

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

FORM 10-K

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

For the Fiscal Year Ended: **December 31, 2000**

OR

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

Commission File Number: **000-25867**

DIRECT FOCUS, INC.

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of incorporation
or organization)

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

1400 NE 136th Avenue, Vancouver, WA
(Address of principal executive offices)

98684
(Zip Code)

Registrant's telephone number, including area code: **360-694-7722**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, without par value**

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K.

The aggregate market value of the voting stock held by non-affiliates of the Registrant is \$543,460,314 as of February 28, 2001 based upon the last sales price as reported by the Nasdaq National Market System.

The number of shares outstanding of the Registrant's Common Stock as of February 28, 2001 was 23,744,414 shares.

The Index to Exhibits appears on page 45 of this document. This document consists of 89 pages.

Documents Incorporated by Reference

The Registrant has incorporated by reference into Part III of this Form 10-K portions of its Proxy Statement for its 2001 Annual Meeting of Stockholders.

**DIRECT FOCUS, INC.
2000 FORM 10-K ANNUAL REPORT
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PART I**Item 1. Business****Forward Looking Statements**

Certain statements contained in this Annual Report on Form 10-K, including, without limitation, statements containing the words "believes," "anticipates," "estimates," "intends," "expects," "projections," and words of similar import, constitute "forward-looking statements." Investors are cautioned that all forward-looking statements involve risks and uncertainties and various factors could cause actual results to differ materially from those in the forward-looking statements. From time to time and in this Form 10-K, we may make forward-looking statements relating to our financial performance, including the following:

- Anticipated revenues, expenses and gross margins;
- Anticipated earnings;
- New product introductions; and
- Future capital expenditures.

Numerous factors could affect our actual results, including the following:

- Our reliance on a limited product line;
- Market acceptance of our existing and future products;

- Growth management challenges;
- Our limited experience in marketing Nautilus Sleep Systems;
- A decline in consumer spending due to unfavorable economic conditions;
- Government regulatory action;
- Our ability to effectively identify and negotiate any future strategic acquisitions, as well as to integrate any acquired businesses into our operations; and
- Unpredictable events and circumstances relating to international operations, including our use of foreign manufacturers.

We describe certain of these and other key risk factors elsewhere in this Form 10-K. Readers are further cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this Form 10-K. We undertake no obligation to update publicly any forward-looking statements to reflect new information, events or circumstances after the date of this Form 10-K or to reflect the occurrence of unanticipated events.

INTRODUCTION

Direct Focus, Inc. is a leading marketing company for fitness and healthy lifestyle products with a highly-effective direct business model. We market consumer products within our direct marketing segment directly to consumers through a variety of direct marketing channels, including spot television commercials, infomercials, print media, response mailings and the Internet.

Our principal and most successful direct-marketed product to date has been our Bowflex line of home fitness equipment. We also offer a line of premium quality air sleep systems under the name "Nautilus Sleep Systems," which we began direct marketing on a nationwide basis in December of 1999.

Another significant component of our operations is our commercial and retail products segment, which encompasses products and operations outside of our direct products segment. Our commercial and retail products segment includes Nautilus commercial and retail fitness equipment and accessories, which we added in January 1999 as part of our acquisition of Nautilus International, Inc. We anticipate further leveraging our Nautilus brand name through expanded marketing of new Nautilus home gyms and a new line of Nautilus free weight home gym equipment which we introduced in the summer of 2000, as well as any other Nautilus-branded home exercise products we may introduce in 2001. We market and sell our Nautilus commercial fitness equipment domestically through a direct sales force and internationally through independent sales representatives. We market our other Nautilus retail products domestically through non-exclusive independent sales representatives. We believe we have effectively integrated the Nautilus commercial business into our operations and stabilized its financial performance, as evidenced by its profitability during our first two years of ownership.

For a discussion of financial information about our two business segments, direct products and commercial and retail products, see Note 2 of the Notes to Consolidated Financial Statements.

Direct Focus was incorporated in California in 1986 and became a Washington corporation in 1993. Our principal executive offices are located at 1400 NE 136th Avenue, Vancouver, Washington 98684, and our telephone number is (360) 694-7722. We maintain our corporate web site at www.directfocusinc.com. None of the information on this web site or our other web sites is part of this Form 10-K.

As used in this Form 10-K, the terms "we," "our," "us," "Direct Focus" and "the Company" refer to Direct Focus, Inc. and its subsidiaries. The names Bowflex®, Nautilus®, Bowflex Power-Pro®, Motivator®, Versatrainer®, Power Rod®, Direct Focus®, Instant Comfort® and Nautilus Sleep Systems® are registered trademarks of Direct Focus, Inc.

DIRECT MARKETING

We direct market our Bowflex home fitness equipment and Nautilus Sleep Systems principally through 30- and 60-second, or "spot," television commercials, television infomercials, the Internet, response mailings and print media. To date, we have been highly successful with what we refer to as a "two-step" marketing approach. In general, our two-step approach focuses first on spot commercials, which we air to generate consumer interest in our products and requests for product information. The second step focuses on converting inquiries into sales, which we accomplish through a combination of response mailings and outbound telemarketing. We supplement our two-step approach with infomercials, which generally are designed to provide potential customers with sufficient product information to stimulate an immediate purchase.

Advertising

Spot Commercials and Infomercials. Spot television commercials are a key element of the marketing strategy for all of our direct marketed consumer products. For direct marketed products that may require further explanation and demonstration, television infomercials are an important additional marketing tool. We have developed a variety of spot commercials and infomercials for our Bowflex product line and several commercials and marketing videos for our Nautilus Sleep Systems product line. We expect to use spot commercials and, where appropriate, infomercials to market any consumer products that we determine are appropriate for direct marketing.

When we begin marketing a new product, we typically test and refine our marketing concepts and selling practices while advertising the product in spot television commercials. Production costs for these commercials can range from \$50,000 to \$150,000. Based on market research and viewer response to our spot commercials, we may produce additional spot commercials and, if appropriate for the product, an infomercial. Production costs for infomercials can range from \$150,000 to \$500,000, depending on the

scope of the project. Generally, we attempt to film several infomercial and commercial concepts at the same time in order to maximize production efficiencies. From this footage we can then develop several varieties of spot commercials and infomercials and introduce and refine them over time. We typically generate our own scripts for spot commercials and hire outside writers to assist with infomercial scripts. We also typically contract with outside production companies to produce spot commercials and infomercials.

Once produced, we test spot commercials and infomercials on a variety of cable television networks that have a history of generating favorable responses for our existing products. Our initial objective is to determine the product's marketing appeal and what, if any, creative or product modifications may be appropriate. If these initial tests are successful, we then air the spot commercials and infomercials on an accelerating schedule of additional cable networks.

Media Buying. An important component of our direct marketing success is our ability to purchase quality media time at an affordable price. The cost of airing spot commercials and infomercials varies significantly, depending on the network, time slot and, for spot commercials, programming. Each spot commercial costs between \$25 and \$5,000 to air, and each infomercial costs between \$600 and \$55,000 to air. We currently purchase the majority of our media time on cable networks, through which we reach more than 70 million homes.

We track the success of each of our spot commercials and infomercials by determining how many viewers respond to each airing of a spot commercial or infomercial. We accumulate this information in a database that we use to evaluate the cost-effectiveness of available media time. In addition, we believe the database enables us to predict with reasonable accuracy how many product sales and inquiries will result from each spot commercial and infomercial that we air. We also believe we can effectively track changing viewer patterns and adjust our advertising accordingly.

We do not currently purchase media time under long-term contracts. Instead, we book most of our spot commercial time on a quarterly basis and most of our infomercial time on a monthly or quarterly basis, as networks make time available. Networks typically allow us to cancel booked time with two weeks' advance notice, which enables us to adjust our advertising schedule if our statistical tracking indicates that a particular network or time slot is no longer cost effective. Generally, we can increase or decrease the frequency of our spot commercial and infomercial airings at almost any time.

Internet. Our eCommerce sales have grown from 7.8% of direct sales in 1999 to 18.6% of direct sales in 2000 (24.4% in the fourth quarter of 2000), and we expect the Internet to continue as an increasingly important part of our direct marketing strategy. For example, we are promoting our web sites in spot commercials and infomercials in an effort to further stimulate electronic product inquiries and eCommerce transactions. We do not presently advertise our products on third-party web sites, but may do so in the future.

We currently operate two direct marketing-oriented web sites. The first, www.bowflex.com, focuses on our Bowflex line of home exercise equipment. The second, www.nautilusleepsystems.com, focuses on our Nautilus Sleep Systems. In an effort to expand and enhance our web presence, we have added dedicated web site development and management personnel. Our immediate Internet-related goals include improving the capabilities at our Bowflex and Nautilus Sleep System web sites. In 1999, we used our web sites to generate interest in our products, but limited the information we provided to potential customers in an effort to induce them to initiate a telephone inquiry. In 2000, we believe we achieved a balance between our goals of finalizing sales and capturing consumer information by strategically designing our web pages and carefully analyzing web page hits, conversion rates, average sales prices and inquiry counts.

Print Media. We have advertised direct-marketed products in health and fitness-related consumer magazines and, to a limited extent, in entertainment, leisure and specialty magazines. We have

determined that television advertising and the Internet generate more immediate consumer responses at a lower cost per inquiry and therefore have reduced the print media advertising expenditures for our direct marketed products. We will evaluate print media advertising expenditures for other direct-marketed products on a case-by-case basis.

Conversion of Inquiries into Sales

Customer Service Call Center and Order Processing. We operate our own customer service call center in Vancouver, Washington, which operates 16-17 hours per day and receives and processes all infomercial-generated and customer service-related inquiries regarding our Bowflex products and Nautilus Sleep Systems. We have developed a skill-based call routing system that automatically routes each incoming call to the most highly qualified inside sales agent or customer service representative available. The appropriate representative then answers product questions, pro-actively educates the potential customer about the benefits of our product line, promotes financing through our private label credit card, and typically upsells the benefits of higher priced models in our product line. This sophisticated system allows us to better utilize our agents, prioritize call types and improve customer service.

We employ two large telemarketing companies to receive and process information requests generated by our spot television advertising 24 hours per day. The telemarketing agents for these companies collect only names, addresses and other basic information from callers and do not sell or promote our products. Consequently, we do not need to train these telemarketing agents.

Internet. We use television and print media to lead consumers to our web sites as we believe that consumers who visit our web sites are more inclined to purchase our products.

Response Mailings. We forward a "fulfillment kit" in response to each inquiry regarding our direct-marketed products. Each kit contains detailed literature that describes the product line and available accessories, a marketing video that demonstrates and highlights the key features of our premium product in the line, and additional information about how to purchase the product. If a potential customer does not respond within a certain time period, we proceed with additional follow-up mailings that convey a different marketing message and typically offer certain inducements to encourage a sale. The specific marketing message and offer at each stage will vary on a case-by-case basis, based on what our statistical tracking indicates is most likely to trigger a sale.

Consumer Finance Programs. We believe that convenient consumer financing is an important tool in our direct marketing sales efforts and induces many of our customers to make purchases when they otherwise would not. Currently, we offer "zero-down" financing to approved customers on all sales of our Bowflex Products and Nautilus Sleep Systems. We arrange this financing through a consumer credit company pursuant to a non-recourse consumer financing agreement. Under this arrangement, our customer service agents can obtain financing approval in a few minutes over the telephone and, if a customer is approved, immediately ship product without the need for cumbersome paperwork. The consumer finance company pays us promptly after submission of the required

documentation and subsequently sends to each approved customer a Direct Focus private label credit card that can be used for future purchases of our products. There were approximately 131,000 private label cards with available credit of approximately \$489 million outstanding as of February 28, 2001. During 2000, approximately 36.0% of our net sales were financed in this manner, and we believe this program will continue to be an effective marketing tool.

NAUTILUS SALES AND MARKETING

We market and sell our Nautilus commercial fitness equipment domestically through a direct sales force, as well as a limited dealer network and internationally through independent sales distributors.

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During 2000, we hired a management team to oversee the sales and marketing operations of our Nautilus retail products business. Each member of the management team has significant industry experience and a history of sales and marketing success. Our retail product line is marketed through specialty fitness, sporting good and other retailers domestically through a direct sales force and independent sales representatives.

Direct Sales Force

Our commercial direct sales force focuses on strengthening the market position of our existing Nautilus product line, which we sell principally to health clubs, large hotels, assisted living facilities and the government. Additionally, as we continue to broaden our product line with products like Nautilus Nitro commercial equipment, our direct sales force will target new market segments and, if successful, broaden our customer base. Internationally, we market and sell our Nautilus commercial fitness products through a worldwide network of independent distributors.

PRODUCTS

Bowflex Home Fitness Equipment

We introduced the first Bowflex home exercise machine in 1986, and since then have implemented several improvements to its design and functionality. We now offer three different Bowflex machines and eight different models. The key feature of each Bowflex machine is our patented "Power Rod" resistance technology. Each Power Rod is made of a solid polymer material that provides lineal progressive resistance in both the concentric and eccentric movements of an exercise. When combined with a bilateral cable pulley system, the machines provide excellent range and direction of motion for a large variety of strength-building exercises.

We currently offer the following Bowflex machines:

- The Power Pro, introduced in 1993, is our best selling product. The Power Pro is available in four different models: the basic Power Pro, the XT, the XTL and the XTLU. Each model offers over 60 different strength building exercises in one compact, foldable and portable design and comes with a 210-pound resistance pack that can be upgraded to 410 pounds. We have also incorporated an aerobic rowing exercise feature into the Power Pro. Prices currently range from \$999 to \$1,597, depending on the model and add-on features.
- The Motivator, introduced in 1996, is our entry-level strength training line. It is available in three different models: the basic Motivator, the XT and the XTL. Each model offers over 40 different strength building exercises in one compact, foldable design and comes standard with a 210-pound resistance pack that can be upgraded to 410 pounds. Prices currently range from \$699 to \$1,049, depending on the model and add-on features.
- The Versatrainer by Bowflex, introduced in 1988, is specifically designed to accommodate wheelchair-bound users. The Versatrainer's key advantage is that it permits users to exercise while remaining in their wheelchair, which offers enhanced independence and esteem. The Versatrainer can be found in many major rehabilitation hospitals, universities and institutions. The Versatrainer is currently priced at \$1,699.

Nautilus Commercial and Retail Fitness Equipment and Accessories

We currently offer the following Nautilus strength training equipment for the commercial market:

- **Nautilus Selectorized Equipment**

The Nautilus 2ST line of commercial strength equipment offers 27 high quality, technologically advanced strength building machines, each of which is specially designed to focus on a particular

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strength building exercise, such as leg presses, bench presses, super pullovers, hip abductors and adductors and leg curls. In addition, we offer a line of specially designed Nautilus 2ST equipment that we market principally to medical therapy and rehabilitation clinics. The key component of each Nautilus 2ST machine is either its "cam" or a four-bar linkage mechanism, which builds and releases resistance as a user moves through an exercise. The resistance is at its minimum during the initial and final stages of an exercise, and at its maximum in the middle of an exercise. The cam or four-bar linkage mechanism is designed to accommodate and maximize the benefits associated with the motion required for that machine. Other features are convergent and divergent upper body compound movements, four-bar linkages that produce functional movement, kevlar belt drives, selectorized one pound add-on weight systems, seat accessible weight stacks, hydraulic seat adjustments, and quick release shields. 2ST is also Fitlinxx and Fitness Advisor compatible.

The Nautilus NITRO line, introduced in late 2000, is a complete line of compact selectorized machines. It is ideal for clubs and other facilities where floor space is limited. Nautilus NITRO features super-smooth belt drives, patented four-bar linkage, classic full range variable resistance

cams and converging axis movements. Each Nautilus NITRO machine features 2" by 4" bent steel frames and 5-pound increment weight adjustments. In addition, EZ Glide seat adjustments make Nautilus NITRO easily adaptable to a variety of sizes, tastes, and exercise movements.

Nautilus Free Weight Equipment

In 1999, we introduced a line of Nautilus free weight equipment with new innovations in design and engineering intended to help club owners better serve their customers. The product line offers a sleeker look, tougher components and increased versatility. This new free weight gear can be coupled with the Nautilus selectorized equipment circuit to give facility managers a complete strength gym to serve all strength fitness tastes.

Nautilus Retail Equipment and Accessories

Our commercial and retail business also distributes a line of quality retail fitness equipment and accessories.

Our Nautilus retail business distributes a full line of fitness accessories, such as weight belts, jump ropes and ankle weights to the specialty fitness retailers and sporting goods industry. The current line includes over fifty products. We intend to continue to build and develop the Nautilus retail fitness business and expand our offering of Nautilus brand retail fitness products.

Significant advances marked the retail line during 2000. To begin with, the entire product line was re-energized as products went through a rigorous re-evaluation based on sales dollars, fitness trends and functionality. Once the product line was developed, the entire line was re-packaged in updated and distinctive signature packaging. Each package was designed to prominently showcase the Nautilus logo, while also showcasing the product in use.

Along with new handheld fitness items, Nautilus Fitness Products introduced two home gyms, the Strength Station and an Adjustable Bench with chrome dumbbells.

At the 2000 Super Show®, we introduced a new twelve-piece line of commercial-quality free weight home gym equipment and selectorized weight stack home gyms. This line represents an important step in expanding our products for the retail fitness market and in bringing Nautilus quality to the home.

Nautilus Sleep Systems

In December 1999, we began marketing a line of premium air sleep systems which we have named the "Nautilus Sleep Systems." The key feature of each Nautilus Sleep System is its variable firmness

support chamber, an air chamber within each airbed that can be electronically adjusted to regulate firmness. All queen and larger airbeds in our Signature, Premier and Ultimate Premier Series are equipped with dual air chambers that enable users to maintain different firmness settings on each side of the bed. We believe that variable firmness and other comfort-oriented features of our Nautilus Sleep Systems favorably differentiate them from conventional innerspring mattresses.

We currently offer four models of our Nautilus Sleep System:

- The Ultimate Premier Series is our top-of-the-line Nautilus Sleep System. It features dual patent pending interlocking variable support chambers that permit users to maintain separate firmness settings on each side of the airbed. The interlocking chambers regulate airflow and pressure to more effectively maintain support when a user changes position. The Ultimate Premier Series comes with a removable wool blend and silk blend pillow top sleeping surface, which permits users to easily convert to a "tight top" surface when they desire extra firmness. The Ultimate Premier Series also has an upgraded comfort layer of visco-elastic foam that conforms to a user's body. The Ultimate Premier Series is available in seven sizes and currently ranges in price from \$1,199.99 for a twin to \$1,799.99 for a California king, excluding foundation.

- The Premier Series features dual patent-pending interlocking variable support chambers that permit users to maintain separate firmness settings on each side of the airbed. The interlocking chambers regulate airflow and pressure to more effectively maintain support when a user changes position. The Premier Series comes with a removable wool blend pillow top sleeping surface, which permits users to easily convert to a "tight top" surface when they desire extra firmness. The Premier Series is available in seven sizes and currently ranges in price from \$699.99 for a twin to \$1,299.99 for a California king, excluding foundation.

- The Signature Series is designed to appeal to consumers who desire the flexibility of dual variable firmness support chambers, but at a more affordable price. Our customers can choose between a tight top and a pillow top sleeping surface over a one and one-half inch convoluted foam comfort layer. The Signature Series is available in seven sizes and currently ranges in price from \$399.99 for a twin to \$999.99 for a California king, excluding foundation.

- The Basic Series is our entry-level Nautilus Sleep System, which features a single, head-to-toe variable firmness support chamber and a traditional tight-top sleeping surface over a one and one-half inch thick convoluted foam comfort layer. The Basic Series is available in five sizes and currently ranges in price from \$249.99 for a twin to \$699.99 for a California king, excluding foundation.

We offer foundations that are specifically designed to support and enhance the performance of our Nautilus Sleep Systems. We advise consumers to use our foundations because conventional box springs tend to sag and wear over time, causing an airbed to eventually mirror the worn box spring. We believe the majority of our Nautilus Sleep System customers will order a complete sleep system, which includes both a mattress and a foundation. Our foundations currently range in price from \$199 for a twin to \$399 for a California king.

Direct Marketing Products

We develop direct marketing products either from internally generated ideas or, as with its Bowflex technology, by acquiring or licensing patented technology from outside inventors and then enhancing the technology. During the evaluation phase of product development, we evaluate the suitability of the product for direct marketing, whether the product can be developed and manufactured in acceptable

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quantities and at an acceptable cost, and whether it can be sold at a price that satisfies our profitability goals. More specifically, we look for high-quality consumer products that:

- Have patented or patentable features;
- Will have a retail price between \$500 and \$2,500;
- Can be marketed as a line of products with materially different features that facilitate upselling; and
- Have the potential for mass consumer appeal, particularly among members of the "baby-boom" generation, who are accustomed to watching television and now have significant disposable income.

In addition, because of our relatively high retail price target, we typically require that a product have a potential television advertising life cycle of at least five years and the possibility of an extended life cycle in retail stores.

Once we determine that a product may satisfy our criteria, we further assess the product's direct marketing potential by continuing to research the product and its probable market and by conducting blind product and focus group studies. If we develop the product internally, or if we acquire or license the rights to the product, we will then proceed to develop and test a direct marketing campaign for the product. In most cases, our direct marketing campaigns will emphasize the use of spot commercials and television infomercials, which we supplement with print media advertisements, written materials, marketing videos and our web sites.

Our growth strategy and financial performance depend in part on our ability to develop or acquire the rights to, and then direct market, new consumer products. Our net sales and profitability would be harmed if we are unable to develop or acquire the rights to premium quality, premium priced consumer products that satisfy our direct marketing criteria. In addition, any new products that we direct market may not generate sufficient net sales or profits to justify their development or acquisition costs.

Nautilus Commercial Fitness Products

Our Nautilus commercial product development group develops and refines our commercial fitness products. The group's members gather and evaluate ideas from various areas, including existing and potential customers, sales and marketing, manufacturing, engineering and finance, and then determine which ideas will be incorporated into existing products or will serve as the basis for new products. Based on these ideas, the group designs new or enhanced products, develops prototypes, tests and modifies products, develops a manufacturing plan, and finally brings products to market. The group evaluates, designs and develops each new or enhanced product, taking into consideration our marketing requirements, target price points, target gross margin requirements and manufacturing constraints. In addition, each new or enhanced product must maintain the Nautilus standard of quality and reputation for excellence. We incorporate principles of physiology, anatomy and biomechanics into all of our Nautilus machines in order to match the movements of the human body throughout an exercise. Our key objective is to produce products that minimize the stress on users' skeletal systems and connective tissues and maximize the safety and efficiency of each workout. In late 2000, the Nautilus Nitro line was introduced after extensive research and development by this group.

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Nautilus Retail Fitness Products and Accessories

We have developed a line of Nautilus retail strength training fitness equipment and hand-held fitness accessories. Current products include free weight home gym equipment, selectorized weight stack home gyms and a variety of hand held fitness accessories, such as jump ropes, hand weights and other similar devices.

MANUFACTURING AND DISTRIBUTION

Bowflex Products and Nautilus Sleep Systems

Our primary manufacturing and distribution objectives for our Bowflex products and Nautilus Sleep Systems are to maintain product quality, reduce and control costs, maximize production flexibility and improve delivery speed. We use a computerized inventory management system to forecast our manufacturing requirements. In general, we attempt to use outside suppliers to manufacture a majority of our raw materials and finished parts. We select these suppliers based upon their production quality, cost and flexibility. Whenever possible and in order to improve flexibility, we will attempt to use at least two suppliers to manufacture each product component. We currently use overseas suppliers to manufacture most of our Bowflex components, although we produce the main component of our Bowflex products, the Power Rods, exclusively in the United States. We intend to use outside suppliers that meet our manufacturing criteria. We have transferred production of some of our Nautilus Sleep Systems components overseas and we are also changing suppliers as we increase sales to enable us to reduce product cost while improving quality.

We inspect, package and ship our products from our Washington, Virginia and Nevada facilities. We rely primarily on UPS to deliver our Bowflex and our Nautilus Sleep Systems products.

