest rebound in strength category performance in both direct and retail. Strength as a category remains one



of our more promising areas for product development, and as such we have launched the Bowflex 560 Dumb Bell and direct catalog reaching consumers by mail this week, and the products will go live online during Q2.

Also, our next major direct product launch will be related to the strength category, but involve a new approach to whole-body training. While we cannot disclose too much about it now, we do currently anticipate this product being ready for market by early 2017. We plan to discuss this product further and demonstrate it at our new product showcase in New York City in late September.

As we exit Q1 and move into our off-season for direct, our current credit, media, and consumer response trends remain very favorable. Based on this data, we anticipate continued direct channel growth in revenue and profits throughout 2016. Now turning to our retail segment, we are very pleased to have delivered sales growth of 82% when compared to the first quarter of 2015. This improvement was primarily due to the addition of Octane Sales to the channel; however, our original retail sales categories, which include sporting goods online sales, also delivered strong growth in revenue and profit.

We are encouraged by recent product contributions from Octane Fitness, including the continued success of Zero Runner. Building on that success, our team introduced the next addition to the zero returning family at the IHRSA and [Tebow] trade shows in Q1. The commercial Zero Runner XR8000 was received very well and we were impressed by the interest that the product generated. XR8000 will launch midyear.

Further, we are also seeing continued interest for recently launched Octane Fitness XT-One cross trainer, including the recent announcement that XT-One has been added to the range of premium Octane Fitness products at the David Lloyd Leisure Clubs in the United Kingdom. This is one of several examples of how the acquisition of Octane Fitness is a diversifying our brand offerings and expanding our channel opportunities.

As Bruce mentioned, we are very pleased to report retail gross margins increased 790 basis points compared to the same quarter last year. Primarily due to the inclusion of Octane Fitness, which has accretive growth and operating margins while adding incremental categories to our retail business.

Excluding the impact to cost of sales of \$0.7 million inventory step-up charge Sid described, retail gross margins would have been 31.8% for the first quarter of 2016. While Octane Fitness growth margins are, and will continue to be, accretive to the overall retail channel, it is important to note that sporting goods and online segment almost posted year over year improvement margin, sustaining the relative gains we reported in Q4 2015. Octane sales in Q1 were impacted by some softness in the overall consumer specialty segment, but this was partially offset by stronger performance in commercial products.

Meanwhile, sporting goods and online sales were strong across multiple categories, including bikes, tread mills, and (inaudible) weights. Further, international sales also grew strongly in Q1 2016, primarily driven by the addition of Octane Fitness Sales and the continued deployment of Bowflex Max Trainer, which is now available in 15 countries.

Turning to the retail bricks and mortar space, we are closely following development related to the Sports Authority, which is currently in reorganization proceedings. We previously fully reserved receivables for that retailer in Q4 2015. Additionally, last month the smaller retail chain, Sport Chalet, announced closure of all doors and we have received -- reserved a small nonmaterial amount for this partner in Q1.

In the bigger picture, our desire is to stay ahead of the changing trends in the retail landscape and adapt our strategies to win in the new environment. Our products are performing well with strong partners in the industry, both online and in store. Our growth in Q1, despite the departure two of accounts from the segment, is reflective of that strategy. We recently included the majority of our retail sell-in process for Fall 2016.

During that process, we previewed retail products that we plan to launch in the next year with buyers and merchandiser from all major accounts. Our products were well-received and we plan to showcase them at our new product showcase event in New York City in late September. The assortment of products includes the new Zero Runner ZR8000, a refresh line of the highly successful Schwinn cardio series of bikes, ellipticals, and treadmills.

In addition, we will launch a new best line of Nautilus Cardio products, targeting incremental price points; and preview a plan line of Bowflex-branded ellipticals and treadmills, targeted at still another incremental price point. The addition of Octane gives us expanded sales reach and expertise in the specialty commercial markets and further it helps in reaching international customers.

