

CYANOTECH CORP  
Form 10-Q  
November 09, 2012  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For Quarterly Period Ended September 30, 2012**

**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 Number 0-14602**

**CYANOTECH CORPORATION**

(Exact name of registrant as specified in its charter)

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NEVADA  
(State or other jurisdiction  
of incorporation or organization)

91-1206026  
(IRS Employer  
Identification Number)

73-4460 Queen Kaahumanu Hwy. #102, Kailua-Kona, HI 96740

(Address of principal executive offices)

(808) 326-1353

(Registrant's telephone number)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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

Number of common shares outstanding as of November 6, 2012:

| Title of Class                  | Shares Outstanding |
|---------------------------------|--------------------|
| Common stock - \$0.02 par value | 5,463,488          |



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CYANOTECH CORPORATION

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## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands except par value and number of shares)

(Unaudited)

|   | September 30,<br>2012 | March 31,<br>2012 |
|---|-----------------------|-------------------|
| <b>ASSETS</b>   |                       |                   |
| Current assets:   |                       |                   |
| Cash and cash equivalents   | \$ 3,603              | \$ 5,061          |
| Accounts receivable, net of allowance for doubtful accounts of \$6 at September 30, 2012 and \$16 at March 31, 2012   | 3,818                 | 2,373             |
| Inventories, net  | 3,357                 | 3,548             |
| Deferred tax assets   | 137                   | 137               |
| Prepaid expenses and other current assets   | 268                   | 300               |
| Total current assets  | 11,183                | 11,419            |
| Equipment and leasehold improvements, net   | 6,704                 | 5,834             |
| Restricted cash   | 2,250                 |                   |
| Deferred tax assets   | 1,307                 | 1,307             |
| Other assets  | 759                   | 478               |
| Total assets  | \$ 22,203             | \$ 19,038         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                       |                   |
| Current liabilities:  |                       |                   |
| Current maturities of long-term debt  | \$ 60                 | \$ 234            |
| Customer deposits   | 43                    | 49                |
| Accounts payable  | 2,176                 | 1,726             |
| Accrued expenses  | 971                   | 1,352             |
| Total current liabilities   | 3,250                 | 3,361             |
| Long-term debt, excluding current maturities  | 2,310                 | 400               |
| Deferred rent   | 15                    | 12                |
| Total liabilities   | 5,575                 | 3,773             |
| Commitments and contingencies   |                       |                   |
| Stockholders' equity:   |                       |                   |
| Common stock of \$0.02 par value, shares authorized 7,500,000; 5,463,488 shares issued and outstanding at September 30, 2012 and 5,440,968 shares at March 31, 2012 | 109                   | 109               |
| Additional paid-in capital  | 28,718                | 28,324            |

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|  |           |           |
|--|-----------|-----------|
| Accumulated deficit                        | (12,199)  | (13,168)  |
| Total stockholders' equity                 | 16,628    | 15,265    |
| Total liabilities and stockholders' equity | \$ 22,203 | \$ 19,038 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share amounts)

(Unaudited)

|  | Three Months Ended<br>September 30, |          | Six Months Ended<br>September 30, |           |
|--|-------------------------------------|----------|-----------------------------------|-----------|
|  | 2012                                | 2011     | 2012                              | 2011      |
| NET SALES  | \$ 6,936                            | \$ 5,989 | \$ 13,442                         | \$ 11,939 |
| COST OF SALES  | 4,124                               | 3,199    | 8,056                             | 7,045     |
| Gross profit   | 2,812                               | 2,790    | 5,386                             | 4,894     |
| <b>OPERATING EXPENSES:</b>                                 |                                     |          |                                   |           |
| General and administrative                                 | 1,285                               | 1,117    | 2,433                             | 2,065     |
| Sales and marketing  | 880                                 | 609      | 1,718                             | 1,176     |
| Research and development                                   | 80                                  | 89       | 131                               | 160       |
| Loss on disposal of equipment and leasehold improvements   | 13                                  | 62       | 35                                | 64        |
| Total operating expenses                                   | 2,258                               | 1,877    | 4,317                             | 3,465     |
| Income from operations                                     | 554                                 | 913      | 1,069                             | 1,429     |
| <b>OTHER EXPENSE:</b>                                      |                                     |          |                                   |           |
| Loss on extinguishment of debt                             | (51)                                |          | (51)                              |           |
| Interest expense, net                                      | (17)                                | (10)     | (29)                              | (24)      |
| Total other expense, net                                   | (68)                                | (10)     | (80)                              | (24)      |
| Income before provision for income taxes                   | 486                                 | 903      | 989                               | 1,405     |
| PROVISION FOR INCOME TAXES                                 | (10)                                | (28)     | (20)                              | (44)      |
| NET INCOME   | \$ 476                              | \$ 875   | \$ 969                            | \$ 1,361  |
| <b>NET INCOME PER SHARE:</b>                               |                                     |          |                                   |           |
| Basic  | \$ 0.09                             | \$ 0.16  | \$ 0.18                           | \$ 0.25   |
| Diluted  | \$ 0.08                             | \$ 0.16  | \$ 0.17                           | \$ 0.25   |
| <b>SHARES USED IN CALCULATION OF NET INCOME PER SHARE:</b> |                                     |          |                                   |           |
| Basic  | 5,450                               | 5,398    | 5,445                             | 5,397     |
| Diluted  | 5,635                               | 5,473    | 5,758                             | 5,471     |

