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HLF - Q1 2012 HERBALIFE LTD Earnings Conference Call

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OVERVIEW:

HLF reported 1Q12 net sales of \$964.2m and diluted EPS of \$0.88. Expects full-year 2012 fully diluted EPS to be \$3.58-3.74 and 2Q12 fully diluted EPS to be \$0.91-0.95.



CORPORATE PARTICIPANTS

Brett Chapman *Herbalife Ltd - General Counsel*

Michael Johnson *Herbalife Ltd - Chairman, CEO*

Des Walsh *Herbalife Ltd - President*

John DeSimone *Herbalife Ltd - CFO*

CONFERENCE CALL PARTICIPANTS

Mike Swartz *SunTrust Robinson Humphrey - Analyst*

David Einhorn *Greenlight Capital - Analyst*

Tim Ramey *D.A. Davidson & Co. - Analyst*

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Linda Bolton Weiser *Caris & Company - Analyst*

John San Marco *Janney Montgomery Scott - Analyst*

Anand Vankawala *Avondale Partners - Analyst*

PRESENTATION

Operator

Good morning and thank you for calling --joining the first quarter 2012 earnings conference call for Herbalife, Ltd. On the call today is Michael Johnson, the Company's Chairman and CEO; the Company's President, Des Walsh; John DeSimone, the Company's CFO; and Brett Chapman, the Company's General Counsel. I would now like to turn the call over to Brett Chapman to read the Company's Safe Harbor language.

Brett Chapman - Herbalife Ltd - General Counsel

Before we begin, as a reminder, during this conference call, comments may be made that include some forward-looking statements. These statements involve risk and uncertainty and, as you know, actual results may differ materially from those discussed or anticipated. We encourage you to refer to yesterday's earnings release and our SEC filings for a complete discussion of risks associated with these forward-looking statements and our business.

In addition, during this call certain financial performance measures may be discussed that differ from comparable measures contained in our financial statements prepared in accordance with US generally accepted accounting principles, referred to by the Securities and Exchange Commission as non-GAAP financial measures. We believe these non-GAAP financial measures assist Management and investors in evaluating and comparing period to period results of operations in a more meaningful and consistent manner.

Please refer to the Investor Relations section of our website, www.herbalife.com to find our press release for this quarter which contains a reconciliation of these measures. Additionally, when Management makes reference to volume during this conference call, they are referring to volume points. I will now turn the call over to Michael.

Michael Johnson - Herbalife Ltd - Chairman, CEO

Thanks, Brett. Good morning everyone and welcome to our first quarter 2012 earnings conference call. Our financial and business trends continue to be strong. Yesterday we announced a 24% increase in EPS, driven by a 24% volume point growth. Each of our six regions experienced strong volume point growth in the quarter.



Five of the six regions had double-digit volume increases. Four of our regions -- Asia, North America, China, South and Central America -- exceeded 20% growth. Mexico had a 16% increase in volume points and EMEA was up 6%. Before I elaborate on the quarter, let me say thank you to our distributors, employees and vendors around the world. The consistency of our growth and financial results is due to your dedication and hard work.

My ninth anniversary with the Company was in April, and as I approach my first decade at Herbalife, I've been reflecting on how much our Company and business have changed over the past decade, primarily because more people than ever are using our products every day. We call that daily consumption.

We have worked very hard to position Herbalife as a global nutrition company that uses network multilevel marketing as its channel of distribution, which we believe by the nature of our human network is a competitive advantage for selling nutrition products in both developed and emerging markets. Our independent distributors are leading this transformation by focusing on creating loyal customers. Their efforts include employing business methods that offer the opportunity for frequent interaction between the distributor and her or his customer. This interaction fosters proper use of our products, while providing the person to person support that leads to a successful product result.

Whether the individual's goal is weight loss or weight gain, weight maintenance, improved health, improved athletic performance, more energy, healthy skin nutrition, or outstanding daily nutrition, our product results drive our customer loyalty and our customer retention. We use the name daily consumption to refer to any distributor business method that allows for frequent customer interaction and focuses on creating long life consumers. Our independent distributors are reinventing the Herbalife direct selling model with daily consumption. It is one of the key drivers of our growth. Today we estimate that more than a third of our volume is being transacted through daily consumption.

These business methods and our journey is just beginning. We have enough data and history to support our belief that daily consumption business methods create more long-term customers and therefore more long-term success for our distributors. While our distributors are independent business operators and choose the method that works best for them in their respective markets, we work with distributors on identifying and training best practices from markets around the world, many of which are grounded in daily consumption. These best practices are high customer touch, and are sustainable, and have high retention. At Herbalife, we have a culture of constant improvement with a goal of moving Herbalife from a good to a great Company.

One of the areas of focus has been able to make modifications in our marketing plan to help our distributors widen their businesses. We made a change in 2009 to our marketing plan that allows distributors to become sales leaders over a longer period of time, building their businesses in a less aggressive, more sustainable manner. This change better reflected important business tenets of the daily consumption business methods having so much success around the world, slower, methodical and sustainable growth through the establishment of a solid customer base.

Later this year, we will begin testing a maximum volume point limit for first time orders. The test will place a cap of 1,500 volume points on first orders from new distributors. We believe limiting first orders will help the new distributor develop a solid foundation for success, taking the extra time to understand the Company, our products and the business before making a larger financial commitment. It may sound odd, but essentially we are speeding up by slowing down.