This, combined with our ongoing effort in sporting goods and online, and with the positive reception our new products has received provide optimism for continued growth in revenue and profitability for our retail channel in 2016. Before returning to Bruce for final comments, I would like to mention that integration efforts involving the Nautilus and Octane teams are well underway and the similar cultures in both organizations is paying off.

Our approach to integration is to take the best of both businesses and unite around a path that delivers highest value for the capital invested. Given the strong talent on both teams, the majority of that value will be in reaching incremental markets and price points faster, but we have already identified some supply chain cost opportunities in terms of freight and other areas where our combined entity has better negotiating power.

Four months into working together, we could not be more pleased with the teamwork we are seeing. The talent and teamwork will be the formula that makes this partnership successful going forward. In short, we are well-positioned to maintain a strong growth trajectory and we are encouraged by the progress of the integration of Octane Fitness with its ideal synergies into the Nautilus businesses.

Looking forward, we remain focused on continuing diversification of our product portfolio, the expansion of our distribution channels, and increasing our access to global markets. With that, I would like to turn the call back over to Bruce for his final comments.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Thank you Bill. I would like to make a few final comments before we open up the call for questions. 2016 is off to a strong start, and progress is good, as we are executing well to a plan that delivers on our goals of achieving another year of robust sales and profitability growth. We continue to push advancements in product innovation and design, coupled with creative ways to expand our reach to both the home use and commercial use customer bases worldwide.

Our brands resonate well with consumers in these varied markets, and we intend to keep building on that. The financial health of our business remains strong, and we are well-positioned to continue to execute on strategies designed to maximize long-term shareholder value. Our strong cash flow and healthy balance sheet affords us investment opportunities to enhance value in multiple aspects of our Company.

One of these is evidenced by the press release from earlier today, announcing an incremental \$10 million stock buyback program. Finally, I would like to take this opportunity to thank our dedicated employees who work so hard to deliver desired results and who create the positive momentum that continues to make our Company stronger, even stronger. That concludes our prepared remarks. Now I would like to open up the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). One moment please for the first question. And our first question is from the line of Lee Giordano with Sterne Agee. Please go ahead.

Lee Giordano - *Sterne Agee - Analyst*

Thank you. Good evening, everybody.



Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Hi Lee.

Lee Giordano - *Sterne Agee - Analyst*

Just on the retail segment first, can you talk about your latest efforts to get into specialty and how that is progressing at this point in time? And then just, secondly, what are you seeing in terms of the softness in the commercial specialty segment? Exactly what is occurring there, and is that a new development? It is not the first time we are hearing that, so just wondering if you can pinpoint what is happening.

Bill McMahon - *Nautilus, Inc. - COO*

Hi Lee, Bill here. We did see -- and we have noted others reported some softness in specialty, and it seemed to be across the board in the category, at least for this fitness season. And multiple categories really of products within that area, and it seems to be a traffic at specialty issue. In terms of what our plans are for specialty, we believe that the way to win in that category is make a reason for people to come to the store.

And Octane has already embarked on this path with the Zero Runner, a unique product, unique solution that people wanted to come and see. And we believe more of that will help the category in general at least as far as we are concerned. So, you know, near term, this event happening does not change our outlook for Octane, which was otherwise strong in the commercial segment; but it does make us say, you know, as we approach the specialty channel we need to continue to do the things we do well, which is bring innovation and partner with those specialty retailers to help drive traffic, which I think we have some capability to do as well.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

I think, Lee, I would add to Bill's comments that, you know, we had the 80 Pro, the Schwinn Airdyne bike that was targeted towards specialty and cross-fit gyms and everything, that channel of distribution. And Octane has picked up at the beginning of this quarter, they have now picked up responsibility for selling that product with all of their field sales organization deployed. And the feedback has been positive in that channel for that, for that bike. So that is a little bit of the early synergies that we talked about from a revenue standpoint.

