

MEDIFAST INC  
Form 10-Q  
November 10, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**FORM 10-Q**

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 001-31573

**Medifast, Inc.**

**(Exact name of registrant as specified in its charter)**

**Delaware**

**13-3714405**

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

**3600 Crondall Lane  
Owings Mills, Maryland 21117  
Telephone Number: (410) 581-8042**

Indicate by checkmark 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerate filer. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12 b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by checkmark whether the Registrant is a shell company (as defined in Rule 12 b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

The number of shares of the registrant's common stock outstanding at November 10, 2014 was 12,060,558.

**Medifast, Inc. and subsidiaries**

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**MEDIFAST, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | (Unaudited)<br>September 30,<br>2014 | (Audited)<br>December 31,<br>2013 |
|--|--------------------------------------|-----------------------------------|
| <b>ASSETS</b>  |                                      |                                   |
| Current assets:  |                                      |                                   |
| Cash and cash equivalents  | \$ 27,631,000                        | \$ 36,382,000                     |
| Accounts receivable-net of allowance for sales returns and doubtful accounts of \$573,000 and \$647,000 at September 30, 2014 and December 31, 2013, respectively  | 2,354,000                            | 1,246,000                         |
| Inventory  | 16,208,000                           | 18,059,000                        |
| Investment securities  | 27,997,000                           | 31,420,000                        |
| Income taxes, prepaid  | 907,000                              | -                                 |
| Prepaid expenses and other current assets  | 1,937,000                            | 2,890,000                         |
| Deferred tax assets  | 2,018,000                            | 1,957,000                         |
| Total current assets   | 79,052,000                           | 91,954,000                        |
| Property, plant and equipment - net  | 36,014,000                           | 40,336,000                        |
| Other assets   | 273,000                              | 360,000                           |
| <b>TOTAL ASSETS</b>  | <b>\$ 115,339,000</b>                | <b>\$ 132,650,000</b>             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                                   |
| Current liabilities:   |                                      |                                   |
| Accounts payable and accrued expenses  | \$ 27,090,000                        | \$ 26,780,000                     |
| Income taxes payable   | -                                    | 99,000                            |
| Current maturities of capital leases   | 229,000                              | 222,000                           |
| Total current liabilities  | 27,319,000                           | 27,101,000                        |
| Other liabilities:   |                                      |                                   |
| Capital leases, net of current portion   | 301,000                              | 474,000                           |
| Deferred tax liabilities   | 5,167,000                            | 6,659,000                         |
| Total liabilities  | 32,787,000                           | 34,234,000                        |
| Stockholders' Equity:  |                                      |                                   |
| Preferred stock, \$.001 par value (1,500,000 authorized, no shares issued and outstanding)   | -                                    | -                                 |
| Common stock; par value \$.001 per share; 20,000,000 shares authorized; 12,368,249 and 13,143,309 issued at September 30, 2014 and December 31, 2013, respectively; 12,058,314 and 13,115,642 issued and outstanding at September 30, 2014 and December 31, 2013, respectively | 12,000                               | 13,000                            |

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|   |                       |                       |
|---|-----------------------|-----------------------|
| Accumulated other comprehensive income            | 282,000               | 703,000               |
| Retained earnings                                 | 82,258,000            | 97,700,000            |
| Total stockholders' equity                        | 82,552,000            | 98,416,000            |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 115,339,000</b> | <b>\$ 132,650,000</b> |

The accompanying notes are an integral part of these consolidated financial statements.

**MEDIFAST, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)**

|                                       | Three Months Ended September 30, |               | Nine Months Ended September 30, |                |
|---------------------------------------|----------------------------------|---------------|---------------------------------|----------------|
|                                       | 2014                             | 2013          | 2014                            | 2013           |
| Revenue                               | \$ 73,992,000                    | \$ 86,480,000 | \$ 241,404,000                  | \$ 279,595,000 |
| Cost of sales                         | 19,076,000                       | 21,627,000    | 62,194,000                      | 69,403,000     |
| Gross Profit                          | 54,916,000                       | 64,853,000    | 179,210,000                     | 210,192,000    |
| Selling, general, and administrative  | 48,977,000                       | 57,504,000    | 157,163,000                     | 183,624,000    |
| Income from operations                | 5,939,000                        | 7,349,000     | 22,047,000                      | 26,568,000     |
| Other income                          |                                  |               |                                 |                |
| Interest and dividend income, net     | 149,000                          | 167,000       | 445,000                         | 317,000        |
| Other income                          | 757,000                          | 362,000       | 2,044,000                       | 581,000        |
|                                       | 906,000                          | 529,000       | 2,489,000                       | 898,000        |
| Income before income taxes            | 6,845,000                        | 7,878,000     | 24,536,000                      | 27,466,000     |
| Provision for income taxes            | 1,990,000                        | 2,205,000     | 7,994,000                       | 8,787,000      |
| Net income                            | \$ 4,855,000                     | \$ 5,673,000  | \$ 16,542,000                   | \$ 18,679,000  |
| Basic earnings per share              | \$ 0.39                          | \$ 0.41       | \$ 1.28                         | \$ 1.35        |
| Diluted earnings per share            | \$ 0.39                          | \$ 0.41       | \$ 1.27                         | \$ 1.34        |
| Weighted average shares outstanding - |                                  |               |                                 |                |
| Basic                                 | 12,457,438                       | 13,884,293    | 12,877,297                      | 13,852,155     |
| Diluted                               | 12,569,387                       | 13,903,412    | 12,975,671                      | 13,955,217     |

The accompanying notes are an integral part of these consolidated financial statements.

**MEDIFAST, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)**

|   | Three Months Ended September |              | Nine Months Ended September |               |
|---|------------------------------|--------------|-----------------------------|---------------|
|   | 30,                          | 2013         | 30,                         | 2013          |
|   | 2014                         |              | 2014                        |               |
| Net income  | \$ 4,855,000                 | \$ 5,673,000 | \$ 16,542,000               | \$ 18,679,000 |
| Other comprehensive income, net of tax  |                              |              |                             |               |
| Change in unrealized gains/losses on marketable securities:                       |                              |              |                             |               |
| Change in fair value of marketable securities, net of tax                         | (146,000 )                   | 304,000      | 171,000                     | (4,000 )      |
| Adjustment for net (gains)/losses realized and included in net income, net of tax | (459,000 )                   | (32,000 )    | (592,000 )                  | (217,000 )    |
| Total change in unrealized gains/losses on marketable securities, net of tax      | (605,000 )                   | 272,000      | (421,000 )                  | (221,000 )    |
| Other comprehensive income  | (605,000 )                   | 272,000      | (421,000 )                  | (221,000 )    |
| Comprehensive income  | \$ 4,250,000                 | \$ 5,945,000 | \$ 16,121,000               | \$ 18,458,000 |

The accompanying notes are an integral part of these consolidated financial statements.



**MEDIFAST, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY****Nine Months Ended September 30, 2014****(Unaudited)**

|   | Number of<br>Shares<br>Issued | Par<br>Value<br>\$0.001<br>Amount | Additional<br>Paid-<br>In Capital | Retained<br>Earnings | Accumulated<br>other<br>comprehensive<br>income | Treasury<br>Stock | Total         |
|---|-------------------------------|-----------------------------------|-----------------------------------|----------------------|---|-------------------|---------------|
| Balance,<br>December 31,<br>2013                              | 13,143,309                    | \$ 13,000                         | \$-                               | \$ 97,700,000        | \$ 703,000                                      | \$-               | \$ 98,416,000 |
| Shares issued<br>to executives<br>and directors               | 352,032                       |                                   |                                   |                      |   |                   |               |
| Share-based<br>compensation<br>to executives<br>and directors |                               |                                   | 1,858,000                         |                      |   |                   | 1,858,000     |
| Share-based<br>compensation<br>tax benefit                    |                               |                                   | 51,000                            |                      |   |                   | 51,000        |
| Treasury stock<br>purchases                                   |                               |                                   |                                   |                      |   | (33,894,000 )     | (33,894,000)  |
| Treasury stock<br>retirement                                  | (1,127,092 )                  | (1,000 )                          | (1,909,000 )                      | (31,984,000 )        |   | 33,894,000        | -             |
| Net income  |                               |                                   |                                   | 16,542,000           |   |                   | 16,542,000    |
| Net change in<br>unrealized gain<br>on investments            |                               |                                   |                                   |                      | (421,000 )                                      |                   | (421,000 )    |
| Balance,<br>September 30,<br>2014                             | 12,368,249                    | \$ 12,000                         | \$-                               | \$ 82,258,000        | \$ 282,000                                      | \$-               | \$ 82,552,000 |

The accompanying notes are an integral part of these consolidated financial statements.