Another aspect of our constant improvement culture is in the science and manufacturing infrastructure of our products, which we call our Seed To Feed strategy. Self manufacturing is and will continue, in the future, to be an important focus for several reasons. First, to ensure that we continue to deliver the highest quality products to our distributors. Second, to support the growth of an increased demand for product around the world. Third, to drive distributor engagement through the confidence they feel regarding the quality of the product. And last, but certainly not least, we believe that to be a leader in the nutrition and supplement industry with regulators around the world, it is important that we be in more control of the manufacturing process for a greater percentage of our products.

We also strive to be a positive influence in the nutritional supplement industry, urging and supporting requirements for adverse event reporting. We believe it was this type of leadership that allowed us to attract people of high caliber like Dr. Bill Frankos, the former head of the Dietary Supplement Division of the FDA, who joined Herbalife to lead our science and safety efforts.



Herbalife is self manufacturing more product than we ever have in the past. We are currently manufacturing approximately 30% of our global volume. Our goal is to self manufacture as much as two-thirds of our inner nutrition products, including the extraction of the raw botanical ingredients used in many of our products today. With respect to science, we often use the terms R&D or Research and Development interchangeably with science. To be clear, we have 180 employees with scientific degrees across a number of disciplines who are employed in ensuring that our products are safe and efficacious. A portion of what our scientists work on is considered by accounting rules to be R&D.

In addition, we dedicate a majority of our spending in the areas of product reformulation and improvement, method development, stability testing, quality testing and international registrations, all of which play a vital role in providing the highest quality product to our distributors and their customers around the world. With respect to new products, they are an important element of driving distributor excitement and engagement. But unlike traditional CPG companies, new products in our distribution channel take time to be integrated into distributor business methods. They first need to have product results. And then they need to understand how to sell the new products, which in turn can generate meaningful future business for them.

For example, our two significant product launches during the past 18 months, Prolessa and our Herbalife24 sports line, represented approximately 1.5% of worldwide volume and 5% of North American volume in the first quarter. But notably the Herbalife24 line is attracting the creation of new business methods and new distributors who have an athletic and performance focus for their Herbalife distributorship. Another area of evolution and transformation of Herbalife in this decade has been the emphasis on building a brand that focuses on using our products to support a healthy, active life.

For many years, the Herbalife message was --Lose Weight Now, Ask Me How. Today we've added to that theme --Hey, I'm An Herbalife independent distributor. Let me give you a shake that's going to be the most nutritious meal you'll have today. Let me help you reach your healthy weight and maintain it through outstanding daily nutrition. Now that's no slogan so today, we are -- Have you had your shake today? That's the Herbalife of today.

The first place we focus on in building our brand is with our distributors and our employees. Our brand is built through each and every experience we have with customers and our communities. Our distributors know that the expectations and claims that they present for our products and our business opportunity will come under more scrutiny than ever before with the increased use of social media and the watchful eye of regulators. We welcome this increased awareness.

Along with our distributor leaders, we are consistent in teaching the importance of integrity and ethics in everything we say and do. When the facts have proven otherwise, we will work with all team Herbalife members, whether the individual is an Herbalife independent distributor, an employee, or even a vendor, to make sure they understand the uncompromising stance we have on taking the high road.

We also promote community service. The more we are all involved in our vision of making our communities better places to live and work, the stronger we will be and our brand will be. We also promote our brand through the association of our products with healthy active lifestyle of sports. We continue and currently sponsor some of the top teams and athletes around the world. And this is a huge source of pride for our distributors. We are a global nutrition Company and athletes and their trainers are influencers in this important area and our distributors help create more access to our products than ever before.

Building a recognized and respected brand and image is a process in which our distributors, and employees, and vendors all participate. We are on a mission to build our Company to be the best at everything we do. As we discussed a few weeks earlier at our Analyst Day, our theme for 2012 is Build A Better. That's truly been our approach for the past nine years and it is a rewarding journey that will continue long into the future.

Investors often ask me, what gives me so much confidence about our future. First of all, I have tremendous respect for our distributor leadership, the women and the men in the field every day working to provide the best daily nutrition to customers around the world and an opportunity for part time or full time income. Our employee team at Herbalife is committed to a collective vision that supports our distributors and their businesses. And we are constantly looking into the future, building and doing it better every single day. We are all incredibly proud to be associated with Herbalife of today and excited about the Herbalife of tomorrow.



Secondly, and you'll hear more from Des about this, our city by city initiative. When you see a city like Zacatecas, Mexico or Reykjavik, Iceland where our penetration and retention rates are very high, you also see a shining Herbalife brand. Our product results are on display because so many people are using our products every day. Our distributors are engaged in building and protecting the brand because these are their communities, this is where they live. They are not some far away brand. They are local and active in the lives of those around them. As we continue to foster the transformation in our business, our distributors will lead the way through daily consumption, deeper city penetration, increased engagement and they will be wearing and living the brand in cities all over the world. To me, that says go confidently into the future.

Thank you for your continued support along our wonderful journey. Now let me turn it over to Des.

Des Walsh - Herbalife Ltd - President

Thank you, Michael. The first quarter was our third consecutive quarter of more than 1 billion volume points and was 24% higher than last year's first quarter results, and is now the highest volume point quarter in Herbalife's history. As Michael mentioned, we continue to be very pleased with the momentum we see and the underlying trends in our business as all six regions posted volume point growth and five regions finished the quarter with double-digit volume point gains.

The main driver of our growth continues to be the adoption and the expansion of daily consumption business methods. Additionally, this initiative has been augmented with the expanded use of systemized training methods that enhance training for new distributors and sales leaders. And our city by city approach continues to localize the Herbalife opportunity and distributor support.

