

LANDEC CORP \CA\
Form 10-Q
October 05, 2011
United States

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Fiscal Quarter Ended August 28, 2011, or

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

For the transition period from _____ to _____.

Commission file number: 0-27446

LANDEC CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	94-3025618
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

3603 Haven Avenue
Menlo Park, California 94025
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code:
(650) 306-1650

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 at least the past 90 days.

Yes ☒ No ☐

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

Yes ☒ No ☐

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

Large Accelerated Filer <input type="checkbox"/>	Accelerated Filer <input checked="" type="checkbox"/>
Non Accelerated Filer <input type="checkbox"/>	Smaller Reporting Company <input type="checkbox"/>

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

As of September 27, 2011, there were 25,913,263 shares of Common Stock outstanding.

-1-

LANDEC CORPORATION

FORM 10-Q For the Fiscal Quarter Ended August 28, 2011

INDEX

	Page
Facing sheet	1
Index	2
Part I. Financial Information	
Item 1. Financial Statements	
a) Consolidated Balance Sheets as of August 28, 2011 and May 29, 2011	3
b) Consolidated Statements of Income for the Three Months Ended August 28, 2011 and August 29, 2010	4
c) Consolidated Statements of Cash Flows for the Three Months Ended August 28, 2011 and August 29, 2010	5
d) Notes to Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3. Quantitative and Qualitative Disclosures About Market Risk	27
Item 4. Controls and Procedures	27
Part II. Other Information	28
Item 1. Legal Proceedings	28
Item 1A. Risk Factors	28
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	28
Item 3. Defaults Upon Senior Securities	28
Item 4. Submission of Matters to a Vote of Security Holders	28
Item 5. Other Information	28
Item 6. Exhibits	28

Signatures

29

-2-

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LANDEC CORPORATION
CONSOLIDATED BALANCE SHEETS
(In thousands except shares and per share amounts)

	August 28, 2011 (Unaudited)	May 29, 2011 (1)
ASSETS		
Current Assets:		
Cash and cash equivalents	\$7,242	\$8,135
Marketable securities	32,112	28,124
Accounts receivable, less allowance for doubtful accounts of \$348 and \$342 at August 28, 2011 and May 29, 2011, respectively	20,355	21,648
Accounts receivable, related party	413	453
Income taxes receivable	522	571
Inventories, net	19,628	20,161
Notes and advances receivable	752	5
Deferred taxes	973	542
Prepaid expenses and other current assets	5,992	5,987
Total Current Assets	87,989	85,626
Investment in non-public company, non-fair value	793	793
Investment in non-public company, fair value	15,714	15,662
Property and equipment, net	52,063	51,779
Goodwill, net	36,462	36,462
Trademarks/tradenames, net	12,428	12,428
Customer relationships, net	3,289	3,366
Other assets	153	196
Total Assets	\$208,891	\$206,312
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$18,160	\$16,747
Related party accounts payable	371	300
Accrued compensation	2,625	3,080
Other accrued liabilities	13,620	3,581
Deferred revenue	1,150	2,657
Current portion of long-term debt	4,330	4,330
Total Current Liabilities	40,256	30,695
Long-term debt, less current portion	14,500	15,500
Deferred taxes	11,470	11,338
Other non-current liabilities	1,324	11,053
Total Liabilities	67,550	68,586
Stockholders' Equity:		
Common stock, \$0.001 par value; 50,000,000 shares authorized; 26,412,131 and 26,405,799 shares issued and outstanding at August 28, 2011 and May 29, 2011,	27	27

respectively

Additional paid-in capital	120,865	119,169
Accumulated other comprehensive loss	(301)	(267)
Retained earnings	18,938	17,126
Total Stockholders' Equity	139,529	136,055
Non controlling interest	1,812	1,671
Total Equity	141,341	137,726
Total Liabilities and Stockholders' Equity	\$208,891	\$206,312

(1) Derived from audited financial statements.

See accompanying notes.

LANDEC CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended	
	August 28, 2011	August 29, 2010
Revenues:		
Product sales	\$70,859	\$62,261
Services revenue, related party	980	1,065
License fees	1,462	1,627
Total revenues	73,301	64,953
Cost of revenue:		
Cost of product sales	59,999	50,724
Cost of product sales, related party	1,270	1,562
Cost of services revenue	782	850
Total cost of revenue	62,051	53,136
Gross profit	11,250	11,817
Operating costs and expenses:		
Research and development	2,333	2,232
Selling, general and administrative	6,044	5,652
Total operating costs and expenses	8,377	7,884
Operating income	2,873	3,933
Dividend income	281	—
Interest income	76	107
Interest expense	(176)	(227)
Other income (expense)	9	(58)
Net income before taxes	3,063	3,755
Income tax expense	(1,110)	(1,352)
Consolidated net income	1,953	2,403
Non controlling interest	(141)	(99)
Net income applicable to Common Stockholders	\$1,812	\$2,304
Basic net income per share	\$0.07	\$0.09
Diluted net income per share	\$0.07	\$0.09
Shares used in per share computation		
Basic	26,409	26,500
Diluted	26,687	26,719

See accompanying notes.

