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Nautilus, Inc. – (NYSE: NLS) ★★

Rating Criteria	Star Rating	Point Rating	Highest Possible Rating
1. Areas of Financial Concern & Quality of Earnings	★★	6	20
2. Accounting Policies	★★★	3	5
3. Clarity and Completeness of Footnotes	★★	2	5
4. Management Discussion and Analysis	★	1	5
5. Governance	★★★	3	5
Overall Rating	★★	**15**	**40**

Rating: Two stars out of a possible five stars, 15 points out of 40 points.

Areas of Financial Concern – Quality of Earnings Summary

Fiscal year end December 31	FY 2004	FY 2003	FY 2002
GAAP Reported Net Income	**$29.985**	**$34.402**	**$97.887**
After-Tax Adjustments:			
Stock-based compensation	(2.744)	(3.115)	(3.141)
Reduction in tax contingency reserve	(0.411)	--	--
Gain on sale of real estate	(1.182)	--	--
Total adjustments, net of tax	**(4.337)**	**(3.115)**	**(3.141)**
Normalized Net Income	**25.648**	**31.287**	**94.746**
Normalized Net Income as % of Reported	86%	91%	97%
Reported Diluted Earnings per Share(1)	$0.90	$1.04	$2.79
Normalized Diluted Earnings per Share (1)	$0.77	$0.95	$2.70

($MM, except per share amounts)
Numbers may not add due to rounding.
(1) Average diluted Common shares outstanding were 33.4 MM in 2004, 33.0 MM in 2003, and 35.1 MM in 2002.

Key Rating Considerations:

- Nautilus, Inc. ("Nautilus" or "the Company") has replaced virtually its entire top management since 2003, following a 62.7% drop in earnings (64.8% drop in normalized earnings) between 2002 and 2003. The Company reported fourth quarter 2004 net sales growth of 11% and earnings per share growth of 50% and declared that it had "concluded its turnaround as planned."

- *Normalized* 2004 diluted earnings per share of $0.77 fell 18.9% from $0.95 in 2003. This is worse than the 13.5% drop in *reported* diluted earnings, which was enhanced by the reversal of a tax accrual and a gain on the sale of real estate. The Company will take a $950,000 ($0.03 per share) charge in the first quarter of 2005 to settle a complaint from the Consumer Products Safety Commission regarding the possible late disclosure of a product recall.

- The Company earned 25% of its net income in 2004 from the spread between shipping and handling fees and the actual expenses. We view this as a low quality contributor to income, and note that the 25% contribution was sharply higher than the 15% generated from the same source in 2003.

- Increased chargeoffs in 2003 ran down the allowance for doubtful accounts receivable to half its previous level relative to receivables. Nautilus made no sigfificant additions to the reserve in 2004. We calculate that it would cost Nautilus $3.1 MM ($0.06 per share) to boost the reserve back to 5.9% of receivables, as it was at the end of 2002.

- An unexplained increase in prepaid expenses and other current assets could be a sign of earnings management, as the Company capitalized costs that might better have been expensed. Nautilus's prepaid expenses and other current assets climbed 55.8% to $9.4 MM at the end of 2004 from $6.0 MM one year earlier.

- Nautilus consistently generates free cash sufficient to fund all capital spending initiatives, acquisitions, and a cash dividend. The Company's 2004 free cash flow was $24.9 MM, up from $23.7 MM in 2003. As a result of the free cash generation, Nautilus carries no long-term debt.

- The *adjusted* 2004 return on equity of 10.7% worsened versus 14.6% in 2003, on both a weakened return on sales and slowing sales turns. This 39 basis point ROE year-over-year decline was greater than the 36 basis point drop in reported results (12.5% from 16.1%).

- In 2004, the Company's revenues were split evenly between its two reported segments, Direct and Commercial/Retail. The returns on assets differ markedly between the segments, at 42.2% and 9.7%, respectively. Nautilus has targeted the latter segment as a key growth driver and is applying more capital in the lower-return segment.

- Nautilus has no pension plan, offering instead a 401K defined contribution program with a modest Company match.

- Nautilus's average working capital climbed sharply in 2004, largely on a 36.2% increase in average receivables. Working capital turns have slowed consistently over the last five years and both the operating and cash cycles have lengthened over the same period.

- We view a ratio of current taxes to total taxes of 94.3% as a positive quality of earnings sign, as it implies that the Company's book income matches its tax income fairly closely.