Our Nautilus manufacturing operations are vertically integrated and include such functions as metal fabrication, powder coating, upholstery and vacuum-formed plastics processes. By managing our own manufacturing operations, we can control the quality of our Nautilus products and offer our commercial customers the opportunity to order certain color variations. We currently distribute Nautilus commercial fitness equipment from our Virginia warehouse facilities directly to customers primarily through our truck fleet. This method of distribution allows us to effectively control the set-up and inspection of equipment at the end-user's facilities. We outsource the manufacturing of Nautilus retail fitness equipment and fitness accessories to outside foreign manufacturers. We currently distribute our Nautilus fitness equipment and accessories from our Nevada facilities using various commercial truck lines or direct to customers at overseas ports.

INDUSTRY OVERVIEW

Fitness Equipment

We market our Bowflex home fitness equipment principally in the United States, which we believe is a large and growing market. According to the Sporting Goods Manufacturers' Association, United States consumers spent roughly \$5.5 billion on home exercise equipment in 1999 and 1998. While sales are flat overall, sales of products in the categories we compete in are up as much as 13% from 1998 to 1999.

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We market our Nautilus commercial fitness equipment throughout the world, including the United States, Europe, Asia, the Middle-East, Latin America and Africa. Within these markets, we target the following commercial customers, among others:

- Health clubs
- Rehabilitation clinics
- The military
- Hospitals
- Hotels and motels
- Corporate fitness centers
- Colleges and universities
- Governmental agencies
- YMCA's and YWCA's
- Professional sports teams

According to the Sporting Goods Manufacturers' Association, aggregate sales of fitness equipment to commercial purchasers in the United States soared from \$575 million in 1998 to \$700 million in 1999, a 22% increase.

Mattresses

The United States mattress market is large and dominated by four major manufacturers whose primary focus is the conventional innerspring mattress. According to the International Sleep Products Association, United States mattress and foundation sales totaled 38.2 million units shipped in 1999, representing a 4.4 percent increase from 1998. Total dollar value of these wholesale shipments reached \$4.3 billion in 1999, an 8% increase from 1998. We believe this equates to over \$7.6 billion in retail sales. The International Sleep Products Association (ISPA) estimates that innerspring mattresses accounted for approximately 90% of total domestic mattress sales in 1999. The ISPA also believes that less than 7% of all mattress sales are made through direct marketing channels. According to the ISPA, the bedding industry has enjoyed years of uninterrupted growth. In 1998, queen-sized mattresses became the largest selling segment. Both queen- and king-sized mattresses picked up market share in 1999.

COMPETITION

Bowflex Home Fitness Equipment

The market for our Bowflex products is highly competitive. Our competitors frequently introduce new and/or improved products, often accompanied by major advertising and promotional programs. We believe the principal competitive factors affecting this portion of our business are price, quality, brand name recognition, product innovation and customer service.

We compete directly with a large number of companies that manufacture, market and distribute home fitness equipment, and with the many health clubs that offer exercise and recreational facilities. We also compete indirectly with outdoor fitness, sporting goods and other recreational products. Our principal direct competitors include ICON Health & Fitness, Inc. (through its Health Rider, NordicTrak, Image, Proform, Weider and Weslo brands), Schwinn Fitness, Precor and Total Gym. In addition, some of our competitors have significantly greater financial and marketing resources, which may give them and their products an advantage in the marketplace.

We believe our Bowflex line of home exercise equipment is competitive within the market for home fitness equipment based on product design, quality and performance and that our direct marketing activities are effective in distinguishing our products from the competition.

Nautilus Commercial Fitness Equipment

The market for commercial fitness equipment is highly competitive. Our Nautilus products compete against the products of numerous other commercial fitness equipment companies, including Life Fitness, Cybex and Precor. Many of our competitors have greater financial and marketing

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resources, significantly more experience in the commercial fitness equipment industry, and more extensive experience manufacturing their products. We believe the key competitive factors in this industry include price, product quality and durability, diversity of features, financing options and warranties. Many commercial customers are also interested in product-specific training programs that educate them regarding how to safely maximize the benefits of a workout and achieve specific fitness objectives. In addition, certain commercial customers, such as hotels and corporate fitness centers, have limited floor space to devote to fitness equipment. These customers tend to favor multi-function machines that require less floor space.

Our principal line of Nautilus commercial fitness equipment, the Nautilus 2ST, carries a premium price, however, we believe its reputation for quality and durability appeals to a significant portion of the market that strives for long-term product value. In addition, the Nautilus 2ST possesses unique features that

appeal to the commercial market, such as low friction working parts, one-pound incremental weight stacks and hydraulic seat adjustments. We also offer training programs that are responsive to marketplace demands.

Our newest line of Nautilus commercial fitness equipment, the Nautilus NITRO was developed especially to meet the needs of commercial customers such as hotels and fitness centers with limited floor space. In addition to being compact, Nautilus NITRO has competitive price points and a universal design that looks good in a variety of settings. With both the 2ST and Nautilus NITRO, we offer low cost lease and rental programs, as well as a wide array of value-added marketing, profit enhancing, and training programs.

Nautilus Sleep Systems

The mattress industry is also highly competitive, as evidenced by the wide range of products available to consumers, such as innerspring mattresses, waterbeds, futons and other air-supported mattresses. According to the International Sleep Products Association, conventional innerspring mattresses presently account for at least 90% of all domestic mattress sales. We believe market participants compete primarily on the basis of price, product quality and durability, brand name recognition, innovative features, warranties and return policies.

We believe our most significant competition is the conventional mattress industry, which is dominated by four large, well-recognized manufacturers: Sealy (which also owns the Stearns & Foster brand name), Serta, Simmons and Spring Air. Although we believe our Nautilus Sleep Systems offer consumers an appealing alternative to conventional mattresses, many of these conventional manufacturers, including Sealy, Serta, Simmons and Spring Air, possess significantly greater financial, marketing and manufacturing resources and have better brand name recognition.

Moreover, several manufacturers currently offer beds with firmness technology similar to our Nautilus Sleep Systems. We believe the largest manufacturer in this niche market is Select Comfort, Inc. Select Comfort offers its sleep systems at company-owned retail stores throughout the United States and engages in a significant amount of direct marketing, including infomercials, targeted mailings, print, radio and television advertising. Select Comfort has an established brand name, marketing and manufacturing resources. Select Comfort also has significantly greater experience in marketing and distributing airbeds. Despite these advantages, we believe the market for airbeds is large enough for both companies to be successful. In addition, we believe our Nautilus Sleep Systems possess features that will enable us to compete effectively against Select Comfort and other airbed companies.

We believe our success in the mattress business depends in part on convincing consumers that variable firmness control and other features of our sleep system favorably differentiate our products from those of our competitors. We also believe our experience with direct marketing will enable us to successfully convey this message. However, the intense competition in the mattress industry, both from

conventional mattress manufacturers and Select Comfort, may adversely affect our efforts to market and sell our airbeds and, consequently, may adversely affect our financial performance.

INTELLECTUAL PROPERTY

Protecting our intellectual property is an important factor in maintaining our competitive position in the fitness and mattress industries. If we do not, or are unable to, adequately protect our intellectual property, our sales and profitability could be adversely affected. Accordingly, we have taken the following protective measures:

- We hold 17 United States patents and have applied for three additional United States patents with respect to our Nautilus products;
- We hold four patents relating to our Bowflex home fitness equipment;
- We have applied for one patent relating to our Nautilus Sleep Systems;
- We have obtained United States trademark protection for various names associated with our products, including "Bowflex," "Nautilus," "Power Rod," "Bowflex Power Pro," "Motivator" and "Versatrainer";
- We have applied for United States trademark protection for the names "Direct Focus," "Instant Comfort" and various other names and slogans associated with our products;
- We have registered the name "Bowflex" in Canada and the European Community, and have registered or applied to register the "Nautilus" trademark in approximately 30 foreign countries;
- We have obtained trademark protection for the "look" of our Bowflex Power Rods; and
- We hold eight United States copyright registrations relating to our Nautilus products.

Notwithstanding these measures, our efforts to protect our proprietary rights may be inadequate, and applicable laws provide only limited protection. For example, of our four Bowflex patents, the most important covers our Power Rods, and this patent expires on April 27, 2004. The other three patents expire on February 16, 2005, April 14, 2007, and January 4, 2010. In addition, we may not be able to successfully prevent others from claiming that we have violated their proprietary rights. We could incur substantial costs in defending against such claims, even if they are invalid, and we could become subject to judgments requiring us to pay substantial damages.

Each federally registered trademark is renewable indefinitely if the mark is still in use at the time of renewal. We are not aware of any material claims of infringement or other challenges to our right to use our marks.

ENVIRONMENTAL REGULATION

Environmental regulations most significantly affect our Nautilus facilities in Independence, Virginia. The Virginia Department of Environmental Quality has issued an air permit for several point sources at this facility. The sources include boilers, flash ovens and high solids paint booths. The permit imposes operation limits based on the length of time each piece of equipment is operated each day, and we operate the plant within these limits. The town of Independence, Virginia has issued an industrial user's wastewater permit that governs our discharge of on-site generated wastewater and storm water. In addition to the foregoing, in early 1999, we completed a Phase I Environmental Site Assessment and a limited Phase II Soil Analysis Assessment at our Nautilus facilities in Independence, Virginia. No significant deficiencies or violations were noted. We do not believe that continued compliance with federal, state and local environmental laws will have a material effect upon our capital expenditures, earnings or competitive position.

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EMPLOYEES

As of December 31, 2000, we employed 398 full-time employees, including 3 executive officers and 38 part-time employees. None of our employees are subject to any collective bargaining agreement.

Item 2. Properties

In August 2000, we purchased a 90,000 square foot facility in Vancouver, Washington as a warehouse, production, distribution and administrative facility. We retained our lease on an approximately 17,325 square foot facility in Vancouver, Washington which we will continue to use as our customer call center. We lease this property pursuant to an operating lease that expires April 30, 2002. The aggregate base rent is approximately \$6,629 per month and is subject to annual adjustments based upon changes in the consumer price index, but no adjustment may exceed 6.0% in any calendar year.

We house our Nautilus commercial operations and our East Coast distribution center for our Bowflex products in Independence, Virginia. We own 54 acres of commercial real property include the following facilities:

- A 124,000 square foot building devoted to fabrication, finishing, assembly, plastics, upholstery, warehousing and shipping;
- A 100,000 square foot building devoted to fabrication, Bowflex warehousing and used equipment operations;
- A 27,105 square foot building that houses our Nautilus engineering, prototyping, customer service and administrative operations; and
- A 9,187 square foot administrative and product display building.

We also have a distribution center in Las Vegas, Nevada. We distribute Bowflex equipment, Nautilus Sleep Systems and Nautilus retail fitness products and accessories from this 93,332 square foot facility. This lease expires November 30, 2002. The aggregate base rent is approximately \$27,066 per month, and is subject to an annual cost of living increase of 3.5%.

In 2000, we purchased approximately 19.5 acres of land in Las Vegas, Nevada for \$1.1 million. We may build a distribution, warehouse and administrative facility on the land.

In general, our properties are well maintained, adequate and suitable for their purposes, and we believe these properties will meet our operational needs for the foreseeable future. If we require additional warehouse or office space, we believe we will be able to obtain such space on commercially reasonable terms.

Item 3. Legal Proceedings

As of March 2001, there were no material pending legal proceedings to which we or our subsidiaries were a party. From time to time, we become involved in ordinary, routine or regulatory legal proceedings incidental to our business.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of our shareholders during the quarter ended December 31, 2000.

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PART II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Market Price of Our Common Stock

Since May 4, 1999, our common stock has been listed for trading exclusively on The Nasdaq National Market System under the symbol DFXI. Prior to such date, our common stock was listed for trading exclusively on the Toronto Stock Exchange in the Province of Ontario, Canada, under the symbol DFX. The following table summarizes the high and low closing prices for each period indicated, adjusted to reflect the three-for-two splits effective August 2000 and January 2001:

	High	Low
1999		
Quarter 1	\$ 8.17	\$ 5.37
Quarter 2	11.55	7.22
Quarter 3	9.33	6.67
Quarter 4	\$ 12.89	\$ 8.11
2000		
Quarter 1	\$ 13.33	\$ 9.67
Quarter 2	21.78	11.95
Quarter 3	27.17	18.17
Quarter 4	\$ 31.00	\$ 21.21

As of February 28, 2001, 23,744,414 shares of our common stock were issued and outstanding and held of record by shareholders.

Payment of any future dividends is at the discretion of our board of directors, which considers various factors, such as our financial condition, operating results, current and anticipated cash needs and expansion plans. Our credit lines do not restrict the payment of dividends. To date, we have never declared or paid any cash dividends on our common stock and do not presently intend to declare any cash dividends in the near future. Instead, we intend to retain and direct any future earnings to fund our anticipated expansion and growth.

USE OF PROCEEDS

We received approximately \$17.9 million in net proceeds from the sale of 975,000 shares of common stock in our May 1999 initial U.S. public offering, which includes proceeds from the over-allotment option exercised by the managing underwriters. We applied \$7 million of the net proceeds toward stock repurchases, \$1.3 million toward computer and related technology upgrades, \$1.1 million to purchase land for a potential distribution site in Nevada, and \$4.2 million to purchase a building in Washington. We also used approximately \$4.3 million of the net proceeds for working capital purposes, including increased direct marketing expenditures and increases in inventory and accounts receivable balances due to the growth of our business.

Item 6. Selected Consolidated Financial Data

The selected consolidated financial data presented below for each of the years in the three-year period ended December 31, 2000 and the selected consolidated balance sheet data presented below as of December 31, 1999 and 2000 have been derived from the audited consolidated financial statements of the company included elsewhere in this report. The selected consolidated statement of operations data for the years ended December 31, 1996 and 1997 and the selected consolidated balance sheet data as of December 31, 1996 and the selected consolidated balance sheet data as of December 31, 1996, 1997 and 1998 have been derived from audited financial statements of the Company not included

herein. The data presented below should be read in conjunction with our financial statements and notes thereto and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

IN THOUSANDS (except per share amounts)	1996	1997	1998	1999	2000
Statement of Operations Data					
Net Sales+	\$ 9,224	\$ 21,546	\$ 63,171	\$ 133,079	\$ 223,927
Cost of sales+	3,330	6,774	18,316	46,483	75,573
Gross profit	5,914	14,772	44,855	86,596	148,354
Operating expenses:					
Selling and marketing	4,712	9,600	22,643	44,630	73,510
General and administrative	473	975	1,701	4,237	8,804
Royalties	269	581	1,623	2,897	4,979
Litigation settlement	—	—	—	4,000	—
Total operating expenses	5,454	11,156	25,967	55,764	87,293
Operating income	460	3,616	18,888	30,832	61,061
Other income (expense)					
Interest income	37	119	527	1,003	3,632
Other-net	(53)	(88)	(228)	3	347
Total other income (expense)	(16)	31	305	1,006	3,979
Income before income taxes	444	3,647	19,193	31,838	65,040
Income tax expense (benefit)	(249)	1,226	6,708	11,495	23,414

Net income	\$	693	\$	2,421	\$	12,485	\$	20,343	\$	41,626
Basic earnings per share(1)*	\$	0.03	\$	0.12	\$	0.59	\$	0.89	\$	1.77
Diluted earnings per share(1)*	\$	0.03	\$	0.11	\$	0.57	\$	0.87	\$	1.73
Basic shares outstanding*		19,256		20,222		21,008		22,874		23,525
Diluted shares outstanding*		20,123		21,401		21,884		23,457		23,999
Balance Sheet Data										
Cash and cash equivalents	\$	1,154	\$	4,790	\$	18,911	\$	35,703	\$	77,181
Working capital		1,973		4,100		15,682		38,209		72,520
Total assets		3,515		7,922		24,373		67,310		117,126
Stockholders' equity		2,220		4,592		17,651		53,031		92,867

+ Balances reflect adoption of EITF Consensus 00-10

* Reflects the three-for-two stock splits effective August 2000 and January 2001

(1) Basic earnings per share have been computed by dividing net income by the weighted average number of shares of common stock outstanding during each period. Diluted earnings per share have been computed by dividing net income by the weighted average number of shares of common stock and common stock equivalents, such as stock options, outstanding during each period.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS

We believe that period-to-period comparisons of our operating results are not necessarily indicative of future performance. You should consider our prospects in light of the risks, expenses and difficulties frequently encountered by companies experiencing rapid growth and, in particular, rapidly growing

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companies that operate in evolving markets. We may not be able to successfully address these risks and difficulties. Although we have experienced net sales growth in recent years, our net sales growth may not continue, and we cannot assure you of any future growth or profitability.

The following table presents certain financial data as a percentage of total revenues:

	Year Ended December 31,		
	1998	1999	2000
Statement of Operations Data			
Net sales	100.0%	100.0%	100.0%
Cost of sales	29.0	34.9	33.7
Gross profit	71.0	65.1	66.3
Operating expenses			
Selling and marketing	35.8	33.5	32.8
General and administrative	2.7	3.2	3.9
Royalties	2.6	2.2	2.2
Litigation settlement	—	3.0	—
Total operating expenses	41.1	41.9	38.9
Operating income	29.9	23.2	27.4
Other income	0.5	0.7	1.6
Income before income taxes	30.4	23.9	29.0
Income tax expense	10.6	8.6	10.5
Net income	19.8%	15.3%	18.6%

COMPARISON OF THE YEARS ENDING DECEMBER 31, 2000 AND DECEMBER 31, 1999

Net Sales

Net sales grew by 68.3% to \$223.9 million in 2000 from \$133.1 million in 1999. Sales within our direct products segment increased by 75.3% over prior year levels and accounted for \$198.1 million, or 88.5%, of our aggregate net sales in 2000. Net sales within our commercial and retail product segment increased by

28.6% over prior year levels and accounted for \$25.8 million, or 11.5% of our net sales.

Sales growth in 2000 primarily resulted from expanded direct marketing of our Bowflex and Nautilus Sleep Systems products and the growth we experienced in eCommerce sales, as well as the positive impact of the strong domestic economy that existed until late 2000. Within our direct products segment, with respect to both our Bowflex products and our Nautilus Sleep Systems, we intend to further expand our use of spot television commercials and expand our use of infomercials of our Bowflex products during 2001 by increasing our presence in existing television markets and entering new television markets. We intend to increase sales within our Nautilus products segment by continuing to develop new products and expanding our direct sales efforts both domestically and internationally.

Except for the fourth quarter, fiscal 2000 sales of our Bowflex products appear to have been consistent with historic trends. As in prior years, first and third quarter sales of our Bowflex products were strong, while the second quarter reflected seasonal weakness. Our direct marketing business is largely dependent upon national cable television advertising, and we are finding that second quarter influences on television viewership, such as the broadcast of national network season finales and seasonal weather factors, are causing our spot television commercials on national cable television to be marginally less effective than in other periods of the year. During the fourth quarter of 2000 and 1999,

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we experienced unusually strong consumer demand compared to the third quarter for our Bowflex products, which we believe is a trend that will not continue for the fourth quarter in future periods.

Sales within our commercial and retail business were, and we believe will continue to be, strongest in the third and fourth quarters. We believe the principal reason for this trend is the commercial fitness industry's preparation for the impact of New Year fitness resolutions and seasonal weather factors in the fourth quarter, and retail fitness store purchases of fitness equipment in preparation for the Christmas buying season and New Year fitness resolutions in the third and fourth quarters.

Notwithstanding our product diversification efforts, we anticipate that sales of our Bowflex Power Pro will continue to account for a substantial portion of our net sales for the foreseeable future. Any significant diminished consumer interest in this product line would sharply reduce our net sales and profitability. In addition, the success of each of our products depends substantially on how consumers decide to spend their money and the amount of disposable income they have. Unfavorable economic conditions may depress consumer spending, especially for premium priced products like ours.

Gross Profit

Gross profit grew 71.3% to \$148.4 million in 2000, from \$86.6 million in 1999. Our gross profit margin increased 1.2% to 66.3% in 2000, from 65.1% in 1999. This increase was mainly attributable to the net sales of direct products as a percentage of total net sales. The margin within our direct products segment was 70.2% in 2000, while there was a 36.2% margin within our commercial and retail products segment for 2000. Sales of our direct products comprised 88.5% of net sales in 2000, compared with 84.9% in 1999. This increase in percentage of direct products sold, along with strong eCommerce sales at higher margins, resulted in the higher profit margin for 2000.

We expect a lower percentage gross profit margin contribution from our Nautilus Sleep Systems, compared to our Bowflex products, as we continue our direct marketing campaign for this product. Similar to our Bowflex products, with the anticipated future higher sales volume of Nautilus Sleep Systems, we expect to take advantage of overseas production and new vendor relationships to strengthen the margins for these products.

Operating Expenses

Selling and Marketing

Selling and marketing expenses grew to \$73.5 million in 2000 from \$44.6 million in 1999, an increase of 64.7%. This increase in selling and marketing expenses resulted primarily from the continued expansion of our direct marketing campaign for Bowflex products and Nautilus Sleep Systems and variable costs associated with our sales growth.

As a percentage of net sales, selling and marketing expenses decreased by 0.7% in 2000 to 32.8% in 2000, compared to 33.5% in 1999. Selling and marketing expenses within our direct products segment were \$67.1 million, a 1.1% increase as a percentage of net sales compared to 1999. Selling and marketing expenses within our commercial and retail business traditionally have been a lower percentage of net sales than we have experienced in direct marketing and were \$6.4 million in 2000 compared with \$5.1 million in 1999. In real dollar terms, we expect our aggregate selling and marketing expenses will continue to increase in real dollar terms, but will also increase as a percentage of net sales, as we:

- Continue to expand our Bowflex direct marketing campaign;
- Expand the direct marketing campaign for our Nautilus Sleep Systems;
- Integrate the marketing and distribution infrastructure for our Nautilus line of commercial fitness equipment; and

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- Expand marketing for our home fitness equipment products and fitness accessories under the Nautilus brand name.

General and Administrative

General and administrative expenses grew to \$8.8 million in 2000 from \$4.2 million in 1999, an increase of 107.8%. As a percentage of net sales, general and administrative expenses increased to 3.9% in 2000 from 3.2% in 1999. Our direct products segment accounted for \$4.0 million of the increase in general and

administrative expenses, due primarily to increased staffing and infrastructure expenses necessitated by our continued growth and the implementation of our information systems. Commercial and retail operations accounted for the remaining increase of \$0.6 million. We believe our general and administrative expenses will continue to increase in future periods in real dollar terms and also as a percentage of net sales.

Royalty

Royalty expense grew to \$5.0 million in 2000 from \$2.9 million in 1999, an increase of 71.9%. The increase in our royalty expense is attributable to increased sales of our Bowflex products in 2000, plus new royalty agreements related to the development of additional products. Our royalty expenses will increase if sales of our Bowflex products continue to increase.

Other Income

In 2000, other income increased to \$4.0 million from \$1.0 million in 1999. The \$3.0 million increase resulted primarily from interest earned on invested cash and cash equivalents. We expect other income to increase if invested cash balances increase and interest rates remain steady.

Income Tax Expense

Income tax expense increased by \$11.9 million in 2000 compared to 1999. We expect our income tax expense to increase in line with increases of our income before taxes.

Net Income

For the reasons discussed above, net income increased 104.6% to \$41.6 million in 2000 compared to \$20.3 million in 1999.

Comparison of Years Ending December 31, 1999, and December 31, 1998

Net Sales

Net sales grew by 110.6% to \$133.1 million in 1999 from \$63.2 million in 1998. Sales within our direct products segment increased by 78.9% over prior year levels and accounted for \$113.0 million, or 84.9%, of our aggregate net sales in 1999. Net sales within our commercial and retail segment generated \$20.1 million of our aggregate net sales and accounted for 33.4% of the aggregate increase. Sales growth in 1999 primarily resulted from expanded direct marketing of our Bowflex products and the addition of our commercial and retail segment.

Except for the fourth quarter, fiscal 1999 sales of our Bowflex products appear to have been consistent with historic trends. As in prior years, first and third quarter sales of our Bowflex products were strong, while the second quarter reflected seasonal weakness. Our direct products segment is largely dependent upon national cable television advertising, and we found that second quarter influences on television viewership, such as the broadcast of national network season finales and seasonal weather factors, caused our spot television commercials on national cable television to be marginally less effective than in other periods of the year. During the fourth quarter of 1999, we

experienced unusually strong consumer demand compared to the third quarter for our Bowflex products.

Sales within our commercial and retail segment were stronger in the third and fourth quarters. We believe the principal reason for this trend is the commercial fitness industry's preparation for the impact of New Year fitness resolutions and seasonal weather factors in the fourth quarter, and retail fitness store purchases of fitness equipment in preparation for the Christmas buying season and New Year fitness resolutions in the third and fourth quarters.