LANDEC CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Three months Ended	
	August 28, 2011	August 29 2010
Cash flows from operating activities:		
Consolidated net income	\$1,953	\$2,403
Adjustments. to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,355	1,306
Stock-based compensation expense	441	506
Tax benefit from stock-based compensation expense	(1,280)	(804)
Increase in receivable from Monsanto for guaranteed termination fee	(200)	(200)
Deferred taxes	(299)	375
Change in investment in non-public company (fair market value)	(52)	—
Changes in current assets and current liabilities:		
Accounts receivable, net	1,293	(982)
Accounts receivable, related party	40	95
Income taxes receivable	1,329	874
Inventories, net	533	(1,963)
Issuance of notes and advances receivable	(752)	(774)
Collection of notes and advances receivable	5	314
Prepaid expenses and other current assets	195	762
Accounts payable	1,413	3,389
Related party accounts payable	71	162
Accrued compensation	(456)	3
Other accrued liabilities	276	104
Deferred revenue	(1,507)	(1,187)
Net cash provided by operating activities	4,358	4,383
Cash flows from investing activities:		
Purchases of property and equipment	(1,561)	(1,676)
Purchase of marketable securities	(18,163)	(34,849)
Proceeds from maturities and sales of marketable securities	14,175	14,382
Net cash used in investing activities	(5,549)	(22,143)
Cash flows from financing activities:		
Repurchase of outstanding common stock	—	(362)
Taxes paid by Company for stock swaps and RSUs	(25)	—
Tax benefit from stock-based compensation expense	1,280	804
Principal payments on long-term debt	(1,000)	(615)
Decrease in other assets	43	14
Net cash provided by (used in) financing activities	298	(159)
Net decrease in cash and cash equivalents	(893)	(17,919)
Cash and cash equivalents at beginning of period	8,135	27,817
Cash and cash equivalents at end of period	\$7,242	\$9,898

Supplemental schedule of noncash operating activities:

Income tax expense not payable	\$ 1,280	\$ 804
Long-term receivable from Monsanto for guaranteed termination fee	\$ 200	\$ 200
Unrealized loss from interest rate swap	\$ 34	\$ 152

See accompanying notes.

LANDEC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization, Basis of Presentation and Summary of Significant Accounting Policies

Organization

Landec Corporation and its subsidiaries (“Landec” or the “Company”) design, develop, manufacture and sell polymer products for food and agricultural products, medical devices and licensed partner applications that incorporate Landec’s patented polymer technologies. The Company has two proprietary polymer technology platforms: 1) Intelimer® polymers, and 2) hyaluronan (“HA”) biopolymers. The Company’s HA biopolymers are proprietary in that they are specially formulated for specific customers to meet strict regulatory requirements. The Company’s polymer technologies, along with its customer relationships and trade names, are the foundation, and a key differentiating advantage upon which Landec has built its business. The Company sells specialty packaged fresh-cut vegetables and whole produce to retailers and club stores, primarily in the United States and Asia through its Apio, Inc. (“Apio”) subsidiary, Hyaluronan-based biomaterials through its Lifecore Biomedical, Inc. (“Lifecore”) subsidiary, and Intellicoat® coated seed products through its Landec Ag LLC (“Landec Ag”) subsidiary.

Basis of Presentation

The accompanying unaudited consolidated financial statements of Landec have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) have been made which are necessary to present fairly the financial position at August 28, 2011 and the results of operations and cash flows for all periods presented. Although Landec believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in financial statements and related footnotes prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted per the rules and regulations of the Securities and Exchange Commission. The accompanying financial data should be reviewed in conjunction with the audited financial statements and accompanying notes included in Landec's Annual Report on Form 10-K for the fiscal year ended May 29, 2011.

The results of operations for the three months ended August 28, 2011 are not necessarily indicative of the results that may be expected for an entire fiscal year because there is some seasonality in Apio’s food business, particularly, Apio’s Export business and the order patterns of Lifecore’s customers can lead to significant fluctuations in Lifecore’s quarterly results of operations.

Basis of Consolidation

The consolidated financial statements are presented on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles and include the accounts of Landec Corporation and its subsidiaries, Apio, Lifecore and Landec Ag. All material inter-company transactions and balances have been eliminated.

Arrangements that are not controlled through voting or similar rights are reviewed under the guidance for variable interest entities (“VIEs”). A company is required to consolidate the assets, liabilities and operations of a VIE if it is determined to be the primary beneficiary of the VIE.

In June 2009, the FASB changed the consolidation analysis for VIEs to require a qualitative analysis to determine the primary beneficiary of the VIE. The determination of the primary beneficiary of a VIE is based on whether the entity has the power to direct matters which most significantly impact the activities of the VIE and has the obligation to absorb losses, or the right to receive benefits, of the VIE which could potentially be significant to the VIE. The guidance requires an ongoing reconsideration of the primary beneficiary and also amends the events triggering a reassessment. The new guidance was effective for the Company beginning May 31, 2010. Additional disclosures for VIEs are required, including a description about a reporting entity's involvement with VIEs, how a reporting entity's involvement with a VIE affects the reporting entity's financial statements, and significant judgments and assumptions made by the reporting entity to determine whether it must consolidate the VIE.

Under the new guidance, an entity is a VIE and subject to consolidation, if by design: a) the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders or b) as a group the holders of the equity investment at risk lack any one of the following three characteristics: (i) the power, through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity's economic performance, (ii) the obligation to absorb the expected losses of the entity, or (iii) the right to receive the expected residual returns of the entity. The Company reviewed the consolidation guidance and concluded that the non-public companies in which the Company holds equity investments are not VIEs. The Company has concluded that there is no impact on the financial statements as a result of the adoption of the new guidance.