**MEDIFAST, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|  | Nine Months Ended September 30, |                  |
|--|---------------------------------|------------------|
|  | 2014                            | 2013             |
| Cash flows from operating activities:  |                                 |                  |
| Net income   | \$ 16,542,000                   | \$ 18,679,000    |
| Adjustments to reconcile net income to net cash provided by operating activities from continuing operations: |                                 |                  |
| Depreciation and amortization  | 7,332,000                       | 7,912,000        |
| Realized gain on investment securities, net  | (949,000 )                      | (337,000 )       |
| Share-based compensation   | 1,858,000                       | 1,772,000        |
| Deferred income taxes  | (1,269,000 )                    | (47,000 )        |
| (Gain)/loss on disposal of fixed assets  | (17,000 )                       | 85,000           |
| Changes in assets and liabilities which provided (used) cash:  |                                 |                  |
| Accounts receivable  | (1,108,000 )                    | 216,000          |
| Inventory  | 1,851,000                       | 3,353,000        |
| Prepaid expenses and other current assets  | 953,000                         | 1,261,000        |
| Other assets   | 64,000                          | 764,000          |
| Accounts payable and accrued expenses  | 310,000                         | 2,117,000        |
| Income taxes   | (1,006,000 )                    | (1,682,000 )     |
| Net cash provided by operating activities  | 24,561,000                      | 34,093,000       |
| Cash Flow from Investing Activities:   |                                 |                  |
| Sale of investment securities  | 23,367,000                      | 7,416,000        |
| Purchase of investment securities  | (19,700,000 )                   | (21,576,000 )    |
| Sale of property and equipment   | 1,215,000                       | -                |
| Purchase of property and equipment   | (4,208,000 )                    | (8,644,000 )     |
| Net cash used in investing activities  | 674,000                         | (22,804,000 )    |
| Cash Flow from Financing Activities:   |                                 |                  |
| Repayment of long-term debt and capital leases   | (166,000 )                      | (3,587,000 )     |
| Decrease in note receivable  | 23,000                          | 19,000           |
| Excess tax benefits from share-based compensation  | 51,000                          | 322,000          |
| Purchase of treasury stock   | (33,894,000 )                   | -                |
| Net cash used in financing activities  | (33,986,000 )                   | (3,246,000 )     |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>   | <b>(8,751,000 )</b>             | <b>8,043,000</b> |
| Cash and cash equivalents - beginning of the period  | 36,382,000                      | 39,937,000       |
| Cash and cash equivalents - end of period  | \$ 27,631,000                   | \$ 47,980,000    |
| Supplemental disclosure of cash flow information:  |                                 |                  |
| Interest paid  | \$ 104,000                      | \$ 49,000        |
| Income taxes paid  | \$ 10,211,000                   | \$ 10,143,000    |

The accompanying notes are an integral part of these consolidated financial statements.

**Medifast, Inc. and subsidiaries**

**Notes to Unaudited Condensed Consolidated Financial Statements**

**General**

1. Basis of Presentation

The condensed unaudited interim consolidated financial statements included herein have been prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). However, in the opinion of management, all adjustments consisting of normal, recurring adjustments considered necessary for a fair presentation of the financial position and results of operations have been included. The condensed consolidated financial statements and notes are presented as permitted on Form 10-Q. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

The results of operations for the three months and nine months ended September 30, 2014 are not necessarily indicative of results that may be expected for the year ending December 31, 2014. The accompanying condensed unaudited interim consolidated financial statements should be read in conjunction with the 2013 audited financial statements and notes thereto, which are included in the Company’s Annual Report on Form 10-K filed with the SEC for the year ended December 31, 2013 (“2013 Form 10-K”).

2. Presentation of Financial Statements

The Company’s condensed consolidated financial statements include the accounts of Medifast, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

3. Recent Accounting Pronouncements

We have considered all new accounting pronouncements and have concluded that there are no new pronouncements that may have a material impact on our results of operations, financial condition, or cash flows, based on current

information, except for Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which requires the Company to recognize revenue for the transfer of goods or services to customers for the amount the Company expects to be entitled in exchange for those goods or services. The Company will be required to identify the contract, identify the relevant performance obligations, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize the revenue when the entity satisfies a performance obligation. The provisions of this ASU are effective for interim and annual periods beginning after December 15, 2016. Management is currently evaluating the effect that the provisions of ASU 2014-12 will have on the Company’s financial statements.

4. Revenue Recognition

Revenue is recognized net of discounts, rebates, promotional adjustments, price adjustments, and estimated returns and upon transfer of title and risk to the customer which primarily occurs at shipping (F.O.B. terms). Upon shipment, the Company has no further performance obligations and collection is reasonably assured as the majority of sales are paid for prior to shipping. Medifast Weight Control Centers’ program fees are recognized over the estimated service period.

5. Inventories

Inventories consist principally of packaged meal replacements held in the Company’s warehouses. Inventory is stated at the lower of cost or market, utilizing the first-in, first-out method. The cost of finished goods includes the cost of raw materials, packaging supplies, direct and indirect labor and other indirect manufacturing costs. On a quarterly basis, management reviews inventory for unsalable or obsolete inventory.

Inventories consisted of the following at September 30, 2014 and December 31, 2013:

|                                | 2014          | 2013          |
|--------------------------------|---------------|---------------|
| Raw Materials                  | \$4,795,000   | \$5,381,000   |
| Packaging                      | 1,000,000     | 757,000       |
| Non-food Finished Goods        | 1,073,000     | 855,000       |
| Finished Goods                 | 9,481,000     | 11,356,000    |
| Reserve for Obsolete Inventory | (141,000 )    | (290,000 )    |
|                                | \$ 16,208,000 | \$ 18,059,000 |

## 6. Earnings per Share

Basic earnings per share (“EPS”) computations are calculated utilizing the weighted average number of shares of common stock outstanding during the periods presented. Diluted EPS is calculated utilizing the weighted average number of shares of common stock outstanding adjusted for the effect of dilutive common stock equivalents.

The following table sets forth the computation of basic and diluted EPS for the three and nine months ended September 30:

|  | Three Months Ended September<br>30, |              | Nine Months Ended September<br>30, |               |
|--|-------------------------------------|--------------|------------------------------------|---------------|
|  | 2014                                | 2013         | 2014                               | 2013          |
| Numerator:   |                                     |              |                                    |               |
| Net income   | \$ 4,855,000                        | \$ 5,673,000 | \$ 16,542,000                      | \$ 18,679,000 |
| Denominator:   |                                     |              |                                    |               |
| Weighted average shares of common stock<br>outstanding | 12,457,438                          | 13,884,293   | 12,877,297                         | 13,852,155    |
| Effect of dilutive common stock equivalents            | 111,949                             | 19,119       | 98,374                             | 103,062       |
| Weighted average shares of common stock<br>outstanding | 12,569,387                          | 13,903,412   | 12,975,671                         | 13,955,217    |
| EPS:   |                                     |              |                                    |               |
| Basic  | \$ 0.39                             | \$ 0.41      | \$ 1.28                            | \$ 1.35       |
| Diluted  | \$ 0.39                             | \$ 0.41      | \$ 1.27                            | \$ 1.34       |

The calculation of diluted earnings per share excluded 67,764 options outstanding for the three and nine months ended September 30, 2014 that could potentially dilute base earnings per share in the future. No options were excluded from the calculation for the three and nine months ended September 30, 2013.

## 7. Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Certain financial assets and liabilities are accounted for at fair value, which is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following fair value hierarchy prioritizes the inputs used to measure fair value:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 – Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies.

Level 3 – Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value from the perspective of a market participant.

