

AeroGrow International, Inc.
Form 10-K
June 26, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended March 31, 2008

or

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

For the transition period from _____ to _____

(Commission File No.) 000-50888

AEROGROW INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

46-0510685
(I.R.S. Employer
Identification No.)

6075 Longbow Drive, Suite 200
Boulder, Colorado 80301
(303) 444-7755

(Address, including zip code and telephone number, including area code, of registrant's of principal executive office)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:
Common Stock, par value \$0.001 per share

Name of each exchange on which registered:
The NASDAQ Capital Market

Securities registered pursuant to Section 12(g) of the Act:

None

Edgar Filing: AeroGrow International, Inc. - Form 10-K

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of September 28, 2007 was \$68,771,665. For the purpose of the foregoing calculation only, all directors and executive officers of the registrant and owners of more than 5% of the registrant's common stock are assumed to be affiliates of the registrant. This determination of affiliate status is not necessarily conclusive for any other purpose.

The number of shares of the registrant's common stock outstanding as of June 16, 2008 is 12,100,387 .

Table of Contents

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from the registrant's proxy statement for the 2008 annual meeting of stockholders to be filed no later than July 29, 2008.

AeroGrow International Inc.
Annual Report on Form 10-K
Year Ended March 31, 2008

	PART I	Page
Item 1.	<u>Description of Business</u>	3
Item 1A.	<u>Risk Factors</u>	12
Item 1B.	<u>Unresolved Staff Comments</u>	16
Item 2.	<u>Description of Property</u>	16
Item 3.	<u>Legal Proceedings</u>	16
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	16
	PART II	
Item 5.	<u>Market for the Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	17
Item 6.	<u>Selected Financial Data</u>	18
Item 7.	<u>Management's Discussion and Analysis or Plan of Operations</u>	19
Item 7A.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	27
Item 8.	<u>Financial Statements</u>	27
Item 9.	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	27
Item 9A.	<u>Controls and Procedures</u>	27
Item 9B.	<u>Other Information</u>	28
	PART III	
Item 10.	<u>Directors, Executive Officers and Corporate Governance</u>	29
Item 11.	<u>Executive Compensation</u>	29
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	29
Item 13.	<u>Certain Relationships and Related Transactions, and Director Independence</u>	29
Item 14.	<u>Principal Accounting Fees and Services</u>	29
	PART IV	
Item 15.	Exhibits, Financial Statement Schedules	
<u>Signatures</u>		30

In addition to historical information, this Annual Report on Form 10-K ("Annual Report") for AeroGrow International, Inc. ("AeroGrow" the "Company," "we," "our" or "us") contains "forward-looking" statements within the meaning of Section of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), including statements that include the words "may," "will," "believes," "expects," "anticipates," or similar

expressions. These forward looking statements may include, among others, statements concerning our expectations regarding our business, growth prospects, revenue trends, operating costs, working capital requirements, competition, results of operations and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. The forward-looking statements in this Annual Report involve known and unknown risks, uncertainties and other factors that could cause our actual results, performance or achievements to differ materially from those expressed or implied by the forward-looking statements contained herein.

Each forward-looking statement should be read in context with, and with an understanding of, the various disclosures concerning our business made elsewhere in this Annual Report, as well as other public reports filed by us with the United States Securities and Exchange Commission. Investors should not place undue reliance on any forward-looking statement as a prediction of actual results of developments. Except as required by applicable law or regulation, we undertake no obligation to update or revise any forward-looking statement contained in this Annual Report.

Table of Contents

PART I

ITEM 1. DESCRIPTION OF BUSINESS

Our Business

We are a developer, marketer, distributor, and seller of advanced indoor garden systems, designed for consumer use and priced to appeal to the gardening, cooking and small indoor appliance, healthy eating, and home and office décor markets worldwide. To date, we have launched multiple lines of proprietary indoor gardens, more than 50 corresponding proprietary seed kits, and various cooking, gardening and décor accessories, both nationally and internationally.