Under applicable accounting guidance, a Company also considered the requirements to consolidate an entity in which it holds voting control and concluded that due to the lack of voting control, the Company is not required to consolidate the investments in non-public companies.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make certain estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. The accounting estimates that require management's most significant, difficult and subjective judgments include revenue recognition; sales returns and allowances; recognition and measurement of current and deferred income tax assets and liabilities; the assessment of recoverability of long-lived assets; the valuation of intangible assets and inventory; the valuation and nature of impairments of investments; and the valuation and recognition of stock-based compensation.

These estimates involve the consideration of complex factors and require management to make judgments. The analysis of historical and future trends, can require extended periods of time to resolve, and are subject to change from period to period. The actual results may differ from management's estimates.

Cash, Cash Equivalents and Marketable Securities

The Company records all highly liquid securities with three months or less from date of purchase to maturity as cash equivalents. These securities consist mainly of certificate of deposits (CDs), money market funds and U.S. Treasuries.

Short-term marketable securities consist of CDs that are FDIC insured and single A or better rated municipal bonds with original maturities of more than three months at the date of purchase regardless of the maturity date as the Company views its portfolio as available for use in its current operations. The aggregate amount of CDs included in marketable securities at August 28, 2011 and May 29, 2011 was \$2.3 million and zero, respectively. The Company classifies all debt securities with readily determined market values as "available for sale". The contractual maturities of the Company's marketable securities that are due in less than one year represent \$25.0 million of its marketable securities and those due in one to two years represent the remaining \$4.8 million of the Company's marketable securities as of August 28, 2011. These investments are classified as marketable securities on the consolidated balance sheet as of August 28, 2011 and May 29, 2011 and are carried at fair market value. Unrealized gains and losses are reported as a component of stockholders' equity. The cost of debt securities is adjusted for amortization of premiums and discounts to maturity. This amortization is recorded to interest income. Realized gains and losses on the sale of available-for-sale securities are also recorded to interest income and were not significant for the three months ended August 29, 2010 and were zero for the three months ended August 28, 2011 as there were no sales of marketable securities during the first quarter of fiscal year 2012. The cost of securities sold is based on the specific identification method.

Financial Instruments

The Company's financial instruments are primarily composed of marketable debt securities, commercial-term trade payables, grower advances, and notes receivable, as well as long-term notes receivables and debt instruments. For short-term instruments, the historical carrying amount estimates their fair value. Fair values for long-term financial instruments not readily marketable are estimated based upon discounted future cash flows at prevailing market interest rates. Based on these assumptions, management believes the fair market values of the Company's financial instruments are not materially different from their recorded amounts as of August 28, 2011.

Investments in Non-Public Companies

The Company's investment in Aesthetic Sciences Corporation ("Aesthetic Sciences"), a medical device company, is carried at cost and adjusted for impairment losses. Since there is no readily available market value information, the Company periodically reviews this investment to determine if any other than temporary declines in value have occurred based on the financial stability and viability of Aesthetic Sciences. Aesthetic Sciences sold the rights to its Smartfil™ Injector System on July 16, 2010. Landec has evaluated its cost method investment for impairment, using a discounted cash flow analysis. Based on the terms of the sale, the Company had determined that its investment in Aesthetic Sciences was other than temporarily impaired and therefore recorded an impairment loss of \$1.0 million as of May 30, 2010. The Company's carrying value of its investment in Aesthetic Sciences of \$793,000 at August 28, 2011 is reported as an investment in non-public company, non-fair value, in the accompanying consolidated balance sheets.

On February 15, 2011, the Company made an investment in Windset Holdings 2010 Ltd., a Canadian corporation ("Windset"), which is reported as an investment in non-public company, fair value, in the accompanying consolidated balance sheets as of August 28, 2011. The Company has elected to account for its investment in Windset under the fair value option (see Note 3).

Intangible Assets

The Company's intangible assets are comprised of customer relationships with a finite estimated useful life of twelve years and trade names and goodwill with indefinite lives.

Finite-lived intangible assets are reviewed for possible impairment whenever events or changes in circumstances occur that indicate that the carrying amount of an asset (or asset group) may not be recoverable. Indefinite lived intangible assets are reviewed for impairment at least annually by comparing the fair value of the asset to its carrying value to determine if there has been an impairment. Goodwill is reviewed for impairment at least annually by comparing the fair value of the related reporting unit to its carrying value to determine if there has been an impairment.

Fair Value Measurements

The Company uses fair value measurement accounting for financial assets and liabilities and for financial instruments and certain other items at fair value. The Company has elected the fair value option for its investment in a non-public company (see Note 3). The Company has not elected the fair value option for any of its other eligible financial assets or liabilities.

The accounting guidance established a three-tier hierarchy for fair value measurements, which prioritizes the inputs used in measuring fair value as follows:

Level 1 – observable inputs such as quoted prices for identical instruments in active markets.

Level 2 inputs other than quoted prices in active markets that are observable either directly or indirectly through – corroboration with observable market data.

Level 3 unobservable inputs in which there is little or no market data, which would require the Company to develop its own assumptions.

As of August 28, 2011, the Company held certain assets and liabilities that are required to be measured at fair value on a recurring basis, including cash equivalents, marketable securities, interest rate swap, liability for contingent consideration in connection with the acquisition of Lifecore and its minority interest investment in Windset.

The fair value of the Company's cash equivalents and marketable securities is determined based on observable inputs that are readily available in public markets or can be derived from information available in publicly quoted markets. Therefore, the Company has categorized its cash equivalents and marketable securities as Level 1.

