

Q-1'09 Updated
Expert Report on
Take Shape for Life, a Division
of Medifast, Inc. (NYSE: MED)

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Submitted to: Fraud Discovery Institute

Re: Analysis of Business Models and Practices of
Medifast and *Take Shape for Life*; Review and
Analysis of Q-1'09 Financial Disclosures;
Implications for Medifast Shareholders

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May 10, 2009

The financial disclosures released by Medifast, Inc. on April 29, 2008 for the company's activities during the first quarter of 2009 further confirm the conclusions I presented in the earlier, comprehensive report on this company.¹

The company's performance and the fate of shareholders depend on the marketing of an "endless chain" income proposition to consumers. The growth of the "multi-level marketing" division, *Take Shape for Life*, continues to be the only factor for significant revenue growth for Medifast. This sector depends entirely upon geometric expansion of its "coaches," that is, consumers who are persuaded to invest in the implausible income proposition.

Core Business in Decline

Excluding revenue gained from the selling of its endless chain income scheme, Medifast revenue *declined* by \$.6 million or 4% comparing Q-1'08 results for the same period of '09. This is in keeping with the trend of the meal replacement industry. Medifast's decline occurred despite opening additional corporate clinics and the introduction of a franchise model.

2008

Medifast Total Revenue at End of Q-1'08:	\$25.2 million
<i>Take Shape for Life</i> Revenue at End of Q-1'08:	\$9.8 million
Company Revenue Excluding TSFL:	\$15.4 million
TSFL Revenue as % of Total Medifast Revenue:	39%

2009

Medifast Total Revenue at End of Q-1'09:	\$33.7 million
<i>Take Shape for Life</i> Revenue at End of Q-1'09:	\$18.9 million
Company Revenue Excluding TSFL:	\$14.9 million
TSFL Revenue as % of Total Medifast Revenue:	56%

Redefinition as Peddler of Income Opportunity

As explained in the earlier report, Medifast has *redefined* itself from a diet and nutrition company into merely another variation of a multi-level marketing company, a mini-Amway. Its main and its true product is the sale of an "income opportunity" not meal replacements. In the classic multi-level marketing model, consumers are induced to pay fees, buy products and purchase marketing materials in the expectation of earning profits. The profits are based not from personal retail sales but from the purchases and sales of a "downline" of other recruits. The payment plans claim each new recruit can gain income from an endless chain of others whom they recruit to also invest. This income scheme can be recognized as the classic "robbing Peter to pay Paul." The Medifast scheme utilizes diet products as the vehicle for disguising and facilitating the money transfer. Without the continuous infusion of new investment capital from more independent distributors (called coaches), the company would collapse.

Medifast now has more in common with any of the companies that sell an income scheme based on purchasing inventory ranging from soap to vitamins and then recruiting others to do the same, than it does with companies such as Weight Watchers and Nutrisystem that actually sell diet products to the public.

¹ <http://www.pyramidschemealert.org/PSAMain/resources/Expert%20Report.Medifast.pdf>

Regulatory and Legal Minefields

The shift from selling diet products to selling an income proposition to consumers that is based on *continuous expansion* of coaches in a *contracting* marketplace has profound implications for Medifast shareholders. Extraordinary legal and regulatory issues arise from this transformation from a diet industry company to multi-level marketing, peddling an income promise.

A similar publicly traded company, *Your Travel Biz.com*, which charges consumers fees to become “travel agents” and then rewards them based on the recruitment of more “agents,” has been sued by the California Attorney General as a “gigantic pyramid scheme.”² Amway itself is the target of an enormous class action suit led by two of the country’s premier class action law firms. The suit claims Amway is an endless chain scheme and that the vast majority of all new recruits, called “independent business owners”, who are promised income based on recruiting other IBOs are “doomed by design” to lose money.³ Government regulators in England recently sought to close down Amway in that country “in the public interest” based on the revelations of false income claims and financial losses by tens of thousands of British consumers who had invested as Amway “independent business owners.”⁴

The Federal Trade Commission had been notably lax in recent years under the Bush Administration in enforcing anti-fraud laws against pyramid selling schemes. However, this policy may be reversed in the coming years under the new Administration. The Direct Selling industry has focused nearly all its lobbying and political contributions on the minority party.