- While the reported balance sheet shows no long-term debt, it does not include certain off-balance sheet obligations. Our balance sheet adjustments eliminate goodwill, and add off-balance sheet obligations such as the guarantee of customer debt and the net present value of operating leases. After these adjustments, we arrive at a still conservative long-term debt-to-equity ratio of 10%.

- Stock options are a regular part of executive compensation. Option expenses are booked at their "intrinsic value," which is essentially zero. Earnings in 2004 would have been 9.2% lower had the Company expensed options at the value determined by the Black-Scholes model.

- The segment disclosure in the 10-K footnotes provides good line-item detail, but the combination of the Commercial and Retail operations masks the performance characteristics of each. The Company provides no geographical detail other than total net sales (13% non-U.S.).

- Even though the Company includes sales and earnings targets in its press releases, the Management Discussion and Analysis section of 10K offers no projections or performance targets for the coming year.

- We find that governance in general is average. Positive aspects include one class of Directors all of whom, with the exception of the Chairman, are independent; relatively modest Director compensation; and a good mix of Directors with experience in several of the Company's key businesses. Unfavorable aspects of corporate governance include employment contracts for virtually all executive officers, the positions of Chairman, President, and CEO held by one executive, and no mention of required stock holdings for corporate officers.

- Chairman, President, and CEO Greggory C. Hammann earned estimated total compensation of $1.3 MM in 2004 and $7.6 MM in 2003, his first year with the Company. The year-over-year decline reflected the absence of an incentive signing bonus paid in 2003, and a grant of 100,000 options in 2004, versus 850,000 options that carried an exercise price significantly below the market value of the underlying stock.

<u>Section I - Detailed Findings</u>

1. Areas of Financial Concern and Quality of Earnings (★ ★)

<u>Positive Aspects</u>

Free Cash Flow

Cash from operations has roughly tracked earnings, showing significant declines since the 2002 peak. The Company's capital needs are relatively modest and there is no debt, leaving most of the operating cash flow free to support the dividend. We calculate free cash flow (Table 1) by subtracting capital spending and the dividend from cash flow from operations. Cash from operations exceeded capital spending and cash dividend payments by $24.9 MM in 2004.

Table 1. Nautilus Consistently Generates Free Cash

Free Cash Flow ($MM)	2004	2003	2002	2001	2000
Normalized Net Income	**25.648**	**31.287**	**94.746**	**NA**	**NA**
Net Cash Provided by Operating Activities	**$47.006**	**$43.721**	**$100.560**	**$66.877**	**$52.785**
Capital spending	(9.043)	(7.017)	(31.542)	(5.716)	(8.762)
Cash dividends	(13.091)	(13.030)	0.000	0.000	0.000
Free Cash Flow	**$24.872**	**$23.674**	**$69.018**	**$61.160**	**$44.024**

Source: Company reports and RateFinancials.

Derivatives

Nautilus does not hedge any exposures, as the Company has no long-term debt, a small foreign exchange exposure, and no exposure to commodity price risk. The Company's income, however, is affected by changes in short-term interest rates, as it carries a relatively large cash position and short-term investment portfolio.

Capital Spending

The Company's capital spending, which is shown in Table 2, has fluctuated significantly over the last five years, ranging from $5.7 MM in 2001 to $31.5 MM in 2002. If we exclude 2002, when Nautilus spent $16.7 MM on a new direct marketing computer system and a further $11.5 MM on the purchase of real estate, then capital spending averaged $7.6 MM over the period. This average approximates just 64.5% of 2004's depreciation and amortization of $12.0 MM. In 2003, management instituted the payment of a cash dividend, which it comfortably covered from free cash flow.

Table 2. Average Capital Spending (excluding 2002) Runs at $7.6 MM Per Year

Capital Spending ($B) for the year ended December 31,	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Capital expenditures	$9.043	$7.017	$31.542	$5.716	$8.762
Depreciation and amortization	11.972	12.274	6.316	3.621	2.874
Capital spending/depreciation	**76%**	**57%**	**499%**	**158%**	**305%**

Source: Company reports and RateFinancials.

Income Taxes

The shortfall of cash taxes paid versus current taxes in each of the last three years was relatively modest. Current tax expense in 2004, as seen in Table 3, was $14.8 MM versus total tax expense of $15.7 MM. We view a ratio of current taxes to total taxes of 94.3% as a positive quality of earnings sign, as it implies that the Company's book income matches its tax income closely. The effective tax rate of 34.3% in 2004 is probably not sustainable, as a $411,000 reduction of its tax contingency reserve accounted for 0.9% of the effective rate cut. We expect to see taxes climb back to the 36.0% rate posted in 2003 and 2002.