See accompanying Notes to Condensed Consolidated Financial Statements.

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## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

|   | Six Months Ended<br>September 30, |          |
|---|-----------------------------------|----------|
|   | 2012                              | 2011     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                   |          |
| Net income  | \$ 969                            | \$ 1,361 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |          |
| Loss on extinguishment of debt  | 51                                |          |
| Loss on disposal of equipment and leasehold improvements                          | 35                                | 64       |
| Depreciation and amortization   | 399                               | 337      |
| Amortization of debt issue costs and other assets                                 | 74                                | 21       |
| Share based compensation expense  | 372                               | 200      |
| Reduction of allowance for doubtful accounts                                      | (10)                              |          |
| Net (increase) decrease in assets:  |                                   |          |
| Accounts receivable   | (1,435)                           | 117      |
| Inventories   | 191                               | 439      |
| Prepaid expenses and other assets   | (64)                              | (100)    |
| Net increase (decrease) in liabilities:   |                                   |          |
| Customer deposits   | (6)                               | (38)     |
| Accounts payable  | 450                               | 182      |
| Accrued expenses  | (381)                             | 196      |
| Deferred rent   | 3                                 |          |
| Net cash provided by operating activities   | 648                               | 2,779    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                   |          |
| Restricted cash from issuance of long term debt                                   | (2,250)                           |          |
| Investment in equipment and leasehold improvements                                | (1,304)                           | (716)    |
| Net cash used in investing activities   | (3,554)                           | (716)    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                   |          |
| Proceeds from long term debt, net of costs  | 2,281                             | 65       |
| Principal payments on long-term debt  | (596)                             | (105)    |
| Payments for debt issuance costs  | (259)                             |          |
| Proceeds from stock options exercised   | 22                                | 6        |
| Net cash provided by (used in) financing activities                               | 1,448                             | (34)     |
| Net (decrease) increase in cash and cash equivalents                              | (1,458)                           | 2,029    |
| Cash and cash equivalents at beginning of period                                  | 5,061                             | 2,062    |
| Cash and cash equivalents at end of period  | \$ 3,603                          | \$ 4,091 |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>                          |                                   |          |
| Cash paid during the period for:  |                                   |          |
| Interest  | \$ 84                             | \$ 21    |



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|              |    |    |    |    |
|--------------|----|----|----|----|
| Income taxes | \$ | 44 | \$ | 18 |
|--------------|----|----|----|----|

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As of September 30, 2012

(Unaudited)

**1. BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information pursuant to the instructions to Form 10-Q and Regulation S-X of the Securities and Exchange Commission (SEC). These interim condensed consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the Condensed Consolidated Balance Sheets, Condensed Consolidated Statements of Operations, and Condensed Consolidated Statements of Cash Flows for the periods presented in accordance with GAAP. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The Condensed Consolidated Balance Sheet as of March 31, 2012 was derived from the audited financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company's consolidated financial statements for the year ended March 31, 2012, contained in the Company's annual report on Form 10-K as filed with the SEC on June 21, 2012.

The accompanying consolidated condensed financial statements include the accounts of Cyanotech Corporation and its wholly owned subsidiary, Nutrex Hawaii, Inc. ( Nutrex Hawaii or Nutrex , collectively the Company ). All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the periods reported. Management reviews these estimates and assumptions periodically and reflects the effect of revisions in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

**2. INVENTORIES**

Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out method. Inventories consist of the following:

|               | September 30, 2012 | March 31, 2012 |
|---------------|--------------------|----------------|
|               | (in thousands)     |                |
| Raw materials | \$ 513             | \$ 344         |

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|                   |          |          |
|-------------------|----------|----------|
| Work in process   | 291      | 253      |
| Finished goods(1) | 2,306    | 2,722    |
| Supplies          | 247      | 229      |
|                   | \$ 3,357 | \$ 3,548 |

(1) Net of reserve for obsolescence of \$13,000 and \$41,000 at September 30, 2012 and March 31, 2012, respectively.