As of March 31, 2008, we had manufactured and shipped over 440,000 AeroGarden® garden units and 1,137,000 seed kits to consumer and retailers worldwide. We commenced initial marketing and distribution of our products in March 2006 and have expanded these marketing efforts to encompass broad retail distribution, home shopping networks, catalogue, international, and direct-to-consumer sales channels including direct television, Internet, and our own in-house direct mail catalogue.

Our principal products are indoor gardens and proprietary seed kits that allow consumers, with or without gardening experience, the ability to grow vegetables such as cherry tomatoes, chili peppers and salad greens, a variety of fresh herbs including cilantro, chives, basil, dill, oregano, and mint, as well as flowers such as petunias, roses, snapdragons, pink geraniums, and phlox. Consumers can also plant and grow their own seeds using our proprietary “master gardener” kits.

Our indoor gardens are designed to be simple, consistently successful, and affordable. We believe that our focus on the design and features of our indoor gardening products made them the first of their kind on the consumer market. This conclusion was reached on the basis of market research, review of potentially competitive products offered at all ranges of functionality and price, and testing of products that may be considered competitive in function although not necessarily competitive in market orientation.

We believe that our products allow almost anyone, from consumers who have no gardening experience to professional gardeners, to produce year-round harvests of a variety of herbs, vegetables, and flowers, regardless of experience, season, weather, or lack of natural light. We believe that our indoor gardening products’ unique and attractive designs make them appropriate for use in almost any location, including kitchens, bathrooms, living areas, and offices.

Our indoor gardening units currently on the market retail from approximately \$99 to \$229 depending on the features and components, including size, design elements, light intensity, and automated features, and are sold through different channels matching customer needs and interests with the appropriate garden unit features and benefits.

Corporate History

AeroGrow International, Inc. (“AeroGrow”) was formed as a Nevada corporation on March 25, 2002. Wentworth I, Inc., a Delaware corporation (“Wentworth”), organized under the laws of the State of Delaware on March 6, 2001, entered into an Agreement and Plan of Merger with us (the “Merger Agreement”) on January 12, 2006, which was consummated on February 24, 2006. Under the Merger Agreement, Wentworth merged with and into AeroGrow, and AeroGrow was the surviving corporation (“Merger”). Our certificate of incorporation and by-laws prior to the Merger are now those of the surviving company, and the surviving company is governed by the corporate law of the State of Nevada.

After more than three years of initial research and product development, we began sales activities in March of 2006. Since that time, we have significantly expanded all aspects of our operations in order to take advantage of what we believe to be an attractive market opportunity. We have substantially increased the depth and breadth of distribution and as of March 31, 2008, sell products nationally and internationally in over 5,100 domestic retail storefronts and more than a dozen countries. We have also developed direct sales channels including web sales, direct television sales including infomercials and 60 and 120 second television commercials, and a direct mail catalogue business with more than 2 million catalogues mailed as of March 31, 2008. In the past two years we have significantly expanded our product lines, now offering 11 different indoor garden models, more than 50 seed kits, and various gardening and kitchen accessories.

Hydroponics Industry - Background and Opportunity

Hydroponics is the science of growing plants using nutrients suspended in water instead of soil. Used commercially worldwide, hydroponics is considered an advanced and often preferred crop production method. Hydroponics is typically used inside greenhouses to give growers the ability to better regulate and control nutrient delivery, light, air, water, humidity, pests, and temperature. Hydroponic growers benefit by producing crops faster and enjoying higher crop yields per acre than traditional soil-based growers.

Aeroponic technology is derived from hydroponics and occurs when plant roots are suspended in an air chamber and bathed with a nutrient solution. AeroGrow believes that the aeroponic technology used in our indoor gardening products is a technological advance over most hydroponic growing systems because plant roots are partially suspended in air and allowed direct access to oxygen, while being bathed in a highly-oxygenated, nutrient rich solution. For these reasons, we believe the use of a well designed and maintained aeroponic system can yield increases in growth rate and plant survival when compared to most hydroponic or dirt-based systems.