Lee Giordano - *Sterne Agee - Analyst*

Got it, thanks. And then, Sid, just quickly, the EBIDTA guidance that you gave in long-term operating metrics, I missed exactly what that was. Can you repeat that, please?

Sid Nayar - *Nautilus, Inc. - CFO*

Sure. The EBIDTA guidance was essentially 13%-17% of revenue. Was the range.

Lee Giordano - *Sterne Agee - Analyst*

Got it. Thank you very much.

Sid Nayar - *Nautilus, Inc. - CFO*

Yeah.



Bill McMahon - *Nautilus, Inc. - COO*

Thank you, Lee.

Operator

Thank you. Our next question is from the line of Mark Schwartz with SunTrust. Please go ahead.

Mark Schwartz - *SunTrust - Analyst*

Hey, guys. How are you?

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Hi, Mark.

Mark Schwartz - *SunTrust - Analyst*

Just to continue on the Octane commentary a little further, maybe just from a 30,000-foot view, can you just give us maybe what some of the early learnings on that business are now that you have had it under your belt for about four or five months?

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Yeah. I think it is kind of everything that we were hoping, I would say, in terms of we talked about culture fit, I think in Bill's commentary. We talked about the innovation pipeline that Octane has, and I think; I guess one of the really neat surprises -- we were not totally surprised -- is our teams, how well they are coming together to jointly fill in product road maps, supply chain efficiencies, and things like that. There is excellent sharing going back and forth, and so we continue to be very optimistic about, you know, the growth potential and possibilities in terms of operating performance that the business has at Octane.

Mark Schwartz - *SunTrust - Analyst*

And then just second question, one of your competitors a few weeks back noted some caution around a large department store chain that obviously is a large retailer of cardio and fitness equipment. Can you just talk about just some of your credit exposure to different retailers out there? I know you talked about some of the sports specialty guys but just maybe a more holistic picture, please?

Sid Nayar - *Nautilus, Inc. - CFO*

Sure. Mark, this is Sid. We do not give breakout by individual customer but what I can say is, you know, we just have one customer that represents over 10% of overall sales. I would say it is a fairly broad-based brick and mortar/eCommerce platform base of customers that we have. And I think really at the end of the day, when you sort of look at -- you know, we continue to look at mitigating our risks by, quite frankly, looking at these customers very closely and it is sort of reflected in our experience with the Sports Authority and Sports Chalet, as you can see both those were relatively immaterial from our perspective.



Mark Schwartz - *SunTrust - Analyst*

Okay, thanks.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Yeah, I would only add to Sid's comment and say our optimism on our ability to grow sporting goods and online is also with that understanding of our desire to remain conservative where appropriate in regards to credit lines.

Bill McMahon - *Nautilus, Inc. - COO*

Thanks, Mike.

Operator

Our next question is from the line of Andrew Burns with D.A. Davidson.

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

Good afternoon. Congratulations on a great quarter.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Thanks, Andrew.

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

It is nice to see an uptick across both channels. Do you think that is entirely product driven, or is there some underlying change in fitness trends that you are tapping into there and potentially tapping into more so with your upcoming product launch? Thanks.

Bill McMahon - *Nautilus, Inc. - COO*

We definitely think, Andrew, Bill again, thank you for the complements on the business results. We definitely think there is a trend going on. We think there is some emerging trends, and we definitely have either incorporated those things into Max, which involve high intensity training as part of cardio.

And our upcoming product we will also incorporate some things that we believe are trends. And strength is related to that. There is a general uptick in participate -- and participation in resistance-based training and incorporating that as part of a greater whole.

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

Great, thanks for that. And I know you are hesitant to give any sort of quarterly or segment growth. As I look at the first quarter performance, direct facing incredibly difficult comparisons and then easting a bit; and then you look at the retail side and great performance at the start of the year, very difficult end markets there. Is it reasonable to think that the segment growth rates would converge over the balance of the year?