The reduction in the tax contingency reserve boosted 2004 earnings per share by $0.01.

Table 3. Book Income Closely Resembles Tax Income

For the year ended December 31, (in $MM)	**2004**	**2003**	**2002**
Current taxes	$14.8	$20.0	$50.1
Deferred taxes	<u>0.9</u>	<u>(0.7)</u>	<u>5.0</u>
Total tax expense	$15.7	$19.4	$55.1
Cash taxes paid	$10.8	$16.3	$46.6
Effective tax rate	34.3%	36.0%	36.0%
Cash tax rate	23.7%	30.4%	30.5%
Cash taxes as a percentage of current taxes	73.2%	81.7%	93.1%

Source: Company reports and RateFinancials.

Fair Value Adjustments

All of the Company's financial assets and liabilities are short-term, thus, their book values approximate fair value. At the end of 2004, the balance sheet showed no non-current assets. The only non-current liabilities were an $11.1 MM deferred tax liability and a $200,000 "other" liability.

Negative Aspects

ROE - Reported

Every relative performance measure declined over the five year period shown in Table 4. Nautilus's return on sales dropped to 5.7% in 2004 from 18.6% in 2000. Sales turns slowed over the same time frame to 1.56 times from 2.43 times. The deterioration in returns depressed the overall return on equity despite a boost in the asset to equity ratio (leverage) to 1.40 times in 2004 from 1.26 in 2000. The return on equity declined in each of the last five years, falling to 12.5% in 2004 from 57.1% in 2000.

Table 4. Returns on Sales and Equity Have Fallen for the Last Four Years…

	Return on sales X net income/sales	**Sales turns X** sales/average assets	**Leverage =** avg. assets/average equity	**Return on equity** income/average equity
2004	5.7%	1.56	1.40	12.5%
2003	6.9%	1.70	1.37	16.1%
2002	16.7%	2.48	1.35	56.0%
2001	18.3%	2.34	1.29	55.4%
2000	18.6%	2.43	1.26	57.1%

Source: Company reports and RateFinancials.

ROE - Normalized

We see the same declining returns, even after we adjust Nautilus's earnings by including the expense of equity-based compensation, back out some one-time gains, and normalize the 2004 tax rate. Table 5 recalculates the returns on sales and equity using the normalized earnings shown on the front page of this research report. Net income in 2004 drops 14.5% to $25.6 MM from reported earnings of $30.0 MM, earnings in 2003 adjust downward by 9.1% to $31.3 MM from $34.4 MM, and 2002 earnings are trimmed by 3.2% to $94.7 MM from $97.9 MM.

Table 5. …and Returns on Normalized Earnings Show the Same Pattern

	Normalized Return on sales X	**Sales turns X**	**Leverage =**	**Normalized Return on equity**
2004	4.9%	1.56	1.40	10.7%
2003	6.3%	1.70	1.37	14.6%
2002	16.2%	2.48	1.35	54.2%

Source: Company reports and RateFinancials.

–Shipping and Handling

The spread between the shipping and handling fees charged to customers (and booked as revenues) and the associated costs (included in the cost of sales) contributed 25.4% of the Company's 2004 net income. We view this spread as a low quality contributor to income, and are troubled by the Company's increasing reliance upon shipping fees. Table 6 shows that the contribution to net income has climbed from 15.6% of total earnings in 2000 to 25.4% in the most recent year.

Table 6. Nautilus Generated 25% of 2004 Earnings From Shipping Charges

Nautilus, Inc. Shipping and Handling (in $MM)					
For the year ended December 31,	**2004**	**2003**	**2002**	**2001**	**2000**
Shipping and handling billed to customers	$35.338	$28.868	$42.314	$29.142	$20.215
Shipping and handling expensed as a cost of sales	23.760	21.038	24.477	16.318	10.076
Contribution to pretax income	11.578	7.830	17.837	12.824	10.139
Contributions to earnings per share	$0.23	$0.15	$0.32	$0.23	$0.18
Percentage of net income	25.4%	14.6%	11.7%	12.2%	15.6%

Source: Company reports and RateFinancials.

Allowance for Bad Debt

Nautilus ran down its allowance for bad receivables during 2003, its first year of poor earnings, and kept it at a reduced level through 2004. The replenishment of the allowance in 2005 back toward 5.9% of receivablesl (see Table 7), where it stood at the end of 2002, from 3.3% at the end of 2004 would require an addition of $2.7 MM. If we add to the allowance increase net chargeoffs, which equaled $0.4 MM in 2004, we would look for a $3.1 MM provision charged against pretax earnings. After taxes at an assumed rate of 36%, the provision would cost Nautilus $0.06 per share. In 2004, the provision was $1.0 MM, equal to $0.02 per share.