The fair value of the Company's interest rate swap is determined based on model inputs that can be observed in a liquid market and key inputs include yield curves and are categorized as Level 2 inputs. As of August 28, 2011, the Company recorded to other comprehensive loss on the consolidated balance sheets an unrealized loss of \$301,000, net of taxes of \$184,000, representing the cumulative change in the interest rate swap since inception. If the interest rate swap is terminated or the debt borrowed is paid off prior to April 30, 2015, the amount of unrealized loss or gain included in other comprehensive income (loss) would be reclassified to earnings. The Company has no intentions of terminating the interest rate swap or prepaying the debt in the next twelve months. The interest rate swap liability is included in other non-current liabilities as of August 28, 2011 and May 29, 2011.

The fair value of the Company's liability for contingent consideration is based on significant inputs not observed in the market and thus represents a Level 3 measurement. The Company determined the fair value of the liability for the contingent consideration based on a probability-weighted discounted cash flow analysis, as further discussed in Note 2.

The Company has elected the fair value option of accounting for its investment in Windset. The fair value of the Company's investment in Windset utilizes significant unobservable inputs in the discounted cash flow models, including projected cash flows, growth rates and the discount rate, and is therefore considered Level 3, as further discussed in Note 3.

Imprecision in estimating unobservable market inputs can affect the amount of gain or loss recorded for a particular position. Furthermore, the Company believes its valuation methods are appropriate and consistent with those of other market participants. The use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The Company has no other financial assets or liabilities for which fair value measurement has been adopted.

New Accounting Pronouncements

Recently Adopted Pronouncements

Fair Value Measurements

In January 2010, the FASB issued new accounting guidance related to the disclosures for transfers in and out of Levels 1 and 2 fair value measurements and the activity in Level 3 fair value measurements. The amendment recommends a reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers. Further, in the reconciliation for fair value measurements using significant unobservable inputs (Level 3), a reporting entity should present separately information about purchases, sales, issuances and settlements (that is, on a gross basis rather than as one net number). Also, the amendment requires clarification in existing disclosures for disaggregation of fair value measurement disclosures for each class of assets and liabilities and disclosures about inputs and valuation techniques. The effective date is for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Company adopted all the amended provisions of new guidance in the first quarter of fiscal year 2011 and such adoption did not have an impact on the Company's results of operations or financial position for the three months ended August 28, 2011.

2. Acquisition of Lifecore Biomedical, Inc.

On April 30, 2010 (the "Acquisition Date"), the Company acquired all of the common stock of Lifecore Biomedical, Inc. ("Lifecore") under a Stock Purchase Agreement ("Purchase Agreement") in order to expand its product offerings and enter into new markets. Lifecore was a privately-held hyaluronan-based biomaterials company located in Chaska, Minnesota. Lifecore is principally involved in the development and manufacture of products utilizing hyaluronan, a naturally occurring polysaccharide that is widely distributed in the extracellular matrix of connective tissues in both animals and humans.

Under the Purchase Agreement, the aggregate consideration payable by the Company to the former Lifecore stockholder at closing consisted of \$40.0 million in cash, which included \$6.6 million that is held in an escrow

account to secure the indemnification rights of Landec and other indemnities with respect to certain matters, including breaches of representations, warranties and covenants included in the Purchase Agreement. The escrow account is in the name of the seller and Landec's rights under the escrow agreement consist solely of its ability to file a claim against the escrow. Half of the escrow, or \$3.3 million, was released and paid to the former Lifecore shareholder in May 2011. In addition, the Company may be required to pay in cash up to an additional \$10.0 million in earn out payments in the event that Lifecore achieves certain revenue targets in calendar years 2011 and 2012.

The acquisition date fair value of the total consideration transferred was \$49.65 million, which consisted of the following (in thousands):

Cash	\$40,000
Contingent consideration	9,650
Total	\$49,650

The assets and liabilities of Lifecore were recorded at their respective estimated fair values as of the date of the acquisition using generally accepted accounting principles for business combinations. The excess of the purchase price over the fair value of the net identifiable assets acquired has been allocated to goodwill. Goodwill represents a substantial portion of the acquisition proceeds because of the workforce in-place at acquisition and because of Lifecore's long history and future prospects. Management believes that there is further growth potential by extending Lifecore's product lines into new channels.

The following table summarizes the estimated fair values of Lifecore's assets acquired and liabilities assumed and related deferred income taxes, effective April 30, 2010, the date the Company obtained control of Lifecore (in thousands).

Cash and cash equivalents	\$318	
Accounts receivable, net	1,860	
Inventories, net	9,009	
Property and equipment	25,529	
Other tangible assets	1,455	
Intangible assets	7,900	
Total identifiable assets acquired	46,071	
Accounts payable and other liabilities	(2,983))
Long-term debt	(4,157))
Deferred taxes	(3,162))
Total liabilities assumed	(10,302))
Net identifiable assets acquired	35,769	
Goodwill	13,881	
Net assets acquired	\$49,650	

The Company used a combination of the market and cost approaches to estimate the fair values of the Lifecore assets acquired and liabilities assumed. During the measurement period (which is not to exceed one year from the acquisition date), the Company is required to retrospectively adjust the provisional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets or liabilities as of that date. The Company has finalized the fair values of the acquired assets and assumed liabilities and has completed the purchase price allocation as of April 30, 2011.

Inventory

A step-up in the value of inventory of \$523,000 was recorded in the allocation of the purchase price based on valuation estimates. During the three months ended August 28, 2010, \$162,000 of this step-up was charged to cost of products sold as the inventory was sold. The entire step up was charged to cost of product sold during fiscal years 2010 and 2011 and no step up remained in inventory as of May 29, 2011.