Gross Profit

Gross profit grew 93.0% to \$86.6 million in 1999, from \$44.9 million in 1998. Our gross profit margin decreased 5.9% to 65.1% in 1999, from 71.0% in 1998. The decrease in gross profit margin was mainly attributable to our commercial and retail operations, which had a gross profit margin in 1999 of 36.6%.

Operating Expenses

Selling and Marketing

Selling and marketing expenses grew to \$44.6 million in 1999 from \$22.6 million in 1998, an increase of 97.1%. This increase in selling and marketing expenses resulted primarily from the continued expansion of our Bowflex direct marketing campaign and variable costs associated with our sales growth. The addition of our commercial and retail business accounted for \$5.1 million of the increase.

As a percentage of net sales, selling and marketing expenses decreased by 2.3% in 1999 to 33.5%, compared to \$22.6 million, or 35.8%, a 0.7% decrease as a percentage of net sales compared to 1998. Selling and marketing expenses within our commercial and retail business traditionally have been a lower percentage of net sales than we have experienced in direct marketing. In real dollar terms, we expect our aggregate selling and marketing expenses will continue to increase, but not materially as a percentage of net sales.

General and Administrative

General and administrative expenses grew to \$4.2 million in 1999 from \$1.7 million in 1998, an increase of 149.1%. Our direct marketing business accounted for \$1.3 million of the increase in general and administrative expenses, due primarily to increased staffing levels in our accounting and information systems departments necessitated by our continued growth and the implementation of our new information system. Commercial and retail operations accounted for the remaining increase of \$1.2 million. As a percentage of net sales, general and administrative expenses increased to 3.2% in 1999 from 2.7% in 1998.

Royalty

Royalty expense grew to \$2.9 million in 1999 from \$1.6 million in 1998, an increase of 81.3%. The increase in our royalty expense is attributable to increased sales of our Bowflex products in 1999.

Other Income

In 1999, other income increased to \$1.0 million from \$0.3 million in 1998. The \$0.7 million increase resulted primarily from interest income generated by higher cash investments accumulated from a combination of results from operations and our public offering completed during the second quarter of 1999.

Income Tax Expense

Income tax expense increased by \$4.8 million in 1999 compared to 1998. Our effective tax rate increased by 1.2% to 36.1% due to state tax liability.

Net Income

For the reasons discussed above, net income increased 62.4% to \$20.3 million in 1999 compared to \$12.5 million in 1998.

Quarterly Results of Operations

The following table presents our operating results for each of the eight quarters in the period ended December 31, 2000. The information for each of these quarters is unaudited and has been prepared on the same basis as the audited financial statements appearing elsewhere in this Annual Report on Form 10-K. In the opinion of management, all necessary adjustments, consisting only of normal recurring adjustments, have been included to present fairly the unaudited quarterly results when read together with our audited financial statements and the related notes. These operating results are not necessarily indicative of the results of any future period.

Selected Quarterly Information

	QUARTER ENDED			
	March 31	June 30	September 30	December 31
	(In thousands, except per share)			
Fiscal 2000:				
Net sales+	47,333	48,131	57,834	70,629
Gross profit	32,149	31,190	39,063	45,952
Operating income	13,359	11,815	16,262	19,625
Net income	8,919	8,168	11,082	13,457
Earnings per share				
Basic*	.38	.35	.47	.57
Diluted*	.37	.34	.46	.55
Fiscal 1999:				
Net sales+	28,782	27,829	34,878	41,589
Gross profit	18,723	17,882	22,982	27,008
Operating income	6,907	1,999(1)	8,099	13,827
Net income	4,479	1,399(1)	5,495	8,969
Earnings per share				
Basic*	.21	.06(1)	.23	.38
Diluted*	.20	.06(1)	.23	.37

+ Net sales reflects the adoption of EITF Consensus 00-10

* Reflects the three-for-two stock splits effective August 2000 and January 2001.

(1) Includes a \$4 million litigation settlement expense. Net income and earnings per share amounts also reflect \$1.4 million of income tax benefit related to the litigation settlement.

Liquidity and Capital Resources

Historically, we have financed our growth primarily from cash generated by our operating activities. During 2000, our operating activities generated \$52.8 million in net cash, which contributed to an aggregate \$77.2 million in cash and cash equivalents on hand as of December 31, 2000 compared to \$35.7 million in cash and cash equivalents at December 31, 1999. Through a stock repurchase program, we bought back \$3.3 million in common stock on the

open market. Our capital expenditures in 2000 totaled \$8.8 million, including \$1.1 million for land in Las Vegas, Nevada and \$4.2 million for land and a building in Vancouver, Washington. These activities resulted in a \$41.5 million, or 116% increase in our cash and cash equivalents during 2000.

We anticipate our working capital requirements will increase as a result of growing our Nautilus commercial and retail fitness operations. We also expect to increase our cash expenditures on spot commercials and infomercials as we continue to expand the direct marketing campaigns for our Bowflex products and Nautilus Sleep Systems. In January 2001, the Board of Directors authorized management to repurchase up to \$20 million of the Company's common stock in open-market transactions from January 25, 2001 through April 30, 2001, with the terms of the purchases to be determined by management based on market condition.

We maintain a \$10 million line of credit with Bank of America (increased from \$5.0 million on April 1, 2000). The line of credit is secured by our general assets and contains certain financial covenants. As of the date of these financial statements, we are in compliance with all material covenants applicable to the line of credit and there is no outstanding balance under the line.

We believe our existing cash balances, combined with our line of credit, will be sufficient to meet our capital requirements for at least the next twelve months.

Inflation and Price Increases

Although we cannot accurately anticipate the effect of inflation on our operations, we do not believe that inflation has had or is likely in the foreseeable future to materially adversely affect our results of operations, cash flows or our financial position. However, increases in inflation over historical levels or uncertainty in the general economy could decrease discretionary consumer spending for products like ours. We have not raised the prices on any of our products since 1997. Consequently, none of our revenue growth is attributable to price increases.

Recent Accounting Pronouncement

In June 1998, the FASB issued Statement of Financial Accounting Standards No. 133, "*Accounting for Derivative Instruments and Hedging Activities*" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards for all derivative instruments. SFAS 133, as amended, is effective for fiscal years beginning after June 15, 2000. We do not currently have any derivative instruments and, accordingly, do not expect the adoption of SFAS 133 to have an impact on our financial position, results of operations, or cash flows.

In the fourth quarter of 2000, we adopted Emerging Issues Task Force Consensus 00-10, "*Accounting for Shipping and Handling Costs*" ("EITF 00-10"). As a result of this adoption, we now account for revenue generated by shipping products to customers as net sales. Previously, these amounts were included in cost of sales along with the related costs incurred to ship the products. Net sales and cost of sales for prior periods have been restated to reflect EITF Consensus 00-10.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

To date, we have invested cash with banks and in highly liquid debt instruments purchased with maturity dates of three months or less. Our bank deposits may exceed federally insured limits and there is risk of loss of the entire principal with any debt instrument. To reduce risk of loss, we limit our exposure to any one debt issuer and require certain minimum ratings for debt instruments that we purchase.

Item 8. Consolidated Financial Statements and Supplementary Financial Data

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INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholders
of Direct Focus, Inc.:

We have audited the accompanying consolidated balance sheets of Direct Focus, Inc. and subsidiaries as of December 31, 1999 and 2000, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2000. Our audits also included the financial statement schedule at Item 14. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Direct Focus, Inc. and subsidiaries at December 31, 1999 and 2000 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

DELOITTE & TOUCHE LLP
Portland, Oregon
January 19, 2001

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DIRECT FOCUS, INC.
CONSOLIDATED BALANCE SHEETS

	December 31, 1999	December 31, 2000
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 35,703,457	\$ 77,181,064
Trade receivables (less allowance for doubtful accounts of: 1999, \$304,727 and 2000, \$352,279)	4,744,213	4,941,286
Inventories	9,167,554	12,653,117
Prepaid expenses and other current assets	1,863,951	591,453
Current deferred tax asset	820,789	950,363
Total current assets	52,299,964	96,317,283
PROPERTY, PLANT AND EQUIPMENT, NET	10,644,838	16,668,884
OTHER ASSETS	4,364,963	4,140,277
TOTAL ASSETS	\$ 67,309,765	\$ 117,126,444
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 5,871,369	\$ 12,335,776
Accrued liabilities	4,051,540	5,344,225
Income taxes payable	2,177,236	2,542,967
Royalty payable to stockholders	893,563	1,481,886
Customer deposits	1,097,748	2,092,611
Total current liabilities	14,091,456	23,797,465
LONG-TERM DEFERRED TAX LIABILITY	187,484	462,004
COMMITMENTS AND CONTINGENCIES (Notes 8 and 15)		
STOCKHOLDERS' EQUITY:		
Common stock—authorized, 75,000,000 shares of no par value; Outstanding, 1999: 23,499,333 shares, 2000: 23,545,181 shares	18,602,420	16,812,476
Retained earnings	34,428,405	76,054,499
Total stockholders' equity	53,030,825	92,866,975
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 67,309,765	\$ 117,126,444

See notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME

Three years ended December 31, 2000

	1998	1999	2000
NET SALES	\$ 63,171,376	\$ 133,078,513	\$ 223,927,365
COST OF SALES	18,316,803	46,482,613	75,573,619
Gross profit	44,854,573	86,595,900	148,353,746
EXPENSES:			
Selling and marketing	22,642,885	44,629,825	73,509,675
General and administrative	1,700,956	4,236,804	8,804,446
Royalties	1,622,726	2,897,278	4,979,287
Litigation settlement	—	4,000,000	—
Total operating expenses	25,966,567	55,763,907	87,293,408
INCOME FROM OPERATIONS	18,888,006	30,831,993	61,060,338
OTHER INCOME (EXPENSE):			
Interest income	526,961	1,003,586	3,631,993
Other, net	(221,889)	2,737	347,175
Total other income, net	305,072	1,006,323	3,979,168
INCOME BEFORE INCOME TAXES	19,193,078	31,838,316	65,039,506
INCOME TAX EXPENSE	6,707,584	11,495,425	23,413,412
NET INCOME	\$ 12,485,494	\$ 20,342,891	\$ 41,626,094
BASIC EARNINGS PER SHARE	\$ 0.59	\$ 0.89	\$ 1.77
DILUTED EARNINGS PER SHARE	\$ 0.57	\$ 0.87	\$ 1.73
Basic shares outstanding	21,007,181	22,872,638	23,525,069
Diluted shares outstanding	21,883,406	23,456,718	23,998,244

See notes to consolidated financial statements.

DIRECT FOCUS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDER'S EQUITY

For the three years ended December 31, 2000

	Common Stock		Retained Earnings	Total
	Shares	Amount		
BALANCES, JANUARY 1, 1998	20,261,988	\$ 2,992,172	\$ 1,600,020	\$ 4,592,192
Options exercised	997,190	134,004	—	134,004
Tax benefit of exercise of nonqualified options	—	439,452	—	439,452
Net income	—	—	12,485,494	12,485,494
BALANCES, DECEMBER 31, 1998	21,259,178	\$ 3,565,628	\$ 14,085,514	\$ 17,651,142

Public offering	2,193,750	17,937,691		17,937,691
Options exercised	521,607	300,482	—	300,482
Stock repurchased	(475,200)	(3,698,793)	—	(3,698,793)
Tax benefit of exercise of nonqualified options	—	497,412	—	
Net income	—	—	20,342,891	20,342,891
BALANCES, DECEMBER 31, 1999	23,499,335	\$ 18,602,420	\$ 34,428,405	\$ 53,030,825
Options exercised	324,201	622,236	—	622,236
Stock repurchased	(278,354)	(3,252,043)	—	(3,252,043)
Tax benefit of exercise of nonqualified options	—	839,863	—	839,863
Net income	—	—	41,626,094	41,626,094
BALANCES, DECEMBER 31, 2000	23,545,182	\$ 16,812,476	\$ 76,054,499	\$ 92,866,975

See notes to consolidated financial statements

DIRECT FOCUS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Three years ended December 31, 2000

	1998	1999	2000
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 12,485,494	\$ 20,342,891	\$ 41,626,094
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	301,913	1,183,412	2,874,101
Loss on equipment disposal	—	1,262	4,504
Tax benefit of exercise of nonqualified options	439,452	497,412	839,863
Deferred income taxes	99,484	(484,448)	144,945
Changes in:			
Trade receivables	41,336	(1,519,116)	(197,073)
Inventories	(668,900)	(3,448,750)	(3,485,563)
Prepaid expenses and other current assets	(166,027)	(1,377,336)	1,272,498
Trade payables	2,423,819	2,001,235	6,464,407
Income taxes payable	(296,353)	1,672,461	365,731
Accrued liabilities and royalty payable to Stockholders	1,099,819	988,414	1,881,008
Customer deposits	107,084	948,811	994,863
Net cash provided by operating activities	15,867,121	20,806,248	52,785,378
CASH FLOWS FROM INVESTING ACTIVITIES:			
Additions to property, plant and equipment	(1,738,836)	(1,929,137)	(8,761,526)
Proceeds from sale of property, plant and equip.	—	159,238	97,067
Additions to other assets	(12,309)	(167,935)	(13,505)
Acquisition cost of Nautilus	(120,454)	(16,615,012)	—
Net cash used in investing activities	(1,871,599)	(18,552,846)	(8,677,964)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Principal payments under capital lease obligations	(9,167)	—	—
Proceeds from public offering	—	17,937,691	—
Funds used for stock repurchase	—	(3,698,793)	(3,252,043)
Proceeds from exercise of stock options	134,004	300,482	622,236
Net cash provided by (used in) financing activities	124,837	14,539,380	(2,629,807)
NET INCREASE IN CASH AND CASH EQUIVALENTS	14,120,359	16,792,782	41,477,607
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	4,790,316	18,910,675	35,703,457
CASH AND CASH EQUIVALENTS, END OF YEAR	\$ 18,910,675	\$ 35,703,457	\$ 77,181,064
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid for interest	455	—	—

Cash paid for income taxes	6,465,006	9,835,000	21,907,800
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See notes to consolidated financial statements

DIRECT FOCUS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Three years ended December 31, 2000

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization

Direct Focus Inc. (the "Company," a Washington corporation) is a leading marketing company for fitness and healthy lifestyle products with highly-effective direct business model. The Company has two operating segments. One is the direct business through which they market consumer products directly through a variety of direct marketing channels, including spot television commercials, infomercials, response mailings, and the Internet. The Company's principal direct segment products are the Bowflex line of home fitness equipment and a line of premium quality sleep systems (Nautilus Sleep Systems). As a result of the acquisition in January 1999 of Nautilus International, Inc., the Company added a second business segment which comprises a significant component of the Company's operations and includes Nautilus commercial and retail fitness equipment and accessories.

Consolidation

The consolidated financial statements of the Company include Direct Focus, Inc., Nautilus HPS, Inc., Nautilus, Inc., DFI Properties, LLC, BFI Advertising, Inc., DFI Sales, Inc., and Nautilus Fitness Products, Inc. All inter-company transactions have been eliminated.

Use of Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, cash deposited with banks and financial institutions and highly liquid debt instruments purchased with maturity dates of three months or less at date of acquisition. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Inventories

Inventories are stated at the lower of average cost or market.

Advertising

The Company expenses the production costs of advertising the first time the advertising takes place.

Property, Plant and Equipment

Property, plant and equipment is stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets.

Management reviews the investment in long-lived assets for possible impairment whenever events or circumstances indicate the carrying amount of an asset may not be recoverable. There have been no such events or circumstances in the three years ended December 31, 2000. If there were an indication of impairment, management would prepare an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows were less than the carrying amount of the asset, an impairment loss would be recognized to write down the asset to its estimated fair value.

Other Assets

Other assets consist of license agreements, patents and trademarks. Amortization is computed using the straight-line method over estimated useful lives of three to twenty years. The trademark associated with the Nautilus acquisition was valued at \$4,349,839 and is being amortized over twenty years. Accumulated amortization was \$272,183 and \$510,374 at December 31, 1999 and 2000, respectively.

Warranty Costs

The Company's warranty policy provides for coverage for defects in material and workmanship. Warranty periods on the Company's products range from two years to limited lifetime on the Bowflex lines of fitness products and twenty years on airbeds. The Nautilus commercial line of fitness products includes a lifetime warranty on the structural frame, welded moving parts and weight stacks, a 120-day warranty on upholstery and padded items, and a one-year warranty on all other parts.

Revenue Recognition

Revenue from product sales is generally recognized at the time of shipment. Revenue is recognized upon installation for the Nautilus commercial equipment, if the Company's truck fleet is used for delivery of the products.

Net Sales

In the fourth quarter of 2000, the Company adopted Emerging Issues Task Force Consensus 00-10 "Accounting for Shipping and Handling Costs" (EITF 00-10). As a result, the Company now accounts for revenue generated by shipping products to customers as net sales. Previously, these amounts were included in cost of sales along with the related costs incurred to ship the products. Net sales and cost of sales for prior periods have been restated to reflect EITF 00-10. This change has no effect on reported net income or earnings per share.

Research and Development

Internal research and development costs are expensed as incurred and included in cost of sales. Third party research and development costs are expensed when the contracted work has been performed.

Research and development expense was \$64,973, \$716,240 and \$1,186,216 for 1998, 1999 and 2000, respectively.

Stock-Based Compensation

The Company continues to measure compensation expense for its stock-based employee compensation plans using the method prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees." The Company provides pro forma disclosures of net income and earnings per share as if

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the method prescribed by Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," had been applied in measuring compensation expense. See Note 9.

Income Taxes

Deferred income tax assets and liabilities are computed annually for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to periods in which the differences are expected to affect taxable income. A valuation allowance is established when necessary to reduce deferred tax assets to the amount more likely than not to be realized. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities.

Comprehensive Income

Effective January 1, 1998, the Company adopted SFAS No. 130, "Reporting Comprehensive Income," which requires presentation of comprehensive income within an entity's primary financial statements. Comprehensive income is defined as net income as adjusted for changes to equity resulting from events other than net income or transactions related to an entity's capital structure. Comprehensive income equaled net income for all periods presented.

Fair Value of Financial Instruments

The carrying amount of the Company's cash and cash equivalents, trade receivables, trade payables, royalties payable, and accrued liabilities approximates their estimated fair values due to the short-term maturities of those financial instruments.

Recent Accounting Pronouncement

In June 1999, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards for all derivative instruments. SFAS 133, as amended, is effective for fiscal years beginning after June 15, 2000. We do not currently have any derivative instruments and, accordingly, do not expect the adoption of SFAS 133 to have an impact on our financial position or results of operations.

Reclassifications

Certain amounts from 1998 and 1999 have been reclassified to conform to the 2000 presentation.

2. OPERATING SEGMENTS

The Company's operating segments include its direct products segment which includes all products marketed directly to consumers through a variety of direct marketing channels. The Bowflex line of fitness equipment and the Nautilus Sleep Systems are the principal products in the Company's direct products segment. The other operating segment is the commercial and retail products line which includes products and operations that are not direct marketed to consumers. Products in this segment include Nautilus commercial and retail fitness equipment and accessories. Accounting policies used by the segments are the same as those disclosed in Note 1.

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The following table presents information about the Company's two operating segments (in thousands):

	Direct Products	Commercial and Retail Products	Total
Year Ended December 31, 2000			

Revenues from external customers	\$	198,107	\$	25,820	\$	223,927
Interest income		3,630		2		3,632
Depreciation and amortization expense		2,068		806		2,874
Income tax expense		22,883		530		23,413
Segment net income		40,684		942		41,626
Segment assets		95,815		21,311		117,126
Additions to property, plant and equipment		8,237		525		8,762

Year Ended December 31, 1999

Revenues from external customers	\$	113,004	\$	20,075	\$	133,079
Interest income		1,002		2		1,004
Depreciation and amortization expense		565		411		1,183
Income tax expense		11,084		618		11,495
Segment net income		19,715		628		20,343
Segment assets		47,753		19,557		67,310
Additions to property, plant and equipment		1,379		550		1,929

Year Ended December 31, 1998

Revenues from external customers	\$	63,171	—	\$	63,171
Interest income		527	—		527
Depreciation and amortization expense		302	—		302
Income tax expense		6,708	—		6,708
Segment net income		12,485	—		12,485
Segment assets		24,373	—		24,373
Additions to property, plant and equipment		1,739	—		1,739

3. PUBLIC OFFERING

On May 5, 1999, the Company completed its initial U.S. public offering of common stock listed on the Nasdaq exchange. The initial offering consisted of 2,250,000 total shares at \$9.11 per share, of which 1,856,250 shares were offered by the Company, with an additional 393,750 shares offered by selling shareholders. On June 10, 1999, the underwriting group exercised a 337,500-share over-allotment. Total net proceeds realized by Direct Focus, Inc. from the offerings were \$17.9 million. The Company was listed on the Toronto Stock Exchange from January 1993 to May 1999.

4. ACQUISITION OF NAUTILUS

Effective January 4, 1999, the Company acquired substantially all of the net assets of Nautilus International, Inc. ("Nautilus"). Nautilus was a manufacturer and distributor of commercial fitness equipment and, to a limited extent, retail fitness equipment and accessories. The acquisition was accounted for under the purchase method of accounting and, accordingly, the assets acquired, liabilities assumed, and results of operations have been included in the accompanying financial statements since the date of acquisition. The Company paid approximately \$16.7 million, including acquisition costs of approximately \$500,000, for the assets and intellectual property of Nautilus and assumed \$1.8 million of current liabilities.

The total cost of the acquisition was allocated to the assets acquired and liabilities assumed as follows:

Cash	\$	8,512
Trade receivables		3,006,890
Inventories		3,104,131
Prepaid expenses and other current assets		108,206
Furniture and equipment		7,991,685
Other assets		4,349,839
Liabilities assumed		(1,825,285)
		<hr/>
Total	\$	16,743,978
		<hr/>

The unaudited pro forma financial information below for the year ended December 31, 1998 was prepared as if the transaction had occurred on January 1, 1998:

Revenue	\$	76,600,696
Net income	\$	9,868,213
Basic earnings per share	\$.47
Diluted earnings per share	\$.45

The unaudited pro forma information is not necessarily indicative of what actual results would have been had the transaction occurred at the beginning of the respective year, nor does it purport to indicate the results of future operations of the Company.

5. INVENTORIES

Inventories at December 31 consisted of the following:

	1999	2000
Finished goods	\$ 4,682,659	\$ 8,093,919
Work in process	1,141,803	1,160,647
Parts and components	3,343,092	3,398,551
	<u>\$ 9,167,554</u>	<u>\$ 12,653,117</u>

6. PROPERTY, PLANT AND EQUIPMENT

Details of property, plant and equipment are summarized as follows at December 31:

	Estimated Useful Life (in years)	1999	2000
Land	N/A	\$ 140,000	\$ 1,718,495
Buildings	31.5	5,870,592	9,636,774
Computer equipment	2-5	2,737,488	5,179,365
Production equipment	5	2,481,839	2,778,679
Furniture and fixtures	5	462,174	915,040
Automobiles	7	53,000	53,000
		<u>11,745,093</u>	<u>20,281,353</u>
Less accumulated depreciation		(1,100,255)	(3,612,469)
Property, plant and equipment, net		<u>\$ 10,644,838</u>	<u>\$ 16,668,884</u>

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7. ACCRUED LIABILITIES

Accrued liabilities at December 31 consisted of the following:

	1999	2000
Accrued payroll	\$ 2,318,771	\$ 3,178,847
Accrued warranty expense	383,356	447,194
Sales return reserve	786,921	1,307,000
Accrued other	562,472	411,184
Total	<u>\$ 4,051,540</u>	<u>\$ 5,344,225</u>

8. COMMITMENTS AND CONTINGENCIES

Lines of Credit

During 1999, the Company obtained a line of credit for \$5 million with a bank which was increased to \$10 million in 2000. The line is secured by the Company's general assets, and interest is payable on outstanding borrowings under the line at the bank's prime rate (9.5% at December 31, 2000). There were no outstanding borrowings on the line of credit at December 31, 2000.