Table 7. The Allowance for Bad Debt Fell in 2003 and Hasn't Been Replenished

Accounts Receivable for the year ended December 31,	**2004**	**2003**	**2002**
(in $MM)			
Accounts receivable (gross)	$98.845	$78.178	$53.246
Allowance for doubtful accounts	3.252	2.686	3.147
Accounts receivable (net)	95.593	75.492	50.099
Loss provision charged to earnings	0.985	0.388	1.369
Charge-offs, net of recoveries	0.419	0.849	0.286
Allowance as % of net sales	0.62%	0.54%	0.54%
Allowance as % of accounts receivables	3.29%	3.44%	5.91%
Net charge-offs as % of net sales	0.08%	0.17%	0.05%
Net charge-offs as % of accounts receivables	0.42%	1.09%	0.54%

Source: Company reports and RateFinancials, Inc.

Sales Return Reserves

The Company's sales returns jumped in 2004 to $12.4 MM from $9.2 MM in 2003. The $15.7 MM charge (see Table 8) against pretax earnings in 2004 not only covered the returns, but also boosted Nautilus's return reserve to 0.95% of sales from 0.34% one year earlier and 0.44% at the end of 2002. While it is too early to discern a trend from the 2004 returns, a rising return trend, and corresponding increases in provisioning would represent a clear deterioration of earnings quality.

Table 8. A Higher Return Reserve Ratio Might Imply Rising Returns in 2005

Sales Returns Reserves for the year ended December 31,	2004	2003	2002
(in $MM)			
Net sales	$523.837	$498.836	$584.650
Year-end sales return reserve	4.955	1.702	2.550
Loss provision charged to earnings	15.702	8.346	14.494
Deductions to the reserve (product returns)	12.449	9.194	14.044
Reserve as % of net sales	0.95%	0.34%	0.44%
Deductions as a % of net sales	2.38%	1.84%	2.40%

Source: Company reports and RateFinancials, Inc.

Warranty Reserves

Nautilus chose to maintain a warranty reserve at 2.7% of sales in 2004, versus 2.9% in 2003, even though warranty claims jumped to 2.6% of the cost of sales in 2004 from 1.5% and 1.3% in 2003 and 2002, respectively. Table 9 shows that 2004 paid claims (deductions from the reserve) were 2.6%, versus a reserve at 2.7%. In the prior two years, the Company comfortably kept the reserve level 90% and 60% higher, respectively, than the claims payouts.

Table 9. Warranty Claims Nearly Doubled in 2004

Warranty Reserves for the year ended December 31,	2004	2003	2002
(in $MM)			
Cost of sales	$279.043	$252.690	$252.336
Year-end warranty reserves	7.537	7.348	5.358
Warranty provision charged to earnings	7.362	5.845	6.155
Deductions to the reserve (paid warranty claims)	7.173	3.855	3.210
Reserve as % of cost of sales	2.70%	2.91%	2.12%
Deductions as a % of cost of sales	2.57%	1.53%	1.27%

Source: Company reports and RateFinancials, Inc.

Equity-Linked Compensation

Nautilus expenses stock options at their intrinsic value, which is essentially zero. Table 6 shows that this policy caused an overstating of earnings by 9% in each of the last two years. In 2003, the Company granted options with a below market exercise price to its new CEO. Therefore, these options had an intrinsic value of $1.7 MM. Nautilus recognizes the related compensation expense over the options' five-year vesting period. The charges were $340,000 in 2004 and $156,000 in 2003.

In Table 10, we see some unusual assumptions behind the Black-Scholes model used to calculate the fair value of the options. A sharp drop in the expected common stock market volatility factor to 48% from 67% in 2002 could serve to reduce the fair market value of the options. It is unclear why the Company chose to use a 10.0 year expected option term in 2003, versus 5.5 years in 2004 and 5.0 years in 2002. The options granted to senior executives in each year had 10 year actual lives.

Table 10. Employee Stock Options are not Expensed at Fair Value

For the year ended December 31,	**2004**	**2003**	**2002**
Stock-based compensation excluded from net earnings ($ MM)	$2.744	$3.115	$3.141
Cost per diluted share	$0.08	$0.09	$0.09
Impact as a % of net earnings	9.2%	9.1%	3.2%
Options Assumptions:			
Annualized dividend yield	2.5%	3.5%	0.0%
Expected common stock market volatility factor	48.0%	59.0%	67.0%
Expected option term (yrs.)	5.5	10.0	5.0
Risk-free interest rate	4.3%	3.9%	4.1%

Source: Company reports and RateFinancials.