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The following table represents cash and the available-for-sale securities adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash and cash equivalents or investment securities as of September 30, 2014 and December 31, 2013:

| September 30, 2014             |              |                  |                   |                  |                      |                         |                       |
|--------------------------------|--------------|------------------|-------------------|------------------|----------------------|-------------------------|-----------------------|
|                                | Cost         | Unrealized Gains | Unrealized Losses | Accrued Interest | Estimated Fair Value | Cash & Cash Equivalents | Investment Securities |
| Cash                           | \$27,177,000 | \$-              | \$-               | \$-              | \$27,177,000         | \$27,177,000            | \$-                   |
| Level 1:                       |              |                  |                   |                  |                      |                         |                       |
| Money Market Accounts          | 454,000      | -                | -                 | -                | 454,000              | 454,000                 | -                     |
| Mutual Funds                   | 11,688,000   | 68,000           | (124,000)         | -                | 11,632,000           | -                       | 11,632,000            |
| Corporate Equity Securities    | 2,736,000    | 472,000          | (57,000)          | -                | 3,151,000            | -                       | 3,151,000             |
| Government & Agency Securities | 4,558,000    | 32,000           | (13,000)          | 13,000           | 4,590,000            | -                       | 4,590,000             |
|                                | 19,436,000   | 572,000          | (194,000)         | 13,000           | 19,827,000           | 454,000                 | 19,373,000            |
| Level 2:                       |              |                  |                   |                  |                      |                         |                       |
| Municipal Bonds                | 3,657,000    | 94,000           | (7,000)           | 24,000           | 3,768,000            | -                       | 3,768,000             |
| Corporate Bonds                | 4,818,000    | 24,000           | (16,000)          | 30,000           | 4,856,000            | -                       | 4,856,000             |
|                                | 8,475,000    | 118,000          | (23,000)          | 54,000           | 8,624,000            | -                       | 8,624,000             |
| Total                          | \$55,088,000 | \$690,000        | \$(217,000)       | \$67,000         | \$55,628,000         | \$27,631,000            | \$27,997,000          |
| December 31, 2013              |              |                  |                   |                  |                      |                         |                       |
|                                | Cost         | Unrealized Gains | Unrealized Losses | Accrued Interest | Estimated Fair Value | Cash & Cash Equivalents | Investment Securities |
| Cash                           | \$30,958,000 | \$-              | \$-               | \$-              | \$30,958,000         | \$30,958,000            | \$-                   |
| Level 1:                       |              |                  |                   |                  |                      |                         |                       |
| Money Market Accounts          | 5,424,000    | -                | -                 | -                | 5,424,000            | 5,424,000               | -                     |
| Mutual Funds                   | 7,887,000    | 127,000          | (164,000)         | -                | 7,850,000            | -                       | 7,850,000             |
| Corporate Equity Securities    | 4,614,000    | 1,076,000        | (9,000)           | -                | 5,681,000            | -                       | 5,681,000             |
| Government & Agency Securities | 6,112,000    | 62,000           | (43,000)          | 26,000           | 6,157,000            | -                       | 6,157,000             |
|                                | 24,037,000   | 1,265,000        | (216,000)         | 26,000           | 25,112,000           | 5,424,000               | 19,688,000            |



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Level 2:

|                 |              |             |              |           |              |              |              |
|-----------------|--------------|-------------|--------------|-----------|--------------|--------------|--------------|
| Municipal Bonds | 3,524,000    | 103,000     | -            | 25,000    | 3,652,000    | -            | 3,652,000    |
| Corporate Bonds | 7,995,000    | 74,000      | (47,000 )    | 58,000    | 8,080,000    | -            | 8,080,000    |
|                 | 11,519,000   | 177,000     | (47,000 )    | 83,000    | 11,732,000   | -            | 11,732,000   |
| Total           | \$66,514,000 | \$1,442,000 | \$(263,000 ) | \$109,000 | \$67,802,000 | \$36,382,000 | \$31,420,000 |

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## 9. Shared-based Compensation

## Stock Options:

The Company has issued non-qualified and incentive stock options to employees and nonemployee directors. The fair value of these options are estimated on the date of grant using the Black-Scholes option pricing model, which requires estimates of the expected term of the option, the expected volatility of the price of the Company's common stock, dividend yield and the risk-free interest rate. Options outstanding as of September 30, 2014 vest over a period of three years with an expiration term of ten years. The exercise price of these options ranges from \$24.26 to \$28.81. The expected volatility is based on the historical volatility of the Company's common stock over the period of time equivalent to the expected term for each award. Due to the Company's lack of option exercise history, the expected term is calculated using the simplified method defined as the midpoint between the vesting period and the contractual term of each award. The risk free interest rate is based on the U.S. Treasury yield curve in effect on the date of grant which most closely corresponds to the expected term of the option. The Company historically has not issued dividends and therefore does not utilize a dividend yield in the calculation. The weighted average input assumptions used and resulting fair values were as follows:

|                          | 2014    | 2013 |
|--------------------------|---------|------|
| Expected life (in years) | 6       | -    |
| Risk-free interest rate  | 1.61 %  | -    |
| Expected volatility      | 63.15 % | -    |
| Dividend yield           | -       | -    |

The following table summarizes the stock option activity:

|                                    | Shares   | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining Contractual<br>Life (Yrs) | Aggregate<br>Intrinsic<br>Value |
|------------------------------------|----------|------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2013   | -        | \$ -                               |   |                                 |
| Granted                            | 70,542   | 26.11                              |   |                                 |
| Exercised                          | -        | -                                  |   |                                 |
| Forfeited                          | (2,778 ) | 27.16                              |   |                                 |
| Outstanding at September 30, 2014  | 67,764   | \$ 26.07                           | 9.10  | 458,340                         |
| Exerciseable at September 30, 2014 | 5,051    | \$ 24.61                           | 7.76  | 41,517                          |

The weighted-average grant date fair value of options granted was \$15.19. The unrecognized compensation expense calculated under the fair value method for shares expected to vest as of September 30, 2014 was approximately \$0.7 million and is expected to be recognized over a weighted average period of 2.2 years.

## Restricted Stock:

The Company has issued restricted stock to employees and nonemployee directors generally with terms up to five years. The fair value is equal to the market price of the Company's common stock on the date of grant. Expense for restricted stock is amortized ratably over the vesting period. The following table summarizes the restricted stock activity:

|                                | Shares    | Weighted-Average<br>Grant Date Fair Value |
|--------------------------------|-----------|---|
| Unvested at December 31, 2013  | 393,532   | \$ 24.23                                  |
| Granted                        | 15,918    | 28.43                                     |
| Vested                         | (85,524 ) | 23.04                                     |
| Forfeited                      | (7,333 )  | 28.81                                     |
| Unvested at September 30, 2014 | 316,593   | \$ 24.93                                  |

The total costs of the options and restricted awards vested and charged against income during the three months ended September 30, 2014 and 2013 was \$782,000 and \$620,000, respectively and \$2.4 million and \$2.0 million for the nine months ended September 30, 2014 and 2013, respectively. The Company accrued an additional \$82,000 and \$471,000 for performance awards for the three months ended September 30, 2014 and 2013, respectively and \$454,000 and \$1.3 million for the nine months ended September 30, 2014 and 2013, respectively. The cost of these awards will depend on the Company's fiscal 2014 performance and will be finalized and approved at the first Board of Directors meeting in 2015. The current cost recognized is based on the performance that management expects the Company will achieve as of September 30, 2014. The total income tax benefit recognized in the consolidated statements of income for these restricted stock awards was approximately \$276,000 and \$211,000 for the three months ended September 30, 2014 and 2013, respectively and \$849,000 and \$602,000 for the nine months ended September 30, 2014 and 2013, respectively. The total tax benefit recognized in additional paid-in capital upon vesting of restricted stock awards for the three months ended September 30, 2014 and 2013 was \$12,000 and \$224,000, respectively and \$51,000 and \$322,000 for the nine months ended September 30, 2014 and 2013, respectively. There was approximately \$5.5 million of total unrecognized compensation cost related to restricted stock awards as of September 30, 2014. The cost is expected to be recognized over a weighted-average period of approximately 3.1 years.

10.

Business Segments

Operating segments are components of an enterprise about which separate financial information is available that is regularly reviewed by the chief operating decision maker about how to allocate resources and in assessing performance. The Company has two reportable operating segments: Medifast, and MWCC and Wholesale. The Medifast reporting segment consists of the following distribution channels: Medifast Direct and Take Shape For Life. The MWCC and Wholesale segment includes what is referred to in MD&A as “Medifast Weight Control Centers and Medifast Wholesale Physicians”.

Total assets and operating expense not identified with a specific segment are listed as “Other” and include items such as auditors’ fees, attorney’s fees, stock compensation expense and corporate governance expense related to compliance with NYSE, Sarbanes-Oxley and SEC regulations. Evaluation of the performance of operating segments is based on their respective income from operations before taxes. The accounting policies of the segments are the same as those of the Company. The presentation and allocation of assets, liabilities and results of operations may not reflect the actual economic costs of the segments as stand-alone businesses. If a different basis of allocation were utilized, the relative contributions of the segments might differ, but management believes that the relative trends in segments would likely not be impacted.