Operating Leases

The Company leases its Vancouver, Washington call center facility under an operating lease which expires April 30, 2002. The lease commitment is subject to an annual rent adjustment based upon changes in the consumer price index, limited to a 6.0% annual change. The agreement provides for an annual cancellation provision by the Company upon proper notification.

Since December 1999, the Company has leased a distribution center in Las Vegas, Nevada to service the Southwestern United States. This operating lease expires November 30, 2002.

Nautilus HPS, Inc. leases trucks and trailers and other equipment used in the Nautilus commercial business. These leases expire over various terms through December 2002.

Rent expense under all leases was \$239,197 in 1998, \$664,922 in 1999, and \$473,920 in 2000.

Obligations

Future minimum lease payments under the operating leases during the years ending December 31 are as follows:

2001	\$ 595,141
2002	416,130
<hr/>	
Total minimum lease payments	\$ 1,011,271

9. STOCK OPTIONS

The Company's stock-based compensation plan was adopted in June 1995. The Company can issue both nonqualified stock options to the Company's officers and directors and qualified options to the Company's employees. The plan was amended in June 2000 so the Company may grant options for up to 5,305,412 shares of common stock. At December 31, 2000, 1,985,136 shares are available for future issuance under the plan. The plan is administered by the Company's Board of Directors which determines the terms and conditions of the various grants awarded under these plans. Stock options granted generally have an exercise price equal to the closing market price of the Company's stock on

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the date of the grant, and vesting periods vary by option granted, generally no longer than four years. If compensation cost on stock options granted under these plans had been determined based on the fair value of the options consistent with that described in SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below for the years ended December 31, 1998, 1999 and 2000.

	1998	1999	2000
Net income, as reported	\$ 12,485,494	\$ 20,342,891	\$ 41,626,094
Net income, pro forma	12,274,208	19,958,204	40,500,561
Basic earnings per share, as reported	\$ 0.59	\$ 0.89	\$ 1.77
Basic earnings per share, pro forma	\$ 0.58	\$ 0.87	\$ 1.72
Diluted earnings per share, as reported	\$ 0.57	\$ 0.87	\$ 1.73
Diluted earnings per share, pro forma	\$ 0.56	\$ 0.85	\$ 1.69

The pro forma amounts may not be indicative of the effects on reported net income for future years due to the effect of options vesting over a period of years and the granting of stock compensation awards in future years.

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1998, 1999 and 2000, respectively; all options granted will vest as scheduled; no dividend yield for all three years; risk-free interest rate of 5%, 6.4% and 5%; expected volatility of 76%, 60% and 51%; and expected lives of five years for all three years.

A summary of the status of the Company's stock option plans as of December 31, 1998, 1999 and 2000, and changes during the years ended on those dates is presented below.

	1998		1999		2000	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	1,829,505	\$ 0.21	1,238,891	\$ 1.06	1,051,064	\$ 4.01
Granted	423,000	2.53	381,780	8.98	536,850	18.65
Forfeited or cancelled	(16,425)	0.43	(48,001)	4.76	(134,250)	8.97
Exercised	(997,190)	0.13	(521,607)	0.58	(324,201)	1.92
Outstanding at end of year	1,238,891	\$ 1.06	1,051,064	\$ 4.01	1,129,463	\$ 12.89
Options exercisable at end of year	695,699		482,630		432,339	

The following table summarizes information about stock options outstanding as of December 31, 2000:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Shares Exercisable	Weighted Average Exercise Price
\$0.11 — \$0.43	154,578	1.3	\$ 0.39	154,578	\$ 0.39
\$2.05 — \$4.33	204,014	2.2	2.11	146,264	2.05
\$9.11 — \$10.47	353,384	3.7	9.17	119,684	8.90
\$20.33 — \$24.09	417,488	4.5	20.78	11,813	20.33
\$0.11 — \$24.09	1,129,464	3.4	\$ 10.99	432,339	\$ 3.85

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10. INCOME TAXES

The Company realizes income tax benefits as a result of the exercise of non-qualified stock options and the exercise and subsequent sale of certain incentive stock options (disqualifying dispositions). For financial statement purposes, any reduction in income tax obligations as a result of these tax benefits is credited to common stock.

The provision for (benefit from) income taxes consists of the following for the three years ended December 31, 2000:

	1998	1999	2000
Current:			
Federal	\$ 6,608,100	\$ 11,973,989	\$ 23,247,566
State	—	5,884	20,901
Total Current	6,608,100	11,979,873	23,268,467
Deferred:			
Federal	99,484	(484,448)	144,945
State	—	—	—
Total Deferred	99,484	(484,448)	144,945
Total Provision	\$ 6,707,584	\$ 11,495,425	\$ 23,413,412

The components of the net deferred tax asset/(liability) at December 31, 1999 and 2000 are as follows:

	1999	2000
Current:		
Assets:		
Accrued vacation	\$ 124,933	\$ 132,725
Allowance for doubtful accounts	106,633	94,742
Inventory reserve	107,083	148,959
Uniform capitalization	43,750	102,882
Accrued reserves	442,847	560,927
Customer deposits	384,034	52,128
Other	202,205	—
Liabilities:		
Prepaid advertising	(440,476)	—
Other prepaids	(150,220)	(142,000)
Net current deferred tax asset	\$ 820,789	\$ 950,363
Noncurrent		
Liabilities:		
Other	\$ (39,908)	\$ —
Depreciation	(147,576)	(462,004)
Net long-term deferred tax liability	\$ (187,484)	\$ (462,004)

A reconciliation of the statutory income tax rate with the Company's effective income tax rate is as follows:

	1999	2000
Federal	35.00%	35.00%
State	1.08%	0.03%
Other	0.03%	0.97%
Total	36.11%	36.00%

11. EARNINGS PER SHARE

The per share amounts are based on the weighted average number of basic and dilutive common equivalent shares assumed to be outstanding during the period of computation. Net income for the calculation of both basic and diluted earnings per share is the same for all periods.

The calculation of weighted average outstanding shares is as follows:

	Average Shares		
	1998	1999	2000
Basic shares outstanding	21,007,180	22,872,637	23,525,068
Dilutive effect of stock options	876,225	584,080	473,175
Diluted shares outstanding	21,883,405	23,456,717	23,998,243

12. STOCK REPURCHASE PROGRAM

Four times during fiscal 2000, the Board of Directors authorized the expenditure of up to \$8 million to purchase shares of Direct Focus, Inc. common stock in open market transactions. During the year ended December 31, 2000, the Company repurchased a total of 278,353 shares of common stock in open market transactions for an aggregate purchase price of \$3.3 million. All authorizations had expired at December 31, 2000.

13. STOCK SPLITS

On June 26, 2000, the Board of Directors approved a three-for-two stock split in the form of a share dividend, payable to the Company's stockholders of record as of July 31, 2000. Shares resulting from the split were distributed by the transfer agent on August 14, 2000. On December 8, 2000, the Board of Directors approved another three-for-two stock split payable to Company stockholders of record as of January 2, 2001 with a payment date of January 15, 2001. All share and per-share numbers contained herein reflect these stock splits.

14. RELATED-PARTY TRANSACTIONS

The Company incurred royalty expense under an agreement with a stockholder of the Company of \$1,603,821 in 1998, \$2,815,116 in 1999, and \$4,837,212 in 2000, of which \$893,563 and \$1,481,886 was payable at December 31, 1999 and 2000, respectively.

15. LITIGATION SETTLEMENT

On July 17, 1999, the Company reached an agreement with a competitor to settle pending litigation. As a result of the settlement, the Company took a one-time, after-tax charge of \$2.6 million in the second quarter of fiscal 1999. The Company made an \$8 million cash payment to the competitor, of which \$4 million was paid by insurance.

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This settlement did not affect the ongoing direct marketing campaign for the Company's Bowflex home fitness equipment. Additionally, in the normal course of business, the Company is a party to various other legal claims, actions and complaints. Although it is not possible to predict with certainty whether the Company will ultimately be successful in any of these legal matters, or what the impact might be, the Company believes that disposition of these matters will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

16. EMPLOYEE BENEFIT PLAN

The Company adopted a 401(k) profit sharing Plan in 1999 covering all employees over the age of 18, who also have three months of service. The Plan was amended in 2000 to allow for immediate eligibility in the plan. Each participant in the 401(k) Plan may contribute up to 20% of eligible compensation during any calendar year, subject to certain limitations. The 401(k) Plan provides for Company matching contributions of up to 50% for eligible contributions for participants who have one year of service. In addition, the Company may make discretionary contributions. Employees are 100% vested in the matching and discretionary contributions after four years of service. Expense for the Plan was \$103,793 and \$134,669 for the years ended December 31, 1999 and 2000, respectively.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

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PART III

Item 10. Directors and Executive Officers of the Registrant

The Information required by this item is included under the captions "Election of Directors," "Executive Officers" and "Section 16(a) Beneficial Ownership Reporting Compliance," respectively, in the Company's Proxy Statement for its 2001 Annual Meeting of Shareholders and is incorporated herein by reference.

Item 11. Executive Compensation

The information required by this item is included under the caption "Executive Compensation" in the Company's Proxy Statement for its 2001 Annual Meeting of Shareholders and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information required by this item is included under the caption "Security Ownership of Certain Beneficial Owners and Management" in the Company's Proxy Statement for its 2001 Annual Meeting of Shareholders and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The information required by this item is included under the caption "Certain Relationships and Related Transactions" in the Company's Proxy Statement for its 2001 Annual Meeting of shareholders and is in-corporated herein by reference.

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a)(1) Financial Statements

See the Consolidated Financial Statements in Item 8.

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(a)(2) Financial Statement Schedule

DIRECT FOCUS, INC.

Schedule II

Valuation and Qualifying Accounts

Three years ended December 31, 2000

(in thousands)

Description	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions	Balance at End of Period
Allowance for doubtful accounts:				
1998	85,000	—	45,000	40,000
1999	40,000	264,727	—	304,727
2000	304,727	47,552	—	352,279
Sales returns and allowances:				
1998	285,000	315,704	—	600,704
1999	600,704	186,217	—	786,921
2000	786,921	520,079	—	1,307,000
Warranty reserves				
1998	20,000	50,000	—	70,000
1999	70,000	313,356	—	383,356
2000	383,356	63,838	—	447,194

All other financial statement schedules have been omitted since they are not required, not applicable, or the information is included in the consolidated financial statements or notes thereto.

(a)(3) Exhibits

The following exhibits are filed herewith and this list is intended to constitute the exhibit index:

Exhibit No.	
3.1	Articles of Incorporation, as Amended—Incorporated by reference to Exhibits 3.1, 3.2 and 3.3 of the Company's Registration Statement on Form S-1, as filed with the Securities and Exchange Commission (the "Commission") on March 3, 1999.
3.2	Amendment to Articles of Incorporation—Incorporated by reference to Exhibit 3 to the Company's Quarterly Report on Form 10-Q for the three months ended June 30, 2000, as filed with the Commission on August 10, 2000.
3.3	Amended and Restated Bylaws—Incorporated by reference to Exhibit 3.4 of Amendment No. 2 to the Company's Registration Statement on Form S-1, as filed with the Commission on April 30, 1999.
10.1	Direct Focus, Inc. Stock Option Plan, as amended—Incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
10.2	Amendment to Direct Focus, Inc. Stock Option Plan—Incorporated by reference to Exhibit 10 to the Company's Quarterly Report on Form 10-Q for the three months ended June 30, 2000, as filed with the Commission on August 10, 2000.

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- 10.3 Lease Agreement dated September 16, 1992, between Bow-Flex of America, Inc. and Christensen Group, Inc.—Incorporated by reference to Exhibit 10.4 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.4 First Amendment to Lease dated September 16, 1992, between Bow-Flex of America, Inc. and Christensen Group, Inc.—Incorporated by reference to Exhibit 10.5 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.5 Amendment to Bowflex, Inc. Lease Extension, dated August 27, 1996, between Bowflex, Inc. and Ogden Business Park Partnership—Incorporated by reference to Exhibit 10.7 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.6 First Amendment to Lease, dated December 10, 1996, between Bowflex, Inc. and Ogden Business Park Partnership—Incorporated by reference to Exhibit 10.8 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.7 Borrowing Agreement, dated December 16, 1998, between Direct Focus, Inc. and Seafirst Bank—Incorporated by reference to Exhibit 10.11 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.8 Modification to Borrowing Agreement dated March 30, 2000 between Direct Focus, Inc. and Bank of America, N.A.
 - 10.9 Royalty Agreement, dated as of April 9, 1988, between Bow-Flex of America, Inc. and Tessema D. Shifferaw—Incorporated by reference to Exhibit 10.9 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.10 Royalty Payment Agreement, dated as of June 18, 1992, between Tessema D. Shifferaw, Brian R. Cook and R.E. "Sandy" Wheeler—Incorporated by reference to Exhibit 10.10 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.11 First Amended and Restated Merchant Agreement dated as January 27, 1999, between Direct Focus, Inc. and Household Bank (SB), N.A.—Incorporated by reference to Exhibit 10.11 of the Company's Registration Statement on Form S-1, as filed with the Commission on March 3, 1999.
 - 10.12 Second Amended and Restated Merchant Agreement dated February 23, 2000 between Direct Focus, Inc. and Household Bank (SB), N.A.
 - 10.13 Lease Agreement, dated July 19, 1999, between Direct Focus, Inc. and Las Vegas Motor Speedway, LLC.—Incorporated by reference to Exhibit 10.12 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999, as filed with the commission on March 29, 2000.
 - 10.14 Agreement of Purchase and Sale and Joint Escrow Instructions dated June 7, 2000, by and between Tyco Valves & Controls, Inc. and Direct Focus, Inc.
 - 21 Subsidiaries of Direct Focus, Inc.
 - 23 Consent of Deloitte & Touche LLP
 - 24.1 Power of Attorney for Kirkland C. Aly
 - 24.2 Power of Attorney for C. Rowland Hanson

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- 24.3 Power of Attorney for Paul F. Little
 - 24.4 Power of Attorney for Roger J. Sharp
 - 24.5 Power of Attorney for Roland E. "Sandy" Wheeler

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the quarter ended December 31, 2000.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 28, 2001

DIRECT FOCUS, INC.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 28, 2001.

Signature	Title
/s/ BRIAN R. COOK	
Brian R. Cook	President (Principal Executive Officer)
/s/ ROD W. RICE	
Rod W. Rice	Chief Financial Officer and Secretary (Principal Financial and Accounting Officer)
KIRKLAND C. ALY *	
Kirkland C. Aly	Director
C. ROWLAND HANSON *	
C. Rowland Hanson	Director
PAUL F. LITTLE *	
Paul F. Little	Director
/s/ RANDAL R. POTTER	
Randal R. Potter	Director
ROGER J. SHARP *	
Roger J. Sharp	Director
ROLAND E. "SANDY" WHEELER *	
Roland E. "Sandy" Wheeler *	Director
* By: /s/ ROD W. RICE	
Rod W. Rice <i>Attorney-In-Fact</i>	March 28, 2001

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**BANK OF AMERICA
Modification to Borrowing Agreement**

This Modification modifies the Borrowing Agreement dated December 10, 1999 ("Borrowing Agreement"), in the maximum principal amount of \$5,000,000.00, executed by **DIRECT FOCUS CORPORATION** ("Borrower") in favor of **Bank of America, N.A.** ("Bank"). Terms used in this Modification and defined in the Borrowing Agreement shall have the meaning given to such terms in the borrowing Agreement. For mutual consideration, Borrower and Bank agree to amend the Borrowing Agreement as follows:

1. *Credit Limit.* The maximum principal amount of the Loan is hereby changed to **\$10,000,000.00**, and Borrower's maximum liability for the Obligations is also changed to **\$10,000,000.00**.

2. *Maturity Date.* The maturity date of the Loan is changed to **June 1, 2001**. Bank's commitment to make advances to Borrower under the Loan is also extended to **June 1, 2001**.

3. *Letter of Credit Facility.* The Letter of Credit Facility of the Agreement is changed in its entirety to read as follows:

Letter of Credit Facility. Upon Borrower's execution of Bank's standard form application and agreement for standby letters of credit or commercial letters of credit ("L/C Agreement"), Bank shall issue on Borrower's behalf standby letters of credit and commercial letters of credit ("Letters of Credit"), until June 1, 2001. Standby letters of credit and commercial letters of credit shall not exceed \$5,000,000.00 in the aggregate. Each standby letter of credit shall expire no later than September 2, 2001, except for a \$12,000.00 standby letter of credit expiring December 31, 2002. Each commercial letter of credit shall expire no later than September 1, 2001. Borrower shall pay to Bank in advance, upon issuance of each standby letter of credit, an issuance fee of 1% per annum or \$250 minimum. Borrower shall pay to Bank issuance fees for all commercial letters of credit in accordance with Bank's standard fee schedule. Borrower shall additionally, on demand, pay transaction fees according to Bank's then-outstanding standard fee schedule on all drafts, transfers, extensions, and other transactions in regard to the Letters of Credit, and reimburse Bank for all out-of-pocket costs, legal fees, and expenses. All draws under Letters of Credit shall be reimbursed to Bank immediately upon demand. Bank shall in addition have all rights provided in each L/C Agreement. Any default in an L/C Agreement shall be a default under this agreement. Bank shall have no obligation to issue a Letter of Credit if, after issuance, the combined balance of all outstanding Letters of Credit and all Advances would exceed \$10,000,000.00. Borrower's obligations under this paragraph are collectively called the "L/C Obligations." The L/C Obligations and the Advances (including all interest thereon) are together referred to as the "Obligations."

4. *Covenants.* The following covenant of the Borrowing Agreement is deleted in its entirety:

- **Within 30 days of quarter's end, Borrower's quarterly balance sheet and income statement, which may be internally prepared, certified by an officer of Borrower as true and correct.**

The following covenants of the Borrowing Agreement are modified as follows:

- **Within 120 days of each fiscal year end, Borrower's year-end balance sheet, income statement, and statement of cash flows, which shall be audited by an independent certified public accountant. The statements shall be prepared on a consolidated basis.**
- **Borrower's quarterly Securities and Exchange Commission Form 10 Q due within 60 days of each quarter end.**

- **Not incur aggregate capital expenditures in excess of \$10,000,000.00 in the year 2000, and \$5,000,000.00 thereafter.**

5. *Other Terms.* Except as specifically amended by this Modification or any prior amendment, all other terms, conditions, and definitions of the Borrowing Agreement, and all other security agreements, guaranties, deeds of trust, and other instruments or agreements entered into with regard to the Loan, shall remain in full force and effect.

DATED 3/30/2000

Bank: **BANK OF AMERICA, N.A.**
By: /s/ DANIEL J. RILER

Title: Vice President

Borrower: **DIRECT FOCUS CORPORATION**
By: /s/ ROD W. RICE

Title: Chief Financial Officer

QuickLinks

[BANK OF AMERICA Modification to Borrowing Agreement](#)

SECOND AMENDED AND RESTATED MERCHANT AGREEMENT

BANK: Household Bank (SB), N.A.
1111 Town Center Drive
Las Vegas, Nevada 89134

MERCHANT: Direct Focus, Inc. f/k/a Bowflex, Inc.
2200 NE 65th Avenue
Vancouver, WA 98661
Phone: 360-418-6178
Facsimile No.: 360-694-7755

This Second Amended and Restated Merchant Agreement ("*Agreement*") is made and entered into as of the 23rd day of February, 2000 ("*Effective Date*"), by and between Household Bank (SB), N.A. for itself and as assignee of Household Bank (Nevada), N.A. (herein "*Household*") and Direct Focus, Inc., formerly known as Bowflex, Inc., a Washington corporation (herein "*Merchant*") and shall be effective as of February 23, 2000. In consideration of the mutual promises, covenants, and agreements set forth below and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Merchant and Household agree as follows:

Section 1. Definitions. In addition to the words and phrases defined above and elsewhere in this Agreement, the following words and phrases shall have the following meanings:

- a. "*Account*" means an account resulting from the issuance of a Card. An Account may have more than one Card issued for it. Each Account shall be owned by, and deemed to be the property of, Household.
 - b. "*Affiliate*" means any entity that is owned by, owns or is under common control with Household or its ultimate parent or Merchant or its ultimate parent.
 - c. "*Applicable Law*" means collectively or individually any applicable law, rule, regulation or judicial, governmental or administrative order, decree, ruling, opinion or interpretation.
 - d. "*Application*" means an application for an Account under the Program.
 - e. "*Authorization*" means permission from Household to make a Card Sale.
 - f. "*Authorization Center*" means the facility designated by Household as the facility at which Card Sales are authorized.
 - g. "*Business Day*" means any day except Saturday or Sunday or a day on which banks are closed in the State of Illinois.
 - h. "*Card*" means the private label credit card bearing Merchant's name and/or logo issued by Household for the Program.
 - i. "*Cardholder*" means (i) the person in whose name an Account is opened, and (ii) any other authorized users of the Account and Card.
 - j. "*Cardholder Agreement and Disclosure Statement*" (hereafter "*Cardholder Agreement*") means the credit card agreement between Household and each Cardholder providing for the extension of credit by Household under the Program pursuant to which the Cardholder is issued a Card, as the same may be revised from time to time by Household with notification to Merchant.
 - k. "*Card Sale*" means any sale of Goods that Merchant makes to a Cardholder pursuant to this Agreement that is charged to an Account.
 - l. "*Chargeback*" means the return to Merchant and reimbursement to Household of a Sales Slip for which Merchant was previously paid pursuant to *Section 8* herein.
-
- m. "*Credit Slip*" means evidence of credit in electronic or paper form for Goods purchased from Merchant.
 - n. "*Discount*" means the fee payable by Merchant to Household as described in Section 3.b.(ii) hereof.
 - o. "*Goods*" means the products described in *Section 2* below, certain warranties expressly authorized by Household, and related services sold by Merchant in the ordinary course of Merchant's business to consumers for individual, family, personal or household use.
 - p. "*Internet Application*" means any Application for a Card which is received by Household on-line via the Household web site.
 - q. "*Mailed-In Application*" means any Application for a Card which is received by Merchant or Household through the mail.
 - r. "*Operating Instructions*" means the regulatory guidelines and operating instructions and/or procedures or written instructions designated by Household and agreed to by Merchant, which agreement shall not be unreasonably withheld, from time to time concerning the Program.
 - s. "*Program*" means the private label revolving credit card program promoted by Merchant whereby Accounts will be established and maintained by Household, Cards issued by Household to qualified consumers purchasing Merchant's Goods, and Card Sales funded all pursuant to the terms of this Agreement.
 - t. "*Sales Slip*" means evidence of a Card Sale in electronic or paper form for Goods purchased from Merchant.
 - u. "*Telephone Application*" means any Application for a Card which is received from a consumer or solicited by Merchant via telephone and for which the applicant's credit or other information required to apply for a Card is obtained by Merchant from the applicant over the telephone.

v. "Terminal" means an electronic terminal or computer capable of communicating by means of an on-line or dial-up electronic link with an Authorization Center.