Intangible Assets

The Company identified two intangible assets in connection with the Lifecore acquisition: trade names valued at \$4.2 million, which is considered to be an indefinite life asset and therefore will not be amortized; and customer base valued at \$3.7 million with a twelve year useful life. The trade name intangible asset was valued using the relief from royalty valuation method and the customer relationship intangible asset was valued using the multi-period excess earnings method.

Goodwill

The excess of the consideration transferred over the fair values assigned to the assets acquired and liabilities assumed was \$13.9 million, which represents the goodwill amount resulting from the acquisition which can be attributable to its work force in place at the time of the acquisition and to Lifecore's long history and future prospects. None of the goodwill is expected to be deductible for income tax purposes. The Company will test goodwill for impairment on an annual basis or sooner, if deemed necessary.

Liability for Contingent Consideration

In addition to the cash consideration paid to the former shareholder of Lifecore, the Company may be required to pay up to an additional \$10.0 million in earn out payments based on Lifecore achieving certain revenue targets in calendar years 2011 and 2012. The fair value of the liability for the contingent consideration recognized on the acquisition date was \$9.88 million and \$9.84 million, as of August 28, 2011 and May 29, 2011, respectively, and is classified as an other accrued liability in the Consolidated Balance Sheets as of August 28, 2011. The Company projects that it will pay the entire \$10 million earn out during fiscal year 2012.

3. Investments in non-public companies

In December 2005, Landec entered into a licensing agreement with Aesthetic Sciences for the exclusive rights to use Landec's Intelimer materials technology for the development of dermal fillers worldwide. The Company received shares of preferred stock in exchange for the license with a valuation of \$1.8 million. Aesthetic Sciences sold the rights to its Smartfil™ Injector System on July 16, 2010. Landec has evaluated its investment in Aesthetic Sciences for impairment, utilizing a discounted cash flow analysis. Based on the terms of the sale, the Company had determined that its investment was other than temporarily impaired and therefore recorded an impairment charge of \$1.0 million as of May 30, 2010. The Company's carrying value of its investment in Aesthetic Sciences is \$793,000 as of August 28, 2011.

On February 15, 2011, Apio entered into a share purchase agreement (the "Purchase Agreement") with Windset. Pursuant to the Purchase Agreement, Apio purchased 150,000 non-voting senior preferred shares for \$15 million and 201 common shares for \$201 that were issued by Windset (the "Purchased Shares"). The Company's common shares represent a 20.1% interest in Windset. The non-voting senior preferred shares yield a cash dividend of 7.5% annually. The dividend is payable within 90 days of each anniversary of the execution of the Purchase Agreement. The Purchase Agreement includes a put and call option, which can be exercised on the sixth anniversary of the Purchase Agreement whereby Apio can exercise the put to sell its Purchased Shares to Windset, or Windset can exercise the call to purchase the Purchased Shares from Apio, in either case, at a price equal to 20.1% of the appreciation in the fair market value of Windset from the date of the Company's investment through the put and call date, plus the purchase price of the Purchased Shares. Under the terms of the arrangement with Windset, the Company is entitled to designate one of five members on the Board of Directors of Windset.

In accordance with accounting guidance, the investment in Windset does not qualify for equity method accounting as the investment does not meet the criteria of in-substance common stock due to returns through the annual dividend on the non-voting senior preferred shares that are not available to the common stock holders. As the put and call options require the Purchased Shares to be put or called in equal proportions, the Company has deemed that the investment, in substance, should be treated as a single security for purposes of accounting. The Company has adopted fair value option in the accounting for its investment in Windset effective on the acquisition date. The Company believes that reporting its investment at fair value provides its investors with useful information on the performance of the Company's investment and the anticipated appreciation in value as Windset expands its business.

The Company also entered into an exclusive license agreement with Windset, which was executed in June 2010, prior to contemplation of Apio's investment in Windset (see Note 4).

The fair value of the Company's investment in Windset was determined utilizing a discounted cash flow model based on projections developed by Windset, and considers the put and call conversion options. These features impact the duration of the cash flow utilized to derive the estimated fair value of the investment. The Company has concluded that the estimated fair value of its investment in Windset approximates the cash consideration paid for the Purchased Shares at the date of acquisition. Assumptions included in the discounted cash flow model will be evaluated quarterly

based on Windset's actual and projected operating results to determine the change in fair value.

For the three months ended August 28, 2011, the Company recorded \$281,000 in dividend income. The change in the fair market value of the Company's investment in Windset for the three months ended August 28, 2011 was determined to be \$52,000 which is recorded as other income.

-11-

4. License Agreements

Monsanto

On December 1, 2006, Landec entered into a five-year co-exclusive technology license and polymer supply agreement (“the Monsanto Agreement”) with Monsanto Company (“Monsanto”) for the use of Landec’s Intellicoat polymer seed coating technology. Under the terms of the Monsanto Agreement, Monsanto agreed to pay Landec Ag \$2.6 million per year. The Monsanto Agreement was amended in November 2009. Under the terms of the amended Monsanto Agreement, Monsanto continues to have an exclusive license to use Landec’s Intellicoat polymer technology for specific seed treatment applications. Along with regaining the use of the Intellicoat technology outside of the specific applications licensed to Monsanto under the amended Monsanto Agreement, Landec also assumed responsibility for Landec Ag’s operating expenses and realizes all the revenues and profits from the sales of existing and new Intellicoat seed coating products.