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The following tables present segment information for the three and nine months ended September 30, 2014 and 2013:

|   | Three Months Ended September 30, 2014 |                  |                |               |
|---|---------------------------------------|------------------|----------------|---------------|
|   | Medifast                              | MWCC & Wholesale | Other          | Consolidated  |
| Revenues                                    | \$63,344,000                          | \$10,648,000     | \$-            | \$73,992,000  |
| Cost of Sales                               | 15,865,000                            | 3,211,000        | -              | 19,076,000    |
| Selling, General and Administrative Expense | 37,528,000                            | 6,258,000        | 2,935,000      | 46,721,000    |
| Depreciation and Amortization               | 1,853,000                             | 347,000          | 56,000         | 2,256,000     |
| Interest(net) and other                     | 12,000                                | 12,000           | (930,000 )     | (906,000 )    |
| Income before income taxes                  | \$8,086,000                           | \$820,000        | \$(2,061,000 ) | \$6,845,000   |
| Segment Assets                              | \$68,724,000                          | \$9,887,000      | \$36,728,000   | \$115,339,000 |

|   | Three Months Ended September 30, 2013 |                  |                |               |
|---|---------------------------------------|------------------|----------------|---------------|
|   | Medifast                              | MWCC & Wholesale | Other          | Consolidated  |
| Revenues                                    | \$73,324,000                          | \$13,156,000     | \$-            | \$86,480,000  |
| Cost of Sales                               | 18,120,000                            | 3,507,000        | -              | 21,627,000    |
| Selling, General and Administrative Expense | 44,970,000                            | 8,434,000        | 1,408,000      | 54,812,000    |
| Depreciation and Amortization               | 1,939,000                             | 684,000          | 69,000         | 2,692,000     |
| Interest(net) and other                     | (306,000 )                            | 3,000            | (226,000 )     | (529,000 )    |
| Income before income taxes                  | \$8,601,000                           | \$528,000        | \$(1,251,000 ) | \$7,878,000   |
| Segment Assets                              | \$91,370,000                          | \$12,450,000     | \$44,576,000   | \$148,396,000 |

|   | Nine Months Ended September 30, 2014 |                  |                |               |
|---|--------------------------------------|------------------|----------------|---------------|
|   | Medifast                             | MWCC & Wholesale | Other          | Consolidated  |
| Revenues                                    | \$206,706,000                        | \$34,698,000     | \$-            | \$241,404,000 |
| Cost of Sales                               | 51,797,000                           | 10,397,000       | -              | 62,194,000    |
| Selling, General and Administrative Expense | 120,552,000                          | 23,116,000       | 6,163,000      | 149,831,000   |
| Depreciation and Amortization               | 5,808,000                            | 1,357,000        | 167,000        | 7,332,000     |
| Interest(net) and other                     | 39,000                               | (1,018,000 )     | (1,510,000 )   | (2,489,000 )  |
| Income before income taxes                  | \$28,510,000                         | \$846,000        | \$(4,820,000 ) | \$24,536,000  |
| Segment Assets                              | \$68,724,000                         | \$9,887,000      | \$36,728,000   | \$115,339,000 |

|  | Nine Months Ended September 30, 2013 |       |              |
|--|--------------------------------------|-------|--------------|
|  | Medifast                             | Other | Consolidated |

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MWCC &  
Wholesale

|   |               |              |                |               |
|---|---------------|--------------|----------------|---------------|
| Revenues                                    | \$238,625,000 | \$40,970,000 | \$-            | \$279,595,000 |
| Cost of Sales                               | 58,790,000    | 10,613,000   | -              | 69,403,000    |
| Selling, General and Administrative Expense | 145,028,000   | 26,058,000   | 4,626,000      | 175,712,000   |
| Depreciation and Amortization               | 5,583,000     | 2,135,000    | 194,000        | 7,912,000     |
| Interest(net) and other                     | (228,000 )    | 7,000        | (677,000 )     | (898,000 )    |
| Income before income taxes                  | \$29,452,000  | \$2,157,000  | \$(4,143,000 ) | \$27,466,000  |
| Segment Assets                              | \$91,370,000  | \$12,450,000 | \$44,576,000   | \$148,396,000 |

11. Contingencies

The Company filed a civil complaint on February 17, 2010 in the U.S. District Court (SD, Cal) against Barry Minkow and the Fraud Discovery Institute, Inc. (collectively, "Minkow"), iBusiness Reporting, and its editor William Lobdell, Tracy Coenen and Sequence, Inc. (collectively, "Coenen"), "Zee Yourself", and Robert L. Fitzpatrick ("FitzPatrick") for defamation, market manipulation and unfair business practices, alleging a scheme of market manipulation of the Company's common stock by defendants' for monetary gain, and damaging the business reputation of the Company and its Take Shape For Life division. Bradley T. MacDonald, former Executive Chairman of the Company and a stockholder, joined the lawsuit individually. The lawsuit seeks \$270 million in compensatory damages, punitive damages, and ancillary relief. In March 2011, the District Court granted in part and denied in part certain Anti-SLAPP Motions to Strike (i.e. motions to dismiss) previously filed by all Defendants. The Company appealed that portion of the District Court's ruling which dismissed its defamation claims against Minkow and Coenen in the 9th Circuit Court of Appeals. Defendant FitzPatrick's motion was denied as to the Company's defamation claim, and FitzPatrick appealed that portion of the Court's ruling. On June 4, 2014, the Panel of the 9th Circuit Court of Appeals issued a decision, denying FitzPatrick's appeal and remanding to the District Court for further consideration; reversing the District Court's decision as to Minkow and remanding for further consideration; denying MacDonald's appeal in its entirety; and denying the Company's appeal as to Coenen. The District Court now has jurisdiction over the matter and has set up a briefing schedule to address the various issues raised by the Ninth Circuit with regard to defendants Minkow and Fitzpatrick. The case as to Coenan and certain other defendants has been finally dismissed, and the Company is evaluating its options regarding the fee applications submitted by these parties.

12. Stockholders' Rights Plan

On August 28, 2014, the Company adopted a stockholders' rights plan whereby the Board of Directors authorized and declared a dividend distribution of one right for each outstanding share of common stock of the Company to the stockholders of record at the close of business on September 9, 2014. The rights are not presently exercisable and remain attached to the shares of common stock until the occurrence of certain triggering events. The rights will expire on August 28, 2015, unless exercised, redeemed, or exchanged prior to that time. The Board of Directors may terminate the rights plan before the expiration date.

13. Subsequent Events

In October 2014, a franchisee announced the closure of seven centers. The Company is a secondary guarantor for a loan associated with these centers. Upon the triggering event of the Franchisee loan default, the Company may be required to perform under this guarantee resulting in a charge up to \$2.0 million.

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. FORWARD LOOKING STATEMENTS**

## Special Note Regarding Forward-Looking Statements

This report contains information that may constitute “forward-looking statements.” Generally, the words “believe,” “expect,” “intend,” “estimate,” “anticipate,” “project,” “will,” and similar expressions identify forward-looking statements, which generally are not historical in nature. However, the absence of these words or similar expressions does not mean that a statement is not forward-looking. All statements that address operating performance, events or developments that we expect or anticipate will occur in the future – including statements relating to future operating results- are forward-looking statements. Management believes that these forward-looking statements are reasonable as and when made. However, caution should be taken not to place undue reliance on any such forward-looking statements because such statements speak only as of the date when made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. In addition, forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and our present expectations or projections. These risks and uncertainties include, but are not limited to, those in our Annual Report on Form 10-K for the year ended December 31, 2013 (the “Form 10-K”), and those described from time to time in our future reports filed with the Securities and Exchange Commission.

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and related notes appearing elsewhere herein.

## Overview

Medifast, Inc. (“Medifast,” the “Company,” “we,” “us,” or “our”) is engaged in the production, distribution, and sale of weight management products and services and other consumable health and diet products. The Company’s product lines include meal replacements, snacks and supplements and conducts its business through two segments, Medifast, and MWCC and Wholesale. Our products and services are sold to weight loss program participants primarily via the internet, telephone, and brick and mortar clinics. Customers of our independent contractor health coaches (“Health Coaches”) in the Take Shape For Life person-to-person direct sales channel are directed to order our products through either the internet or through the Company’s in-house call center. Our product sales accounted for 97% of our revenues in the first nine months of 2014 and 96% of our revenues in the first nine months of 2013. Program sales in our Medifast Weight Control Center channel accounted for 1% of revenues in the first nine months of 2014 and 2% in the first nine months of 2013. Shipping revenue and other accounted for 2% in the first nine months of 2014 and 2013. Revenue consists primarily of meal replacement food sales. In the first nine months of 2014, total revenue decreased to \$241.4 million compared to \$279.6 million in the first nine months of 2013, a decrease of \$38.2 million or 13.7%. The decline was due to a decrease in revenue in all channels of the Company as detailed below in the “Overview of Results of Operations” section. The Take Shape For Life sales channel accounted for 66.7% of total revenue, Medifast Direct 18.9%, and MWCC and Wholesale segment accounted for 14.4%. See Note 10, “Business Segments” of the notes to the financial statements for a detailed breakout of revenues, profit or loss, and total assets of each of the Company’s business segments.