Daily consumption business methods not only drive increased distributor engagement, they also drive increased consumer engagement. One key characteristic of daily consumption business methods, whether nutrition clubs, weight loss challenges, our distributor-led fitness camps is that the distributor and their customers have much more frequent contact than is normal for traditional direct sellers. As Michael mentioned a few moments ago, the benefit of creating lifelong customers cannot be underestimated for either the distributor or the Company. And with daily consumption in its infancy in so many markets, we believe we have a long runway of growth still ahead of us.

Let me spend a few minutes discussing nutrition clubs and, perhaps more importantly to some of you, the number of commercial nutrition clubs our distributors are operating. In the past, we have provided investors with a global count of nutrition clubs that encompass both home-based and commercial clubs. However, while both are estimates, the number of home clubs has been much more challenging to establish than commercial clubs. So starting today, we will provide you with our estimated number of commercial clubs on a regional basis.

It is important to remember that this is an estimated number of clubs based on information provided by distributors. We have begun a validation process for commercial clubs utilizing different methods of tracking by region. It's not a precise science and we are further along in the validation process in some regions, but we do understand that for many of our investors and analysts, this is a number that they feel is important for their investment thesis.

We estimate that in the first quarter of 2012, there were approximately 33,500 commercial or non-residential clubs. As we mentioned in our last quarter, and at our recent Analyst Day, we believe that approximately 34% to 41% of our overall volume is currently driven by daily consumption business methods. Distributor engagement continues to be strong as evidenced by the average active sales leaders growth of 23% again this quarter. This is our fifth consecutive period of greater than 20% growth in this metric, which we believe speaks to the momentum in our business.

Now let me provide regional highlights and color on some key regions. The North American region had another strong quarter posting almost 26% net sales and local currency net sales growth and 23% growth in volume points, each compared to the prior year period. New distributors increased 17% in the quarter, and average active sales leaders increased 19% in the North American region compared to last year's first quarter results. Interestingly, this is the strongest average active sales leader growth for the region since we began reporting the metric in 2008. We estimate there are approximately 3,550 commercial nutrition clubs in the region.

For the quarter, US net sales grew 26%, and volume points increased 23%, versus the same quarter last year. Compared to the prior year period, new distributors in the US increased 17%, and average active sales leaders increased 19%. The growth in the US continues to be driven by the

expansion of daily consumption business methods, particularly in the general market segment of the business, building on the continued successes of our Latino business. In the US, we are seeing continued momentum and business growth in the Generation H distributor group, our name for those distributors under 35 years old. We are seeing very exciting adaptations of the nutrition clubs spring up through this group and a higher utilization of the Herbalife24 products in addition to stronger use of social networking.

We are also very pleased to see long standing distributors beginning to re-engage, often incorporating nutrition clubs and daily consumption in their daily methods of operation. As we have discussed before, within the distributor base success often begets success. As more distributors are seeing like-minded distributors having success with different business methods, they too are inclined to also incorporate those methods into their business.

Moving on to Mexico, local currency net sales for the quarter increased 21% and volume points increased 16%. Each is compared to the prior year period. For the first quarter, new distributors increased 7% compared to the prior year, and average active sales leaders increased 24% for the quarter. This is the fifth consecutive quarter that the region has posted an increase in average active sales leaders greater than 20% over the comparable period of the prior year.

As we have discussed in prior quarters, we are continuing to see more distributors in Mexico adopt a non-residential nutrition club model, which is helping to expand consumer access to clubs and Herbalife product. In Mexico, we estimate that there are currently about 10,700 non-residential nutrition clubs. Secondly, many distributors in the region have been integrating more structured training methods into their businesses that introduce an element of discipline that is proving to be beneficial in helping distributors grow their nutrition club businesses.

The Asia Pacific region continues to grow. During the first quarter, local currency net sales increased 34% and volume points grew 38%. Each is compared to the prior year period. For the first quarter, new distributors increased 44% versus the prior year. The growth within the region continues to be driven by the expansion of daily consumption business methods and the high degree of distributor engagement. Average active sales leaders increased 38% in the quarter, over the same quarter in 2011.

While we continue to see strong growth out of both Korea and India, we are very pleased with the growth of the other markets within the region, particularly Indonesian and Malaysia, two countries that experienced volume point increases of more than 100% and 50%, respectively, compared to the prior year period. In India, we continue to work with our distributor leadership to ensure that distributor training keeps pace with the strong growth we continue to see in that country.

Applying the city-by-city tactics within the Asia Pacific region, we've identified a significant number of potential sub regions, where, over the next several years, we may place localized sales support that will work alongside distributor leadership to help support the key elements of daily consumption and systemized training programs. Within the Asia Pacific region, we estimate that there are about 9,500 non-residential nutrition clubs.

In May, several of us will be in Asia for our two regional extravaganzas where we are expecting 20,000 distributors in Korea and an additional 25,000 distributors in Singapore. And assertive of the strong growth that the region has been seeing, last year we had only one extravaganza with 20,000 attendees compared to this year's two events with more than twice as many people.

Local currency net sales in the South and Central America region increased 36%, and volume points in the region were up 32%, each as compared to the first quarter of 2011. Average active sales leaders in the region increased 31% over last year's first quarter. New distributors increased 16% for the quarter compared to the prior year period. One of the things that we continue to be pleased with in the South American region is that daily consumption is moving out of the early adopter markets in the region and is now driving sales throughout numerous countries in the region.

All but one market in the region posted positive volume point growth in the quarter, which we believe illustrates how the momentum behind daily consumption can continue to drive growth in the marketplace. We estimate that there were approximately 7,400 non-residential nutrition clubs in the region as of March 31, 2012.