Table of Contents

Until the development of our indoor gardening products, significant barriers have prevented hydroponic or aeroponic technology from being incorporated into mainstream, mass-marketed consumer products, including:

- Consumers generally lack the specialized knowledge required to select, set up, operate, and maintain the various components for a typical hydroponic or aeroponic system, including growing trays, irrigation channels, growing media nutrient reservoirs, and nutrient delivery systems consisting of electronic timers, pumps, motors, tubing, and nozzles;
- Consumers generally do not possess the specialized knowledge required to select, set up, operate, and maintain the varied indoor lighting systems that are necessary to grow plants indoors in the absence of adequate natural light;
- Consumers are unable to properly mix and measure complex hydroponic nutrient formulas, which change depending on the plant variety and the stage of plant growth. In addition, consumers are unable to deal with the problem of nutrient spoilage; and
- Federally-mandated water quality reports show that the water in many large cities is not suitable for hydroponic or aeroponic growing and requires treatments in order to sustain growth.

Our research has led us to believe that these complexities have been accepted in existing hydroponic market channels because hydroponic manufacturers have generally focused their product development and marketing efforts on satisfying the needs of the commercial greenhouse and dedicated hobbyist markets. These users are motivated to gain the specialized knowledge, equipment and experience currently required to successfully grow plants with these products. Our research indicated that the hydroponic growing equipment currently available in these markets is bulky, expensive, and comprised of many parts.

We believe that the complexities of currently available commercial hydroponic products fail to address the needs and wants of the mass consumer market, leaving that market unserved. We further believe that our trade secrets, patent-pending inventions, and companion technologies have simplified and improved hydroponic and aeroponic technologies and have enabled us to create the first indoor aeroponic gardening system appropriate for the mass consumer market.

Our Proprietary Technology

We have spent almost six years innovating, simplifying, combining, and integrating numerous proprietary technologies and inventions into a family of “plug and grow” indoor gardening products and related seed kits specifically designed and priced for the mass consumer market. We have used this technology platform to develop 11 different models of indoor gardens, each with different features and technology groupings, priced from approximately \$99 to \$229. We have filed 18 patent applications in the United States to protect our inventions. Following is a description of our proprietary technologies and inventions that are used in our indoor garden system and seed kits. The inventions under the patent applications have not been granted patents, and there can be no assurance that patents will be granted.

Rainforest Nutrient Delivery System. Our “rainforest” nutrient delivery system combines our patent-pending technologies with features from several hydroponic or aeroponic methodologies into a proprietary system that leaves plant roots suspended in an air gap. Plant roots take oxygen directly out of the air and, in testing of aeroponic systems by multiple different sources, including NASA Small Business Innovation Research lettuce studies, grow faster as a result.

Advanced Growing System. Our Advanced Growing System (AGS) is available on many of our newer indoor gardening products and combines features from our rainforest delivery system with new technologies that deliver increased nutrient oxygenation, faster, healthier root growth, decreased needs for consumer maintenance, and increased product reliability. With AGS, plant roots are suspended in air in a 100% humid aeroponic chamber and then pass into a continuously oxygenated nutrient bath.

Pre-Seeded Bio-Grow Seed Pods. Our proprietary bio-grow seed pods include pre-implanted, specially selected seeds, a bio-sponge growing medium, removable bio-dome covers, and a grow basket to assist with the proper distribution of moisture. In development, attention was paid to delivering optimal amounts of nutrient, oxygen and moisture to seeds to maximize germination and survival rates.

Microprocessor-Based Control Panel and Nutrient Cycle Delivery System. Microprocessor-based control panels are included on our current indoor gardening products. This control panel can include microprocessor-controlled lights and nutrient and water reminder systems that alert consumers to add water and nutrients when needed and help ensure that plants are properly fed and receive the proper lighting. In addition, several systems allow consumers to select from multiple plant types (for example, lettuce, herbs, tomatoes, or flowers) and the system then automatically adjusts and optimizes the nutrient, water, and lighting cycles based on the plant variety selected. In addition, some systems take into account stage of growth of the specific plants when optimizing these factors.