We review and analyze a number of key operating and financial metrics to manage our business, including revenue to advertising spend, number of active Health Coaches and average monthly revenue generated per health coach in the Take Shape For Life channel, and average same store sales improvement for the Medifast Weight Control Center channel.

In December 2013, the Company closed eight corporate centers and incurred \$2.1 million of clinic closure costs included in selling, general and administration expenses. Clinic closure costs are expensed and recognized as a liability at their fair value when incurred. One-time employee severance costs are expensed and recognized as a liability when the plan is finalized by management, approved and committed to by management, and communicated to the employee. Contractual costs that will continue to be incurred (operating leases) are recognized at the cease use date. The fair value of operating lease contracts is determined based on the present value of the remaining lease payments. Other costs associated with closing the clinic or relocating employees are expensed as incurred. As of December 31, 2013, \$1.3 million of clinic closure costs are included in accrued expenses. The roll-forward of severance charges and lease payments as of September 30, 2014 is below.

|   | MWCC &<br>Wholesales |
|---|----------------------|
| Accrued severance charges as of December 31, 2013   | \$ 80,000            |
| Payments during the period                          | (80,000 )            |
| Ending balance accrued as of September 30, 2014     | \$-                  |
| Accrued net lease liability as of December 31, 2013 | \$ 1,131,000         |
| Payments and settlements during the period          | (584,000 )           |
| Ending balance as of September 30, 2014             | \$ 547,000           |

### Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with GAAP. Our significant accounting policies are described in Note 2 of the consolidated financial statements included in the Form 10-K.

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management develops, and changes periodically, these estimates and assumptions based on historical experience and on various other factors that it believes to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The accounting estimates we consider critical include revenue recognition, impairment of fixed assets and intangible assets, income taxes, reserves for returns, operating leases and clinic closure costs.

During the nine months ended September 30, 2014, we did not make any material changes to our critical accounting policies.

### **Medifast Segment**

**Medifast Direct** – In the direct-to-consumer channel (“Medifast Direct”), customers order Medifast product directly through the Company’s website, [www.medifastnow.com](http://www.medifastnow.com) or our in-house call center. This business is driven by a multi-media customer acquisition and retention strategy that includes both national and regional television, print, radio, digital advertising, direct mail, and email as well as public relations, word of mouth referrals, and social media initiatives. The Medifast Direct division focuses on targeted marketing initiatives to acquire and retain customers and provides support through its in-house call center and nutrition support team of registered dietitians to better serve its customers.

**Take Shape For Life™** – Take Shape For Life, a member of the Direct Selling Association, is the personal coaching division of Medifast. This physician-led coaching network consists of Health Coaches, who are trained to provide coaching and support to clients on Medifast weight-loss products and programs. The role of the Health Coach is to give clients the encouragement and mentoring to assist them to successfully reach a healthy weight and adopt a healthy lifestyle. The Take Shape For Life program provides a road map to empower the individual to take control of their health through adopting better long-term habits. Take Shape For Life moves beyond the scope of weight loss to teach clients how to achieve optimal health through the balance of body, mind, and finances. The program uses the high-quality, medically validated products of Medifast that have been proven safe and effective in clinical studies. In addition to the encouragement and support provided by Health Coaches, clients of Take Shape For Life are offered a bio-network of support including product and program information on our website, weekly medical and general support calls, and access to our registered dietitians.

## **MWCC and Wholesale Segment**

**Medifast Weight Control Centers** – Medifast Weight Control Centers is the brick and mortar clinic channel of Medifast with affiliate-owned locations in Pennsylvania, New Jersey, Delaware, Texas, Florida, Maryland, North Carolina, and Virginia. Jason Properties, LLC, a subsidiary of Medifast had a total of 51 Medifast Weight Control Centers in operation at September 30, 2014. Medifast Weight Control Centers offer a high-touch model including comprehensive Medifast programs for weight loss and maintenance, customized client counseling, an InBody™ body composition analysis, and monitoring with a BodyGem™ indirect calorimeter that determines resting metabolic rates. Medifast Weight Control Centers conduct local advertising including radio, print, television and web initiatives. The Centers also benefit from the enterprise brand advertising which encourages walk-ins and referrals from their customers and other Medifast business channels.

In 2008, Medifast Franchise Systems, Inc. (“MFSI”), a subsidiary of Medifast, began offering the center model as a franchise opportunity. As of September 30, 2014, MFSI had franchised centers located in Alabama, Arizona, California, Florida, Louisiana, Minnesota, Tennessee, Wisconsin, Maryland, Pennsylvania, Texas and Virginia. As of September 30, 2014, 69 franchise centers were in operation.

**Medifast Wholesale-** Since 1980, over 20,000 doctors have recommended Medifast products and programs to their patients as a medically-proven solution to control their weight and improve their health. Medifast provider practices carry an inventory of wholesale products and resell them to patients while providing appropriate medical monitoring, testing, and support to ensure healthy weight loss.

The Company offers extensive resources to assist the providers, their staff and their patients in achieving success with their programs. Medifast Medical Providers have access to marketing assets and training modules to help the practice grow their program and enable patients to achieve their weight loss and associated health goals. Medifast’s nutrition support team includes registered dietitians and a behavioral specialist who provide program support and advice via phone and email.

In 2012, the Company entered into a 3-year strategic partnership with Medix, a leader in pharmaceutical obesity products in Mexico. The agreement granted Medix an exclusive license for the distribution of Medifast products and programs through physicians and weight control centers in Mexico under the Medifast brand. Inventory is shipped to Medix within the United States and the resulting revenues are classified as domestic sales for the Company.

In January 2013, the Company and Medix, amended their partnership agreement to provide an exclusive 5-year licensing agreement to increase distribution of Medifast meal replacement products and programs beyond Mexico and into Argentina, Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala,

Honduras, Nicaragua, Panama, Paraguay, Peru, Venezuela, and Uruguay. In September 2013, Medix held the grand opening of the first international Medifast Weight Control Center in Mexico City. Medix now has three Medifast Weight Control Centers open in Mexico with plans to expand. In December 2013, Medix opened the first Medifast Weight Control Center in Bogota, Colombia. In March 2014, Medix acquired 13 Slim Center locations across Mexico City and Guadalajara. This acquisition gives them 12 locations in Mexico City, creating a strong geographic footprint and allows them to integrate complementary weight management brands including Medifast, Slim Center and Medix nutraceuticals. The Slim Center locations are currently selling Medifast products with plans to deploy the Medifast weight loss and maintenance programs in 2015. Including the 4 Medifast Weight Control Centers and the 13 Slim Centers, Medix now has 17 locations in operation in Mexico and Columbia that offer Medifast products. The Company expects this relationship to continue to grow throughout 2014 with the focus on expanding into additional countries and further penetrating the market in established regions.

The Company also expanded its international presence into Canada in March 2014, opening new channels of distribution. Its current sales are through the Medifast Direct and Medical Provider channels, with the long-term goal of expanding other Medifast channels into Canada.