Within the South and Central American region, we need to mention the strength we are continuing to see in Brazil. Brazil experienced volume point growth of approximately 22% in the first quarter, as both nutrition clubs and traditional business methods continued to experience growth. Our distributors in this market are just beginning to scratch the surface of the real market opportunity.

Turning to EMEA, during the first quarter, local currency net sales increased almost 5%, and volume points in the region grew 6%, compared to the same period in the prior year. New distributors for the first quarter increased 10% over the prior year period, average active sales leaders in the region were up 15% in the quarter, as each is compared to the first quarter 2011. We estimate that there were approximately 1,200 non-residential clubs at the end of the first quarter, of which approximately 50% are located in Russia.

Within EMEA, Russia had another amazing quarter. Compared to the first quarter 2011, this quarter's volume points were up approximately 26%, with a 43% increase in new distributors. Russia continues to be a market that exemplifies the benefits of a market built on daily consumption, systemized training, a unified distributor leadership group, and a city by city focus. It has had strong volume point growth for the past eight consecutive quarters and new distributor growth for the past six consecutive quarters. As we reported last quarter, this is also a market that had annual sales leader retention of 77%, compared to our Company average of 52%. The strength of these core metrics illustrate the benefits created by building a business on a strong, stable foundation grounded in daily consumption, coupled with a systemized training, and a local focus city by city.

We were encouraged by the continued success of weight loss challenges throughout countries in Western Europe, and the growth of nutrition clubs in more southern markets. And, like the US, we launched the Herbalife24 product in the fall and we believe we are seeing a younger, athletic distributor group in Western Europe really embrace this product.

We are often asked about daily consumption and growth in Western Europe. The UK is a good example of how daily consumption can bring change to a market. This quarter, we experienced almost 36% growth in volume, and a 48% increase in new distributors in the UK, our oldest market in the EMEA region, largely driven by the success of the weight loss challenge concept and distributors' focus on healthy, active lifestyle.

Now let's turn to China, where local currency net sales increased 19%, and volume points grew 25% in the first quarter compared to the prior year period. While we continue to believe that our sales leaders in China are making progress at culturing the concept of daily consumption, we believe that we are still working to fine tune the nuances of the daily consumption model that will work best in the market. We continue to see more nutrition clubs open and while we are very pleased with the progress of the business in China, we remain cautious about expecting too much, too soon from this market. We are focused there on building a sustainable business on a solid foundation of long-term customers. We estimate that there were approximately 1,000 nutrition clubs in China as of the first quarter.

Before I turn the call over to John, let me take a minute to applaud our distributors for another very strong quarter and also remind everyone on the call that we believe that the momentum we have seen in our business, due to the transformation to a more daily consumption based model, remains in the early stages and that there is still a long runway of opportunity ahead of us. Now let me pass the call over to John to review the financials.

John DeSimone - Herbalife Ltd - CFO

Thank you, Des. For the first quarter we reported net sales of \$964.2 million, an increase of 21.3% compared to the first quarter of 2011. For the period, foreign currency had an approximate 300 basis point drag on net sales and local currency net sales increased by 24.3%. Since Des has already covered in detail all the necessary color of our volume and net sales results, I will move on to gross margin.

Our gross profit margin improved slightly compared to the first quarter of last year. Our Seed to Feed strategy and price increases benefited gross margin in the quarter by approximately 40 basis points each, partially offset by the impact of currency on gross margin, and by country mix, as well as slightly higher inventory reserves. Sequentially, gross profit margins declined by approximately 100 basis points, comprised of the negative impact of currency in excess of 100 basis points, which was partially offset by the additional benefits from our Seed to Feed strategy.



As I discussed last month at our Analyst Day, the foreign currency impact to gross margin for countries that purchase most of their product from the US, as opposed to being purchased locally, have a lag of essentially one inventory turn. Accordingly, the impact from the strengthening dollar during the latter part of 2011 is reflected in our Q1 results and negatively impacts the sequential comparison.

Turning to SG&A. SG&A as a percentage of sales, both with and without China independent service provider expenses, was essentially flat for the quarter compared to a year ago. From a dollar perspective, most of the increases this year are associated with the volume growth that we've experienced. However, specific to recorded foreign currency gains and losses, this year's first quarter included \$9.1 million in losses, compared to \$2.1 million recorded in the prior period, resulting in a net negative impact of approximately \$7 million in the comparison to last year's quarter.

Included in this quarter's recorded FX losses, was approximately \$2 million, relating to the repatriation of bolivars from Venezuela. Based on current accounting guidance, we used the SITME rate of VEF5.3 to \$1 to re-measure our results in Venezuela. However, the effective exchange rates of the transactions in the first quarter, though small in quantity, was approximately VEF9 to \$1. The difference between the two rates yielded approximately 40% less US dollars.

While we hope to continue to repatriate small amounts of bolivars each quarter, nothing is assumed in our current guidance. One additional comment on Venezuela. Although it may be a little early to note, we believe that sometime after Venezuela's Presidential election in October, either late this year or early next year, there could be a formal devaluation of the bolivar.

Moving on to taxes, the Q1 effective tax rate was approximately 210 basis points higher than a year ago and 70 basis points higher than the high end of our guidance range. The variance to guidance is due mostly to changes in geographic mix. However, we expect no change to the 2012 full year effective tax rate guidance previously provided.