Custom Nutrient Tablets and Automatic pH Adjustment. We have developed time-release nutrient tablets designed specifically to deliver the proper nutrients to the plants, while offering consumers a user-friendly nutrient system. Plant specific nutrients are included with each seed kit, and consumers simply add them when instructed by the microprocessor-based nutrient reminder. The nutrient tablets eliminate the need for measuring and mixing multi-part nutrient formulas and storing various nutrients in separate containers. Also included in the nutrient tablets is a proprietary formula that automatically adjusts tap water from around the country to the right pH ranges for plant growth. Without this adjustment, tap water from many areas in the country will severely limit, or inhibit, plant growth in most aeroponic and hydroponic systems.

Table of Contents

Integrated and Automated Lighting System. Hydroponic systems typically do not incorporate built-in lighting systems. Our indoor gardening products include built-in adjustable grow lights with ballast, reflector hood, grow bulbs, and an electronic timer. Our integrated lighting systems include high-output compact fluorescent light bulbs that deliver a spectrum and intensity of light designed to help optimize plant growth without natural light. In addition, our lighting system is fully automated and controlled by our microprocessor-based control panel described above. Variations in lighting are a differentiator in our product lines, and we have several gardens on the market with “twice the light and twice the height” of our standard gardens, allowing consumers to grow larger plants such as full sized tomatoes in our indoor gardens, and deliver higher yields.

New Technologies in Development. We are continually engaged in developing incremental improvements in lights, nutrients, oxygenation, seed variety selection, and style and design innovation that are introduced to products on an ongoing basis.

Markets

Based on our sales experience to date and our existing channels of distribution, and supplemented by our own formal and informal market research consisting of individual consumer interviews, focus groups, blog monitoring, customer modeling, and Internet survey responses, we believe that our indoor gardening products appeal to a broad spectrum of consumers across multiple areas of interest. For these and other reasons, our products have gained broad distribution through retailers and other sales channels. We believe that our products appeal to at least four major market segments:

Gardener Market. The 2002 National Gardening Survey conducted by the National Gardening Association states that gardening is America’s number one hobby with more than 70 million active gardeners. Based upon this survey, there were estimated to be: 27 million vegetable gardeners, with one out of every four households having a vegetable garden; over 15 million fresh herb gardeners; and over 20 million flower gardeners. We believe that our indoor gardening products and related products offer both expert and novice gardeners several major benefits not readily available through traditional gardening methods, including:

- the ability to grow fresh herbs, lettuces, vegetables, tomatoes, and flowers year-round, regardless of indoor light levels or seasonal weather conditions,

- the ability to easily start plants indoors during colder months and then transplant them outdoors at the onset of the outdoor growing season,

- the ability to use stem cuttings to propagate multiple reproductions of the desired plants in our indoor gardening products, and

- the ease of growing in our indoor gardens in contrast to the toil associated with traditional gardening, including preparing the soil, planting, thinning, weeding, watering, and removing pests.

“Want-to-be” Gardener Market. We believe that many people have an interest in gardening but lack the knowledge, confidence, available space, equipment, or time to garden. We have observed the following barriers that often prevent people from gardening:

- gardening requires an ongoing time commitment,

- apartment, high-rise, and condominium dwellers often lack the land needed for a traditional garden,

gardening requires physical work, which can be a significant barrier to people with limited mobility or health issues,
buying the necessary equipment to garden can be expensive, and

gardening requires knowledge and expertise.

We believe that our indoor gardening products overcome many of these barriers and provide a simple, convenient way for many current non-gardeners to begin to garden.

Table of Contents

Kitchen Products and Small Appliances Market. Many Americans enjoy cooking as a hobby and these people repeatedly purchase new kitchen appliances and will be motivated to purchase our indoor gardening products and related seed kits. Consumers in this potential market include:

people interested in cooking who would appreciate the convenience and satisfaction of having a readily available supply of fresh-cut herbs to flavor soups, salads, and other dishes,

people who prefer the distinctive texture and taste of freshly picked, vine-ripened tomatoes, basil, lettuces, and other vegetables over days-old supermarket produce, and

people interested in healthy, pesticide-free foods for themselves and their families, reflecting both the rapidly growing interest in naturally and organically grown foods and the increasing number of people who, for health or weight concerns, include salads and fresh vegetables as part of their families' diets.