Section 2. Scope and Purpose. Merchant engages in the sale of fitness equipment and other products. Pursuant to that certain Merchant Agreement dated February 4, 1997, as amended by that First Amended and Restated Merchant Agreement (collectively referred to as the "Existing Merchant Agreement"), Household and Merchant had agreed that Household would make financing available to customers of Merchant purchasing Goods from Merchant. Merchant has requested Household to continue to make financing available to consumers purchasing Goods from Merchant and Merchant has agreed to execute this Agreement in order to continue the Program and secure its benefit for Merchant. Household and Merchant agree that this Agreement shall supersede and replace the Existing Merchant Agreement. Household, a credit card bank in the business of providing revolving credit financing pursuant to a credit card, has agreed to continue to provide financing under the Program to individual qualified consumers purchasing Merchant's Goods pursuant to the terms and conditions set forth in this Agreement.

a. **Forms and Cards.** Household will provide to Merchant standard Sales Slips, Credit Slips and other forms from time to time for use by Merchant in the Program, which documents may be changed from time to time by Household. Merchant agrees to pay for the combined Application and Cardholder Agreement and Disclosure Statement and will be charged a fee for non-standard forms and for forms in excess of normal usage. The design and content of Cards and billing statements and the terms and conditions of Accounts and combined Applications and Cardholder Agreement and Disclosure Statement shall be determined by Household and are subject to change by Household from time to time.

b. **Credit Review, Ownership of Accounts.** All completed Applications for Accounts submitted by Merchant to Household whether mailed, telephoned or otherwise electronically transmitted will be processed and approved or declined in accordance with Household's credit criteria and procedures from time to time established by Household, with Household having and retaining all rights to reject or accept such Applications. Household will only accept Applications for revolving credit pursuant to the credit card it issues for individual, personal, family or household use. Household or its Affiliates shall own, all Cardholder e-mail addresses and the Accounts and shall bear the credit risk for such Accounts, except as otherwise provided in this Agreement. Merchant acknowledges and agrees that it shall have no interest whatsoever in the Accounts. Household shall not be obligated to take any action under an Account, including making future advances or credit available to Cardholders. Household shall not be obligated to accept Applications for a Card or to approve any Card Sale for consumers that do not have their principal residence and billing address in the fifty United States and the District of Columbia.

c. **Card Promotions, Services and Enhancements.** Household and Merchant may from time to time mutually agree to offer to existing or potential Cardholders special credit promotions, additional services and/or enhancements. The terms of such promotions, services and enhancements shall be mutually agreed upon by Household and Merchant and are subject to change or discontinuance by Household and Merchant. In consideration of Household's providing special credit promotions and to compensate Household for such promotions, Merchant agrees to pay to Household for the period agreed upon by Household and Merchant such rates, amounts and/or discounts set forth herein. Household may deduct amounts owed to it hereunder from amounts owed to Merchant under this Agreement.

d. **Merchant Customer Lists.** Household acknowledges that the names and addresses of Merchant customers provided by Merchant to Household constitute a merchant list and customer list respectively, of Merchant in which Merchant has proprietary rights and which Merchant regards as (and which is acknowledged by Household to constitute) a trade secret of Merchant. Accordingly, Household shall not use such list except with the prior written consent of Merchant, or to carry out its obligations under this Agreement. Merchant grants to Household the right to use such merchant and customer lists solely for such purposes. Household shall exercise such care with respect to such merchant and customer lists as it does with its own trade secrets. Notwithstanding the confidentiality provisions of this Agreement, Merchant as owner of such merchant and customer list may use such names and addresses for any purpose.

e. **Cardholder List.** Merchant agrees that Household is the owner of the Cardholder list and that Household and its Affiliates may use such list to solicit Cardholders for credit card products offered by Household and/or any of its Affiliates or other types of accounts or financial products or insurance services offered by Household and/or any of its Affiliates. Household agrees that Merchant may solicit, at its expense the Cardholder list for products or services offered by Merchant; provided that such products or services, as determined by Household do not compete with the Program, Household or its Affiliates and such solicitation does not reference the Program. The Cardholder list shall be subject to the confidentiality provisions of this Agreement.

Section 3. Fees, Discounts, Charges, Rates and Funding. Except as otherwise provided herein, the following consumer rate, fees, Discount and charges shall be effective for the Initial Term of this Agreement.

a. **Consumer Rate.** The consumer rate to be charged on purchases with the Card shall be 21.8%, subject to change from time to time by Household.

b. **Determination of Fees and Discounts.** The rate, fees, discounts and charges described in this Section 3 are subject to change from time to time by Household.

c. **Merchant.** Merchant agrees to pay Household the following fees and discounts (some of which are more fully described in this Agreement):

(i) "**Credit Promotion Discount Fee**": Household shall make certain deferred payment and/or deferred interest credit promotion ("Credit Promotions") available to Merchant. Each Sales Slip generated pursuant to each credit promotion shall be subject to a Credit Promotion discount fee as set forth herein which is a designated percentage of the amount of each Sales slip accepted and funded by Household. Each Sales Slip generated pursuant to non-promotional Card Sale shall be subject to a non-promotional discount fee also as set forth herein which is a designated percentage of the amount of each Sales Slip accepted and funded by Household. The Credit Promotion and non-promotional discount fees shall be collectively referred to as the "Discount Fees".

The Credit Promotions and Discount Fees available as of the date of this Agreement are listed below:

Promotional Period	Promotional Type	Discount Fee
Regular Sale	Non-Promotional Card Sale	.15%
3 Months	Same As Cash W/O Payment	2.66%

6 Months	Same As Cash W/Payment	5.18%
7 Months	Same As Cash W/Payment	6.21%
8 Months	Same As Cash W/Payment	7.10%
9 Months	Same As Cash W/Payment	7.99%
10 Months	Same As Cash W/Payment	8.88%
11 Months	Same As Cash W/Payment	9.76%
12 Months	Same As Cash W/Payment	10.65%

(ii) "Start-up Fee": \$0.00.

(iii) "Forms Fee": \$0.00.

d. *Acceptance, Offset & Funding.* Subject to the terms, conditions, warranties and representations in this Agreement and provided that Merchant has satisfied all of the conditions set forth in this Agreement, including, without limitation, *Sections 4, 5, 6 and 7*, Household agrees to pay to Merchant the amount of each valid and authorized Sales Slip presented to Household during the term of this Agreement, less the amount of the fees, charges, and Discounts described above in this Section, outstanding Account balances for Sales Slips subject to Chargeback, reimbursements, refunds, customer credits and any other amounts owed to Household under this Agreement by Merchant. Household may also offset or recoup said amounts from future amounts owed to Merchant under this Agreement. Any amounts owed by Merchant to Household which cannot be paid by the aforesaid means shall be due and payable by Merchant on demand. Any payment made by Household to Merchant shall not be final but shall be subject to subsequent review and verification by Household. Household's liability to Merchant with respect to the funding of any Card Sale, Sales Slip or Credit Slip shall not exceed the amount on the Sales Slip or Credit Slip in connection with such transaction. In no event shall Household be liable for incidental or consequential damages.

e. *Funding.* Funding of Sales Slips by Household to Merchant shall be made to Merchant's account at a bank designated by Merchant. Household will use its best efforts to make such payments on the first Business Day after receipt, verification and processing by Household of the transmission of the transaction data, if such transmission is received by 7:30 am Central Standard Time; if received later than 7:30 am Central Standard Time, then on the second Business Day after said transmission, however, in no event shall such payments be made later than the third Business Day after receipt of said transmission by Household.

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Section 4. Merchant Responsibilities Concerning Consumer Transactions. Merchant covenants and agrees that Merchant shall:

a. Honor all valid Cards without discrimination, when properly presented by Cardholders for payment of Goods.

b. Not require, through an increase in price or otherwise, any Cardholder to pay any surcharge at the time of sale or pay any part of any charge imposed by Household on Merchant.

c. Not establish minimum or maximum charge amounts without Household's prior written approval.

d. Prominently display at each of its locations, advertising and promotional materials relating to the Card, including, without limitation, take-one Applications for the Card and use and display such materials in accordance with any specifications provided by Household. Such materials shall be used only for the purpose of soliciting accounts for the Program. Any solicitation, written material, advertising or the like relating to the Program or the products offered pursuant to the Program shall be prepared or furnished by Household or shall receive Household's prior written approval. Household will charge Merchant and Merchant agrees to pay for any such advertising and promotional materials. Any such materials shall not be used by Merchant following termination of this Agreement.

e. Use only the form of, or modes of transmission for, Application/Cardholder Agreements, Sales Slips and Credit Slips as are provided by Household, and not use any Application/Cardholder Agreements, Sales Slips, and Credit Slips provided by Household other than in connection with a Card transaction.

f. With respect to Telephone Applications, Merchant shall:

(i) Make sure all information requested on the Telephone Application is complete;

(ii) Give the applicant the applicable initial disclosures at the time the Telephone Application information is requested or such other disclosures as may be required by Household from time to time;

(iii) Provide all information required by Household from time to time for approval of Applications by telephone or other electronic transmission;

(iv) Designate on the Application and/or enter into the Terminal that it was a Telephone Application and Card Sale;

(v) Not submit to Household for funding any Sales Slip resulting from a telephone or mail order Card Sale until not less than five (5) Business Days after receipt by Merchant and approval by Household of the Telephone or Mail Order Application; and

(vi) Merchant represents and warrants that in connection with telephone solicitations, it has adopted such policies and procedures to ensure compliance with all applicable federal and state laws, regulations or rules relating to telemarketing and/or telephone solicitations including but not limited to the Telephone Consumer Protection Act of 1991 ("TCPA") 42 USC 227 and 152(b); Chapter I, Title 47 of the Code of Federal Regulations, parts 64 and 68, the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFAPA) 15 U.S.C. §6101-6108; 16 CFR Part 310 and any applicable telemarketing or telephone solicitation laws of the state from which Merchant shall be initiating telephone solicitations for the Card.

g. With respect to Mailed-In Applications, Merchant shall:

(i) Make sure all information requested on the Application is complete;

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(ii) Provide all information required by Household from time to time for approval of Applications by mail and legibly insert the Account number on the Application in the designated area;

(iii) Designate on the Application and Sales Slip that it is a Mailed In Application and Card Sale;

(iv) Merchant represents and warrants that in connection with mail-order sales, it has adopted such policies and procedures to ensure compliance with all applicable federal and state laws, regulations or rules relating to mail order sales including but not limited to all applicable requirements of Title 16 Code of Federal Regulations, Chapter I, Subchapter D, part 435.1 ("Mail Order Rule");

(v) Not ship or deliver or cause to be shipped or delivered any Goods to a Cardholder until not less than five (5) Business Days after receipt by Merchant and approval by Household of the Telephone or Mailed-In Application;

(vi) Not submit to Household for funding any Sales Slip resulting from a telephone or mail order Card Sale until not less than five (5) Business Days after receipt by Merchant and approval by Household of the Telephone or Mailed-In Application; and

(vii) Send a copy of the approved Telephone or Mailed-In Application to Household within five (5) Business Days after the date the Goods are shipped to the Cardholder or the Sales Slip funded by Household.

h. With respect to Internet Applications, Merchant shall:

(i) Include a link on its web site to the Household web site, and include language notifying visitors that they may complete an application for a Card via the Internet by clicking on such link;

(ii) Not submit to Household for funding any Sales Slip resulting from an Internet Application until not less than five (5) Business Days after receipt by Merchant and approval by Household of the Internet Application;

(iii) Include a copy of the Cardholder Agreement and Disclosure Statement with all Goods shipped via overnight courier; and

(iv) Not permit any additional purchases, Internet or otherwise, on an Account for a period of not less than seven (7) days after notification from Household that Household has approved an Internet Application for an Account.

i. With respect to Sales Slips Merchant shall:

(i) Enter legibly on a single Sales Slip prior to obtaining the Cardholder's signature (1) a description of all Goods purchased in the same transaction in detail sufficient to identify the transaction; (2) the date of the transaction; (3) the Authorization number; and (4) the entire amount due for the transaction (including any applicable taxes);

(ii) **REQUEST AUTHORIZATION FROM HOUSEHOLD'S AUTHORIZATION CENTER UNDER ALL CIRCUMSTANCES.** (Household may refuse to accept or fund any Sales Slip that is presented to Household for payment more than sixty (60) days after the date of Authorization of the Card Sale). Merchant agrees not to divide a single transaction between two or more Sales Slips or between a Household Sales Slip and a sales slip for another credit provider. If Authorization is granted, legibly enter the Authorization number in the designated area on the Sales Slip. If Authorization is denied, not complete the transaction and follow any instructions from the

Authorization Center. Merchant shall use its best efforts, by reasonable and peaceful means, to retain or recover a Card:

(1) if Merchant is advised to retain the Card in response to an Authorization request; or

(2) if Merchant has reasonable grounds to believe that the Card is counterfeit, fraudulent, or stolen. The obligation to retain or recover a Card imposed by this Section does not authorize a breach of the peace or any injury to persons or property, and Merchant will hold Household harmless from any claim arising from any injury to person or property or other breach of the peace.

(iii) Imprint legibly on the Sales Slip the embossed legends from the Card or if the transaction is to be completed electronically or otherwise without a Card imprint, then enter legibly on the Sales Slip sufficient information to identify the Cardholder and Merchant, including at least, Merchant's name, Cardholder's name, Account number, expiration date and any effective date on the Card. Merchant shall be deemed to warrant the Cardholder's true identity as an authorized user of the Card;

(iv) Check the effective date, if any, and the expiration date on the Card;

(v) Obtain the signature of the Cardholder on the Sales Slip, and compare the signature on the Sales Slip with the signature panel of the Card and if identification is uncertain or if Merchant otherwise questions the validity of the Card, contact Household's Authorization Center for instructions. For telephone orders (TO), mail orders (MO) or Internet orders (IO) only, the Sales Slip may be completed without the Cardholder's signature and a Card imprint, but Merchant shall, in addition to all other requirements under this Section 4, enter legibly on the signature line of the Sales Slip the letters "TO", "MO" or "IO", as appropriate, and not deliver Goods or perform services after being advised that the "TO", "MO" or "IO" has been canceled or that the Card is not to be honored;

(vi) **IDENTIFICATION OF THE CARDHOLDER IS THE RESPONSIBILITY OF MERCHANT;**

(vii) Not present the Sales Slip to Household for funding until all Goods are delivered and all the services are performed to the Cardholder's satisfaction. With respect to Internet Sales, present the Sales Slip for funding as described in Section 4.h.(ii) above. If the Card Sale is canceled or the Goods or services canceled or returned, the Sales Slip is subject to Chargeback;

(viii) Enter the Card Sale into the Terminal and, if applicable, Household's approval code; and

(ix) Deliver a true and completed copy of the Sales Slip to the Cardholder at the time of delivery of the Goods.

j. *Credit Slips.* If Goods are returned, any Card Sale or services are terminated or canceled, or Merchant allows any price adjustment, then Merchant shall not make any cash refund, but shall complete and deliver promptly to Household a Credit Slip evidencing the refund or adjustment and deliver to the Cardholder a true and complete copy of the Credit Slip at the time the refund or adjustment is made. Merchant shall sign and date each Credit Slip and include thereon a brief description of the Goods returned, services terminated or canceled, refund or adjustment made, the date of the original Card Sale, Authorization number, Cardholder's name, address and Account number, and the date and amount of the credit, all in sufficient detail to identify the transaction. Merchant shall imprint or legibly reproduce on each Credit Slip the embossed legends from the Card and from Merchant's imprinter plate. The amount of the Credit Slip cannot exceed the amount of the original transaction as reflected on the Sales Slip. Merchant shall issue Credit Slips only in connection with previous bona fide Card Sales and only as permitted hereunder.

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k. Not receive any payments from a Cardholder for charges included on any Sales Slip resulting from the use of any Card, nor receive any payments from a Cardholder to prepare and present a Credit Slip for the purpose of effecting a deposit to the Cardholder's Account.

l. *Cardholder Complaints.* Merchant shall within five (5) days of receipt provide Household with a copy of any written complaint from any Cardholder concerning an Account.

m. *Right of First Refusal.* Merchant shall actively promote the Program. Merchant agrees to give Household right of first refusal in presenting consumer credit Applications and/or Sales Slips. During the term of this Agreement, Merchant shall not issue, arrange to issue, or accept, in the fifty United States and the District of Columbia, any private label credit card or account other than the Card, under any of Merchant's names or logos, except with respect to Applications declined by Household. To the extent Merchant displays other third party credit or charge card materials, it shall display the advertising and promotional materials relating to the Card in a manner and with a frequency equal to or greater than that accorded any other third party credit or charge card.

n. Satisfy all other requirements designated in any Operating Instructions or as may be required from time to time by Household. In the event there is any inconsistency between any Operating Instructions and this Agreement, this Agreement shall govern unless otherwise expressly indicated by Household in any Operating Instructions.

o. Present each Sales Slip and deliver each Credit Slip to Household or such other person designated by Household, within ten (10) Business Days after the date of the respective sale or credit transaction.

Section 5. Merchant Representations and Warranties. Merchant represents and warrants to Household as of the Effective Date and throughout the term of this Agreement the following:

- a. That each Card Sale will arise out of a bona fide sale of Goods by Merchant and will not involve the use of the Card for any other purpose.
- b. That each Card Sale will be to a consumer for personal, family, or household purposes.
- c. That Cardholder Applications will be available to the public (i) without regard to race, color, religion, national origin, sex, marital status, or age (provided the applicant has the capacity to enter into a binding contract) and (ii) not in any manner which would discriminate against an applicant or discourage an applicant from applying for the Card.
- d. That it has full corporate power and authority to enter into this Agreement; that all corporate action required under any organization documents to make this Agreement binding and valid upon Merchant according to its terms has been taken; and that this Agreement is and will be binding, valid and enforceable upon Merchant according to its terms.
- e. That it is not in violation of any covenants in any debt instruments to which it is a party as of the Effective Date of this Agreement.
- f. Neither (i) the execution, delivery and performance of this Agreement, nor (ii) the consummation of the transactions contemplated hereby will constitute a violation of law or a violation or default by Merchant under its articles of incorporation, by laws or any organization documents, or any material agreement or contract and no authorization of any governmental authority is required in connection with the performance by Merchant of its obligations hereunder.
- g. There are no proceedings or investigations pending, or, to the knowledge of Merchant, threatened, before any court, regulatory body, administrative agency, or other tribunal or governmental instrumentality having jurisdiction over Merchant or its properties: (i) asserting the invalidity of this Agreement or seeking to prevent the consummation of any of the transactions contemplated hereunder,

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or (ii) which, individually or in the aggregate, could reasonably be expected to have a material adverse effect on the ability of Merchant to perform its obligations hereunder.

h. Merchant has and will retain throughout the term of this Agreement all required licenses to perform its obligations under this Agreement.

i. Any Card Sale subject to rescission has not been rescinded.

Section 6. Chargebacks to Merchant. Merchant agrees as follows:

a. *Chargebacks.* Any Sales Slip or Card Sale is subject to Chargeback under any one or more of the following circumstances, and thereupon the provisions of *Section 6.b.* below shall apply:

- (i) The Application or any information on the Application or the Sales Slip or any required information on the Sales Slip (such as the account number, expiration date of the Card, description of Dealer or Goods purchased, transaction amount or date) is illegible or incomplete, or except as provided in *Section 4.f.*, the Sales Slip or Application is not executed by the Cardholder; or Authorization is not obtained from Household's Authorization Center, or a

valid Authorization number is not correctly and legibly entered on the Sales Slip; or the Sales Slip is a duplicate of an item previously paid, or the price of the Goods or services shown on the Sales Slip differs from the amount shown on the Cardholder's copy of the Sales Slip;

(ii) Household determines that (1) Merchant has breached or failed to satisfy, any term, condition, covenant, warranty, or other provision of this Agreement, including, without limitation, *Sections 4 and 5* above, or of the Operating Instructions, in connection with a Sales Slip or the transaction to which it relates, or an Application for a Card or the opening of an Account; or (2) the Sales Slip, Application/Cardholder Agreement or Card Sale is fraudulent or is subject to any claim of illegality, cancellation, rescission, avoidance or offset for any reason whatsoever, including, without limitation, negligence, fraud, misrepresentation, or dishonesty on the part of the customer or Merchant or its agents, employees, licensees, or franchisees, or that the related transaction is not a bona fide transaction in Merchant's ordinary course of business;

(iii) the Cardholder disputes or denies the Card Sale or other Card transaction, the execution of the Sales Slip or Application/Cardholder Agreement, or the delivery, quality, or performance of the goods, services or warranties purchased, or the Cardholder has not authorized the Card Sale, or alleges that a credit adjustment was requested and refused or that a credit adjustment was issued by Merchant but not posted to the Account; or

(iv) Merchant fails to deliver to Household the Sales Slip, Credit Slip, Application or other records of the Card transaction within the times required in this Agreement.

b. *Resolution and Payment.* Merchant is required to resolve any dispute or other of the circumstances described above in (a) of this Section 6 to Household's satisfaction within fifteen (15) days of notice of Chargeback or Merchant shall pay to Household the full amount of each Sales Slip subject to Chargeback or the portion thereof designated by Household, as the case may be, plus the finance charges thereon, any attorney fees incurred by Household, and other fees and charges provided for in the Cardholder Agreement. Upon Chargeback to Merchant of a Sales Slip, Merchant shall bear all liability and risk of loss associated with such Sales Slip or Account, or the applicable portion thereof, without warranty by, or recourse or liability to, Household. Household may deduct amounts owed to Household under this Section from any amounts owed to Merchant under this Agreement.

c. *Excessive Chargebacks.* If (i) the aggregate number of Sales Slips subject to Chargeback exceeds 3.0% of the total number of Card Sales submitted by Merchant with respect to an individual Merchant location in any calendar quarter or (ii) the aggregate dollar amount of all Sales Slips subject to Chargeback in any monthly billing cycle exceeds 5% of the total net balances of all Accounts at the

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end of such monthly billing cycle ((i) and (ii) are herein individually and collectively called "*Excessive Chargebacks*"). Excessive Chargebacks shall be deemed a material breach of this Agreement and Household has the right, in its sole discretion, to terminate this Agreement pursuant to *Section 15*.

d. The terms and provisions of this *Section 6* shall survive the termination of this Agreement.

Section 7. Tape or Electronic Transmission & Records. Data, records and information shall be transmitted and maintained as described below.

a. *Transmission of Data.* In lieu of depositing paper Sales Slips and Credit Slips with Household, Merchant shall transmit to Household, by electronic transmission or other form of transmission designated by Household all data required by this Agreement to appear on Sales Slips and Credit Slips. All data transmitted shall be in a medium, form and format designated by Household and shall be presorted according to Household's instructions. Any errors in such data or in its transmission shall be the sole responsibility of Merchant. The means of transmission indicated above in this Section or other means approved by Household, shall be the exclusive means utilized by Merchant for the transmission of Sales Slip or Credit Slip transaction data to Household. Merchant shall use a leased line, supplied by Household, for communicating with Household pursuant to the guidelines set forth in *Section 4*. Household's voice Authorization Center will be available for use for times when the leased line authorization system is not in operation.

b. *Receipt of Transmission.* Upon successful receipt of any transmission, Household shall accept such transmission and pay Merchant in accordance with this Agreement, subject to subsequent review and verification by Household and to all other rights of Household and obligations of Merchant as set forth in this Agreement. If data transmission is by tape, Merchant agrees to deliver upon demand by Household a duplicate tape of any prior tape transmission, at the expense of Household, if such demand is made within forty-five (45) calendar days of the original transmission.

c. *Records.* Merchant shall maintain the actual paper Sales Slips, Credit Slips, and other records pertaining to any transaction covered by this Agreement for such time and in such manner as Household or any law or regulation may require, but in no event less than two (2) years after the date Merchant presents each transaction data to Household, and Merchant shall make and retain for at least seven (7) years legible copies of such actual paper Sales Slips, Credit Slips or other transaction records. Within fifteen (15) days, or such earlier time as may be required by Household, of receipt of Household's request, Merchant shall provide to Household the actual paper Sales Slips, Credit Slips or other transaction records, and any other documentary evidence available to Merchant and reasonably requested by Household to meet its obligations under law (including its obligations under the Fair Credit Billing Act) or otherwise to respond to questions, complaints, lawsuits, counterclaims or claims concerning Accounts or requests from Cardholders, or to enforce any rights Household may have against a Cardholder, including, without limitation, litigation by or against Household, collection efforts and bankruptcy proceedings, or for any other reason. In the event Merchant fails to comply in any respect with the provisions of this Section 7, Household may process a Chargeback for each Card Sale involved pursuant to Section 6 above.

d. *Production.* Promptly upon termination of this Agreement or upon the request of Household, Merchant will provide Household with all original and microfilm copies of documents required to be retained under this Agreement.

Section 8. Payments by Cardholder and Endorsement. Merchant agrees that Household has the sole right to receive payments on any Sales Slip funded by Household. Unless specifically authorized in writing by Household, Merchant agrees not to make any collections on any such Sales Slip. Merchant agrees to hold in trust for Household any payment received by Merchant of all or part of the amount of any such Sales Slip and to deliver promptly the same in kind to Household as soon as received together with the Cardholder's name, Account number, and any correspondence accompanying the

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payment and deliver same promptly within five (5) days of receipt by Merchant. Merchant agrees that Merchant shall be deemed to have endorsed any Sales Slip, Credit Slip, or Cardholder payments by check, money order, or other instrument made payable to Merchant that a Cardholder presents to Household in Household's favor, and Merchant hereby authorizes Household to supply such necessary endorsements on behalf of Merchant.