First quarter diluted earnings per share of \$0.88 was \$0.17 better than the adjusted results from a year ago, and \$0.08 higher than the high end of our guidance range provided in February. This beat was primarily driven by higher volume as we exceeded the high end of volume guidance by 64 million volume points. Partially offsetting the benefit from higher volume was the negative impact of the higher effective tax rate previously noted. On a year-over-year basis, currency had a \$0.09 negative impact on this quarter's reported full year diluted earnings per share results.

With respect to cash flow for the quarter, the Company generated cash flow from operations of approximately \$120 million and free cash flow for the quarter, net of approximately \$25 million of CapEx, was \$95 million, which, as is common for the first quarter, was slightly below reported net income of approximately \$108 million. The \$25 million in capital expenditures is comprised of approximately \$15 million of IT costs, both infrastructure and new strategic initiatives, \$5 million on our Seed to Feed and operation strategies, and \$5 million on other items. During the first quarter, we repurchased \$50 million in common stock, which leaves us with approximately \$428 million remaining on our \$1 billion repurchase authorization.

Now I will discuss our guidance for 2012, both the second quarter and full year. First, for transparency, let me note the currency assumptions we utilized. Similar to the prior two quarters, we used average rates as opposed to any one specific spot rate. In this case, we used the average rate of the daily closing exchange rates during the first two weeks of April. These rates are better than the rates assumed in our previous guidance and favorably impacted guidance by \$0.05 for the full year. From a volume perspective, we are raising our annual volume expectations 200 basis points to a range of 12% to 14%, mostly reflecting the beat in Q1 with slight increases in each of the subsequent quarters.

For the second quarter we are providing initial guidance for volume point growth of 11.5% to 13.5%, which is on top of the impressive 17% and 20% volume growth we experienced in the prior two years. Fully diluted EPS in the second quarter is expected to be between \$0.91 and \$0.95. For the full year, we are raising our fully diluted EPS guidance range, adding \$0.18 and \$0.14 to the low end and the high end of the range previously provided. This results in new 2012 guidance of \$3.58 to \$3.74. The 2012 EPS guidance includes an approximate \$0.25 headwind from currency compared to 2011. Thank you, that ends our prepared comments. We will now open up the call for your questions.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And your first question is from the line of Mike Swartz with SunTrust Robinson Humphrey.

Mike Swartz - SunTrust Robinson Humphrey - Analyst

Good morning, everyone. Maybe you could start off by fleshing out some of your thoughts that you touched on in your opening remarks about the 1500 volume point limit that you are going to be instating at some point. Maybe you can quantify how many of your new distributors or what percentage order above that right now and do you expect any kind of short-term impact from that?

Des Walsh - Herbalife Ltd - President

Yes, hi, Mike, this is Des. One of the things we've seen with the increased adoption of the 5K supervisor qualification, is the tremendous impact that happens when people qualify as supervisors over an extended period of time and they do so having built a solid customer base. And so the 1500 volume point first order limitation is sort of a step in that same direction. We're going to be testing this in a number of countries and we think just like the 5K qualification, we think it's going to be a very positive addition to the business.

Mike Swartz - SunTrust Robinson Humphrey - Analyst

Is there any way to quantify maybe how many of your new distributors are coming in ordering more than that? Is it a very high percentage?

Des Walsh - Herbalife Ltd - President

So the majority of our distributors today come in using the 4K method or two months of 2500 volume points. What we saw is that for all of 2011, approximately 20% of worldwide supervisors now come in through the 5K method. In Russia, where, as you know, the 5K method was first implemented, about a year and a half before we rolled it out elsewhere, that number through the 5K method is 45%. So that sort of gets you just a rough indication of how many come in through the 4K method today if you subtract the two. But what we believe again, Mike, is this is another step along the road of daily consumption, where we have a lot of people doing a little volume and then moving up the marketing plan as a result.

Mike Swartz - SunTrust Robinson Humphrey - Analyst

Okay. Great. Then, second question, on Herbalife24, based on what you said in the preamble, it sounds like it was about \$15 million in the first quarter, is that right? Is that a run rate we should be looking at for the rest of the year?

Des Walsh - Herbalife Ltd - President

Directionally, that's correct, Mike. But again, we see Herbalife24 as having a greater impact than purely the product sale itself. What you're seeing is this is contributing to continuing to make Herbalife a hip, cool company, attract a younger generation of distributors and attract people who are focused on a healthy, active lifestyle. So we see the impact -- the halo effect of Herbalife24 way beyond the product sale itself.



Mike Swartz - SunTrust Robinson Humphrey - Analyst

Right. From what it sounds like, you are seeing a lot of new clubs open up around this product and you would assume that would mean it's not cannibalistic to the legacy portfolio, so maybe that \$15 million number should build as we move throughout the year.

Des Walsh - Herbalife Ltd - President

Yes, it's absolutely possible. You are right, by the way, Mike about the impact of the clubs. I think for those of you on the call who have actually seen the fit camps, the Herbalife24 is just an essential element of that, and we believe it's capable of attracting a whole new generation and focus for our distributors.

Mike Swartz - SunTrust Robinson Humphrey - Analyst

Great, thanks a lot.

Operator

Your next question is from the line of David Einhorn with Greenlight Capital.

David Einhorn - Greenlight Capital - Analyst

I've got a couple of questions for you. First is how much of the sales that you make in terms of final sales are sold outside the network and how much are consumed within the distributor base?

Des Walsh - Herbalife Ltd - President

David, we have a 70% customer rule, which effectively says that 70% of all products are sold to consumers or actually consumed by distributors for their own personal use. So, obviously what we've seen with Nutrition Clubs is that we now have visibility for the first time to our customers. You know that we reported on this call for the first time the number of commercial clubs around the world, which is in excess of 30,000. So that has given us visibility to the tremendous amount of products that are being sold directly through to consumers and we see that as a growing trend in our business.