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Approximately \$481,000 and \$714,000 of abnormal production costs were charged to cost of sales for the three and six months ended September 30, 2012, respectively. Approximately \$218,000 and \$416,000 of abnormal production costs were charged to cost of sales for the three and six months ended September 30, 2011.

**3. EQUIPMENT AND LEASEHOLD IMPROVEMENTS**

Equipment and leasehold improvements are stated at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives for equipment and furniture and fixtures, or the shorter of the land lease term or estimated useful lives for leasehold improvements as follows:

|                        |                |
|------------------------|----------------|
| Equipment              | 3 to 10 years  |
| Furniture and fixtures | 3 to 7 years   |
| Leasehold improvements | 10 to 25 years |

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Equipment and leasehold improvements consist of the following:

|  | September 30, 2012 | March 31, 2012 |
|--|--------------------|----------------|
|  | (in thousands)     |                |
| Equipment(1)                                   | \$ 7,182           | \$ 6,695       |
| Leasehold improvements                         | 8,191              | 7,524          |
| Furniture and fixtures                         | 177                | 154            |
|  | 15,550             | 14,373         |
| Less accumulated depreciation and amortization | (10,231)           | (9,867)        |
| Construction-in-progress                       | 1,385              | 1,328          |
| Equipment and leasehold improvements, net      | \$ 6,704           | \$ 5,834       |

(1) Includes \$97,000 of equipment under capital lease with accumulated amortization of \$49,000 and \$39,000 at September 30, 2012 and March 31, 2012, respectively.

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amount to forecasted undiscounted future cash flows expected to be generated by the asset. If the carrying amount exceeds its estimated future cash flows, then an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Management has determined no asset impairment existed as of September 30, 2012. The Company recognized a loss on disposal of assets in the amount of \$13,000 and \$35,000 for the three and six months ended September 30, 2012, respectively. The Company recognized a loss on disposal of assets in the amount of \$62,000 and \$64,000 for the three and six months ended September 30, 2011, respectively.

#### 4. ACCRUED EXPENSES

Accrued expenses consist of the following:

|                    | September 30, 2012 | March 31, 2012 |
|--------------------|--------------------|----------------|
|                    | (in thousands)     |                |
| Wages, commissions | \$ 509             | \$ 491         |
| Customer rebates   | 192                | 69             |
| Bonuses            | 51                 | 642            |
| Rent               | 47                 | 17             |
| Other expenses     | 172                | 133            |
|                    | \$ 971             | \$ 1,352       |

#### 5. LONG-TERM DEBT

Long-term debt consists of the following:

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|  | September 30, 2012 |       | March 31, 2012 |       |
|--|--------------------|-------|----------------|-------|
|  | (in thousands)     |       |                |       |
| Term loans                                   | \$                 | 2,370 | \$             | 634   |
| Less current maturities                      |                    | (60)  |                | (234) |
| Long-term debt, excluding current maturities | \$                 | 2,310 | \$             | 400   |

*Term Loan Agreements*

On September 7, 2012, the Company completed a loan agreement with a lender providing for \$5,500,000 in aggregate credit facilities (the Loan ), secured by substantially all the Company s assets, pursuant to a Term Loan Agreement dated August 14, 2012 (the Loan Agreement ). The Loan Agreement is evidenced by promissory notes in the amounts of \$2,250,000 and \$3,250,000, the repayment of which is partially guaranteed under the provisions of a United States Department of Agriculture ( USDA ) Rural Development Guarantee program (the Guarantees ). The proceeds of the Loan will be used to acquire new processing equipment and leasehold improvements at its Kona, Hawaii facility.

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The provisions of the Loan require the payment of interest only for the first 12 months of the term; thereafter, and until its maturity on August 14, 2032, the obligation fully amortizes over nineteen (19) years. Interest on the Loan accrues on the outstanding principal balance at an annual variable rate equal to the published Wall Street Journal prime rate (3.25% at September 30, 2012) plus 1.0% and is adjustable on the first day of each calendar quarter and fixed for that quarter. At no time shall the annual interest rate be less than 5.50%. The Loan has a prepayment penalty of 5% for any prepayment made prior to the first anniversary of the date of the Loan Agreement, which penalty is reduced by 1% each year thereafter until the fifth anniversary of such date, after which there is no prepayment penalty. The balance under this Loan was \$2,250,000 at September 30, 2012. Proceeds from the Loan are classified as restricted cash until drawn upon to acquire new processing equipment and leasehold improvements.