Section 9. Merchant Credit Information. Household may annually review Merchant's financial stability. To assist Household in doing this, Merchant shall deliver to Household no later than ninety (90) days after the end of each fiscal year, an audited financial statement, including, without limitation, all footnotes, and supporting materials with sufficient detail to accurately portray the financial condition of Merchant. Merchant warrants and represents that its credit Application and financial statements submitted to Household by or on behalf of Merchant are true and accurate and Merchant agrees to supply such additional credit information as Household may reasonably request from time to time. Merchant understands that Household may verify the information on any financial statement or other information provided by Merchant and, from time to time, may seek credit and other information concerning Merchant from others and may provide information regarding this Program including financial and other information to its Affiliates or others for purposes of its asset securitizations and sales.

Section 10. Merchant Business Practices. Merchant agrees to provide adequate services in connection with each Card Sale pursuant to standard customs and trade practices and any applicable manufacturer's warranties, and to provide such repairs, service and replacements and take such other corrective action as may be required by law.

Section 11. Cardholder Account Information. Merchant shall comply with all Applicable Law regarding privacy and the Direct Marketing Association privacy promise. Merchant shall not sell, purchase, provide, or exchange Account information in the form of imprinted Sales Slips, carbon copies of imprinted Sales Slips, mailing lists, tapes or other media obtained by reason of a Card transaction to any third party other than to Merchant's agents for the purpose of assisting Merchant in its business with Household or pursuant to a government request.

Section 12. Change in Ownership. Each party agrees to send the other party at least thirty (30) days prior written notice of any change in such party's name or location, any material change in ownership of Merchant's business or any change in Sales Slip or Credit Slip information concerning Merchant.

Section 13. Indemnification.

a. *Indemnification by Merchant.* Merchant shall be liable to and shall indemnify and hold harmless Household and its Affiliates associated with the Program and their respective officers, employees, agents and directors from any losses, damages, claims or complaints incurred by Household or any Affiliate of Household or their respective officers, employees, agents and directors arising out of: (i) Merchant's failure to comply with this Agreement or any of the Operating Instructions; (ii) any claim, dispute, complaint or setoff made by a Cardholder with respect to anything done or not done by Merchant in connection with Card Sales or Credit Slips; (iii) anything done or not done by Merchant in connection with the furnishing of any Goods, warranties or services purchased by Cardholders; (iv) the death or injury to any person or the loss, destruction or damage to any property arising out of the design, manufacture or furnishing by Merchant of any Goods, warranties or services purchased by Cardholders; (v) any claim or complaint of a third party in connection with Merchant's advertisements and promotions relating to the Card which have not been reviewed or approved by Household; (vi) any illegal or improper conduct of Merchant or its employees or agents; and (vii) any claim or complaint by a consumer that Merchant has violated the Equal Credit Opportunity Act, Truth in Lending Act, or any other act and related Applicable Laws. Household may deduct any amounts incurred by Household under this Section from amounts owed Merchant under this Agreement.

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b. *Indemnification by Household.* Household shall be liable to and shall indemnify and hold harmless Merchant and its subsidiaries or Affiliates and their respective officers, employees, agents and directors from any losses, damages, claims or complaints incurred by Merchant or any subsidiary or affiliate of Merchant or their respective officers, employees, agents and directors arising out of (i) Household's failure to comply with this Agreement or any of the Operating Instructions; (ii) any claim, dispute or complaint by a Cardholder made in good faith resulting from anything done or not done by Household in connection with such Cardholder's Account; (iii) any illegal or improper conduct of Household, or its employees or agents with respect to the Card, a Card Sale, an Account or any other matters relating to the Program; (iv) any claim, dispute, complaint or setoff by a consumer made in good faith resulting from a violation by Household, with respect to the Application/Agreement, of the Equal Credit Opportunity Act, Truth in Lending Act or any other act and related Applicable Laws and regulations; and (v) any claim, dispute or complaint of any third party made in good faith in connection with advertisements and promotions prepared by Household relating to the Card. Notwithstanding the foregoing, the indemnification by Household shall not apply to any claim or complaint relating to the failure of Merchant to resolve a billing inquiry or dispute with a Cardholder where such failure was not caused by Household.

c. *Internet Purchases.* Merchant shall reimburse Household for any losses suffered by Household for any reason if Merchant ships to an address that does not match Household's billing address.

d. *Notice of Claim & Survival.* In the event that Household or Merchant shall receive any claim or demand or be subject to any suit or proceeding of which a claim may be made against the other under this Section, the indemnified party shall give prompt written notice thereof to the indemnifying party and the indemnifying party will be entitled to participate in the settlement or defense thereof with counsel satisfactory to indemnified party at the indemnifying party's expense. In any case, the indemnifying party and the indemnified party shall cooperate (at no cost to the indemnified party) in the settlement or defense of any such claim, demand, suit, or proceeding. The terms of this *Section 13* shall survive the termination of this Agreement.

Section 14. Nonwaiver. Merchant's liability under this Agreement, including, without limitation, its liability under *Section 6* above, shall not be affected by any settlement, extension, forbearance, or variation in terms that Household may grant in connection with any Sales Slip or Account or by the discharge or release of the obligations of the Cardholder(s) or any other person by operation of law or otherwise. Merchant hereby waives any failure or delay on Household's part in asserting or enforcing any right that Household may have at any time under this Agreement or under any Account.

Section 15. Term and Termination.

a. *Term.* This Agreement shall be effective as of the Effective Date and shall remain in effect for three (3) years ("*Initial Term*"), subject to earlier termination as set forth below. Thereafter, this Agreement shall be automatically renewed for successive one year terms (the "*Renewal Term(s)*") unless and until terminated as provided herein. The termination of this Agreement shall not affect the rights and obligations of the parties with respect to transactions and occurrences which take place prior to the effective date of termination, except as otherwise provided herein.

b. *Termination.* This Agreement may be terminated:

(i) By Household or Merchant at the end of the Initial Term or the end of any Renewal Term upon not less than ninety (90) days prior written notice to the other;

(ii) By either party upon notice to the other in the event the other party shall elect to wind up or dissolve its operation or is wound up and dissolved; becomes insolvent or repeatedly fails to pay its debts as they become due; makes an assignment for the benefit of creditors; files a voluntary petition in

(iii) by Household upon notice (a) if there occurs any material change in ownership of Merchant or if a change occurs in Merchant's financial condition as determined by Household in Household's sole discretion, or if Merchant suspends or goes out of business or substantially reduces its business operations or sends a notice of a proposed bulk sale of all or part of its business; or (b) in the event Merchant materially breaches its obligations or any warranty or representation under this Agreement or in any Operating Instructions; or (c) if Household has reasonable cause to believe that Merchant will not be able to perform its obligations under this Agreement, or if Household receives a disproportionate number of Cardholder inquiries, disputes, or complaints; or (d) if in Household's judgment, any Applicable Law requires that this Agreement or either party's rights or obligations hereunder be amended, modified, waived or suspended in any respect, including, without limitation, the amount of finance charges or fees that may be charged or collected or the consumer rate that may be charged on purchases with the Card.

c. *Termination of Card Acceptance.* Household upon notice to Merchant may elect to terminate the acceptance of the Card at a particular Merchant location if at such location there are Excessive Chargebacks, high fraudulent activity or other course of business conduct that is injurious to the business relationship between Household and Merchant. In addition, Household may terminate this Agreement upon thirty (30) days prior notice to Merchant if the termination of a particular Merchant location materially affect(s) the volume of Card Sales generated by Merchant.

d. *Duties and Rights Upon Termination.* Upon termination of this Agreement, Merchant will promptly submit to Household all Card Sales, Sales Slips, credits and other data made through the date of termination. Household is not liable to Merchant for any direct damages that Merchant may suffer as a result of Household's termination of this Agreement as provided in this Agreement. In the event this Agreement is terminated for any reason or notice of termination is given by either party, Household may take such other reasonable actions including but not limited to establishing and maintaining a reserve from payments otherwise payable to Merchant to protect Household's rights under this Agreement and to cover Chargeback amounts and other amounts owing to Household.

e. *Purchase Requirements.* Upon termination of this Agreement due to material breach or termination without notice by Merchant, Merchant, its successors and assigns shall, at Household's option and upon Household's request, purchase or arrange to purchase by a third party, the Accounts, without recourse to Household and without representations or warranty, express or implied, at a price determined by Household, in Household's sole discretion, but not less than the full amount of all of the outstanding Account balances; the purchase to occur not later than ninety (90) days after the effective date of termination of this Agreement and to be under such terms and conditions as are reasonably acceptable to Household. In any event, commencing on the effective date of termination of this Agreement, Merchant shall pay to Household, monthly, within ten (10) days of Household's request, a liquidation fee in the amount of \$5.00 per active Account per month until such time as the outstanding Account balances/receivables are liquidated and paid in full or, if a purchase is required as stated above, such purchase of all of the outstanding Account balances is consummated and Household receives the purchase price.

Section 16. Status of the Parties. In performing their responsibilities pursuant to this Agreement, Household and Merchant are in the position of independent contractors, and in no circumstances shall either party be deemed to be the agent or employee of the other. This Agreement is not intended to create, nor does it create and shall not be construed to create, a relationship of partner or joint venturer or an association for profit between Household and Merchant. Any amounts ever owing by Merchant pursuant to this Agreement represent contractual obligations only and are not a loan or debt.

Section 17. Force Majeure. Neither party to this Agreement shall be liable to the other by reason of any failure in performance of this Agreement in accordance with its terms if such failure arises out of a cause beyond the control and without the fault or negligence of such party. Such causes may

include but are not limited to acts of God, of the public enemy or of civil or military authority, unavailability of energy resources, system or communication failure, delay in transportation, fires, strikes, riots or war. In the event of any force majeure occurrence, the disabled party shall use its best efforts to meet its obligations as set forth in this Agreement.

Section 18. Limited License. Merchant hereby authorizes Household for purposes of this Agreement to use Merchant's name, logo, registered trademarks and servicemarks (if any) and any other proprietary designations ("Proprietary Materials") on the Cards, Applications, periodic statements, billing statements, collection letters or documents, promotional or advertising materials and otherwise in connection with the Program, subject to Merchant's periodic reasonable review of such use and to such reasonable specifications of Merchant. Merchant represents and warrants that it has obtained appropriate federal and state trademark registrations to protect its interest in the use and ownership of the Proprietary Materials. Merchant shall, indemnify, defend and hold Household harmless from any loss, damage, expense or liability arising from any claims of alleged infringement of the Proprietary Materials (including attorneys' fees and costs). Merchant may not use any name or service mark of Household or any of its Affiliates in any manner without the prior written consent of Household.

Section 19. Confidentiality. Merchant will keep confidential and not disclose to any person or entity (except to employees, officers, partners or directors of Merchant who are engaged in the implementation and execution of the Program) all information, software, systems and data, that Merchant receives from Household or from any other source, relating to the Program and matters which are subject to the terms of this Agreement, including, but not limited to, Cardholder names and addresses or other Account information, and shall use, or cause to be used, such information solely for the purposes of the performance of Merchant's obligations under the terms of this Agreement. Household will keep confidential and not disclose to any person or entity (except employees, officers, agents or directors of Household, its subsidiaries or affiliates who are engaged in the implementation and execution of the Program) any information that Household receives from Merchant which is designated confidential by Merchant. In the event Household sells or assigns the Accounts or any portion of the Accounts under the Program, Household may disclose any information under this provision reasonably necessary or required to effectuate such sale or assignment. The provisions of this Section 19 shall survive the termination of this Agreement.

Section 20. Additional Products & Services. Household and/or any of its Affiliates may at any time, whether during or after the term of this Agreement and whether the Accounts are owned by Household, solicit Cardholders for any other credit cards or other types of accounts or financial products or insurance services offered by Household and/or any of its Affiliates.

Section 21. Notices. All notices required or permitted by this Agreement shall be in writing and shall be sent to the respective parties; if to Household, to the Attention of President (with a copy to the Attention of General Counsel, HRS Law Department 2700 Sanders Road, Prospect Heights, IL 60070); if to Merchant, to the Attention of General Counsel, Direct Focus, Inc. 2200 NE 65th Avenue, Vancouver, WA 98661, or such other addresses as each party may designate to the other by notice hereunder. Said notices shall be deemed to be received when sent to the above addresses (i) upon three (3) Business Days after deposit in the U.S. first class mail with postage prepaid, (ii) upon personal delivery, or (iii) upon receipt by telex, facsimile, or overnight/express courier service or mail.

Section 22. *Amendments and Supplementary Documents.* Household may amend this Agreement upon ten (10) days prior notice to Merchant if such modification is reasonably determined by Household to be required by any state or federal law, rule, regulation, governmental or judicial order, opinion, interpretation or decision. Reference herein to "this Agreement" shall include any schedules, appendices, exhibits, and amendments hereto. Any amendment or modification to this Agreement must

be in writing and signed by a duly authorized officer of Household to be effective and binding upon Household; no oral amendments or modifications shall be binding upon the parties.

Section 23. *Assignment.* This Agreement is binding upon the parties and their successors and assigns. Notwithstanding Merchant may not assign this Agreement without the prior written consent of Household; any purported assignment without such consent shall be void. Household may without Merchant's consent assign this Agreement or any of its rights or obligations hereunder to any Affiliate of Household at any time. In the event of such assignment, the assignee shall have the same rights and remedies as Household under this Agreement.

Section 24. *Nonwaiver and Extensions.* Household shall not by any act, delay, omission, or otherwise be deemed to have waived any rights or remedies hereunder. Merchant agrees that Household's failure to enforce any of its rights under this Agreement shall not affect any other right of Household or the same right in any other instance.

Section 25. *Rights of Persons Not a Party.* This Agreement shall not create any rights on the part of any person or entity not a party hereto, whether as a third party beneficiary or otherwise.

Section 26. *Section Headings.* The headings of the sections of this Agreement are for reference only, are not a substantive part of this Agreement and are not to be used to affect the validity, construction or interpretation of this Agreement or any of its provisions.

Section 27. *Integrations.* This Agreement contains the entire agreement between the parties. There are merged herein all prior oral or written agreements, amendments, representations, promises and conditions in connection with the subject matter hereof. Any representations, warranties, promises or conditions not expressly incorporated herein shall not be binding on Household or Merchant.

Section 28. *Governing Law/Severability.* This Agreement shall be governed by and construed in accordance with the laws of the State of Illinois. If any provision of this Agreement is contrary to Applicable Law, such provision shall be deemed ineffective without invalidating the remaining provisions hereof.

Section 29. JURISDICTION. ANY SUIT, COUNTERCLAIM, ACTION OR PROCEEDING ARISING OUT OF OR RELATING TO THIS AGREEMENT MUST BE BROUGHT BY EITHER PARTY IN THE COURTS OF THE STATE OF ILLINOIS OR IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS; AND MERCHANT HEREBY IRREVOCABLY SUBMITS TO THE EXCLUSIVE JURISDICTION OF SUCH COURTS AND ANY APPELLATE COURTS THEREOF FOR THE PURPOSE OF ANY SUCH SUIT, COUNTERCLAIM, ACTION, PROCEEDING OR JUDGMENT (IT BEING UNDERSTOOD THAT SUCH CONSENT TO THE EXCLUSIVE JURISDICTION OF SUCH COURTS WAIVES ANY RIGHT TO SUBMIT ANY DISPUTES HEREUNDER TO ANY COURTS OTHER THAN THOSE ABOVE). NOTHING HEREIN SHALL PRECLUDE HOUSEHOLD FROM BRINGING AN ACTION OR PROCEEDING RELATED TO THIS AGREEMENT IN ANY OTHER STATE OR PLACE HAVING JURISDICTION OVER SUCH ACTION.

Section 30. WAIVER OF JURY TRIAL. HOUSEHOLD AND MERCHANT HEREBY KNOWINGLY, VOLUNTARILY AND INTENTIONALLY WAIVE ANY RIGHT TO A TRIAL BY JURY IN ANY ACTION, SUIT, PROCEEDING OR COUNTERCLAIM CONCERNING ANY RIGHTS UNDER THIS AGREEMENT, ANY RELATED DOCUMENT OR UNDER ANY OTHER DOCUMENT OR AGREEMENT DELIVERED OR WHICH MAY IN THE FUTURE BE DELIVERED IN CONNECTION HERewith OR THEREWITH, OR ARISING FROM ANY RELATIONSHIP EXISTING IN CONNECTION WITH THIS AGREEMENT, AND AGREE THAT ANY SUCH ACTION, SUIT, PROCEEDING OR COUNTERCLAIM SHALL BE TRIED BEFORE A COURT AND NOT BEFORE A JURY; THIS PROVISION IS A MATERIAL INDUCEMENT FOR HOUSEHOLD AND MERCHANT ENTERING INTO THIS AGREEMENT.

IN WITNESS WHEREOF, Household and Merchant have caused their duly authorized representatives to execute this Agreement as of the date set forth above.

BANK:
HOUSEHOLD BANK (SB), N.A.

MERCHANT:
DIRECT FOCUS, INC.

By: _____
Print Name: _____
Title: _____

By: _____
Print Name: _____
Title: _____

ATTESTED OR WITNESSED

ATTESTED OR WITNESSED

By: _____
Print Name: _____
Title: _____

By: _____
Print Name: _____
Title: _____

QuickLinks

[Exhibit 10.12](#)
[SECOND AMENDED AND RESTATED MERCHANT AGREEMENT](#)

**AGREEMENT OF PURCHASE AND SALE
AND JOINT ESCROW INSTRUCTIONS**

By And Between

**TYCO VALVES & CONTROLS, INC., a Texas corporation
("Seller")**

**DIRECT FOCUS, INC., a Washington corporation
("Purchaser")**

**Property Address: 1400 N.E. 136th Avenue
Vancouver, Washington**

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**AGREEMENT OF PURCHASE AND SALE
AND JOINT ESCROW INSTRUCTIONS**

THIS AGREEMENT OF PURCHASE AND SALE AND JOINT ESCROW INSTRUCTIONS (the "Agreement") is entered into and effective as of the 7th day of June 2000 (the "Effective Date") by and between Tyco Valves & Controls, Inc., a Texas corporation ("Seller") and Direct Focus, Inc., a Washington corporation.

**ARTICLE 1.
PURCHASE AND SALE**

1.1 *Purchase and Sale.* Subject to the terms and conditions of this Agreement, Seller hereby agrees to sell and convey to Purchaser, and Purchaser hereby agrees to buy and pay for through an escrow to close on or before August 1, 2000, the following properties and assets:

- (a) That certain tract of real property commonly known as 1400 N.E. 136th Avenue, Vancouver, Washington and legally described in Exhibit A attached hereto and incorporated herein by reference, together with all and singular the rights, easements and appurtenances pertaining to such real property (all of such real property, rights and appurtenances herein referred to as the "Real Property"); and
- (b) All permanent improvements, buildings and structures now constructed and completed or under construction with respect to and situated on the Real Property, along with all accessions and additions thereto, specifically including all of those buildings and miscellaneous structures, and all those fixtures affixed to or located upon the Real Property and not expressly excluded by Section 1.2 of this Agreement below, which fixtures include any electrical distribution systems (power panel, buss ducting, conducts, disconnects, lighting fixtures), telephone distribution systems (lines, jacks and connections only), heating systems (and space heaters), ventilating systems, air conditioning equipment ("HVAC"), air lines, fire sprinkler and fire detection systems, security systems, carpets, window coverings and wall coverings (herein collectively referred to as the "Improvements").

All of the foregoing items to be purchased under this Agreement shall be herein collectively referred to as the "Property."

1.2 *Excluded Items.* Notwithstanding anything to the contrary set forth above or elsewhere in this Agreement, Purchaser and Seller agree that the following items are not included within the purchase and sale terms of this Agreement, shall remain the property of Seller, and shall be removed from the Property by Seller (without harm to the remaining improvements) prior to Closing:

- (a) Three (3) of the eight (8) existing cranes (to be selected by Seller in its discretion) together with related bridge, end trucks and hoist, but excluding all craneways which shall remain intact. Any damage caused to the remaining improvements (including the 5 remaining cranes) on account of such removal shall be repaired by Seller to the condition existing prior to such removal;
- (b) All air compressors and receivers;

- (c) All "racking";
- (d) All welding water chillers;
- (e) All aisle way mirrors;
- (f) All portable fire extinguishers;
- (g) All computer hubs; and

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- (h) All other personal property, equipment and furniture of Seller not described in Section 1.1(b), or not permanently attached to the land or building, and all inventory associated with Seller's business operations on the Property.

ARTICLE 2. PURCHASE PRICE

2.1 *Purchase Price.* The purchase price for the Property (the "Purchase Price") shall be Four Million Four Hundred Twenty-Five Thousand Dollars (\$4,425,000).

2.2 *Payment of Purchase Price.* Subject to the adjustments required by Sections 7.4 and 7.5, the Purchase Price shall be payable to Seller as follows:

- (a) All cash at closing (including Earnest Money)

2.3 *Earnest Money.* Within three (3) business days of the mutual execution of this Agreement by both Purchaser and Seller, Purchaser shall open an escrow respecting this Agreement with Fidelity National Title Insurance Company, 703 Broadway, Suite 100, Vancouver, Washington 98660 (the "Title Company") and at that time deliver to the Title Company, as escrow, the sum of One Hundred Thousand Dollars (\$100,000) (the "Earnest Money"). The Earnest Money together with any and all other Purchaser deposits required by this Agreement, and any interest earned thereon, shall be referred to herein as the "Earnest Money." The Earnest Money shall be deposited into an interest-bearing account maintained by the Title Company (using a state or federal FDIC insured bank) to be invested at the direction of Purchaser and the amount in that account, including interest thereon, shall be credited against the Purchase Price if and when Closing occurs or shall be released to Purchaser or Seller as otherwise provided for in this Agreement.

2.3.1 *Release of Earnest Money.* Upon waiver of the Feasibility Contingency as described in this Agreement below, the Earnest Money (subject only to Seller's subsequent default hereunder) shall be completely non-refundable to Purchaser. Upon Seller's notice to the Title Company that Purchaser has waived the Feasibility Contingency, and that Seller has cured any Purchaser objections as described in Article 3 below, the Title Company shall immediately release the Earnest Money to Seller without need for further consent or instruction from Purchaser; it being agreed by Seller and Purchaser that the terms of this agreement shall constitute irrevocable escrow instructions (absent further written agreement signed by both Purchaser and Seller) to the Title Company to act as provided herein.

ARTICLE 3. TITLE, SURVEY, BOOKS AND RECORDS AND OTHER CONTINGENCIES

3.1 *Title and Survey.* Within ten (10) days following the Execution Date, Seller, at its sole cost and expense, shall furnish or cause to be furnished to Purchaser:

- (a) A current title commitment (the "Preliminary Title Commitment") for the owner's title policy referred to in Section 6.1 (the "Title Policy"), issued by the Title Company in the amount of the Purchase Price, showing the status of title of the Real Property and all exceptions, including encumbrances, liens, adverse claims, easements, restrictions, rights-of-way, covenants, reservations and other conditions, if any, affecting the Real Property which would appear in a Title Policy, if issued, and committing the title Company to issue such a Title Policy to Purchaser; and
- (b) Complete and legible copies of all instruments referred to in the Preliminary Title Commitment as conditions or exceptions to the title of the Property.

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By the execution of this Agreement, Seller hereby authorizes and directs the Title Company to furnish to Purchaser the items referred to in this Section 3.1.

3.2 *Books and Records.* Within ten (10) days following the mutual execution of this Agreement, Seller, at its sole cost and expense, shall furnish or cause to be furnished to Purchaser complete and legible copies of each of the following: (a) any agreements to be assigned to Purchaser at closing including any existing employment and service contracts; (b) all property tax statements, assessments, liens, L.I.D.'s or other governmental assessments relating to the property for the current year; and (c) to the extent Seller has actual knowledge of the following items and such items are reasonably accessible to Seller and are not otherwise of public record: (i) any surveys, soils studies, environmental surveys, structural reports, or other reports and plans in Seller's possession relating to the Real

Property or Improvements; (ii) all governmental permits and approvals relating to the construction, operation, use or occupancy of the Property, as well as all zoning, land use, subdivision, environmental, building and construction rulings and permits restricting, regulating or otherwise affecting the use and occupancy or enjoyment of the Property, together with any notices of violation of any of those permits or any of the laws and regulations governing the Property; (iii) any reports relating to environmental remediation or structural repairs; and (iv) any warranties or similar contract rights relating to the Property which are to be assigned to Purchaser at Closing (collectively "Books and Records"). Within ten (10) days following the mutual execution of this Agreement, Seller shall provide Purchaser written notice designating one or more persons who shall be available to Purchaser to respond to questions and coordinate Purchaser's review of Books and Records and Purchaser's inspection of the Property pursuant to the terms hereof.