Advertising

The Company cut its advertising budget in 2004, even though sales are highly dependent upon television commercials and infomercials. Nautilus's 2004 advertising expense was $82.8 MM (15.8% of sales), down from $89.5 MM (17.9%) in 2003 and $88.3 MM (15.1%) in 2002.

Prepaid Expenses

An unexplained increase in prepaid expenses and other current assets could be a sign of earnings management, as the Company capitalized costs that might better have been expensed. Nautilus's prepaid expenses and other current assets climbed 55.8% to $9.4 MM at the end of 2004 from $6.0 MM one year earlier.

Working Capital Management

Nautilus's average working capital, as shown in Table 11, climbed in each of the last five years, surging to $63.6 MM in 2004 from $2.0 in 2000. While the Company's sales and earnings also grew over this period, receivables and inventories expanded much faster, slowing turns and growing the number of days outstanding.

Receivable turns fell to 6.1 times in 2004 from 46.2 times in 2000. This measure declined in each of the last five years.

The deterioration in inventory turns was halted, at least in 2004, when it accelerated to 5.5 times from 4.3 times in 2003. The Company has been able to slow its payments to suppliers, but the increase in payables was not nearly enough to offset the growth in short-term assets.

Table 11. Working Capital Use Climbed in Each of the Last 5 Years

For the year ending December 31, ($MM)	2004	2003	2002	2001	2000
Average working capital[1]	$63.623	$60.938	$45.506	$17.073	$1.952
Turns	8.2	8.2	12.8	21.3	114.7
Days outstanding	44	44	28	17	3
Average accounts receivable (net of reserve)	$85.543	$62.796	$37.479	$14.900	$4.843
Turns	6.1	7.9	15.6	24.4	46.2
Days outstanding	59	45	23	15	8
Average inventories	$51.117	$58.464	$54.657	$29.085	$10.910
Turns	5.5	4.3	4.6	4.8	6.9
Days outstanding	66	83	78	74	52
Average accounts payable	$46.370	$38.084	$33.272	$18.796	$9.104
Turns	5.9	6.4	8.1	9.2	8.7
Days outstanding	61	57	44	39	41
Operating cycle in days[2, 3]	125	129	101	89	60
Cash cycle in days[3]	64	72	57	50	18

[1] Working capital is defined as receivables plus inventory minus the sum of accounts payable and accrued liabilities. Working capital turns equal net sales divided by average working capital.
[2] Operating cycle equals receivable days outstanding plus inventory days outstanding.
[3] Cash cycle equals operating cycle minus payable days outstanding.
Source: Company reports and RateFinancials.

Operating and Cash Cycles

Table 11 shows that the 2004 operating cycle was 125 days, down from 129 in 2003. This improvement came on the strength of faster inventory turns, which overcame increasing weakness in receivables management. The cash cycle improved by 8 days, versus the 4 day improvement in the operating cycle, as Nautilus was able to slow its payable days.

Capital Allocation

Capital spending was heavier relative to depreciation and amortization in the commercial/retail segment than in the direct sales segment. While the net margins of the two businesses differed by only 90 basis points (see Table 12), the return on average assets for direct sales wasy 42.2%, versus just 9.7% for the clearly capital intensive commercial/retail business. Therefore, as the Company continues to invest and grow its commercial/retail business, we should see continued deterioration in the overall return on assets.

Table 12. Capital Spending is Heaviest in Lower-Return Commercial/Retail

Nautilus, Inc. Segment Analysis 2004 Results	Direct	Commercial/Retail	Corporate	Total
Percentage of total sales	50.0%	50.0%	0.0%	100.0%
Net margin	7.4%	6.5%	NM	5.7%
Return on average assets	42.2%	9.7%	-5.6%	8.9%
Capital spending/ depreciation and amortization	71.4%	94.6%	0.0%	75.5%

Source: Company reports and RateFinancials.

Deferred Taxes

The net deferred tax liability on the balance sheet rose in 2004 to $6.4 MM from $5.6 MM. The increase all came on the liability side, as the non-current deferred tax liability climbed by $0.9 MM to $11.1 MM from $10.2 MM, slightly more than the net increase of $0.8 MM.

Net Present Value of Future Operating Lease Payments

Even though the balance sheet shows no long-term debt, the Company does have long-term operating lease obligations. We adjust the balance sheet by including as long-term debt the net present value of the future minimum payments for the Company's operating leases. The offset is an increase in fixed assets. We derived a net present value of $22.2 MM for the operating leases. The net present value was based on total future minimal operating lease payments of $28.7 MM and a discount rate of 6.0%.