We believe that our indoor gardening products are embraced in this market by people who understand the value of having an ongoing supply of fresh herbs and fresh produce throughout the year.

Office and Home Decor Market. Flowers are frequently used to brighten homes and offices around the world. It is difficult to readily grow flowers indoors due to a lack of sufficient light and growing knowledge. As a result, people often use cut flowers, which are expensive, short-lived, and require ongoing maintenance. Our indoor gardening products enable colorful and fragrant flowers to be easily grown indoors year-round. Flowers grown with our indoor gardening products will last for months with minimal care and maintenance. Flowers can be grown in a wide variety of indoor locations, including kitchen and bathroom countertops, living rooms, bedrooms, family rooms, offices, work stations, waiting rooms, and lobbies.

Products

AeroGarden Indoor Gardens. We currently offer 11 different indoor garden models priced from approximately \$99 to \$229 and differentiated based on size, design, light intensity, degree of automation, inclusion of Adaptive Growth Technology or Advanced Growing Systems, height potential of light hoods, and inclusions of plant support systems.

Currently, our product lines are divided into four main categories:

1. AeroGarden Classic 7-Pod Series. Our first products launched feature the rainforest nutrient delivery system and automated lights and reminder systems. Retail price \$149.
2. AeroGarden Pro Series. Seven pod garden configuration with degrees of upgraded, stainless steel trim, Adaptive Growth Software, more lumens of light output, and extended lamp arms for growing larger vegetables. Retail price \$169 to \$229.
3. AeroGarden SpaceSaver 6 Series. Features the Advanced Growing System, improved grow lights, and an innovative design that delivers increased outputs relative to our classic 7-pod systems with a 30% smaller footprint. Fits easily on countertops and in corners for apartments, condos, and smaller kitchens. Retail price \$149 to \$169.
4. AeroGarden3 Series – The AeroGarden3 series features the Advanced Growing System, improved grow lights, and an attractive, stylish design that makes it suitable for use as a decorative feature throughout the home or office. Our smallest gardens fit easily on kitchen counters, night stands, and end tables. Retail price \$99 to \$109.

Edgar Filing: AeroGrow International, Inc. - Form 10-K

AeroGarden Seed Kits. We currently offer more than 50 seed kits for use in our indoor gardening products. These seed kits include pre-seeded bio-grow seed pods and a three-to-six-month supply of nutrients, including our proprietary formula for adjusting water quality. Our seed kits retail at prices ranging from \$14.99 to \$29.99, and include kits like:

Vegetable Gardens: cherry tomato, chili pepper, green beans, salsa garden.

Herb Gardens: gourmet herbs, Italian herbs, herbs for poultry, herbs for seafood, French herbs.

Flower Gardens: petunias, baby roses, spring bouquet, English garden, splash of color.

Salad Gardens: salad greens, romaine lettuce, baby greens, mesclun mix.

Table of Contents

Our seed kits are sold to consumers for use with our indoor gardening products. Individual seed kits are grown by consumers for three to six months and then new seed kits may be purchased for replanting.

AeroGarden Seed-Starting Kits. Developed for more experienced gardeners, our line of Seed Starting Trays and Master Gardner Kits are designed to allow consumers to plant and grow their own seeds in the AeroGarden. With our Seed Starter Trays, consumers can start up to 70 seedlings in our indoor gardens for transplant into their outdoor gardens when weather allows. With the Master Gardener Kit, consumers can grow their own seeds to maturity in the AeroGarden, or transplant seeds outdoors when weather allows.

Other Accessories. To complement and expand the functionality of our indoor gardening products, we have developed a variety of accessory products including cookbooks and cooking accessories. We also offer multiple wall brackets and other shelving and support systems, which can hold multiple indoor gardens at the same time. We also offer our own design of a battery-operated herb blender and salad dressing maker called the Herb 'n Serve.