3.3 *Purchaser's Contingencies and Waiver Thereof.* Purchaser's obligation to close shall be subject to the following contingencies (collectively "Purchaser's Contingencies"), each of which Purchaser shall waive, or be deemed to have waived, as provided below:

3.3.1 *Title Contingency.* Purchaser shall have ten (10) days following the receipt of the last of the Preliminary Title Commitment (and the documents referenced in Section 3.1(b)) and the books and Records (the "Title Contingency Period"), to review and comment on the exceptions and matters contained in or disclosed by the Preliminary Title Commitment and the Books and Records (collectively the "Title Documents"). During the Title Contingency Period, Purchaser shall be entitled, in its sole discretion, to terminate this agreement or to object to any of the matters disclosed and/or to condition its acquisition of the Property upon the release, discharge or removal of said matters prior to the Closing Date and the deletion of such exception or exceptions from the Title Policy to be issued at the Closing. In the event Purchaser terminates this Agreement pursuant to this section 3.3.1, any cancellation fee or other costs of the Title Company shall be borne by Purchaser. In the event Purchaser does not provide Seller written notice of its objections, if any, on or prior to the expiration of the Title Contingency Period, this title Contingency shall be deemed waived by Purchaser for all purposes under this Agreement and Purchaser shall have accepted title as set forth in the Title Documents.

(a) *Seller's Right to Cure Objections to Title.* If Purchaser raises any objections to the Title Documents in accordance with the procedures of Section 3.3.1, then Seller may, at its option, within ten (10) days of the receipt of such objections, use its best efforts to eliminate such exceptions to title (or assure that the same will be eliminated on or prior to the Closing Date) and at no additional cost to Purchaser; provided, Seller shall not be obligated to expend any funds to cure any such exceptions to title other than normal out-of-pocket expenses and attorneys' fees in connection therewith. If Seller is unable or elects not to satisfy any or all such title objections on or prior to the Closing Date, Seller shall notify Purchaser immediately of such election and in no event later than the twenty (20) day period described above (Seller's Cure Notice). In the event Seller does not, within such ten (10) day period, provide Purchaser written notice of its election to satisfy any such title objections, Seller shall be

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conclusively deemed to have elected not to satisfy such title objection. Purchaser may either waive such title objections and close the transaction contemplated hereby, or terminate this Agreement with the Earnest Money returned to Purchaser in accordance with Section 3.6 below, by notice delivered to Seller on or before the earlier to occur of ten (10) days from the date of Seller's Cure Notice or expiration of Seller's twenty (20) day period to provide such notice (failing which Purchaser shall be deemed to have waived such objections to the Title Documents).

3.3.2 *Feasibility Contingency.* Purchaser shall have forty-five (45) days from the Effective Date (the "Feasibility Contingency Period") to investigate the feasibility of the Property for Purchaser's intended use including any environmental investigation (subject to Section 3.4.1 below) and any investigation or procurement of any development approvals or permits Purchaser deems desirable, all at Purchaser's sole cost and expense; *provided*, however, Purchaser shall only have thirty (30) days from the Effective Date to complete its Phase I environmental investigation and provide Seller the Phase II Notice described below (the "Feasibility Contingency"). In the event Purchaser does not intend to unconditionally waive this Feasibility Contingency, Purchaser shall provide Seller written notice on or prior to the expiration of the Feasibility Contingency Period of either Purchaser's election to: (i) not waive the Feasibility Contingency under any conditions in which event this Agreement shall be deemed terminated by Purchaser in accordance with the terms of Section 3.6 below, or (ii) waive the Feasibility Contingency but only on condition Seller remedies or cures the items expressly set forth in Purchaser's notice to Seller (the "Conditional Waiver Notice") in which event Purchaser shall be deemed to have fully waived this Feasibility Contingency subject to only Seller agreeing to remedy or cure the items expressly set forth in such notice (and in any Phase II Notice described below). Within five (5) business days of Seller's receipt of any Conditional Waiver Notice, Seller shall provide Purchaser notice of whether Seller will cure or remedy the specified items prior to Closing. If Seller fails to timely provide such notice to Purchaser (in which case Seller will be deemed to have elected not to cure such items), or if Seller timely notifies Purchaser that it will not cure or remedy all of said items, Purchaser may by notice to Seller within five (5) business days thereof either waive the items Seller has elected not to cure, or terminate this Agreement in accordance with the provisions of Section 3.6 below, otherwise, Purchaser shall be deemed to have waived any objections Seller has elected not to cure. If Seller elects to cure or remedy some or all of the described items in accordance with the above, and Purchaser has not otherwise properly terminated this Agreement, Purchaser shall be deemed to have fully waived the Feasibility Contingency, and Seller shall be obligated to cure such items prior to Closing. Purchaser shall have no right to terminate this Agreement on the basis of this Feasibility Contingency if Seller timely provides Purchaser notice of its intent to cure or remedy all of the items set forth in any Conditional Waiver Notice. In the event Purchaser fails to timely provide Seller any of the above notices (or any notice described in Section 3.4.1), Purchaser shall be conclusively deemed to have waived this Feasibility Contingency for all purposes under this Agreement. Upon Waiver of the Feasibility Contingency the Earnest Money shall be nonrefundable to Purchaser and shall be released to Seller as provided in Section 2.3.1 above.

3.4 *Purchaser's Right of Inspection.* Throughout each of the above contingency periods, and subject to the provisions of Section 3.4.1 below, Purchaser shall have reasonable access to the Property, through its employees, representatives and agents, to inspect the Property, including, but not limited to, the physical and environmental condition thereof. Such inspections shall not unreasonably interfere with Seller's use of the Property and shall be at Purchaser's sole risk and expense. Purchaser shall at its sole cost return the Property to the same condition as existed prior to any such inspection. Purchaser shall not allow any liens or encumbrances of any kind to attach to the Property. Purchaser agrees to indemnify, defend and hold Seller harmless from any and all liens, personal injuries, property damages, cost and expenses, including attorney fees, arising from or relating to the activities of Purchaser, its

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employees, contractors and agents on the Property. The indemnity set forth herein shall survive any termination or expiration of this Agreement.

3.4.1 *Phase II Environmental.* Notwithstanding any other provision of this Agreement, in the event Purchaser performs a "Phase I Environmental Audit" of the Real Property and, in Purchaser's reasonable opinion, based upon the results thereof, Purchaser will require a "Phase II Environmental Audit" as a condition to proceeding to Closing, and provided Purchaser is otherwise prepared to waive the Feasibility Contingency as provided above, Purchaser shall not proceed with any such Phase II Environmental Audit but, rather, Purchaser shall notify Seller within the thirty (30) day Phase I

investigation period set forth in Section 3.3.2 above that Purchaser desires to conduct a Phase II Environmental Audit report reasonably acceptable to Purchaser (the "Phase II Notice"). Notwithstanding anything to the contrary above, however, and to expedite completion of work prior to closing, Purchaser may initiate non-invasive review relative to a Phase II Environmental Audit at the same time as it performs the Phase I Environmental Audit so long as Seller has previously approved Purchaser's work plan for such non-invasive review, which approval will not be unreasonably withheld [or delayed]. Following Purchaser's delivery of the Phase II Notice, Purchaser may promptly proceed (at Purchaser's sole cost and expense) with a Phase II Environmental Audit ("Phase II") but only in accordance with the following conditions: (a) all work shall be subject to the terms of Section 3.4; (b) the Phase II contractor retained by Purchaser shall be subject to Seller's prior approval (which approval shall not be unreasonably withheld), Seller shall be named as an additional insured under the Phase II Contractor's "all risk" general liability insurance policy(ies) with limits not less than \$1,000,000 per occurrence, and contractor shall agree to indemnify, defend and hold Seller harmless from any and all liens, personal injuries, property damage, claims, actions, costs and expenses arising from or relating to such contractor's activities on the Property; (c) Purchaser shall consult with Seller on the scope of the Phase II and all work shall be under Seller's supervision; (d) Purchaser shall provide Seller its proposed Phase II work plan no later than five (5) days prior to commencing any work, and no work shall commence if Seller objects thereto in its reasonable discretion; *provided*, if Seller does not allow Purchaser to proceed with its Phase II Purchaser may terminate this Agreement without penalty as provided in Section 3.6 hereof by notice to Seller within five (5) days of Seller's notice to Purchaser that Seller will not allow the Phase II to proceed; and (e) with respect to any and all sampling, Purchaser shall provide Seller split samples of all materials sampled or tested by Purchaser and its contractor in sufficient quantity to allow Seller to perform its own independent test. In the event Purchaser elects to proceed with a Phase II, and subject to extension as set forth in Section 7.1 of this Agreement, Purchaser shall complete the Phase II within twenty (20) days of the Phase II Notice, and shall provide Seller a copy of the Phase II report as well as any interim test results or other reports from the Phase II contractor within said twenty (20) day period. Within five (5) business days of Purchaser's receipt of the Phase II report Purchaser shall notify Seller of Purchaser's election to either: (i) accept the Phase II report in which event Purchaser shall be conclusively deemed to have accepted the environmental condition of the Real Property and the Feasibility Contingency shall be fully and conclusively waived; or (ii) not accept the Phase II report and terminate this Agreement without penalty in accordance with Section 3.6 below in which event all Earnest Money shall be returned to Purchaser, *provided*, Purchaser must have commercially reasonable cause to not accept the Phase II report and shall provide Seller an opportunity to cure as follows:

If Purchaser has commercially reasonable cause not to accept the Phase II report, Purchaser shall provide Seller written notice within five (5) business days of Purchaser's receipt of the Phase II report identifying each item of the Phase II report Purchaser to which Purchaser objects, and upon such notice Purchaser shall be deemed to have accepted the Phase II report subject only to the items set forth in Purchaser's notice to Seller. As used herein the phrase "commercially reasonable cause" shall include but not be limited to Phase II report

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recommendations for remediation estimated to cost in excess of \$100,000, or Phase II report recommendations for additional invasive testing estimated to cost in excess of \$25,000. Within five (5) business days of Purchaser's notice, Seller shall provide Purchaser notice of whether Seller will cure or remedy the environmental condition prior to Closing. If Seller fails to timely provide such notice to Purchaser (in which case Seller will be deemed to have elected not to cure such conditions), or if Seller timely notifies Purchaser that it will not cure or remedy some or all of said condition(s), Purchaser may by notice to Seller within five (5) business days thereof either waive said Phase II objections and proceed to Closing, or terminate this Agreement in accordance with the provisions of Section 3.6 below. If Purchaser fails to timely provide Seller such notice, Purchaser shall be deemed to have waived such Phase II objections and shall proceed to Closing. If Seller elects to cure or remedy some or all of the objected to environmental conditions in accordance with the above, and Purchaser has not otherwise properly terminated this Agreement, Seller shall cure or remedy the same prior to Closing at Seller's expense, and Purchaser shall be deemed to have fully waived the Feasibility Contingency.

3.5 *Notices.* Any Notices required to be sent by either party pursuant to this Agreement shall be in writing and shall be either personally delivered, sent overnight courier (next day delivery), or sent by facsimile, to either Purchaser or Seller at the address set forth under each parties signature to this Agreement. Notice sent by overnight courier shall be deemed given the day following the date the same is deposited with the courier service.

3.6 *Termination.* If this Agreement is rightfully terminated by Purchaser pursuant to any provisions of this Agreement, the Title Company (or Seller as the case may be) shall return to Purchaser the Earnest Money and thereafter the parties hereto shall have no further obligations or liabilities hereunder, one to the other, except to the extent that either party is expressly entitled under this Agreement to seek indemnification from the other party notwithstanding such termination. In the event of such termination by Purchaser, Purchaser shall provide Seller copies of any and all written reports, surveys, studies or feasibility analysis respecting the property and prepared by or on behalf of Purchaser.

3.7 *Confidentiality.* Purchaser agrees that any and all environmental reports (including without limitation any Phase I or Phase II reports) respecting the Property, and all other reports or documentation respecting the Property, received or created during the Feasibility Contingency (collectively "Evaluation Material") shall be used by Purchaser for the sole purpose of evaluating its purchase of the Property as set forth herein. Purchaser shall keep the Evaluation Material confidential and shall not disclose any of the Evaluation Material in any manner whatsoever; *provided*, however, that, (i) Purchaser may make disclosure of information to which Seller gives its prior written consent, and (ii) any information contained in the Evaluation Material may be disclosed to Purchaser's directors, officers, employees, agents, lenders, attorneys, accountants and consultants who need to know such information for purposes of evaluating or closing this transaction and who agree to keep the same Confidential. In the event this Agreement is terminated through no default of Seller, Purchaser shall continue to maintain the confidentiality provided above and deliver to Seller all reports, studies and investigations performed by Purchaser, or otherwise in Purchaser's possession, and relating to the Property. This Section 3.7 shall survive the termination of this Agreement, other than by Closing.

ARTICLE 4. COVENANTS AND AGREEMENTS

4.1 *Existing Employment and Service Contracts.* If requested by Purchaser in writing at least 30 days prior to closing, Seller shall terminate or cause to be terminated, as of the Closing Date, any and all agreements affecting the Property including without limitation any maintenance, management, security, service, supply, snow removal and other similar contracts and agreements. Otherwise, such

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agreements shall be assigned to Purchaser at Closing and Purchaser shall assume all of Seller's rights and obligations thereunder as of the Closing Date.

4.2 *Materialman's and Mechanic's Liens.* On or before the Closing Date, Seller shall pay for any materials, supplies or work provided or ordered for the Property by Seller or Seller's agent prior to the Closing and for which a labor, materialman's or mechanic's lien may be claimed under applicable law and, if required by the Title Company, shall provide the Title Company with such indemnifications or security as it may require to insure title to the Property at the Closing without exception for any unrecorded labor, materialman's or mechanic's claim of lien arising through Seller.

4.3 *Property Condition at Closing.* At Closing Seller shall deliver the Property to Purchaser in substantially the same condition as existing as of the date of this Agreement, except for normal wear and tear, and except as follows:

- (a) the building floors under the equipment removed by Seller shall be in a reasonably level and smooth condition and shall be broom swept clean;
- (b) all heating and ventilation ducting within the manufacturing area for specific workstations or processes shall be removed by Seller (it being understood that all general ducting, heating and cooling systems and general HVAC systems shall remain in place);
- (c) all exposed electrical distribution systems within the manufacturing area shall be removed by Seller to the nearest wall or ceiling mounted electrical junction box; and
- (d) Seller shall remove all of Seller's personal property except that which is sold to Purchaser pursuant to the terms hereof.

Each of the above conditions shall conclusively be deemed satisfied, or waived, upon the Closing.

ARTICLE 5. REPRESENTATIONS AND WARRANTIES

5.1 *Representations and Warranties of Seller.* For the purposes of inducing Purchaser to enter into this Agreement and to consummate the transactions contemplated hereby pursuant to the terms and conditions hereof, and to Seller's actual knowledge, Seller represents and warrants to Purchaser, as of the date hereof and as of the Closing Date, except as otherwise set forth herein, as follows:

- (a) Seller is (i) a corporation duly organized, validly existing and in good standing under the laws of the state in which Seller was organized, (ii) has full power, authority and legal right to carry on its business as now being conducted and to own the Property, and (iii) is duly qualified or licensed to do business and is in good standing in the jurisdiction where the Property is located unless Seller has been advised by legal counsel that such qualification is not required by applicable state law;
- (b) Seller has full power, authority and legal right to execute, deliver and perform this Agreement, and all other documents and certificates contemplated hereby, and the execution, delivery and performance thereof have been duly authorized by Seller;
- (c) No other action is or was required to be taken by Seller to permit the execution, delivery and performance of this Agreement, and all other documents and certificates contemplated hereby, and the transactions contemplated hereby, and no consent or approval of any third party or governmental authority is or was required or appropriate in connection with the execution of this Agreement, or to consummate the transactions contemplated hereby;
- (d) This Agreement constitutes the legal, valid and binding obligation of Seller, enforceable against Seller in accordance with its terms;

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- (e) Neither the execution or delivery of this Agreement nor the consummation by Seller of the transactions contemplated hereby is or was in violation of or in conflict with (i) any provision of any agreement (including, without limitation, the organizational documents under which Seller is organized), instrument or other restriction of any kind to which Seller is a party or by which Seller or the Property is bound or (ii) in any material or adverse way, any statute, law, decree, regulation or order of any governmental authority, or resulted or will result in a default under any agreement, or caused or will cause the acceleration of any obligation or loan to which Seller is a party or by which Seller or the Property is bound;
 - (f) To the best of Seller's actual knowledge, there are no actions, suits, proceedings, orders or investigations pending or, to the best of Seller's knowledge, threatened against or affecting Seller at law or in equity, or before or by any federal, state, municipal or other governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, which might adversely affect Seller's performance under this Agreement or the consummation of the transactions contemplated hereby;
 - (g) To the best of Seller's actual knowledge, and except as may be otherwise disclosed to Purchaser by Seller, as of the Closing Date (i) there are no underground storage tanks or PCB containing equipment on the Property, and (ii) there is no Hazardous Material on, in, or released from or onto, the Property and Seller has not generated, manufactured, refined, transported, stored, handled, disposed of or released any Hazardous Material on the Property in violation of applicable law. As used herein, the term "Hazardous Material" means any hazardous or toxic substances, materials or wastes listed in 49 C.F.R. §172.01, 40 C.F.R. Part 302 and amendments thereto, or RCW 70.105D and RCW 82.21;
 - (h)

To the best of Seller's actual knowledge, there is not pending or, to the best of Seller's knowledge, threatened condemnation or similar proceedings with respect to the Property or any part thereof;

- (i) To the best of Seller's actual knowledge, there is not pending or, to the best of Seller's knowledge threatened (i) public improvements in, about or outside the Property which have resulted in or might result in the imposition of any assessment, lien or charge against Seller, the Property or any owner of the Property, or (ii) legal action of any kind or nature, affecting Seller or the Property, which would enjoin or restrict the right of Seller to consummate the transactions contemplated hereby;
- (j) To the best of Seller's actual knowledge, the Property is not affected by any special assessment, whether or not a lien thereon, which has not or will not be paid in full by Seller prior to the closing Date, nor does Seller know of any pending or contemplated assessments or similar charges which will affect the Property and, to the best of Seller's knowledge, there is no proceeding pending for any increase of the assessed valuation of the Property or any portion thereof;
- (k) To the best of Seller's actual knowledge all Books and Records delivered to Purchaser hereunder are accurate and complete in all material respects (unless noted otherwise) and no such Books or Records have been knowingly altered or withheld;
- (l) Seller has no actual knowledge of (i) any violation of applicable zoning, land use, building, construction, subdivision or other local, state and federal laws, ordinances and regulations, (ii) any breach of any existing covenant, condition, restriction or easement affecting the Property, and (iii) any encroachment on the Property;
- (m) To the best of Seller's actual knowledge, all public utilities required to operate the Property as currently operated are in place, are connected, and in sufficient size and capacity to service

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the Property as presently being operated, and there are no material defects in the heating and cooling systems to be transferred to Purchaser pursuant to the terms of this Agreement; and

- (n) To the best of Seller's actual knowledge, the Property has vehicular access to a public street.

5.2 *Representations and Warranties of Purchaser.* For the purpose of inducing Seller to enter into this Agreement and to consummate the transactions contemplated hereby pursuant to the terms and conditions hereof, to the extent of Purchaser's actual knowledge, Purchaser represents and warrants to Seller, as of the date hereof, and except as otherwise set forth herein, as of the Closing Date, as follows:

- (a) Purchaser (i) is a corporation duly organized, validly existing and in good standing under the laws of the state in which Purchaser was organized, (ii) has full power, authority and legal right to carry on its business as now being conducted and to own the property and assets it now owns, and (iii) is, or will prior to Closing be, duly qualified or licensed to do business and is in good standing in the jurisdiction where the Property is located unless Purchaser has been advised by legal counsel that such qualification is not required by applicable state law;
- (b) Purchaser has full power, authority and legal right to execute, deliver and perform this Agreement, and all other documents and certificates contemplated hereby or thereby, and the execution, delivery and performance thereof have been duly authorized by Purchaser;
- (c) No other action is or was required to be taken by Purchaser to permit the execution, delivery and performance of this Agreement, and all other documents and certificates contemplated hereby, and the transactions contemplated hereby, and no consent or approval of any third party or governmental authority is or was required or appropriate in connection with the execution of this Agreement, or to consummate the transactions contemplated hereunder;
- (d) This Agreement constitutes the legal, valid and binding obligation of Purchaser, enforceable against Purchaser in accordance with its terms;
- (e) Neither the execution or delivery of this Agreement nor the consummation by Purchaser of the transactions contemplated hereby is or was in violation of or in conflict with (i) any provision of any agreement (including, without limitation, the organizational documents under which Purchaser is organized), instrument or other restriction of any kind to which Purchaser is a party or by which Purchaser or any of its properties is bound or (ii) in any material or adverse way, any statute, law, decree, regulation or order of any governmental authority, or resulted or will result in a default under any agreement, or caused or will cause the acceleration of any obligation or loan to which Purchaser is a party; and
- (f) There are no actions, suits, proceedings, orders or investigations pending or, to the best of Purchaser's knowledge, threatened against or affecting Purchaser at law or in equity, or before or by any federal, state, municipal or other governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, which might adversely affect Purchaser's performance under this Agreement or the consummation of the transactions contemplated hereby.

5.3 *Seller's Knowledge.* As used in this Agreement, references to "Seller's Knowledge," "Seller's Actual Knowledge" or similar phrases shall mean the actual knowledge of the following persons employed by Seller: Tom Pickett and Keith Thompson.

(a)

Disclaimer. EXCPET AS MAY BE OTHERWISE EXPRESSLY PROVIDED IN THIS AGREEMENT, PURCHASER ACKNOWLEDGES THAT IT IS PURCHASING THE PROPERTY IN ITS "AS IS" EXISTING CONDITION AND THAT SELLER MAKES NO WARRANTIES OR REPRESENTATIONS, EXPRESS OR IMPLIED UNLESS EXPRESSLY SET FORTH OTHERWISE HEREIN, AND SELLER SHALL NOT BE IN

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ANY WAY LIABLE FOR ANY REPRESENTATIONS OR WARRANTIES WITH RESPECT TO (BUT NOT LIMITED TO): (A) THE DIMENSIONS, SIZE OR ACREAGE OF THE PROPERTY; (B) THE CONDITION OF THE PROPERTY (INCLUDING ENVIRONMENTAL CONDITION) OR THE SUITABILITY OF THE PROPERTY, OR ANY PART THEREOF, FOR HABITATION OR FOR PURCHASER'S INTENDED USE OR FOR ANY USE WHATSOEVER; (C) APPLICABLE BUILDING, ZONING, LAND USE OR FIRE LAWS OR REGULATIONS OR WITH RESPECT TO COMPLIANCE THEREWITH OR WITH RESPECT TO THE EXISTENCE OF OR COMPLIANCE WITH ANY REQUIRED PERMITS, IF ANY, OF ANY GOVERNMENTAL AGENCY; (D) THE AVAILABILITY OR EXISTENCE OF ANY WATER, SEWER OR UTILITIES OR RIGHTS THERETO; (E) WATER, SEWER OR OTHER UTILITY DISTRICTS OR ASSESSMENTS (INCLUDING LID AND ULID); OR (F) ACCESS TO PUBLIC STREETS OR TO ANY PUBLIC OR PRIVATE SANITARY SEWER SYSTEM. PURCHASER ACKNOWLEDGES AND REPRESENTS TO SELLER THAT PURCHASER HAS FULLY INSPECTED (OR WILL FULLY INSPECT) THE PROPERTY AND PURCHASER ASSUMES THE RESPONSIBILITY AND RISKS OF ANY AND ALL DEFECTS AND CONDITIONS, INCLUDING SUCH DEFECTS AND CONDITIONS, IF ANY, THAT CANNOT BE OBSERVED BY CASUAL INSPECTION.