Limits on “Unlimited” Recruiting

Setting aside legal and regulatory issues, from a purely economic perspective the shift to multi-level marketing inextricably ties Medifast’s continued growth to recruiting an ever-expanding base of “coaches.” While a theoretical potential for market expansion of Medifast, based on gaining market share from competitors, might be viable, the continuous expansion of diet coaches is not.

In the April 29 press release, Medifast acknowledged that growth now depends on recruiting more coaches.

Growth in revenues for the segment was driven by increased customer product sales as a result of an increase in active health coaches. The number of active health coaches during the first quarter increased to approximately 4,000 compared with 2,200 during the period a year ago, an increase of 82% and up from 3,400 at the close of 2008.

The inherent restraints on Medifast’s own growth are revealed by projecting the model forward just 10 years. To sustain the growth for 10 years, which the company has reported this past year, the number of coaches would expand from 4,000 to 1.6 million!

² <http://ag.ca.gov/newsalerts/release.php?id=1596>

³ Jeff Pokorny and Larry Blenn on behalf of themselves and those similarly situated, Plaintiffs, v. Quixtar, Inc., James Ron Puryear, Georgia Lee Puryear and World Wide Group, L.L.C; Britt Worldwide L.L.C., American Multimedia Inc., Britt Management, Inc. Bill Britt and Peggy Britt, Defendants, Case No. C 07 0201, United State District Court, Northern District of California, Class Action.

⁴ <http://www.pyramidschemealert.org/PSAMain/news/AmwayCaseAppealed.html>

To put the limits on the model into a more realistic context, for *Take Shape for Life* to reach the size of its nearest and most similar competitor, Nutrisystem, it would need 160,000 “coaches.” Whom would these coaches sell to or recruit? How many potential customers would be available for the coaches in a competitive marketplace? These types of simple projections reveal the trickery of selling “endless” chain income schemes and why they have become the targets of individual and class action lawsuits by “failed” consumers, why they were outlawed in China as frauds, and why the country of England sought to close down the veritable icon of this business model, the Amway Corporation, on the grounds of large-scale deception.

The coach recruitment business is a distinct activity that is essentially unrelated to the meal replacement industry. Its driving incentive is the sale of *income opportunity* for prospective coaches.

Industry trends show that the meal replacement market is contracting.⁵ However, as recent revelations of consumer and investor fraud have shown, the market for selling a bogus income proposition in the midst of the Recession is expanding.

Questions for the SEC

The sales of an endless chain income proposition has extraordinary implications for disclosure and transparency. With Medifast’s fate now clearly dependent on the selling of this type of income proposition to consumers, shareholders and the SEC ought to know much more about the “coaches” whose fate and fortunes are the lynchpin of the company’s future. On this subject, Medifast is *silent and secretive*.

For example,

- Medifast offers no information on its website or in SEC filings about the actual number of coaches recruited in any time frame or their dropout rates. It only offers a count of “active” coaches at the end of a quarter. Therefore, the churn rate, if there is one, is not disclosed.
- The actual number of retail customers per “coach” is also not disclosed.
- Similarly, the company does not disclose the percentages of incomes of coaches that are based on *personal* retail sales versus “bonuses and overrides.”
- The average income of *all* coaches, active and inactive over and extended time, is not reported to shareholders or to prospective coaches.
- The percentage of annual revenue sourced directly from the coaches (their own fees and personal purchases) is not disclosed.
- Perhaps most important, regarding the coaches’ profitability, the shareholders do not know how many coaches are in the various levels of the sales hierarchy and the proportions of commission payments made to each of the various levels of coaches. The *Take Shape for Life* pay plan allocates commissions to 10 levels of recruiters, who collectively gain more *per sale* than the person actually making a sale. If most of

⁵ Q-1'09 disclosures by diet industry giants Weight Watchers and Nutrisystem report year to year respective revenue declines of 11% and 25% and respective income drops of 18% and 37%. Medifast’s anomalous rise in revenue, especially during a general economic decline, is a red flag of possible malfeasance.

the commissions are transferred to the few at the top, the thousands of newly recruited coaches are condemned to a futile struggle to get to the top, where only a few can ever be positioned.