Future Products. Our core technology platform can be leveraged by bundling different components into new products with a wide variety of features and price points that then can be sold through a variety of retail channels for use in a variety of different settings around the home or office. Examples include a children's garden series, a desk garden series, a professional system for larger plants and vegetables, patio and deck gardens, home décor and air freshening gardens, and additional seed kits and accessories.

For the fiscal years ending March 31, 2008 and 2007, we invested \$2,605,112 and \$2,113,255 in research and development activities. As a result, we have a strong backlog of new product innovations in the pipeline. In calendar 2008, we are introducing additions to our product line-up, including a six-pod configuration in both a traditional footprint and a space-saver design, launching a three-pod model at retail, and a variety of new seed kits and accessory items.

Integrated Marketing and Sales Channel Strategy

We consider our products to be an entirely new product category. A primary objective since launch has been to maximize the exposure of the product and educate consumers on the benefits of indoor gardening through an integrated marketing and distribution strategy. We launched with a nationwide public relations campaign during the first quarter of 2006, and have since received extensive media exposure, with multiple features on national talk shows as well local television features, local and national print articles and blog and Internet pieces. We combined the public relations launch with a retail and direct strategy focusing on high visibility partners and media, including product sales through mass retail chains, national cataloguers, home shopping channels, direct television commercials, our own in-house direct response catalogue and inbound and outbound telemarketing.

Retail Sales. Initial shipments to retail launch partners, including Sur La Table, Frontgate, and others commenced in March 2006. By December 2006, our products were distributed through more than 750 retailers, including catalogers like Skymall, Brookstone and Herrington, and web merchants like Amazon.com. In 2007 we expanded into Linen's n Things, Bed, Bath & Beyond, Sears, Macy's and JCPenney, and had successful tests at Target and other large chains. This grew our retail distribution to 4,300 retailers by December 2007, and by March 31, 2008, we had expanded to 5,100. In 2008 we plan additional retail distribution into existing channels like lawn and garden, mass and department stores, and new retail distribution with tests or rollouts into grocery, office and drug store chains. Further, based on the breadth of concept application and the range of interest of many consumer segments, we believe that our indoor gardening products present opportunities in up to 15 different retail channels, including culinary, department stores, mass, clubs, specialty, home centers, lawn and garden, hardware, office, drugstores, gift shops, grocery, toy, schools/education, and hydroponic.

Direct Sales. In the fall of 2006 we launched an infomercial advertising campaign, which began with 30 minute programming and has since been supplemented with 60-second and 120-second television commercials. In 2008 we are planning the creation of new 60-second and 120-second commercials focused on highlighting our new products.

In June of 2007 we produced and began mailing our own in-house, direct mail product catalogue, which tested successfully with a mailing of approximately 50,000 catalogues. We mail up to 750,000 catalogues every 45 to 60 days. With our catalogue sales we focus on remarketing to current customers and also prospect for new customer acquisition using database marketing techniques.

We established our first consumer product website in the fall of 2006 and in late 2007 supplemented this with search engine advertising, banner advertising, email campaigns, and web affiliate programs, some of which are managed by third-party providers. A key focus of our web and catalogue marketing will continue to be sales of our repeat purchase seed kits, light bulbs, and accessories to our existing customers, and focusing on building and maximizing the lifetime value of our AeroGarden customers.

In the fall of 2007 we successfully tested our own in-house telemarketing center to handle inbound and outbound orders for our various direct sales channels. This call center supplements our outsourced call center which handles the bulk of our infomercial calls.

Table of Contents

International Sales. We began testing international sales opportunities in the UK and Japan in late 2007, and have since expanded internationally into Australia, South Korea, Mexico, Germany, and several other European countries. International expansion in 2008 will likely focus primarily on gaining broader distribution in existing countries in Europe and the Pacific Rim, while incrementally expanding into new areas as resources allow.

Competition

Aeroponic and hydroponic technologies have historically been limited to ardent hobbyists and commercial growing facilities. We believe that we are the first company to develop and offer a simple soil-less indoor growing system for the mass consumer market.