Off-Balance Sheet Recourse Debt

The Company arranges for commercial customer equipment leasing with third parties and, in some cases, guarantees the debt. Nautilus carries on its balance sheet an estimated $146,000 fair value of its contingent guarantees of $4.4 MM. We adjust the balance sheet to reflect the "maximum contingent liability under all recourse and guarantee provisions" by increasing long-term liabilities and reducing equity by the net amount of $4.3 MM. Nautilus does not disclose the non-recourse amount outstanding.

Adjusted Balance Sheet

Balance sheet adjustments create long-term debt by recognizing the net present value of the Company's operating leases. Table 13 shows that despite the addition of this off-balance sheet obligation, and the reduction of equity associated with recognizing customer debt guarantees, Nautilus still carries very low balance sheet leverage. We made three adjustments to the balance sheet: we eliminated goodwill of $29.8 MM from both assets and equity; we recognized the $22.2 MM net present value of operating lease payments as long-term debt and as an asset; and we recognized $4.3 MM of off-balance sheet recourse financing provided to commercial customers by boosting other assets and reducing equity. The addition of long-term debt and the reduction of equity created a long-term debt-to-equity ratio of 10%.

Table 13. Our Adjustments Create $22.2 MM of Long-Term Debt

Adjusted Balance Sheet ($MM) At December 31, 2004	**Reported**	**Adjustment**	**Adjusted**
Assets			
Goodwill	29.8	(29.8)	0.0
NPV of future minimum operating lease payments	--	22.2	22.2
All other assets	329.9	--	329.9
Total assets	359.6	(7.6)	352.1
Liabilities			
Long-term debt	0.0	--	0.0
NPV of future minimum operating lease payments	--	22.2	22.2
Adjusted long-term debt			22.2
All other liabilities	107.6	--	107.6
Maximum contingent liability under off-balance sheet guarantees		4.3	4.3
Adjusted All other liabilities			111.9
Total liabilities	107.6	26.5	134.1
Stockholders' equity	252.0	--	252.0
Goodwill		(29.8)	(29.8)
Maximum contingent liability under off-balance sheet guarantees		(4.3)	(4.3)
Adjusted stockholders' equity		(34.1)	218.0
Liabilities and stockholders' equity	359.6		352.1
Long-term debt/equity	**0%**		**10%**

Source: Company reports and RateFinancials.

Regulatory Issues

On April 12, 2005, the Company settled with the Consumer Products Safety Commission (CSPC) and agreed to pay a civil penalty of $950,000 in the 2005 first quarter. Nautilus's products and advertising are subject to regulation by the Consumer Products Safety Commission and the Federal Trade Commission. The CPSC alleged that the Company failed to timely report product defects in certain of its products sold between 1995 and 2004.

Product Recall

Nautilus accrued and spent $3.0 MM on a product recall in 2003. Despite the Company's listing of potential product recalls as a key risk factor, no details regarding the 2003 recall were included in the 2004 or 2003 10K filings. Additionally, we could not find a mention of whether the recall was associated with the regulatory action taken by the CPSC, nor if there was any associated litigation.

2. Accounting Policies (★★★)

<u>Positive Aspects</u>

Revenue Recognition

Nautilus's revenue recognition policy is straight-forward—most sales (net of estimated returns) are booked when products are shipped. Large commercial installations are recorded when the installations are completed. The Company books estimated future warranty expenses as part of the cost of goods.

Advertising

Advertising costs are expensed as incurred, except for commercial advertising production costs, which are expensed when the commercial is first shown. The latter policy may create opportunities for earnings management; the amount of such expenditures is not disclosed. Nautilus's 2004 advertising expense was $82.8 MM (15.8% of sales), down from $89.5 MM (17.9%) in 2003 and $88.3 MM (15.1%) in 2002.

Derivatives

The Company does no hedging of interest rates, foreign currency exchange rates, or commodity prices.

Negative Aspects

Equity-Linked Compensation

Nautilus expenses stock options at their intrinsic value, essentially incurring no equty-linked compensation costs. The Company expects to adopt the "fair value" reporting requirement of FAS 123R before the end of 2005. The change will boost the Company's expenses and reduce net income.

Inventory Valuation

The Company appears to have an opportunity to manipulate costs by valuing inventory at either the lower of average cost (determined using the first-in, first-out method) or market or at the lower of standard cost (FIFO) or market. Additionally, FIFO accounting can understate expenses in a rising cost environment.