Bill McMahon - *Nautilus, Inc. - COO*

I think we -- I think -- and Sid can chime in here, but I think, Andrew, we -- as you said, we are pleased with the revenue growth that direct delivered on top of that big comp. Retail remains -- you know, we -- I would say that we are solidly in the double digits for retail. That is excluding the incremental sale from Octane. That will just be additive.

But I would say that we are still comfortable with the long-range revenue growth parameters that Sid outlined in his commentary of that low double digit, let us say 10%-12%, I think we said; and I think that that is basically what we are seeing. It is still early in the year, but we feel like we have a line of sight to be able to deliver on our commitment as far as that long-range operating metric this year and then beyond.

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

Good, thanks. In years past, in the second quarter and third quarter, there have been times where you have invested marketing spend to create awareness and drive regeneration ahead of the upcoming 4Q, 1Q sales season. Did not know if you could perhaps outline plans this season, or just help us better understand what that would mean for the P&L here?

Bill McMahon - *Nautilus, Inc. - COO*

Yeah, I think, Andrew, the answer to that is we do not have a specific plan to intentionally inflate over our current ratios in terms of media spend. I will say our media spend will be higher year over year as we continue to invest in Max Trainer, but we would anticipate getting returns on that as Max becomes a more mature category at this point versus a launch category. And this year, in the off-season, we will be increasing spend, but I would expect to see the good return on that.

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

Great, thanks. And one last one, as you look at your approach to specialty, there is the Octane acquisition, AD Pro, I would imagine the Bowflex, the cardio would have the potential to be in specialty. Clearly some effort going into that channel. I was hoping you could maybe characterize your view in terms of the health of that channel versus mainline sporting goods, which clearly has hit a soft patch here.

Bill McMahon - *Nautilus, Inc. - COO*

I think specialty actually is healthy. There -- some of the things contributing, we think, to what has happened recently is, there was a large specialty dealer who changed hands in ownership and there was some -- you know, any time that happens there is usually some stepping in and some caution initially before things get settled out over time. And I think the specialty dealers that exist today have been through that sort of thinning out that happened post-recession, and we believe the majority of those partners are certainly strong and they are looking for unique products to grow with.

But it is going to be, as we go forward, they face the same challenges that the bricks and mortar folks do, which is that move to online sales. We see that trend shifting in our own direct business, where the shift to online sales, and mobile especially, is very strong. And I think we are sort of uniquely situated compared to some of our competitors to be able to help those partners with ways to, you know, drive traffic and awareness of products that are in their store.

Now we need to prove that out, but we believe that is our secret to helping them, so those specialty guys that work with us going forward I think will be the beneficiaries of that multi-channel reach that we can bring to the table.



Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

The other thing I would add, Andrew, is just to put -- scale it for you, is to think about -- we talked a lot about specialty here, but that is really only one of a number of channels that Octane does business in in terms of a revenue stream, and not to mention obviously our traditional bricks and mortar and dot-com business and our direct to consumer.

So, I mean, you have to scale it, you know, even if there is a little bit of perceived headwinds right now; and I think they are real in the early part of 2016 and specialty, you have to look at that. That is a -- you know, maybe \$300 million, \$400 million industry on the basis of a \$10 billion worldwide industry. So you have to keep that in mind too. It is still a value add, that channel provides that we believe in, and there is a void out there that they fill very nicely.

So it is still very active for us, and we think we can grow in that channel for sure. So -- but it is just important to keep in mind in terms of the scale of it relative to everything else too, though.

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

Good. Thanks and good luck.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Thank you, Andrew.

Bill McMahon - *Nautilus, Inc. - COO*

Any other questions, Operator?

Operator

(Operator Instructions). Our next question is from the line of Frank Camma with Sidoti & Company. Please go ahead.

Frank Camma - *Sidoti & Company - Analyst*

Good afternoon, guys.

Bill McMahon - *Nautilus, Inc. - COO*

Hey, Frank.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Hi, Frank.