On September 9, 2011, Monsanto informed the Company that it intends to allow the Monsanto Agreement to expire in accordance with its terms on December 1, 2011 and therefore, Monsanto is not going to exercise its purchase option. Upon termination, Monsanto will be obligated to pay Landec Ag a \$4 million termination fee and all rights to the Intellicoat seed coating technology will revert to Landec.

For each of the three months ended August 28, 2011 and August 29, 2010, Landec recognized \$1.35 million in License revenues from the Monsanto Agreement.

Air Products

In March 2006, Landec entered into an exclusive license and research and development agreement with Air Products and Chemicals, Inc. (“Air Products”). Landec will provide research and development support to Air Products for three years with a mutual option for two additional years. The license fees were recognized as license revenue over a three year period beginning March 2006. In addition, in accordance with the agreement, Landec receives 40% of the gross profit generated from the sale of products by Air Products occurring after April 1, 2007, that incorporate Landec’s Intelimer materials.

Chiquita

In September 2007, the Company amended its licensing and supply agreement with Chiquita Brands International, Inc. (“Chiquita”). Under the terms of the amendment, the license for bananas was expanded to include additional exclusive fields using Landec’s BreatheWay® packaging technology, and a new exclusive license was added for the sale and marketing of avocados and mangos using Landec’s BreatheWay packaging technology. The agreement with Chiquita, which terminates in December 2011 (subject to Chiquita’s five year renewal option), requires Chiquita to pay annual gross profit minimums to Landec in order for Chiquita to maintain its exclusive license for bananas, avocados and mangos. Under the terms of the agreement, Chiquita must notify Landec before December 1st of each year whether it is going to maintain its exclusive license for the following calendar year and thus agree to pay the minimums for that year. Landec was notified by Chiquita in November 2010 that Chiquita had chosen to maintain its exclusive license for calendar year 2011 and thus agreed at that time to pay the minimum gross profit for calendar year 2011.

Windset

In June 2010, Apio entered into an exclusive license agreement with Windset for Windset to utilize Landec’s proprietary breathable packaging to extend the shelf life of greenhouse grown cucumbers, peppers and tomatoes

("Exclusive Products"). In accordance with the agreement, Apio received and recorded a one-time upfront research and development fee of \$100,000 and will receive license fees equal to 3% of net revenue of the Exclusive Products utilizing the proprietary breathable packaging technology, with or without the BreatheWay® trademark. The ongoing license fees are subject to annual minimums of \$150,000 for each of the three types of exclusive product as each is added to the agreement. As of August 28, 2011, only one product has been added to the agreement. In addition, the first year minimum payment period had an original payment date of June 2011 which has been deferred until April 2012 due to delays in obtaining required packaging materials.

5. Stock-Based Compensation

In the three months ended August 28, 2011, the Company recognized stock-based compensation expense of \$441,000 or \$0.02 per basic and diluted share, which included \$202,000 for restricted stock unit awards and \$239,000 for stock option grants. In the three months ended August 29, 2010, the Company recognized stock-based compensation expense of \$506,000 or \$0.02 per basic and diluted share, which included \$244,000 for restricted stock unit awards and \$262,000 for stock option grants.

The following table summarizes the stock-based compensation by income statement line item:

	Three Months Ended August 28, 2011	Three Months Ended August 29, 2010
Research and development	\$ 124,000	\$ 146,000
Sales, general and administrative	317,000	360,000
Total stock-based compensation	\$441,000	\$506,000

As of August 28, 2011, there was \$2.6 million of total unrecognized compensation expense related to unvested equity compensation awards granted under the Landec incentive stock plans. Total expense is expected to be recognized over the weighted-average period of 1.7 years for stock options and 1.6 years for restricted stock unit awards.

6. Diluted Net Income Per Share

The following table sets forth the computation of diluted net income per share (in thousands, except per share amounts):

	Three Months Ended August 28, 2011	Three Months Ended August 29, 2010
Numerator:		
Net income applicable to Common Stockholders	\$ 1,812	\$ 2,304
Denominator:		
Weighted average shares for basic net income per share	26,409	26,500
Effect of dilutive securities:		
Stock options and restricted stock units	278	219
Weighted average shares for diluted net income per share	26,687	26,719
Diluted net income per share	\$0.07	\$0.09

For the three months ended August 28, 2011 and August 29, 2010, the computation of the diluted net income per share excludes the impact of options to purchase 1.8 million shares and 2.0 million shares of Common Stock, respectively, as such impacts would be antidilutive for these periods.

7. Income Taxes

The provision for income taxes for the three months ended August 28, 2011 was \$1.1 million. The effective tax rate for the three months ended August 28, 2011 was 38 percent compared to 37 percent for the same period in fiscal year 2011. The effective tax rate for the three months ended August 28, 2011 differs from the statutory federal income tax rate of 35 percent as a result of several factors, including state taxes, non-deductible stock-based compensation expense, tax exempt interest and the benefit of federal and state research and development credits.

As of May 29, 2011, the Company had unrecognized tax benefits of approximately \$760,000. Included in the balance of unrecognized tax benefits as of May 29, 2011 is approximately \$601,000 of tax benefits that, if recognized, would result in an adjustment to the Company's effective tax rate. The Company expects its unrecognized tax benefits to change by \$240,000 within the next twelve months related to the expiration of tax attributes.

In accordance with accounting guidance, the Company has decided to classify interest and penalties related to uncertain tax positions as a component of its provision for income taxes. The Company has accrued an insignificant amount of interest and penalties relating to the income tax on the unrecognized tax benefits as of August 28, 2011 and May 29, 2011.