Depreciation—Property and Equipment

Property and equipment are depreciated using the straight-line method over the useful lives of the assets. Buildings and improvements are depreciated from 7 to 31.5 years. The estimated useful life of all other assets varies from two to seven years.

3. Clarity and Completeness of Footnotes (★★)

Positive Aspects

Reserves

Nautilus discloses the beginning and ending balances of both its sales and warranty expenses, the charges to pretax income and the actual chargeoffs. Estimated returns for direct sales are booked as expenses and carried on the balance sheet as accrued liabilities. Estimated returns for the commercial/retail channel are booked as reductions of revenue and carried on the balance sheet as a reduction to trade receivables. It is unclear why the two are treated differently.

Negative Aspects

Segment Information

Segment line item disclosure was thorough, but in our view, management should have reported three, rather than two operating units. The segment footnote included net sales, interest income, depreciation and amortization expense, income tax expense, segment net income, segment assets, and segment capital spending. The Company provided the data for its direct marketing segment, but then combined commercial and retail, two seemingly different channels, which we expect would show significantly different levels of profitability.

Geographical Operations

The Company only provides international net sales. Nautilus states that non-U.S. sales were 13%, 13%, and 10% of total sales in 2004, 2003, and 2002, respectively, and that sales were "concentrated" in the United Kingdom, Germany, and Canada. No other data is provided.

4. Management's Discussion and Analysis (★)

Positive Aspects

Growth Strategies

The Company provides in its 10-K business summary a general growth strategy that it adopted subsequent to the new management team's 2003 arrival. Strategies include international expansion, increased retail distribution, enhanced product development either through internal research and development or acquisition, and operational streamlining.

Market Data

The Company provides data describing the size of the exercise equipment and nutrition products markets in the U.S., Europe, and other international marketplaces.

Negative Aspects

Revenue Disclosure

Sales discussions do not include any reference to unit volumes, pricing, or product mix issues. We would like to see consistently helpful discussions of operations that include pricing, volume, mix, and specific cost drivers.

Consumer Finance Terms Disclosure

The Company points to increasingly easy consumer finance terms as an important growth factor, but gives no information regarding the cost of its financing programs. The Company mentions in its 10K filing that two consumer finance companies book the receivables as non-recourse debt. In a 2005 8K filing, the Company disclosed that it had extended the terms of its consumer finance agreement with Household Bank.

Forecasts or Targets

Nautilus provided sales and earnings growth targets (15% and 25-30%, respectively) in its February 2, 2005 earnings press release, but did not include any in its 10-K filings. We have seen other companies disclose targets and forecasts for financials that include: sales, earnings, and capital spending, among others.

No Market Share Disclosure

In its 10-K filings, Nautilus discusses its operations and lists several competitors on a business unit basis. However, there is no disclosure of market share data, either for itself or for the competition.

5. Governance (★★★)

Positive Aspects

Single Class of Directors

Nautilus has one class of Directors that is elected annually. We view a staggered Board of Directors as an anti-takeover measure that works against shareholder interest. The Company's eight Directors are elected to one year terms.

Audit Review Committee Expertise

Independent Director Robert S. Falcone is the Audit Committee's "audit financial expert." Mr. Falcone is the Executive Vice President and Chief Financial Officer of BearingPoint, Inc. and was the Chief Financial Officer of Nike, Inc. from 1992 to 1998. Prior to his CFO experience, he spent over 20 years with Price Waterhouse.

Executive Stock Ownership

We look for corporate requirements for managers to own stock at specified multiples of salary. Stock options are a portion of management compensation, but there is no mention of required holdings in the Company's filings.

Director Independence

RateFinancials believes that no more than two Directors should be insiders—seven of Nautilus's eight Board members are independent.

Director Compensation

Annual Director Compensation is modest, in our view. Directors are paid $35,000 annually (up from $25,000 in 2004), and paid $2,000 for each meeting attended. Committee chairmen can earn up to an additional $10,000 (Audit Committee). Non-employee Directors were granted options on 10,000 shares in 2004 and 5,000 shares in 2003. These option grants can materially increase annual compensation and should be monitored.

Auditor Independence

RateFinancials belives that audit and audit-related fees should meet or exceed 75% of total compensation paid to the outside auditor—Deloitte & Touche earned 87.9% of its $1.0 MM 2004 compensation, up sharply from 28.3% of its $1.6 MM 2003 compensation, from audit and audit-related fees. Conflicts can arise when auditors are paid for services other than auditing a company's financials. The higher the amounts paid for non-audit services, the greater the chance for conflict. Deloitte & Touche was paid $1.0 MM (63.9% of total fees) in 2003 and $4.1 MM (89.6%) in 2002 for "all other" work. These payments largely represented consulting fees related to the design and implementation of the Company's new information systems. The Company did not disclose the length of the current outside audit firm's tenure.