Frank Camma - *Sidoti & Company - Analyst*

Can you talk about the way you are marketing the new dumbbells? You have mentioned you already went out on a catalog basis, rather than going online. So is it mostly right now to former customers? Is that how you are going about it?



Bill McMahon - *Nautilus, Inc. - COO*

Our catalog goes out to incremental and former customers so it is a little bit of everything there. Next it will be online on our own eCommerce sites and we will use digital marketing to promote it as well. And then it will grow from there. It is not going to be a TV product, but at some point a new dumbbell technology will certainly be shared across both direct and retail.

Frank Camma - *Sidoti & Company - Analyst*

Okay, all right. And on international, you mentioned you are in 15 countries now. Can you just remind us like this time last year, roughly how many countries you were in?

Bill McMahon - *Nautilus, Inc. - COO*

I think -- yeah, Max Trainer. I think maybe one at this time last year.

Frank Camma - *Sidoti & Company - Analyst*

Okay.

Bill McMahon - *Nautilus, Inc. - COO*

Maybe two.

Frank Camma - *Sidoti & Company - Analyst*

One or two, all right. Fine. And last question for me is just on the R&D spend, you know, it has ticked up to 3%, which I think a long time ago you mentioned that was kind of where -- the direction you were going in. Is that the -- but that was pre-Octane and everything. Is that a level you think you are comfortable with, that 3% of revenue? Or is it -- I mean, is it even tied to revenue. Can you discuss that a little bit? Because obviously it is up above a percentage and an absolute basis.

Sid Nayar - *Nautilus, Inc. - CFO*

Yeah. I think as you pointed out the Octane combination is a big part of that increase, but back to your point, Frank, I think sort of short-term we are continuing to invest heavily on the product development side.

So we may even see a slight tick up above that 3% in 2016. But, you know, we do believe that is where the game is at. It is in terms of new product and in terms of new renovation. So that will be, from our perspective, sort of that 3% is still very real and it could go up to something, you know, 20, 30 basis points above that too in 2016.

Frank Camma - *Sidoti & Company - Analyst*

Okay, great. Thanks, guys.



Bill McMahon - *Nautilus, Inc. - COO*

Thanks, Frank.

Operator

Thank you. And our next question is from the line of Rommel Dionisio with Wunderlich Securities. Please go ahead.

Rommel Dionisio - *Wunderlich Securities - Analyst*

Thanks, good afternoon.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Hi, Rommel.

Rommel Dionisio - *Wunderlich Securities - Analyst*

Hi Bruce. Just a clarification question on the improved product mix that is being key driver and for gross margins in the retail channel. Is that, you know obviously Octane Fitness has higher gross margins, but there also just within the organic retail segments positive gross margin driver there? Whether that is price point differential or moving to strength or something? If you can provide more granularity on that, please.

Sid Nayar - *Nautilus, Inc. - CFO*

Sure, Rommel. Actually there has been substantial price point improvements in the organic channel as well. If you recall it was about 22% last year but really a imitation of product. It is some higher price points. It is a change in product mix as well. Clearly, growth in the strength product category, as well as channel-related improvement in selling Max Trainer, all of those are key drivers to improving and going up the organic retail margins.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

-- and International.

Sid Nayar - *Nautilus, Inc. - CFO*

Right.

Rommel Dionisio - *Wunderlich Securities - Analyst*

Okay. Also, just, you know, thinking about more strategically the timing of certain new product launches; you know, obviously the M7 and this new SelectTech are coming in after that sort of that holiday post-New Year's Resolution period. Is the thought, strategically, just to stagger the product launches and focus on specific product launches as time goes on. or it seems that you are missing the key holiday season, obviously it will be there for next year, but can you just maybe talk to that point to some degree?



Bill McMahon - *Nautilus, Inc. - COO*

Sure, Rommel. On the direct product field you will probably recall with did he launch last fall the TC100 and 200 Refreshes, and TreadClimber. We do try to stagger our launches so we are not launching on top of each other, especially if it is a TV product like TreadClimber and/or Max.