**Overview of Results of Operations**

|  | Three Months ended September 30, |              |                |          |
|--|----------------------------------|--------------|----------------|----------|
|  | 2014                             | 2013         | \$ Change      | % Change |
| Revenue                                    | \$73,992,000                     | \$86,480,000 | \$(12,488,000) | -14 %    |
| Cost of sales                              | 19,076,000                       | 21,627,000   | (2,551,000 )   | -12 %    |
| Gross Profit                               | 54,916,000                       | 64,853,000   | (9,937,000 )   | -15 %    |
| Selling, general, and administrative costs | 48,977,000                       | 57,504,000   | (8,527,000 )   | -15 %    |
| Income from operations                     | 5,939,000                        | 7,349,000    | (1,410,000 )   | -19 %    |
| Other income                               |                                  |              |                |          |
| Interest income, net                       | 149,000                          | 167,000      | (18,000 )      | -11 %    |
| Other income                               | 757,000                          | 362,000      | 395,000        | 109 %    |
|  | 906,000                          | 529,000      | 377,000        | 71 %     |
| Income before provision for income taxes   | 6,845,000                        | 7,878,000    | (1,033,000 )   | -13 %    |
| Provision for income tax expense           | 1,990,000                        | 2,205,000    | (215,000 )     | -10 %    |
| Net income                                 | \$4,855,000                      | \$5,673,000  | \$(818,000 )   | -14 %    |
| <i>% of revenue</i>                        |                                  |              |                |          |
| Gross Profit                               | 74.2                             | % 75.0       | %              |          |
| Selling, general, and administrative costs | 66.2                             | % 66.5       | %              |          |
| Income from Operations                     | 8.0                              | % 8.5        | %              |          |

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|  | Nine Months ended September 30, |               |                |          |
|--|---------------------------------|---------------|----------------|----------|
|  | 2014                            | 2013          | \$ Change      | % Change |
| Revenue                                    | \$241,404,000                   | \$279,595,000 | \$(38,191,000) | -14 %    |
| Cost of sales                              | 62,194,000                      | 69,403,000    | (7,209,000 )   | -10 %    |
| Gross Profit                               | 179,210,000                     | 210,192,000   | (30,982,000)   | -15 %    |
| Selling, general, and administrative costs | 157,163,000                     | 183,624,000   | (26,461,000)   | -14 %    |
| Income from operations                     | 22,047,000                      | 26,568,000    | (4,521,000 )   | -17 %    |
| Other income                               |                                 |               |                |          |
| Interest income, net                       | 445,000                         | 317,000       | 128,000        | 40 %     |
| Other income                               | 2,044,000                       | 581,000       | 1,463,000      | 252 %    |
|  | 2,489,000                       | 898,000       | 1,591,000      | 177 %    |
| Income before provision for income taxes   | 24,536,000                      | 27,466,000    | (2,930,000 )   | -11 %    |
| Provision for income tax expense           | 7,994,000                       | 8,787,000     | (793,000 )     | -9 %     |
| Net income                                 | \$ 16,542,000                   | \$ 18,679,000 | \$(2,137,000 ) | -11 %    |
| % of revenue                               |                                 |               |                |          |
| Gross Profit                               | 74.2                            | % 75.2        | %              |          |
| Selling, general, and administrative costs | 65.1                            | % 65.7        | %              |          |
| Income from Operations                     | 9.1                             | % 9.5         | %              |          |

Revenue: Revenue decreased approximately 14.7% and 13.7% to approximately \$74.0 million and \$241.4 million for the three and nine months ended September 30, 2014, respectively, as compared to approximately \$86.5 million and \$279.6 million for the three and nine months ended September 30, 2013, respectively. For the three months ended September 30, 2014, the Take Shape For Life sales channel accounted for 67.5% of total revenue, Medifast Direct 18.1%, and MWCC and Wholesale segment 14.4%. For the nine months ended September 30, 2014, the Take Shape For Life sales channel accounted for 66.7% of total revenue, Medifast Direct 18.9%, and MWCC and Wholesale segment 14.4%. In the third quarter of 2014, the Company's revenue to spend ratio was 17.2-to-1 versus 15.8-to-1 in the third quarter of 2013. Total advertising spend was \$4.3 million in the third quarter of 2014 versus \$5.5 million in the third quarter of 2013, a decrease of \$1.2 million or 21.9%. The year to date revenue to spend ratio for 2014 was 13.5-to-1 compared to 11.9-to-1 for 2013. Total advertising spend year to date in 2014 was \$17.9 million compared to \$23.5 million for the same period in 2013.

For the three months ended September 30, 2014, Take Shape For Life revenue decreased 11% to \$49.9 million compared to \$56.2 million in 2013. Revenue declined \$16.1 million, 9%, to \$160.9 million for the nine months ended September 30, 2014 compared to the prior year. The decline in revenue for Take Shape For Life was driven by a decrease in the number of Health Coaches and revenue per Health Coach along with the accrued impact from the creation of the new BeSlim Club loyalty program. The number of active Health Coaches at the end of the third quarter of 2014 decreased to 10,200 compared with 11,700 during the same period for 2013, a decrease of 13.0%. Active

Health Coaches are defined as Health Coaches receiving income from a product sale in the last month of the quarter. The average revenue per health coach per month decreased from \$1,650 for the nine months ended September 30, 2013 to \$1,565 for the nine months ended September 30, 2014.

Medifast Direct revenue decreased 22% to \$13.4 million and 26% to \$45.8 million for the three and nine months ended September 30, 2014, respectively, compared to the same period for 2013. Revenues in this channel are driven primarily by targeted customer advertising on-line, across local radio, via email and direct mail campaigns, and by highlighting customer successes in large national publications and on television. New customer acquisition has been challenging and the Company limited marketing spending in the quarter based on lower efficiencies and the desire to optimize profitability. The Company expects to invest additional dollars into marketing, as compared to the fourth quarter of 2013, while continuing to focus on efficient management of those investments.



The MWCC and Wholesale segment experienced revenue decline of 20% and 15% in the three and nine months ended September 30, 2014 compared to the same periods in 2013. The Company closed 11 centers since the first quarter of 2013 and sold a total of 24 centers to franchise partners at the end of the second quarter of 2014, leaving 51 corporate locations in operation. Four franchise centers were closed during the quarter, decreasing the number of locations in operation as of September 30, 2014 to 69. Same store sales for centers open greater than one year decreased by 13% for the nine months ended September 30, 2014 compared to 2013. The decline in revenue for the quarter was driven by the closure of 8 corporate centers in December 2013, the sale of 24 corporate centers, and the Company's continued focus to improve profitability by creating operational efficiencies, optimizing staffing, and managing expenses contributed to the decrease in same store sales and overall revenues. The year to date decrease was driven to closure of 11 corporate centers over the prior twelve months, the sale of 24 corporate centers, additional expense accrued for the loyalty program, and the Company's focus to improve profitability. There were 51 centers in the comparative same-store-sales base at September 30, 2014.

**Costs of Sales:** Cost of sales decreased approximately \$2.6 million to \$19.1 million and \$7.2 million to \$62.2 million for the three and nine months ended September 30, 2014 compared to the same periods in 2013. As a percentage of sales, gross margin decreased to 74.2% from 75.0% in the third quarter of 2014 and 74.2% from 75.2% for the first nine months of 2014 versus the prior year. The decrease in gross margin for the periods was primarily due to variances resulting from the decreased manufacturing volume, sales mix changes from the transition of the 24 centers to the franchise model, and the introduction of the several incremental products, such as Flavors of Home, which are sold at a lower margin. The year to date decrease was also caused by the accrual of loyalty program expenses.

**Selling, General and Administrative Costs:** Selling, general and administrative expenses were \$49.0 million and \$157.2 million for the three and nine months ended September 30, 2014 compared to \$57.5 million and \$183.6 in the same periods of 2013. As a percentage of sales, selling, general and administrative expenses decreased to 66.2% versus 66.5% in the third quarter of 2014. For the nine months ended September 30, 2014, selling, general and administrative expenses decreased as a percentage of sales to 65.1% from 65.7% for the same period in 2013. Take Shape For Life commission expense, which is variable based upon product sales, decreased by approximately \$4.5 million and \$12.4 million for the three and nine months ended September 30, 2014 as TSFL sales declined 11% and 9% compared to the prior year.

Salaries and benefits decreased by approximately \$2.5 million in the third quarter of 2014 compared to the same period in 2013 and \$5.6 million for the nine months ended September 30, 2014 compared to last year. The decrease for both periods was driven by a decrease in bonuses, salaries and medical insurance expense resulting from improved focus on headcount monitoring and the closure of 11 centers and transition of 24 corporate Medifast Weight Control Centers to franchisees over the prior nine months.

Sales and marketing expense decreased by \$0.6 million in the third quarter of 2014 compared to same period in 2013 and \$5.1 million for the nine months ended September 30, 2014 compared to the prior period. The decrease is the result of lower advertising spending in both the quarter and year to date compared to the prior year, partially offset by an increase in Take Shape For Life convention related costs. The Company continues to focus on efficiency

improvements and balancing sales and marketing expense in an effort to drive profitability.