CEO Compensation

CEO compensation appears reasonable. Chairman and CEO Hammann earned estimated total compensation of $1.3 MM in 2004, down from $7.6 MM in 2003, the year he joined the Company. Included in the compensation total was an annual salary of $500,000, a discretionary bonus of $200,000, and a grant of 100,000 options worth an esimated (using the Black-Scholes model) $560,000. The sharp decline versus 2003 reflects the absence of a one-time $1.0 MM cash signing bonus, a grant of 850,000 options with an estimated (using the Black-Scholes model) value of $4.1 MM, and $1.7 MM of imputed value from a below-market exercise price assigned to the options.

<u>Negative Aspects</u>

Chairman/CEO

We believe that the separation of these executive responsibilities generally improves governance. Greggory C. Hammann is the Company's Chairman, President, and CEO.

CEO Employment Agreement

The Company has employment agreements, which we generally view unfavorably, with all of its "named" executives. CEO Hammann signed a one-year, annually renewable contract when he joined the Company in 2003. The Contract stipulates a starting annual salary of $500,000 with annual reviews, and a largely discretionary bonus targeted at 100% of annual salary. Severance terms call for one year of salary and bonus in the case of termination without cause.

Severance Agreements

Employment agreements with the Company's "named" officers include severance terms that call for one year of salary in case of termination without

"cause." The contracts, which are disclosed in Nautilus's annual filings, do not include change of control triggers.

<u>Section II - The Company</u>

Vancouver, Washington-based Nautilus, Inc. generated 2004 net income of $30.0 MM on revenues of $523.8 MM. The United States, the Company's primary market, represented 87% of revenues. Nautilus produces and markets health and fitness products primarily under the Nautilus, Bowflex, Schwinn, StairMaster, and Trimline brand names. The Company's fitness equipment products are sold through three distinct channels: the direct channel markets direct to consumers, largely through television; the commercial channel incorporates sales to health clubs; and the retail channel entails sales to consumers through retail outlets. A sales decline and sharp margin deterioration in 2003 and 2004 triggered a complete turnover of the Company's top management.

<u>Sources:</u>

Form 10-K for the year ended December 31, 2004; Form 10-K for the year ended December 31, 2003; Form 10-K for the year ended December 31, 2002; Form 10-K for the year ended December 31, 2001; Form 10-K for the year ended December 31, 2000; Form 10-K for the year ended December 31, 1999; Schedule 14A dated April 15, 2005; Schedule 14A dated April 23, 2004; Press releases; Company website.

Prepared by Lloyd Widom, CFA
with contribution from Allan J. Young, CFA

<u>Note:</u>

RateFinancials Inc. ("RateFinancials" or the "Company") is located at 845 Third Avenue, Suite 1410, New York, NY 10022. Telephone: (212) 957-3000; www.ratefinancials.com.

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The Company's mission is to rate the financial reporting of the largest U.S. public companies - the S&P 500 and selected other public companies - based on the key SEC reporting requirements, such as 10Ks, 10Qs, 8Ks, proxies, etc. It is the general practice of RateFinancials not to speak with the companies' management but to let the public reports speak for themselves. The above ratings are based solely on publicly available information and rate three major areas: 1. the clarity, transparency, quality, and completeness of the companies' financial reporting - which focus on three sub-areas - accounting policies, footnotes and management's discussions and analysis of operations; 2. areas of financial concern or potential financial exposure that the companies' reporting might reveal - or a quality of earnings approach which focuses on potential financial problems, and 3. rating corporate governance based on best company practices.

RateFinancials ranks companies' financial reporting based on a numerical and a five star rating system. The numerical ratings are based on pre-set standards, which are then reviewed internally. The companies can receive up to five points for each of the following four rating criteria: accounting policies, footnotes, management description, and governance. The remaining rating criteria - areas of financial concern and potential exposure -

are equal in weight to the first four criteria, or a maximum of twenty points. The total number of points that can be awarded to a company is forty points. Based on the numerical rating, the companies can be awarded from one to five stars: five stars is considered outstanding; four stars is considered superior or above average; three stars is considered average; two stars is considered below average and one star is considered poor. When the data is complete, companies will be rated against the entire universe of companies that are rated, within their industry peer group as well as over time.