Typical hydroponic manufacturers offer a range of equipment and accessories through distributors or small independent “hydro-shops” in a trade-oriented manner similar to plumbing or electrical suppliers. Purchasers typically mix and match equipment from various suppliers in an “a la carte” fashion to individually customize a large system that they then assemble on their premises. We believe that these products are substantially more expensive than our products.

We believe that our simplified and complete indoor gardening products and current and planned methods of distribution offer significant benefits from these traditional hydroponic industry practices. However, we recognize that there are companies that are better funded and have greater experience in producing hydroponic products in commercial markets, including, but not limited to, companies such as General Hydroponics and American Hydroponics. These companies could potentially decide to focus on the consumer market with competing products. We could also potentially face competition from gardening wholesalers and large and profitable soil-based gardening companies, including, but not limited to, the Burpee Seed Company and Gardener’s Supply Company, should they decide to produce a competitive product. These companies may have better consumer acceptance and may be better funded than us.

Manufacturing

We manufacture our products using contract manufacturing sources, which are supervised by our internal engineering and manufacturing teams. Our bio-grow seed pods are currently produced and assembled in our laboratory facilities in Longmont, Colorado.

We currently have three main suppliers of our different indoor garden models in China, and multiple, dual sourced manufacturers of our many component parts and accessories. Our first garden manufacturer was Mingkeda Industries Co, Ltd. (“Mingkeda”) a Chinese company capable of producing 40,000 gardens per month. Our second manufacturer was Main Power Electrical Factory Ltd. (“Main Power”), which began shipping products during the first calendar quarter of 2007. Production capacity at Main Power is estimated to be 180,000 units per month, with more capacity available with the addition of multiple sets of tools in a short time period. Our third manufacturer, Kayue Electric Company Limited, started producing gardens in June 2007, and has a production capacity of 50,000 units per month. Capacity expansion up to 100,000 per month can be achieved over a short period of time with a nominal tooling investment.

We produce and assemble our seed kits in our manufacturing facilities in Longmont, Colorado. The seed kits and indoor gardening products are shipped to a fulfillment center in Chino, California. A third-party logistics firm provides warehousing, order fulfillment, and shipping for our products. Our 2008 plans call for the opening of an additional, company-owned distribution center in Indianapolis, Indiana. Some seed kit manufacturing may be completed there as well.

Product Returns and Warranties

To date, product returns have been within our expectations for both retail and direct-to-consumer sales. At retail, we utilize a “Destroy in Field” methodology for certain customers as the cost of shipping the return, if used, does not justify the value of the recovered unit. In certain cases, customers are provided a fixed allowance, usually in the 1% to 2% range, to cover returned goods which allowance is deducted from payments from such customers. To our knowledge, our retailers are satisfied with this arrangement. Our manufacturers will provide us with replacement parts at no charge for products which are deemed defective due to materials or manufacturing complications. We record warranty liabilities at the time of sale for the estimated costs that may be incurred under our basic warranty program. The specific warranty terms and conditions vary depending upon the product sold but generally include technical support, repair parts, and labor for periods up to one year. Factors that affect our warranty liability include the number of installed units currently under warranty, historical and anticipated rates of warranty claims on those units, and cost per claim to satisfy our warranty obligation.

Table of Contents

Intellectual Property

We have filed 18 patent applications in the United States to protect our technologies and products. These applications are for:

seed germination pods that transport, support and germinate seedlings in aeroponic or hydroponic devices and support the growth of the plant to maturity, filed in November 2003, application serial number 10/714,786, and have responded to examiner's fourth action,

devices and methods for growing plants, RAIN (rain-aerated ionized nutrient) system technology, which hyper-oxygenates and ionizes plant roots in 7-pod garden systems, filed in March 2005, application serial number 10/528,110, and responding to examiner's first action,

methods for growing plants using seed germination pods, filed in April 2005, application serial number 11/112,269, and responding to examiner's fourth action,

indoor gardening appliance, filed in August 2005, application serial number 29/235,880, design of 7-pod gardens, and responded to an office communication,