General expenses increased \$0.6 million and decreased \$0.9 million for the three and nine months ended September 30, 2014 in comparison to the same periods in 2013. The quarterly increase was driven by an increase in legal fees year-over-year, including \$1.6 million in extraordinary expenses resulting from recent 13D filings. The increase was offset by a decrease in consulting fees, insurance expense and rent expense. The decrease in rent was the result of the closure of 11 and sale of 24 corporate centers during the twelve month period. The year to date decrease was driven by a decrease in consulting, accounting, and rent expenses compared to the prior year and a benefit from rent expense settlements with landlords for four of the eight Medifast Weight Control Centers that were closed during the fourth quarter of 2013. These improvements were offset by the increase in legal fees year-over-year. The Company anticipates incurring approximately \$0.5 million in additional legal fees in response to the 13D filings during the fourth quarter. Other expenses consisting primarily of depreciation, credit card processing fees, and licenses and fees, decreased by \$1.3 million and \$2.1 million for the three and nine months ended September 30, 2014. The decrease in expenses for the periods was the result of the Company's intangible assets becoming fully amortized, the reduction of corporate owned centers, a reduction in revenue, a decrease in the sales taxes paid for by the Company on behalf of the customer, and general improvements in expense control.

**Income taxes:** In the third quarter of 2014, the Company recorded \$2.0 million in income tax expense, an effective rate of 29.1%, compared to \$2.2 million in income tax expense, an effective rate of 28.0% in the third quarter of 2013. For the nine months ended September 30, 2014, the Company recorded \$8.0 million in income tax expense, an effective tax rate of 32.6%, compared to \$8.8 million in income tax expense, an effective tax rate of 32.0% for the nine months ended September 30, 2013. The increase in the effective tax rate for the third quarter of 2014 in comparison to 2013 was primarily due to the reduction of the state effective tax rate that was offset by the decrease in the permanent difference of the manufacturer domestic deduction. The minimal increase in the effective tax rate for the nine months ended September 30, 2014 in comparison to 2013 was mainly due to the impact of the research and development credits that were in effect in 2013, coupled with the reduction in the state effective tax rate. The Company anticipates a full year tax rate of approximately 33-34% in 2014.

**Net income:** Net income was \$4.9 million in the third quarter of 2014 compared to \$5.7 million in the third quarter of 2013, a decrease of \$0.8 million. For the nine months ended September 30, 2014, net income was \$16.5 million compared to \$18.7 million in the prior year. Pre-tax profit as a percent of sales increased to 9.3% in the third quarter of 2014 compared to 9.1% in the third quarter of 2013. For the nine months ended September 30, 2014, pre-tax profit as a percent of sales increased to 10.2% compared to 9.8% for the prior year. The improvements in profit despite a 14.7% and 13.7% decrease in revenue quarter-over-quarter and year-over-year, respectively, and the \$1.6 million in extraordinary legal and advisory expenses incurred in relation to the recent 13D filings, is a result of the Company's continued efforts to closely monitor spending as demonstrated in its decrease in selling, general and administrative expenses outlined above. The year-over-year profit improvement is also driven by the gain on the sale of the centers.

## **Liquidity and Capital Resources**

The Company had stockholders' equity of \$82.6 million and working capital of \$51.7 million on September 30, 2014 compared with \$98.4 million and \$64.9 million at December 31, 2013. The \$15.9 million net decrease in stockholder's equity reflects \$16.5 million in 2014 profits, significantly offset by the \$33.9 million used to purchase shares of the Company's common stock as well as the other equity transactions outlined in the "Consolidated Statement of Changes in Stockholders' Equity". The Company's cash and cash equivalents position decreased from \$36.4 million at December 31, 2013 to \$27.6 million at September 30, 2014.

In the nine months ended September 30, 2014 the Company generated cash flow of \$24.6 million from operations, partially attributable to \$16.5 million in net operating income. Sources of cash of \$12.4 million include depreciation and amortization of \$7.3 million, share-based compensation of \$1.9 million, a \$1.9 million decrease in inventory, a \$1.0 million decrease in prepaid expenses and other current assets, and a \$0.3 million increase in accounts payable and accrued expenses. This was offset by a total use of \$4.3 million which includes a deferred income tax benefit of \$1.3 million, a \$1.1 million increase in accounts receivable, a \$1.0 million increase in income taxes, and a \$0.9 million realized gain on investment securities.

In the nine months ended September 30, 2014, net cash generated in investing activities was \$0.7 million, which was due to \$19.7 million for the purchase of investment securities offset by \$23.4 million of cash generated by the sale of investment securities and \$4.2 million for the purchase of property and equipment offset by \$1.2 million of cash generated by the sale of property and equipment.

In the nine months ended September 30, 2014, financing activities used \$34.0 million in cash including \$33.9 million for the repurchase of shares of the Company's common stock and \$0.2 million for the repayment of capital leases.

In pursuing its business strategy, the Company may require additional cash for operating and investing activities. The Company expects future cash requirements, if any, to be funded from operating cash flow and financing activities.

The Company has an undrawn, unsecured, revolving \$5 million line of credit with Bank of America. The line of credit will expire on August 1, 2015, at which point the Company expects to extend the term or pursue other financing opportunities.

On August 28, 2014, the Company adopted a stockholders' rights plan whereby the Board of Directors authorized and declared a dividend distribution of one right for each outstanding share of common stock of the Company to the stockholders of record at the close of business on September 9, 2014. The rights are not presently exercisable and remain attached to the shares of common stock until the occurrence of certain triggering events. The rights will expire on August 28, 2015, unless exercised, redeemed, or exchanged prior to that time. The Board of Directors may terminate the rights plan before the expiration date.

The Company evaluates acquisitions from time to time as presented.

#### **Off-Balance Sheet Arrangements**

The Company has entered into guarantee agreements with two key franchisee partners in order to support them obtaining additional funding to expand their business into new markets. This is in line with the Company's long-term strategy of expanding the franchise business utilizing knowledgeable franchise partners.

The first guarantee provides financial coverage for a \$1.0 million loan and a \$1.0 million line of credit. The variable rate term loan has a 2 year term expiring in September 2015; payment calculations assume a 7 year amortization with a balloon payment due at the end of the term. The line of credit has a two year term expiring in September 2015. In October 2014, the franchisee associated with these loans closed seven centers due to poor performance. Upon the triggering event of the Franchisee loan default, the Company may be required to perform under this guarantee resulting in a charge up to \$2.0 million. The Company is a secondary guarantor on the loan and line of credit and therefore has personal recourse against the franchisee owner should it be deemed necessary.

The second guarantee provides financial coverage for a \$1.0 million loan and a \$0.5 million revolving line of credit. The revolving line of credit is due in full no later than October 2015. The variable rate term loan has a 2 year term expiring in October 2015; payment calculations assume a 7 year amortization with a balloon payment due at the end of the term. The Company is the third guarantor on these loans and has recourse against an another entity owned by the franchisee and the franchisee owner(s) themselves should it be deemed necessary.

**SEGMENT RESULTS OF OPERATIONS**

| Segments           | Net Sales by Segment for the three months ended September 30, |            |               |            |  |  |
|--------------------|---|------------|---------------|------------|--|--|
|                    | 2014  |            | 2013          |            |  |  |
|                    | Sales   | % of Total | Sales         | % of Total |  |  |
| Medifast           | \$ 63,344,000   | 86 %       | \$ 73,324,000 | 85 %       |  |  |
| MWCC and Wholesale | 10,648,000  | 14 %       | 13,156,000    | 15 %       |  |  |
| Total Sales        | \$ 73,992,000   | 100 %      | \$ 86,480,000 | 100 %      |  |  |

| Segments           | Net Sales by Segment for the nine months ended September 30, |            |                |            |  |  |
|--------------------|--|------------|----------------|------------|--|--|
|                    | 2014   |            | 2013           |            |  |  |
|                    | Sales  | % of Total | Sales          | % of Total |  |  |
| Medifast           | \$ 206,706,000   | 86 %       | \$ 238,625,000 | 85 %       |  |  |
| MWCC and Wholesale | 34,698,000   | 14 %       | 40,970,000     | 15 %       |  |  |
| Total Sales        | \$ 241,404,000   | 100 %      | \$ 279,595,000 | 100 %      |  |  |

*Medifast Segment:* The Medifast segment consists of the sales from Medifast Direct and Take Shape For Life. As this represents the majority of our business, this is discussed in the Overview of Financial Results above.