Due to tax attribute carry forwards, the Company is subject to examination for tax years 1996 forward for U.S. tax purposes. The Company was also subject to examination in various state jurisdictions for tax years 1998 forward, none of which were individually significant.

8. Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market and consisted of the following (in thousands):

	August 28, 2011	May 29, 2011
Finished goods	\$10,070	\$10,261
Raw materials	7,653	7,999
Work in progress	1,905	1,901
Total	\$19,628	\$20,161

9. Debt

On April 30, 2010, Lifecore entered into a \$20 million Credit Agreement with Wells Fargo Bank N.A. ("Wells Fargo") with a five-year term that provides for equal monthly principal payments plus interest. All of Lifecore's assets, valued at approximately \$83 million as of August 28, 2011, have been pledged to secure the debt incurred pursuant to the Credit Agreement. Landec is the guarantor of the debt.

On August 19, 2004, Lifecore issued variable rate industrial revenue bonds ("IRB"). These bonds were assumed by Landec in the acquisition of Lifecore (see Note 2). The bonds are collateralized by a bank letter of credit secured by a first mortgage on the Company's facility in Chaska, Minnesota. In addition, the Company pays an annual remarketing fee equal to 0.125% and an annual letter of credit fee of 0.50% on the outstanding principal balance.

The Credit Agreement and the IRB contain certain restrictive covenants, which require Lifecore to meet certain financial tests, including minimum levels of net income, minimum quick ratio, minimum fixed coverage ratio and maximum capital expenditures.

Long-term debt consists of the following (in thousands):

	August 28, 2011	May 29, 2011
Credit agreement with Wells Fargo; due in monthly payments of \$333,333 through April 30, 2015 with interest payable monthly at one-month Libor plus 2% per annum (2.25% and 2.375% at August 28, 2011 and May 29, 2011, respectively)	\$ 15,000	\$ 16,000
Industrial revenue bonds issued by Lifecore; due in annual payments through 2020 with interest at a variable rate set weekly by the bond remarketing agent (0.40% at both August 28, 2011 and May 29, 2011)	3,830	3,830
Total	18,830	19,830
Less current portion	(4,330)	(4,330)
Long-term portion	\$14,500	\$15,500

The maturities on the IRB are held in a sinking fund account, recorded in Prepaid expenses and other current assets in the accompanying Consolidated Balance Sheets and are paid out each year on September 1st.

10. Derivative Financial Instruments

In May 2010, the Company entered into a five-year interest rate swap agreement under the Company's Credit Agreement which expires on April 30, 2015. The interest rate swap was designated as a cash flow hedge of future interest payments and has a notional amount of \$20 million. As a result of the interest rate swap transaction, the Company fixed for a five-year period the interest rate at 4.24%, subject to market based interest rate risk on \$20 million of borrowings under its Credit Agreement. The Company's obligations under the interest rate swap transaction are guaranteed and secured on the same basis as is its obligations under the Credit Agreement. As of August 28, 2011, the Company recorded to Other Comprehensive Loss on the Consolidated Balance Sheets an unrealized loss of \$301,000, net of taxes of \$184,000, as a result of the interest rate swap. If the interest rate swap is terminated or the debt borrowed is paid off prior to April 30, 2015, the amount of unrealized loss or gain included in Other Comprehensive Income (Loss) would be reclassified to earnings. The Company has no intentions of terminating the interest rate swap or prepaying the debt in the next twelve months. The interest rate swap liability is included in other non current liabilities in the accompanying Consolidated Balance Sheets as of August 28, 2011 and May 29, 2011.

11. Related Party

The Company provides cooling and distribution services to both a farm and Beachside Produce LLC ("Beachside"), a commodity produce distributor, in which the Chairman of Apio has a farming and ownership interest, respectively. During the three months ended August 28, 2011 and August 29, 2010, the Company recognized revenues of \$1.1 million and \$1.2 million, respectively, from the sale of products and providing cooling services to these parties which have been included in product sales and in service revenues in the accompanying Consolidated Statements of Income. The related receivable balances of \$413,000 and \$453,000 are included in accounts receivable in the accompanying Consolidated Balance Sheets as of August 28, 2011 and May 29, 2011, respectively.

Additionally, unrelated to the revenue transactions above, the Company purchases produce from the farm in which the Chairman of Apio has an ownership interest, Beachside, and Windset (see Note 3) for sale to third parties. During the three months ended August 28, 2011 and August 29, 2010, the Company recognized cost of product sales of \$1.3 million and \$1.6 million, respectively, from the sale of products purchased from these parties which have been included in cost of product sales in the accompanying Consolidated Statements of Income. The related accounts payable of \$454,000 and \$346,000 are included in accounts payable and other accrued liabilities in the accompanying Consolidated Balance Sheets as of August 28, 2011 and May 29, 2011, respectively.

All related party transactions are monitored quarterly by the Company and approved by the Audit Committee of the Board of Directors.

12. Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income and other comprehensive income including unrealized gains and losses on interest rate swaps. Accumulated other comprehensive loss is reported as a component of stockholders' equity. For the three months ended August 28, 2011, the comprehensive loss from the unrealized loss on the interest rate swap, net of \$184,000 of income taxes, was \$301,000. For the three months ended August 29, 2010, the comprehensive loss from the unrealized loss on the interest rate swap, net of \$105,000 of income taxes, was \$152,000.

13. Stockholders' Equity

During the three months ended August 28, 2011, the Company granted options to purchase 7,500 shares of common stock and 2,500 restricted stock unit awards.