David Einhorn - Greenlight Capital - Analyst

What is the percentage that is actually sold to consumers that are not distributors?

Des Walsh - Herbalife Ltd - President

We don't have an exact percentage, David, because we don't have visibility to that level of detail.

David Einhorn - Greenlight Capital - Analyst

Do you have an approximation?

Des Walsh - Herbalife Ltd - President

So again, going back to our 70% rule, we believe that it's at 70% or potentially in excess of that.

David Einhorn - Greenlight Capital - Analyst

Okay. What is the incentive for a supervisor to sign somebody up to become a distributor as opposed to -- if they are just going to consume for themselves, as opposed to just selling them the product for the mark-up? How does the supervisor come out better?

Des Walsh - Herbalife Ltd - President

I think there's two reasons for that. So, we know from our business today that many of our future supervisors and business builders come in as customers and then they become distributors. So the benefit from a supervisor is the ability for greater retention of that customer/distributor, because they are now earning a 25% discount. The second issue is that it preserves lineage. So obviously, if I sign you up, David, as a distributor, my hope and my expectation is that based on the tremendous product results that you are going to achieve, that you will have friends and families go to you and say -- Gosh, David, you look great, what are you on? You are going to respond and say I'm on Herbalife, and that will encourage you to say, wow, maybe this is a business opportunity I could be interested in. So the benefit for me as your supervisor is one, the discount that you would get and therefore my greater likelihood of retaining you as a permanent customer, and secondly, the hope that at some stage, you will decide to do the business and therefore that you are already in my lineage and as part of my group.

David Einhorn - Greenlight Capital - Analyst

Just so I understand this clearly, if I sell to a customer, I bought -- I'm a supervisor, I buy at a 50% discount, I sell to a customer, I make 50 points, if he pays the full price. If he signs up as a distributor and buys it himself, I get -- he gets a 25% discount and I get 7 points as a royalty? Is that how it works?

Des Walsh - Herbalife Ltd - President

No, you would get the other 25%.

David Einhorn - Greenlight Capital - Analyst

I would get 25% plus the 7?

Des Walsh - Herbalife Ltd - President

So unless you are in royalties, you would simply earn the difference. So you earn a 50% discount, you're selling at a 25% discount and so the difference between the two is your profit on that sale.

David Einhorn - Greenlight Capital - Analyst

Right, so if he signs up as a distributor and buys it for himself from Herbalife, I still get the 25%?

Des Walsh - Herbalife Ltd - President

That is correct.



David Einhorn - *Greenlight Capital - Analyst*

Okay, good. One last question, when you had your previous 10-K, you disclosed three groups of distributors at the low end -- you called 29% self consumers, 57% small retailers, and 14% potential sales leaders. Then that disclosure did not repeat in the subsequent 10-K, so I have two questions. First of all, how do you track that and how do you characterize and know which ones are which? And second, why did you stop disclosing that in the last 10-K? Is that something that you've stopped tracking or just stopped disclosing?

John DeSimone - *Herbalife Ltd - CFO*

David, hi, this is John. The criteria for grouping distributors into different classes was based off of their volume purchases. We're making assumptions that people below a certain volume weren't doing the business, they were buying self consumption. And I don't remember the exact amounts, but I can get it to you after the call. It's how we delineated between the three classes.

The reason we took it out of 10-K is a change in CFO, from Rich to me. I didn't view it as valuable information to the business or to the investors. However, we can easily provide the exact same breakout going forward, if you'd like. I could email it to you and to our investors. Again, I don't remember the exact delineation between the three classes but I can certainly get it to you. Our objective is to be completely transparent.

David Einhorn - *Greenlight Capital - Analyst*

Thanks, I appreciate that sort of follow up, that would be helpful. Thanks so much, guys.

Operator

Next question is from the line of Tim Ramey, from D.A. Davidson and Company.

Tim Ramey - *D.A. Davidson & Co. - Analyst*

Good morning. Focusing on EMEA for a second, just wondering how large the contribution from Russia is to EMEA, and if you have looked at it, how EMEA is doing without Russia, because it obviously seems to be a tale of two cities there.

Des Walsh - *Herbalife Ltd - President*

Tim, this is Des. So, obviously, Russia is the driving force behind the growth in EMEA. What's interesting for us of course is that everything that is happening in Russia we believe is duplicable in the rest of Europe. And so to that extent, the 5K adoption, the systemized training, the united leadership, the city by city approach, all of those are elements which are absolutely duplicable and which our leadership in other parts of Europe are very focused on. I think you know that the driving force behind Russia is one key leader. He in fact gave a master class at the end of last year which was attended by all of our top leaders throughout the rest of Europe. So that's one of the reasons that we think we are going to see those same philosophies spread to Western Europe and we're going to see that happen in the months ahead.

Tim Ramey - *D.A. Davidson & Co. - Analyst*

Sounds good. And John, if I could follow up -- thanks for your early heads up on the gross margin impact of the FX on inventory. How does that play out in the 2Q; can you give us any sense of how the 2Q will look on a sequential basis relative to gross margin?

John DeSimone - Herbalife Ltd - CFO

So, I don't know the answer off the top of my head, but I will get it to you. There's always one inventory lag, so I can easily get it, I just don't know the information off the top of my head. I don't think it's material. You are talking sequential, right, or are you talking (multiple speakers)?

Tim Ramey - D.A. Davidson & Co. - Analyst

Sequential. Terrific, thanks so much.