ARTICLE 6. TITLE POLICY

6.1 *Title Policy.* At the Closing, Seller agrees, at its sole cost and expense, to furnish to Purchaser a standard ALTA Owner's Title Policy, insurable at standard rates, or, if such a policy is not available in the jurisdiction where the Property is located, a comparable policy with substantially the same coverage (the "Title Policy"), issued by the Title Company, in Purchaser's favor in the amount of the Purchase Price, insuring Purchaser's marketable and indefeasible fee simple title to the Real Property, subject only to those exceptions, if any, approved by Purchaser pursuant to Section 3.3.1 of this Agreement, and the printed form of general exceptions contained in such standard ALTA Owner's Title Policy; *provided*, Purchaser may purchase an extended ALTA Owner's Title Policy so long as Purchaser pays all costs in excess of the cost of a standard ALTA Owner's Title Policy. If title is not insurable as provided above and cannot be made so insurable by the date of Closing, this Agreement shall terminate; *provided*, however, Purchaser may in its sole discretion elect to waive one or more of the defects to title and proceed with the acquisition of the Property pursuant to the terms of this Agreement.

ARTICLE 7. CLOSING

7.1 *Closing Date.* The consummation of the purchase and sale contemplated hereby (the "Closing") shall be held on or before August 1, 2000 in the offices of the Title Company, or at such other place as may be agreed upon in writing by Seller and Purchaser; *provided*, if Purchaser's Phase II Environmental Audit report pursuant to Section 3.4.1 above has not been completed due to reasons other than Purchaser caused delay, and Purchaser has otherwise fully and irrevocably waived all other contingencies to Purchaser's obligation to close on its purchase of the Property, Purchaser may at its option extend the Closing Date (by notice to Seller on or prior to July 27, 2000), to a date that is on or prior to ten (10) business days from the date Purchaser received the completed Phase II Environment Audit report. The date and hour of Closing are referred to as the "Closing Date." Each party hereto agrees to undertake all actions and procedures reasonably necessary as when and required by this Agreement and execute and deliver to the title Company such closing escrow instructions as may be necessary to implement and coordinate the Closing as set forth in this Agreement.

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7.2 *Seller's Closing Obligations.* At the Closing, Seller shall:

- (a) transfer marketable and indefeasible fee simple interest in the Property to Purchaser by statutory warranty deed, in recordable form in the jurisdiction where the Property is located, free and clear of all liens and encumbrances, easements, reservations, covenants, restrictions, rights, conditions and defects except non-delinquent real property taxes or assessments, the standard pre-printed exceptions in the title policy and those matters disclosed in the Preliminary Title Commitment and the Books and Records approved or waived by Purchaser as provided in Article III;
- (b) execute, acknowledge and deliver such other agreements, documents and instruments as may be necessary to transfer, convey and assign to Purchaser all other property rights and assets to be assigned to Purchaser by Seller pursuant to the terms hereof including without limitation a bill of sale for all personal property;
- (c) deliver to Purchaser satisfactory evidence that all necessary action on the part of Seller has been taken with respect to the execution and delivery of this Agreement and the consummation of the transaction contemplated hereby so that all of said documents are or will be validly executed and delivered and binding upon Seller;
- (d) deliver to Purchaser, pursuant to Section 1445 of the Internal Revenue Code of 1986, as amended, a non-foreign affidavit, stating that Seller is not a foreign person and providing Seller's United States taxpayer identification number, and
- (e) deliver to Purchaser such other instruments or documents as may be required pursuant to the provisions hereof or as mutually agreed by counsel for Seller and Purchaser to be necessary to fully consummate the transaction contemplated hereby.

7.3 *Purchaser's Closing Obligations.* At the Closing, Purchaser shall:

- (a) deliver to Seller cash or funds readily available in the location set forth in Section 2.2 in the amount set forth in Section 2.1;
- (b) deliver to Seller satisfactory evidence that all necessary corporate, partnership or other action on the part of Purchaser has been taken with respect to the execution and delivery of this Agreement and the consummation of the transaction contemplated hereby so that all of said documents are and will be validly executed and delivered and will be binding upon Purchaser; and
- (c) deliver to Seller such other instruments or documents as may be required pursuant to the terms hereof or mutually agreed by counsel for Seller and Purchaser to be necessary to fully consummate the transaction contemplated hereby.

7.4 *Allocation of Closing Expenses.* The cost of closing the transaction shall be allocated between Seller and Purchaser as follows:

- (a) Seller shall pay:
 - (i) the premium for the standard owner's Title Policy required by Section 6.1,
 - (ii) the cost of providing to Purchaser all information to be reviewed and approved by Purchaser pursuant to the terms hereof,
 - (iii) one-half of the escrow fees or similar charges of the Title Company,
 - (iv) any transfer taxes, deed or documentary stamps, document taxes, mortgage taxes, intangible taxes and similar taxes and charges with respect to the transaction,
 - (v) the cost of obtaining any other item to be delivered to Purchaser at Closing, and

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- (vi) all other costs and expenses that may be allocated to Seller pursuant to the terms of this Agreement.

- (b) Purchase shall pay:
 - (i) the cost (exclusive of any transfer or similar taxes) of recording the general warranty deed and any other documents that Purchaser may choose to record,
 - (ii) all costs for an extended ALTA Owner's Title Policy in excess of a standard owner's policy as described in Section 6.1, if Purchaser elects to purchase such an extended policy of title insurance,
 - (iii) one-half of the escrow fees or similar charges of the Title Company, and
 - (iv) all other costs and expenses that may be allocated to Purchaser pursuant to the terms of this Agreement.
- (c) All other expenses incurred by Seller or Purchaser with respect to Closing, including but not limited to attorneys' fees, shall be borne and paid exclusively by the party incurring the same unless the parties hereto expressly agree in writing to the allocation of part or all of such expenses to one of the parties.

7.5 *Proration of Income and Expenses.* The following items shall be adjusted or prorated between Seller and Purchaser at the Closing, as of the Closing Date:

- (a) Ad valorem and similar taxes (excluding assessments) for the then current tax year relating to the Property shall be prorated. If the Closing occurs before the tax rate is fixed for the then current tax year, the apportionment of taxes shall be made on the basis of the tax rate for the preceding tax year applied to the latest assessed valuation of the Property, and when the tax rate is fixed for the tax year in which the Closing occurs, Seller and Purchaser hereby agree, one to the other, to adjust the proration of taxes and, if necessary, to refund or pay such sums to the other party as shall be

necessary to effect such adjustment;

- (b) All unpaid assessments, if any, existing as of the Closing Date, whether due and payable before or after such date, shall be allocated such that Seller pays any amounts due prior to closing and Purchaser is responsible for any amounts coming due after Closing; and
- (c) All other income and operating expenses for or pertaining to the Property, including, but not limited to, public utility charges maintenance, security, and similar contractual charges, and all other operating charges with respect to the Property shall be prorated between Purchaser and Seller as of the Closing Date.

7.6 *Post-Closing Adjustments.* Seller and Purchaser agree that, to the extent items are prorated or adjusted at the Closing on the basis of estimates, or are not prorated or adjusted at the Closing pending actual receipt of funds or compilation of information upon which such prorations or adjustments are to be based, each of them will, upon a proper accounting, pay to the other such amounts as may be necessary such that Seller will receive the benefit of all income and will pay all expenses of the Property prior to the Closing Date and Purchaser will receive all income and will pay all expenses of the property after the Closing Date to the extent required by Section 7.5. If Purchaser receives any bill or invoice which relates to periods prior to the Closing, Purchaser will refer such bill to Seller and Seller agrees to pay, promptly upon receipt, such a portion of the bill or invoice as relates to the period prior to the closing Date for which it is responsible. If Seller does not pay such bill in a timely manner, Purchase may, at its option, pay such bill or invoice and Seller shall become liable to Purchaser for the full amount of such payment.

ARTICLE 8. CONDITIONS

8.1 *Purchaser's Conditions.* Purchaser shall not be obligated to close the transaction unless and until:

- (a) Seller has delivered to Purchaser all instruments required to be delivered by Seller pursuant to the terms of this Agreement;
- (b) There has been no material uncured breach by Seller of any of the agreements, representations, warranties or covenants contained in this Agreement;
- (c) Marketable title has been shown to be vested in Seller and Seller shall be in a position to convey title to the Property as provided in this Agreement; and
- (d) Each of the conditions precedent to the Closing specified in Article III has been satisfied, or has been waived by Purchaser, in accordance with the terms of this Agreement.

8.2 *Seller's Conditions.* Seller shall not be obligated to close the transaction unless and until:

- (a) Purchaser shall have delivered or cause to be delivered to the Title Company the Purchase Price due to the Seller for delivery upon satisfaction of Seller's closing obligations;
- (b) Purchaser has delivered to Seller all instruments required to be delivered by Purchaser pursuant to the terms of this Agreement; and
- (c) There has been no material uncured breach by Purchaser of any of the agreements, representations, warranties or covenants contained in this Agreement.

ARTICLE 9. AGENCY DISCLOSURE

9.1 *Brokerage Commissions.* At the time of signing this Agreement, Shawn Kelter of Grubb & Ellis Company represented Seller and Scott Fraser of Grubb & Ellis Company represented Purchaser, and upon consummation of Closing Seller agrees to pay said brokers a commission through escrow in accordance with the terms of a separate written agreement between Seller and said brokers. Except as disclosed in the preceding sentence, at the time of signing this Agreement neither party has incurred any liability to any real estate broker or agent and each party agrees to indemnify and hold the other party harmless from and against any and all claims for brokerage commission arising out of this transaction and occasioned by the actions of such indemnifying party.

ARTICLE 10. TERMINATION AND REMEDIES

10.1 *Purchaser's Defaults.*

- (a) *Purchaser's Defaults.* Purchaser shall be deemed to be in default hereunder in the event Purchaser fails, for a reason other than Seller's default hereunder, to timely meet, comply with, or perform any covenant, agreement or obligation on its part required within the time limits and in the

manner required in this Agreement, or there shall have occurred a material breach of any representation or warranty made by Purchaser.

(b) *Seller's Remedies.* In the event Purchaser shall be deemed to be in default hereunder by virtue of the occurrence of one or more of the events specified in 10.1(a), Seller may elect in its discretion to:

(i) pursue any remedy available at law or equity for such Purchaser default including without limitation specific performance; or

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(ii) pursue any remedy available at law or equity for such Purchaser default including without limitation specific performance; or

(iii) *Liquidated Damages.* Seller may elect to retain the Earnest Money as Seller's sole remedy as follows: IN THE EVENT PURCHASER SHALL BE DEEMED TO BE IN DEFAULT HEREUNDER BY VIRTUE OF THE OCCURRENCE OF ONE OR MORE OF THE EVENTS SPECIFIED IN SECTION 10.1(A), SELLER MAY TERMINATE THIS AGREEMENT BY WRITTEN NOTICE TO PURCHASER AND ELECT TO RETAIN THE EARNEST MONEY FOR SUCH DEFAULT, IN WHICH EVENT, SELLER SHALL BE ENTITLED TO RETAIN THE EARNEST MONEY, AND ANY ACCRUED INTEREST THEREON, AS SELL'S SOLE AND EXCLUSIVE REMEDY, IT BEING AGREED BETWEEN PURCHASER AND SELLER THAT SUCH SUM SHALL BE LIQUIDATED DAMAGES FOR A DEFAULT HEREUNDER BECAUSE OF THE DIFFICULTY, INCONVENIENCE AND UNCERTAINTY OF ASCERTAINING ACTUAL DAMAGES FOR SUCH DEFAULT. PURCHASER AND SELLER HEREBY IRREVOCABLY INSTRUCT THE TITLE COMPANY TO DISBURSE THE EARNEST MONEY AND ANY ACCRUED INTEREST TO SELLER UPON RECEIPT OF SELLER'S NOTICE TERMINATING THE AGREEMENT ON ACCOUNT OF PURCHASER'S DEFAULT WITH ELECTION TO RETAIN THE EARNEST MONEY.

Seller's Initials

Purchaser's Initials

10.2 *Seller's Defaults.*

(a) *Seller's Defaults.* Seller shall be deemed to be in default hereunder in the event Seller fails, for a reason other than Purchaser's default hereunder, to timely meet, comply with, or perform any covenant, agreement or obligation on its part required within the time limits and in the manner required in this Agreement, or there shall have occurred a material breach of any representation or warranty made by Seller.

(b) *Purchaser's Remedies.* In the event Seller shall be deemed to be in default hereunder by virtue of the occurrence of one or more of the events specified in Section 10.2(a), Purchaser may pursue any remedy available at law or equity for such Seller default.

(c) *Return of Earnest Money.* In the event Purchaser terminates this Agreement due to Seller's default in accordance with the terms of this Agreement, the Earnest Money, and any accrued interest thereon, shall be promptly returned to Purchaser.

ARTICLE 11. MISCELLANEOUS

11.1 *IRC § 1031 Exchange.* At Seller's request, Purchaser agrees to cooperate in qualifying all or any portion of this transaction as an Internal Revenue Code Section 1031 tax deferred exchange for Seller. Seller agrees to hold Purchaser harmless from any and all claims, costs or other liability and to indemnify Purchaser for any loss which may arise from Seller's Section 1031 tax deferred exchange, including without limitation any loss arising from the acquisition of the exchange property.

11.2 *Assignment of Contract.* Except in connection with an assignment to a facilitator for purposes of completing an I.R.C. Section 1031 exchange, this Agreement may not be assigned by Purchaser without the prior written consent of the Seller; *provided*, however, that Seller hereby consents to any assignment by Purchaser to any affiliate of Purchaser in which Purchaser has a controlling interest or to a limited partnership in which Purchaser serves as a general partner. In the event

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Purchaser assigns its rights under this Agreement pursuant to the terms of this Section, there shall be no release of Purchaser from any liability hereunder, Purchaser shall notify Seller of such assignment prior to the closing and the assignee shall for all purposes be regarded as Purchaser under this Agreement.

11.3 *Risk of Loss.*

(a) Subject to Section 11.3(b) below, risk of loss or damage to the Property by condemnation, eminent domain, or similar proceedings (or deed in lieu thereof), or by fire or any other casualty, from the date hereof to the Closing Date will be on Seller and thereafter will be on Purchaser.

(b)

In the event of loss or damage to the Property which occurs on or prior to the Closing Date, which will cost \$10,000 or more to repair or cure, of if any material part of the Property has been permanently taken by condemnation or eminent domain proceedings (or deed in lieu thereof), or if any means of access to the Property has been permanently blocked or substantially impaired by any such taking, Purchaser may, at its option, elect to terminate this Agreement, in which event Purchaser shall receive a full and immediate refund of the Earnest Money and any interest thereof, or Purchaser may consummate the transaction and receive an assignment of all proceeds of insurance or condemnation awards attributable to such damage. In such event, Seller shall have no additional obligation if such insurance proceeds or condemnation awards are insufficient to repair such damage, or compensate for such loss. If such casualty loss or damage is \$10,000 or less, Purchaser shall have no right to terminate this Agreement and Seller shall repair or cure such loss or damage prior to Closing.

11.4 *Entire Agreement; Modifications.* This Agreement embodies and constitutes the entire understanding between the parties with respect to the transactions contemplated herein, and all prior to contemporaneous agreements, understandings, representations, and statements, oral or written, are merged into this Agreement and are of no further force or effect. Neither this Agreement nor any provision hereof may be waived, modified, amended, discharged or terminated except by an instrument in writing signed by the party against which the enforcement of such waiver, modification, amendment, discharge or termination is sought, and then only to the extent set forth in such instrument.

11.5 *Time of Essence.* Time shall be of the essence of this Agreement.

11.6 *Survival of Terms.* The terms and provisions hereof shall survive the Closing and shall remain in full force and effect thereafter.

11.7 *Interpretation.* Words of any gender used in this Agreement shall be held and construed to include any other gender, and words of a singular number shall be held to include the plural, and vice versa, unless the context requires otherwise.

11.8 *Captions.* The captions used in this Agreement are for convenience only and shall not be deemed to construe or to limit the meaning of the language of this Agreement.

11.9 *Multiple Counterparts/Facsimile Signature.* This Agreement may be executed in a number of identical counterparts and by facsimile signature. If so executed, each of such counterparts and signatures is to be deemed an original for all purposes, and all such counterparts shall collectively constitute one agreement.

11.10 *Binding Effect.* Subject to the restrictions on assignment contained in Section 11.1, this Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, legal representatives, successors and assigns.

11.11 *Attorneys' Fees.* Should either party employ an attorney or attorneys to enforce any of the provisions hereof or to protect its interest in any manner arising under this Agreement, or to recover

damages for the breach hereof, the nonprevailing party in any action pursued in courts of competent jurisdiction (the finality of which action is not legally contested) agrees to pay to the prevailing party all reasonable costs, damages and expenses, including attorneys' fees, expended or incurred in connection therewith; provided, however, that if more than one item is disputed and the final decision is against each party as to one or more of the disputed items, then such costs, expenses and attorneys' fees shall be apportioned in accordance with the monetary values of the items decided against each party.

11.12 *Separability.* If one or more of the provisions of this Agreement or any application thereof shall be invalid, illegal or unenforceable in any respect, the validity, legality and enforceability of the remaining provisions or any other application thereof shall in no way be affected or impaired.

11.13 *Further Action.* Seller and Purchaser agree that they will, at any time and from time to time after the Closing Date, upon the request of the other party, do, execute, acknowledge, and deliver or will cause to be done, executed, acknowledged and delivered all such further acts, deeds, assignments, transfer, conveyances, powers of attorney and assurances as may be reasonably required for the effective assigning, transferring, granting, conveying, assuring and confirming to them, their heirs, legal representatives or assigns or for aiding and assisting in the collecting and reducing to possession, any and all of the assets or property to be assigned to them as provided herein, at the cost of the requesting party.

11.14 *Right to Possession.* Upon Closing, Purchaser shall be entitled to exclusive possession of the Property subject to the following:

- (a) If Seller deems it necessary for an orderly transition of Seller's business to a new facility, and for the period commencing with Closing Date through August 15 2000, Seller shall have the right to retain exclusive possession of all of the warehouse and manufacturing areas on the Property, but Purchaser shall have unrestricted access to, and possession of, all office areas on the Property which office areas shall be delivered by Seller to Purchaser on the Closing Date in a broom clean condition with all of Seller's personal property (not subject to sale to Purchaser) removed from said office areas;
- (b) In addition to the above, and for the period commencing August 16, 2000 through August 31, 2000, Seller shall have the right to retain possession of up to 10,000 square feet of warehouse and manufacturing area, the precise location of which shall be as agreed between Purchaser and Seller, which agreement shall not be unreasonably withheld by either party;
- (c) On and after September 1, 2000, Seller shall have no further right to occupy or possess any portion of the Property and, if Seller holds over without Purchaser's consent, Purchaser may pursue its remedies at law for unlawful detainer and any other legal remedies;
- (d) If Seller retains possession of any portion of the Property following Closing as provided above, Seller agrees to defend, indemnify and hold Purchaser harmless from any loss, damage, injury, claims, actions, costs, and expenses, including attorneys' fees, arising from or relating to the activities of Seller, its employees agents and contractors on the Property; and
- (e)

During any period where Seller retains possession of any portion of the property as provided above, Purchaser agrees to defend, indemnify and hold Seller harmless from any loss, damage, injury, claims, actions, costs and expenses, including attorneys' fees, arising from or related to Purchaser's, its employees', agent's and contractor's grossly negligent or wrongful acts or omissions on the Property.

11.15 *Agreement Date.* All references in this Agreement to the "date hereof," "the date of this Agreement," or other phrases of similar import shall be deemed to refer to the date first written above at the beginning of this Agreement.

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11.16 *Applicable Law.* This Agreement shall be governed by and construed in accordance with the laws of the State in which the Property is located.

11.17 *Waiver of Jury Trial.* Seller and Purchaser hereby waive their respective rights to trial by jury in any action or proceeding involving the Property or arising from this Agreement.

11.18 *Construction of Agreement.* This Agreement has been mutually negotiated by both parties and, therefore, shall not be construed as if prepared by one of the parties, but rather according to its fair meaning as a whole as if prepared by both parties.

11.19 *Escrow Instructions.* Upon acceptance hereof by Seller, this Agreement shall constitute not only the agreement of purchase and sale between Purchaser and Seller, but also irrevocable escrow instructions to the Title Company for the consummation of this agreement through the Closing of escrow. Title Company shall not prepare any further escrow instructions restating or amending the Agreement unless specifically so instructed by both parties. Subject to the reasonable approval of both parties, Title Company may, however, include its standard general escrow provisions.

11.20 *Termination of Offer.* This Agreement is submitted by Seller to Purchaser as an offer to purchase the Property on the terms and conditions set forth herein. This offer shall expire if Seller and Purchase have not fully executed this Agreement by 5:00 p.m., June 6, 2000.

IN WITNESS WHEREOF, this Agreement has been executed by each of the parties as of the first date set forth above.

SELLER

TYCO VALVES & CONTROLS, INC.
a Texas corporation

Date: 06/07/2000

By: /s/ John J. Guarnieri

Its: Vice President

Seller's Address for Notice:

One Tyco Park

Exeter, NH 09833

PURCHASER

DIRECT FOCUS, INC.
a Washington corporation

Date: 06/02/2000

By: /s/ Brian R. Cook

Its: President

Purchaser's Address for Notice:

2200 N.E. 65th Avenue

Vancouver, WA 98661

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[ARTICLE 10. TERMINATION AND REMEDIES](#)

[ARTICLE 11. MISCELLANEOUS](#)

SUBSIDIARIES OF DIRECT FOCUS, INC.

Nautilus Fitness Products, Inc., a Washington corporation
Nautilus Human Performance Systems, Inc., a Virginia corporation
Nautilus, Inc., a Washington corporation
Direct Focus Sales Corporation, a Washington corporation
Direct Focus FSC, Ltd., a Barbados corporation
DFI Properties, LLC, a Virginia limited liability company
BFI Advertising, Inc., a Washington corporation
DFI Leaseco, LLC, a Washington limited liability company

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[SUBSIDIARIES OF DIRECT FOCUS, INC.](#)

INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in Registration Statements No. 333-79643 and No. 333-46936 of Direct Focus, Inc. on Form S-8 of our report dated January 19, 2001, appearing in the Annual Report on Form 10-K of Direct Focus, Inc. for the year ended December 31, 2000.

DELOITTE & TOUCHE, LLP

Portland, Oregon

March 28, 2001

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[INDEPENDENT AUDITORS' CONSENT](#)

POWER OF ATTORNEY

KIRKLAND C. ALY

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, Kirkland C. Aly, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2000, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 27th day of March, 2001.

Signature:

/s/ KIRKLAND C. ALY

Kirkland C. Aly

QuickLinks

[POWER OF ATTORNEY KIRKLAND C. ALY](#)

POWER OF ATTORNEY

C. ROWLAND HANSON

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, C. Rowland Hanson, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2000, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 27th day of March, 2001.

Signature:

/s/ C. ROWLAND HANSON

C. Rowland Hanson

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[POWER OF ATTORNEY C. ROWLAND HANSON](#)

POWER OF ATTORNEY

PAUL F. LITTLE

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, Paul F. Little, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2000, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 27th day of March, 2001.

Signature:

/s/ PAUL F. LITTLE

Paul F. Little

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[POWER OF ATTORNEY PAUL F. LITTLE](#)

POWER OF ATTORNEY

ROGER J. SHARP

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, Roger J. Sharp, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2000, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 27th day of March, 2001.

Signature:

/s/ ROGER J. SHARP

Roger J. Sharp

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[POWER OF ATTORNEY ROGER J. SHARP](#)

POWER OF ATTORNEY

ROLAND E. "SANDY" WHEELER

KNOW ALL MEN BY THESE PRESENTS, that the undersigned, Roland E. Wheeler, hereby constitutes and appoints Brian R. Cook or Rod W. Rice, severally and not jointly, his true and lawful attorney-in-fact and agent, for him and his name, place and stead, in any and all capacities, to sign the Form 10-K of Direct Focus, Inc., a Washington corporation, for the fiscal year ended December 31, 2000, and any amendments or supplements thereto, and to file this Power of Attorney and the Form 10-K, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission and the NASDAQ National Market System, granting unto said attorney-in-fact and agent full power and authority to do and perform each requisite and necessary act to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, may do or cause to be done by virtue hereof.

Dated this 27th day of March, 2001.

Signature:

/s/ ROLAND E. WHEELER

Roland E. Wheeler

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[POWER OF ATTORNEY ROLAND E. "SANDY" WHEELER](#)