*The MWCC and Wholesale Segment:* The MWCC and Wholesale segment consists of the sales of Medifast Corporate and Franchise Weight Control Centers as well as Medifast Wholesale Physicians. Sales decreased \$2.6 million, or 20%, and \$6.3 million or 15%, for the three and nine months ended September 30, 2014 as compared to 2013. The decrease in sales for both of the periods was driven by the closure of 11 and sale of 24 corporate centers over the prior twelve months, the accrued impact from the creation of a loyalty program, and the Company's focus to improve profitability by creating operational efficiencies, optimizing staffing, and managing expenses. The Company had 51 corporate centers and 69 franchise centers in operation as of September 30, 2014 compared to 86 and 36, respectively in 2013.

| Segments                   | Income Before Income Taxes by Segment for the three months ended September 30, |            |              |            |  |  |
|----------------------------|--|------------|--------------|------------|--|--|
|                            | 2014   |            | 2013         |            |  |  |
|                            | Profit   | % of Total | Profit       | % of Total |  |  |
| Medifast                   | \$ 8,086,000   | 118 %      | \$ 8,601,000 | 109 %      |  |  |
| MWCC and Wholesale         | 820,000  | 12 %       | 528,000      | 7 %        |  |  |
| All Other                  | (2,061,000)  | -30 %      | (1,251,000)  | -16 %      |  |  |
| Income before income taxes | \$ 6,845,000   | 100 %      | \$ 7,878,000 | 100 %      |  |  |

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| Segments                   | Income Before Income Taxes by Segment for the nine months ended September 30, |            |   |                |            |   |
|----------------------------|---|------------|---|----------------|------------|---|
|                            | 2014<br>Profit  | % of Total |   | 2013<br>Profit | % of Total |   |
| Medifast                   | \$ 28,510,000   | 116        | % | \$ 29,452,000  | 106        | % |
| MWCC and Wholesale         | 846,000   | 3          | % | 2,157,000      | 8          | % |
| All Other                  | (4,820,000)   | ) -19      | % | (4,143,000)    | ) -14      | % |
| Income before income taxes | \$ 24,536,000   | 100        | % | \$ 27,466,000  | 100        | % |

*Medifast Segment:* The Medifast reporting segment consists of the activity of Medifast Direct and Take Shape For Life. This represents the majority of our business and is discussed in the Overview of the Financial Results section above. Also see Note 10, “Business Segments” of the financial statements for a detailed breakout of expenses.

*The MWCC and Wholesale Segment:* Profitability of this segment increased \$0.3 million for the three months ended September 30, 2014, compared to 2013. The improvement was driven by the closure of 11 corporate centers, the transition of 24 centers to the franchise model at the end of the second quarter and the opening of additional franchise centers over the prior twelve months. Profitability decreased \$1.3 million for the nine months ended September 30, 2014 compared to 2013. The decline was caused by the decrease in revenue compounded by the accrued impact from the creation of a loyalty program and reduced program sales in comparison to the prior year. These were offset by the opening of additional franchise centers over the prior twelve months, the closure of 11 and sale of the 24 corporate centers at the end of the second quarter, and the Company's continued focus to optimize spending as a percentage of sales for each corporate center.

The Company had 51 corporate centers and 69 franchise centers in operation as of September 30, 2014 compared to 86 and 36, respectively in 2013.

*Other:* Other segment consists of income on investments and corporate expenses related to the Company's operations that are unrelated to a particular operating segment. Corporate expenses include items such as auditors' fees, attorney's fees, stock compensation expense and corporate governance expenses related to compliance with NYSE, Sarbanes Oxley, and SEC regulations. See footnote 10, "Business Segments", for additional detail. Corporate expenses increased \$0.8 million and \$0.7 million for the three and nine months ended September 30, 2014 compared to the prior year. The changes were primarily driven by increased legal fees.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest rates and a decline in the stock market. The Company does not enter into derivatives, foreign exchange transactions or other financial instruments for trading or speculative purposes. The Company paid off its outstanding debt during the first quarter of 2013, eliminating its current exposure to interest rate risk. However, it has an undrawn and unsecured revolving line of credit for \$5,000,000, should it choose to draw on this line of credit in the future it would be subject to market risk due to changing interest rates.

The Company is exposed to market risk related to changes in interest rates and market pricing impacting our investment portfolio. Its current investment policy is to maintain an investment portfolio consisting mainly of U.S. money market and high-grade corporate securities, directly or through managed funds. Its cash is deposited in and invested through highly rated financial institutions in North America. Its marketable securities are subject to interest rate risk and market pricing risk and will fall in value if market interest rates increase or if market pricing decreases. If market interest rates were to increase and market pricing were to decrease immediately and uniformly by 10% from levels at September 30, 2014, it estimates that the fair value of its investment portfolio would decline by an immaterial amount and therefore it would not expect its operating results or cash flows to be affected to any significant degree by the effect of a change in market conditions on our investments.



There have been no material changes to our market risk exposure since December 31, 2013.

#### **Item 4. Controls and Procedures**

Management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of September 30, 2014. Our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported accurately and on a timely basis. Based on this evaluation performed in accordance with the criteria established in the 1992 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, our management concluded that the Company’s disclosure controls and procedures are effective of the reasonable assurance level as of the end of the period covered by this report.

#### **Changes in Internal Control over Financial Reporting:**

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended September 30, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **Part II Other Information**

#### **Item 1. Legal Proceedings**

The Company filed a civil complaint on February 17, 2010 in the U.S. District Court (SD, Cal) against Barry Minkow and the Fraud Discovery Institute, Inc. (collectively, “Minkow”), iBusiness Reporting, and its editor William Lobdell, Tracy Coenen and Sequence, Inc. (collectively, “Coenen”), “Zee Yourself”, and Robert L. Fitzpatrick (“FitzPatrick”) for defamation, market manipulation and unfair business practices, alleging a scheme of market manipulation of the Company’s common stock by defendants’ for monetary gain, and damaging the business reputation of the Company and its Take Shape For Life division. Bradley T. MacDonald, former Executive Chairman of the Company and a stockholder, joined the lawsuit individually. The lawsuit seeks \$270 million in compensatory damages, punitive damages, and ancillary relief. In March 2011, the District Court granted in part and denied in part certain Anti-SLAPP Motions to Strike (i.e. motions to dismiss) previously filed by all Defendants. The Company appealed that portion of the District Court’s ruling which dismissed its defamation claims against Minkow and Coenen in the 9th Circuit Court of Appeals. Defendant FitzPatrick’s motion was denied as to the

Company's defamation claim, and FitzPatrick appealed that portion of the Court's ruling. On June 4, 2014, the Panel of the 9th Circuit Court of Appeals issued a decision, denying FitzPatrick's appeal and remanding to the District Court for further consideration; reversing the District Court's decision as to Minkow and remanding for further consideration; denying MacDonald's appeal in its entirety; and denying the Company's appeal as to Coenan. The District Court now has jurisdiction over the matter and has set up a briefing schedule to address the various issues raised by the Ninth Circuit with regard to defendants Minkow and Fitzpatrick. The case as to Coenan and certain other defendants has been finally dismissed, and the Company is evaluating its options regarding the fee applications submitted by these parties.

**Item 1A. Risk Factors**

There have been no material changes to the risk factors set forth in Part I, Item 1A of the Form 10-K.

**Item 5. Other Information**

At the outset of the quarter ended September 30, 2014, there were 888,000 shares of the Company's common stock eligible for repurchase under the repurchase authorization dated December 12, 2013. On September 16, 2014, the Company authorized an additional 1 million shares of common stock to be repurchased.

The following is a summary of our common stock purchases during the quarter ended September 30, 2014:

| Period                           | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------------------------|----------------------------------|------------------------------|--|--|
| July 1 - July 31, 2014           | -                                | \$ -                         | -  | 888,000  |
| August 1- August 31, 2014        | 676,092                          | \$ 28.76                     | 676,092  | 211,908  |
| September 1 - September 30, 2014 | -                                | \$ -                         | -  | 1,211,908  |

**Item 6. Exhibits**

## EXHIBIT INDEX

## Exhibit Number Description of Exhibit

|     |  |
|-----|--|
| 3.1 | Certificate of Incorporation of the Company and amendments thereto incorporated by reference to Exhibit 3.1 of the Company's current report on Form 10-K filed March 31, 2010. |
|-----|--|

- 3.2 Amended and Restated Bylaws of Medifast, Inc. effective June 17, 2014 (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K (File No. 001-3573) filed on June 20, 2014).
  - 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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**SIGNATURES**

Pursuant to the requirements 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.

**Medifast, Inc.**

BY:/S/ MICHAEL C. MACDONALD November 10, 2014

Michael C. MacDonald  
Chief Executive Officer  
(principal executive officer )

BY:/S/ TIMOTHY G. ROBINSON November 10, 2014

Timothy G. Robinson  
Chief Financial Officer  
(principal financial officer)

EXHIBIT INDEX

Exhibit Number Description of Exhibit

|      |   |
|------|---|
| 3.3  | Amended and Restated Bylaws of Medifast, Inc. effective February 5, 2014 (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K (File No. 001-3573) filed on February 11, 2014). |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |

In accordance with SEC Release No. 33-8238, Exhibit 32.1 is being furnished and not filed.