Two Bucks a Day Peddled as “Unlimited Income”

From the current disclosure, Medifast revealed that it increased revenue in the *Take Shape for Life* segment by \$9.1 million between the end of Q-1'08 and the same period in '09. It also reported that the total of “active coaches” at the end of this time period increased by 1,800. This indicates that the total new revenue generated for each new coach is approximately \$5,000 ($\$9.1 \text{ million} \div 1,800$) That total *revenue* figure per new coach reveals the absurdity of claims about “unlimited” *incomes* available to new coaches.

Medifast's website presents charts showing the potential for \$8,000 and \$20,000 *incomes per month*. Yet, with each new coach equating to just \$5,000 in new revenue, the *rewards* to those coaches must be minimal.⁶ 50% of all revenue is paid to the entire network of coaches in commissions but at least 70% of this commission is allocated to 10 levels of recruiters, not the salesperson at the bottom. So the actual *income* available to the newest coaches based on the new revenue gained is less than \$15 a week!

These per capita revenue and income figures presented in the Medifast press release – as small as they are and misleading in their incompleteness – are likely even more bogus. They are based only on the total *current* count of coaches at the end of the quarter, not the *cumulative* count of coaches that were churned through the company during the entire 12-month period. That truer number would reduce the per-coach revenue and income figures further.

Capital Investments Versus Retail Sales

Medifast does not reveal how much of the new revenue came directly out of the pockets of the new coaches, rather than from any retail sales they generated in the open market.

- Each new coach can pay as much as \$300 just to gain the right to get overrides from recruits.
- The *Take Shape for Life* meal replacement products cost about \$300 per month. Presumably most coaches are also buying the products for their own use and to give away as samples.
- Additionally, they must buy marketing materials from the company.

Fees, inventory purchases and marketing investments by the coaches themselves could, therefore, be a substantial portion of total *Take Shape for Life* revenue before any actual sales are ever made.

Questionable Legality

In the earlier report, I explained in detail why I thought *Take Shape for Life* was in jeopardy of violating California's law against endless chain schemes. That law is cited in

⁶ The earlier report presented a simple mathematical calculation that included the total number of coaches, and the total commissions paid (50% of TSFL revenue). It revealed that only a tiny percentage of coaches could possibly earn even a sustainable income equivalent to a minimum wage job.

the current class action suit against Amway, on which *Take Shape for Life* is modeled. It was also used as the basis for a recent FTC action against another multi-level marketing company, similar to *Take Shape for Life*, called BurnLounge. That company charged consumers fees to become “moguls” with the right to sell “downloaded music” through the company and then to receive rewards when they recruited other mogul/recruiters.⁷

The California law seeks to ban the use of the endless chain incentive for selling goods or for gaining financial investments.

Other states describe the endless chain incentive as a scheme in which the value of a product or the promised returns on investment depend on the “future action” (recruiting) of others. In those cases, the schemes are viewed as purveyors of unregistered “securities.”

In my view, the *Take Shape for Life* income scheme potentially can be seen as a violation of such laws. The law in the state of New York is an example.

359-fff. Chain distributor schemes prohibited

1. It shall be illegal and prohibited for any person, partnership, corporation, trust or association, or any agent or employee thereof, to promote, offer or grant participation in a chain distributor scheme.

2. As used herein a "chain distributor scheme" is a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. A limitation as to the number of persons who may participate, or the presence of additional conditions affecting eligibility for such license or right to recruit or solicit or the receipt of profits therefrom, does not change the identity of the scheme as a chain distributor scheme. As used herein, "investment" means any acquisition, for a consideration other than personal services, of property, tangible or intangible, and includes without limitation, franchises, business opportunities and services, and any other means, medium, form or channel for the transferring of funds, whether or not related to the production or distribution of goods or services. It does not include sales demonstration equipment and materials furnished at cost for use in making sales and not for resale.

3. A chain distributor scheme shall constitute a security within the meaning of this article and shall be subject to all of the provisions of this article.

⁷ <http://www.ftc.gov/opa/2007/06/burnlounge.shtml>