Operator

Our next question is from the line of Bill Leach with TIAA-CREF.

Bill Leach - TIAA-CREF - Analyst

I was just wondering why you haven't been more aggressive buying back your stock -- you only went down 200,000 shares from the fourth quarter -- given the fact you have a net cash position?

John DeSimone - Herbalife Ltd - CFO

We routinely buy back is what we [total invest] around \$50 million worth of stock a quarter. We have the capacity to do much more and we had said we would keep that as dry powder for a potential overreaction in the stock, at which time we could buy more shares.

Bill Leach - TIAA-CREF - Analyst

Well, I think that opportunity has arisen.

John DeSimone - Herbalife Ltd - CFO

It's a possibility.

Bill Leach - TIAA-CREF - Analyst

All right. Thanks.

Operator

Next question is from the line of Linda Bolton Weiser with Caris.

Linda Bolton Weiser - Caris & Company - Analyst

Hi. I guess there has been some speculation out there that your stock is believed to be -- hello?

John DeSimone - Herbalife Ltd - CFO

I can hear you, Linda, I don't know who that was that interrupted.

Linda Bolton Weiser - Caris & Company - Analyst

There's been some speculation out there that your stock is a short sell idea. And I can say that I've been looking at stocks for over 20 years, and the type of cash flow growth that you guys are producing is quite amazing. You did have 11% operating cash flow growth in the quarter, and free cash flow growth, I think was over 30%. I guess the one question I had on the cash flow was your inventories were up 36%, which I think that was the case last quarter and I remember asking you about it. But can you just remind us again about that? That's really the only thing I saw in working capital that would impact cash flow. But is there anything else in cash flow that would be anything unusual to mention? But your cash flow pattern has been extremely strong and it looks to me like your cash flow in this quarter is strongly growing as well, so can you just address the inventory question and any other thing that might be a one-time item in cash flow?

John DeSimone - Herbalife Ltd - CFO

Let me address the one-time item first. There's a line item in our cash flow that's titled Excess Tax Benefits from Share Based Payment Arrangements. It's a negative \$20 million in the quarter and it's a really a non-cash item. It's a re-class from an operating cash flow item to a financing cash flow item. Basically, it is the compensation expense the Company gets -- excuse me, compensation deduction the Company gets from the exercise of employee options. That gets booked right to equity, not to the P&L, at least the excess amount above the FAS 123R amounts. The way the FASB is written, that should be viewed as, from a cash flow standpoint, an expense, so it looks like a negative item to cash. And then it's a pick up, in financing, as if it was issuing stock. So, that's an unusual item in the first quarter, it was a \$20 million item this year, only \$6 million last year. So you can kind of normalize that out, and you'll see our cash flow is more in line with where it's been historically.

Other than that, this is a high cash flow generating business. Inventory is a relatively small percentage of our net sales price, so the investment in inventory to support the growth we have been having is one we felt was a valuable investment, which is why you've seen a growth in inventory, especially in the high growth markets. I think -- and we've got the transition to our own manufacturing, so we built a little inventory buffer. So I think that's behind us. But to your first point, our cash flow is usually in excess of net income or pretty close to net income, and that's a signal that it's a strong financial model.

Linda Bolton Weiser - Caris & Company - Analyst

Right. And then, I just want to applaud you for increasing the reporting and the transparency by reporting to us the number of Nutrition Clubs. I think that's really great. There has actually been some numbers circulated among distributors that indicate the numbers are higher, but I think that would include the home clubs as well. The numbers I've seen would be globally about 70,000, which is about double the number that you gave, and in the US or North America the number I saw was 6,000, which is about double. So is that roughly correct that the total number might be about double the commercial clubs?

John DeSimone - Herbalife Ltd - CFO

Yes, it's roughly correct -- I've got to put the right qualifiers on that. The information that gets circulated is information that the Company is putting out, but the information comes from the Company from distributors and the home clubs are not validated. Whereas the commercial clubs we've instituted a validation process. It's not completely implemented but it's much further along than anything we've done for the home clubs, so we just feel more comfortable giving the commercial club data.



Linda Bolton Weiser - *Caris & Company - Analyst*

Great. Can I ask just about -- I thought it was very interesting the explanation you provided about Mexico and the difference between the volume point growth and the average active sales leader growth and that there is a gap between those two numbers. And you indicated because when you increase access points within a company, it actually spurs on the growth of ordering. People are ordering more from the Company, the distributors, rather than from their upline distributors. So, I wonder if a follow on to that would be acceleration of the volume points to follow the acceleration of the active sales leader growth, if you follow what I'm saying. Is that something we could expect, or am I not thinking right on that?

John DeSimone - *Herbalife Ltd - CFO*

As you create more access to the products, more distributors have the ability to order directly from the Company instead of their upline. And they do that for two reasons, one is access, two is because of the change to the 5K program, the distributors can accumulate volume and become a sales leader. To accumulate that volume, they need to order from the Company. So in a market like Mexico, where we dramatically increased the access points, we're seeing more distributors order. Those distributors were already buying product from the Company, I mean -- from the Company, but indirectly through the upline. Now they're buying it directly from the Company, so you see a greater increase in the activity and a slightly less increase in the total volume points.

Linda Bolton Weiser - *Caris & Company - Analyst*

Finally, on the point of access, you showed at your analyst meeting, the Angelina. I know you don't want to call it a vending machine, but that could be very instrumental in increasing access points further around the world. I know you don't want to talk about it a lot, but do you have any plans for when you might know from the testing you are doing, whether you would expand this globally?