As of August 28, 2011 the Company has reserved 3.4 million shares of Common Stock for future issuance under its current and former equity plans.

On July 14, 2010, the Company announced that the Board of Directors of the Company had approved the establishment of a stock repurchase plan which allows for the repurchase of up to \$10 million of the Company's Common Stock. The Company may repurchase its common stock from time to time in open market purchases or in privately negotiated transactions. The timing and actual number of shares repurchased is at the discretion of management of the Company and will depend on a variety of factors, including stock price, corporate and regulatory requirements, market conditions, the relative attractiveness of other capital deployment opportunities and other corporate priorities. The stock repurchase program does not obligate Landec to acquire any amount of its common stock and the program may be modified, suspended or terminated at any time at the Company's discretion without prior notice. During the three months ended August 28, 2011, the Company did not purchase any shares on the open market.

Consolidated Statements of Changes in Stockholders' Equity
(in thousands, except share amounts)

	August 28, 2011
Common Stock Shares	
Balance at May 29, 2011	26,405,799
Stock options exercised, net of shares tendered	—
Vested restricted stock units, net of shares tendered	6,332
Common stock repurchased on the open market	—
Balance at August 28, 2011	26,412,131
Common Stock	
Balance at May 29, 2011	\$27
Stock options exercised, net of shares tendered	—
Vested restricted stock units, net of shares tendered	—
Common stock repurchased on the open market	—
Balance at August 28, 2011	\$27
Additional Paid-in Capital	
Balance at May 29, 2011	\$119,169
Stock options exercised, net of shares tendered	—
Vested restricted stock units, net of shares tendered	—
Taxes paid by Company for RSUs vested	(25)
Stock-based compensation expense	441
Tax-benefit from stock based compensation expense	1,280
Common stock repurchased on the open market	—
Balance at August 28, 2011	\$120,865
Accumulated Other Comprehensive Loss	
Balance at May 29, 2011	\$(267)
Change in other comprehensive loss	(34)
Balance at August 28, 2011	\$(301)
Retained Earnings	
Balance at May 29, 2011	\$17,126
Net income	1,812
Balance at August 28, 2011	\$18,938
Non controlling Interest	
Balance at May 29, 2011	\$1,671
Non controlling interest in net income	141
Distributions to non controlling interest	-
Balance at August 28, 2011	\$1,812

14. Business Segment Reporting

The Company manages its business operations through four strategic business units. Based upon the information reported to the chief operating decision maker, who is the Chief Executive Officer, the Company has the following

reportable segments: the Food Products Technology segment, the Food Export segment, the Hyaluronan-based Biomaterials segment and the Technology Licensing segment. The Food Products Technology segment markets and packs specialty packaged whole and fresh-cut vegetables that incorporate the BreatheWay specialty packaging for the retail grocery, club store and food services industry. In addition, the Food Products Technology segment sells BreatheWay packaging to partners for non-vegetable products. The Food Export segment consists of revenues generated from the purchase and sale of primarily whole commodity fruit and vegetable products to Asia and domestically. The HA-based Biomaterials segment sells products utilizing hyaluronan, a naturally occurring polysaccharide that is widely distributed in the extracellular matrix of connective tissues in both animals and humans for medical use primarily in the Ophthalmic, Orthopedic and Veterinary markets. The Technology Licensing segment licenses Landec's patented Intellicoat seed coatings to the farming industry and licenses the Company's Intelimer polymers for personal care products and other industrial products. Corporate includes corporate general and administrative expenses, non Food Products Technology and non HA-based Biomaterials interest income and Company-wide income tax expenses. All of the assets of the Company are located within the United States of America. For the three months ended August 28, 2011, the Company's international sales were \$9.4 million to Taiwan, \$7.5 million to Indonesia, \$5.0 million to Canada and \$8.2 million to all other countries. For the three months ended August 29, 2010, the Company's international sales were \$8.5 million to Taiwan, \$4.6 million to Indonesia, \$3.7 million to Canada, \$3.0 million to Belgium and \$5.7 million to all other countries.

Operations and identifiable assets by business segment consisted of the following (in thousands):

	Food Products Technology	Food Export	HA-based Biomaterials	Technology Licensing	Corporate	TOTAL
Three Months Ended August 28, 2011						
Net sales	\$ 43,363	\$21,355	\$ 7,121	\$1,462	\$—	\$73,301
International sales	\$ 5,071	\$21,310	\$ 3,766	\$—	\$—	\$30,147
Gross profit	\$ 6,059	\$1,014	\$ 2,715	\$1,462	\$—	\$11,250
Net income (loss)	\$ 3,358	\$297	\$ 462	\$374	\$(2,679)	\$1,812
Depreciation and amortization	\$ 780	\$2	\$ 528	\$45	\$—	\$1,355
Dividend income	\$ 281	\$—	\$ —	\$—		\$281
Interest income	\$ 8	\$—	\$ 47	\$—	\$21	\$76
Interest expense	\$ —	\$—	\$ 176	\$—	\$—	\$176
Income tax expense	\$ —	\$—	\$ —	\$—	\$1,110	\$1,110
Three Months Ended August 29, 2010						
Net sales	\$ 40,558	\$16,483	\$ 6,385	\$1,527	\$—	\$64,953
International sales	\$ 4,605	\$16,446	\$ 4,433	\$—	\$—	\$25,484
Gross profit	\$ 6,363	\$932	\$ 2,995	\$1,527	\$—	\$11,817
Net income (loss)						