Hence the decision, Max as a category was doing quite well so a little bit of staggering away from the TreadClimber launch was in our opinion a good move. 560, since it is not on TV and to be honest we are a little late getting it out so we are just trying to get it launched and move on. But direct, we have a lot of flexibility on when we can and decide to launch things. And direct speak period really is Q1 versus F4.

On retail, there is very fixed product launch dates that need to be hit and that has to do with the retailers' needs. So, you know, the channels themselves are sort of independent in regards to product launch timing. But there is a method to the way we approach it and as you said, it is about staggering the launches where possible in direct.

Rommel Dionisio - *Wunderlich Securities - Analyst*

Great. That is very helpful. Thanks and congratulations on the quarter.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Thank you, Rommel.

Bill McMahon - *Nautilus, Inc. - COO*

Thank you.

Operator

Thank you. And our next question is from the line of Steven Martin with Slater Capital Management. Please go ahead.

Steven Martin - *Slater Capital Management - Analyst*

Hi, guys.

Bill McMahon - *Nautilus, Inc. - COO*

Hi, Steve.

Steven Martin - *Slater Capital Management - Analyst*

Recognizing that this acquisition was not one designed to reduce a lot of redundant costs, can you talk a little bit about -- and I know you alluded to it -- you know, what you are seeing now that you are sort of past the first quarter in terms of any redundancies or benefits from combined distribution sourcing, overseas, sales forces, et cetera?

Bill McMahon - *Nautilus, Inc. - COO*

Steven, Bill here. We absolutely see, you know, in terms of redundancy and people, we do not see any reductions coming in that area. We wanted the talent from Octane to meld with our talent, and that viewpoint has been proven factual and necessary going forward. So there is little to no overlap on our sales forces, for example, to specifically address that.

In regards to supply chain, though, we went into this with the assumption of the products, you know, very different price points, very different channels. But we are already seeing in terms of our logistics capability and overall supply chain that there will in fact be opportunities to save money across the board with the combined entity, and we anticipate some of that benefit will come perhaps sooner than we would have guessed.

So there are definitely some positives in terms of savings and efficiencies. But I would not look for it in terms of head count. We definitely want the talent we have on both teams.

Steven Martin - *Slater Capital Management - Analyst*

Got you. Specifically as it relates to the retail channel, recognizing Sports Authority and Sports Chalet are -- well, one is definitely disappearing, and I think the assumption most people are making is that Sports Authority as an entity will disappear, but that many of the stores or volumes will be picked up by competitors. If I look at a Sports Authority door versus a Dick's door versus an Academy door, how would you categorize your exposure or your volume to each?

Bill McMahon - *Nautilus, Inc. - COO*

We do not give away or disclose information related to various account sizes. I will say that that we are well-represented in Dick's Sporting Goods and Academy. However, we would always like to earn our place into more spaces.

Part of the reason that we are able I think to continue to grow in retail overall, despite let us say some turmoil in the space at the moment, is that we are a very small share from a starting point; and hence, in some cases these challenges create openings for us because retailers are looking for answers. When our product performs well and it is very well-reviewed online as our product is, then it actually nowadays becomes more and more of a selling point to have the product on the floor.

So for us we think opportunity -- now we have to be cautious, and as Sid talked about earlier, we need to work with the right partners at the right level of credit. But we believe that there is opportunity in the retail space, both online and bricks and mortar right now because of what is going on, and we are looking to have our strategy and products fit that need.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Any other questions, Operator?

Operator

And there are no further questions on the phone lines. I will turn it back to the management team for their closing comments.

Bruce Cazenave - *Nautilus, Inc. - CEO, Director*

Great, thank you. Thank you all for joining our call today and for your continued interest in Nautilus. We look forward to updating you on our progress on our next call in August, and hope everyone has a great afternoon. Thank you.



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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