Des Walsh - *Herbalife Ltd - President*

Linda, thank you for noting we don't call it that word that you mentioned. For everybody on the call who isn't familiar, this is an automated sales venture that we believe this will have a significant impact in terms of improving access points to our distributors. The plan is to put it in test in the second quarter of this year. Based on the success of that test then we actually will roll out on a larger scale in the second half of 2012 and then 2013. So, more to follow on that. But again, we saw the impact of improved product access in Mexico. Obviously we are constrained with the absence of Waldo's equivalents in other parts of the world, and therefore Angelina, the automated sales venture, is our opportunity to re-create a Waldo's type environment but on a very large scale around the world. So it's something we are very excited about in the future.

It also obviously, Linda, very much leads into our city by city focus because what we know is that city-by-city focus with our distributor leadership combined with greater access gives us deeper penetration. And again, going back to our presentation at Analyst Day, we look to Iceland as our north star about 19 volume points per person in Iceland. Around the world, as you know, less than 1 volume point per person, and that's one of the reasons why once we replicate some of these factors for success, we believe that we can be on our way from that 1 towards that 19.

Linda Bolton Weiser - *Caris & Company - Analyst*

Great. Thanks very much.

Operator

Your next question is from the line of John San Marco with Janney Montgomery Scott.



John San Marco - *Janney Montgomery Scott - Analyst*

Good morning. I know sometimes in the past the rapid growth of daily consumption in a new market has temporarily driven negative volume per supervisor. Until this quarter, I guess it's been a couple years since the last time volume per supervisor grew in the North American segment. So was just wondering if there's any unusual products, promotional activity or anything like that or maybe to what do you attribute the higher volume per supervisor this quarter?

Des Walsh - *Herbalife Ltd - President*

I think, John, it's just an indication of greater productivity of our distributors in North American market. Traditionally, as you say, the average volume point per supervisor may decline because of that switch away from 4,000 volume point orders. But then I think what we're seeing is increased productivity make up for that change here in North America. You know the club market is a very efficient model because it's a model in which your customers come to you every day. And therefore, that frees up more time for greater invitations, greater other activities. So, a very efficient business model. I think we're seeing that translate into that increased productivity.

John San Marco - *Janney Montgomery Scott - Analyst*

Okay, I got it, but, you don't think the mix shift shifted back away towards the traditional methods at all, do you?

Des Walsh - *Herbalife Ltd - President*

No, we do not believe that.

John San Marco - *Janney Montgomery Scott - Analyst*

Okay. And then my second question is on Latin America. Coming out -- it's your first quarter after coming out of 4Q's pretty monstrous new distributor number. Just in general your observation so far with that promotional experience and how you think these new recruits are progressing through the system.

Des Walsh - *Herbalife Ltd - President*

Yes, so John, we obviously were pleased with the results of that Welcome to Herbalife test. It certainly showed that we could bring in significant number of new distributors into the business. The key issue for us and for our distributor leaders in South America wasn't whether we could bring in more new distributors. We actually were pretty confident that was the case. The real issue was how productive would those new distributors be and whether our distributors in the company had the infrastructure in place to train and support those new distributors. So, we were pleased enough with the results of the test in terms of, not just the number of new distributors, but more importantly their productivity to actually repeat the test. We've just begun it; it will continue through the end of this year. And then based on the results of that longer test period, we'll make a decision as to whether we expand it either in South America or perhaps even in other markets around the world in 2013.

John San Marco - *Janney Montgomery Scott - Analyst*

That's helpful. Thank you very much for taking the questions.

Operator

Your final question comes from the line of Anand Vankawala with Avondale Partners.



Anand Vankawala - *Avondale Partners - Analyst*

Good morning, guys. Thanks for taking my question. Just a few quick follow-ups on manufacturing. Given that currently 30% of the volume is being manufactured by in-house, and you want to get up to two-thirds, what is the current capacity of the manufacturing facility? Will there be a need to acquire another facility?

John DeSimone - *Herbalife Ltd - CFO*

So, we are getting close to the capacity of the facilities we have. There's a little bit of expansion available in the China facility and a little bit of ramp up left in the H.I.M. facility. But we are going to need to acquire assets outside of what we currently have in order to hit our target of two-thirds self-manufacturing.

Anand Vankawala - *Avondale Partners - Analyst*

Then I'm just trying to get a feel for the margin benefit from the extraction facility. Can you give us an idea of what you have built into your model for the remainder of this year? I know it was 38, 40 basis points in this quarter. Should we expect something similar going forward or should we expect something a little bit more modest?

John DeSimone - *Herbalife Ltd - CFO*

While we expect some benefit from the extraction facility, we have modeled in nothing for the rest of this year. So, in our guidance there is no assumption, so anything we get will be upside. I can tell you that we've test piloted all our key ingredients in the new facility, we are still right now scaling up. So, whatever benefit is generated from that facility, by the time it rolls through inventory, won't likely be till early next year. It might be late this year but we haven't incorporated anything yet.

Anand Vankawala - *Avondale Partners - Analyst*

Perfect. Thanks, guys.

Michael Johnson - *Herbalife Ltd - Chairman, CEO*

Let me close by first saying thank you, everybody, for being on the call with us. We've had our best quarter ever in the Company, this reported growth, it's really sensational. Our distributors, our employees, our vendors, everybody is benefiting from the opportunity here. Consumers who are losing weight, people are getting the better and healthier active lifestyles. Terrific momentum in our Company, we are very excited, very confident and secure in what we are doing and confident about the future. So, thank you for joining us. We appreciate it, and we'll see you again next quarter.

Operator

Thank you for joining today's conference call. You may now disconnect.



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