The Loan includes a one-time origination and guaranty fees totaling \$214,500 and an annual renewal fee payable in the amount of 0.25% of the USDA guaranteed portion of the outstanding principal balance as of December 31 of each year, beginning December 31, 2012. The USDA has guaranteed 80% of all amounts owing under the Loan. The Company is subject to financial covenants and customary affirmative and negative covenants. The Company was in compliance with these financial covenants at September 30, 2012.

In February 2008, the Company executed a Term Loan Agreement with a lender providing for \$1.1 million in aggregate credit facilities, secured by the Company's assets. The Term Loan had a maturity date of March 1, 2015 and was payable in 84 equal monthly principal payments plus interest. The interest rate under the Term Loan, in the absence of a default under the agreement, was the prime rate in effect as of the close of business on the first day of each calendar quarter, plus 1%. As of September 30, 2012, the prime rate was 3.25%. The balance under this loan was \$0 and \$506,000 at September 30, 2012 and March 31, 2012, respectively. The Company was prohibited from declaring any common stock dividends without the lender's prior written consent. The credit agreement required the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at September 30, 2012. The outstanding balance of \$441,000 under this loan was paid in full on September 7, 2012.

The Company has five equipment loans with John Deere credit providing for \$163,000 in equipment financing; four of these loans are payable in 48 equal monthly principal payments and one is payable in 36 equal monthly principal payments. At September 30, 2012 and March 31, 2012 the total outstanding combined balance was approximately \$87,000 and \$76,000, respectively. The equipment loans have maturity dates of December 2012 as to \$2,000, March 2013 as to \$4,000, May 2015 as to \$29,000, November 2015 as to \$24,000 and June 2016 as to \$28,000. The loans are at a 0% rate of interest and are net of unamortized discount of \$3,000 at September 30, 2012.

In September 2011, the Company executed a Term Loan Agreement with Nissan Motor Acceptance Corporation providing for \$23,000 in equipment financing, secured by the equipment. The Term Loan has a maturity date of September 13, 2016 and is payable in 60 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and is being amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$17,000, less the unamortized discount of \$700 at September 30, 2012.

*Capital Lease*

In March 2010, the Company executed a capital lease agreement with Thermo Fisher Financial providing for \$97,000 in equipment, secured by the equipment financed. The capital lease has a maturity date of March 2013 and is payable in 36 equal monthly payments. The interest rate under this capital lease is 6.6%. The balance under this capital lease was \$18,000 and \$34,000 at September 30, 2012 and March 31, 2012, respectively.

Future principal payments under the term loans and capital lease agreement as of September 30, 2012 are as follows:

| <b>Payments Due</b>      | <b>(in<br/>thousands)</b> |       |
|--------------------------|---------------------------|-------|
| Next 12 Months           | \$                        | 58    |
| Year 2                   |                           | 99    |
| Year 3                   |                           | 100   |
| Year 4                   |                           | 89    |
| Year 5                   |                           | 82    |
| Thereafter through 2032  |                           | 1,942 |
| Total principal payments | \$                        | 2,370 |

**6. LEASES**

The Company leases facilities, equipment and land under operating leases expiring between 2012 and 2035. The land lease provides for contingent rental in excess of minimum rental commitments based on a percentage of the Company's sales. Management has accrued for the estimated contingent rent as of September 30, 2012.

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Future minimum lease payments under all non-cancelable operating leases at September 30, 2012 are as follows:

| <b>Payments Due</b>          | <b>(in<br/>thousands)</b> |       |
|------------------------------|---------------------------|-------|
| Next 12 Months               | \$                        | 465   |
| Year 2                       |                           | 471   |
| Year 3                       |                           | 455   |
| Year 4                       |                           | 352   |
| Year 5                       |                           | 300   |
| Thereafter through 2026      |                           | 5,161 |
| Total minimum lease payments | \$                        | 7,204 |

**7. COMMITMENTS AND CONTINGENCIES**

On September 12, 2012, the Company entered into an agreement with Uhde Corporation of America ( Uhde ) for the purchase of supercritical carbon dioxide extraction equipment to be used in the processing of its natural astaxanthin ( Equipment ). Pursuant to the terms of the agreement, Uhde will build, ship and provide assistance in installing the Equipment, which is required to be delivered in approximately 14 months from the date of the agreement. The Company will pay Uhde an aggregate of \$3,221,093 for the equipment and services

**8. SHARE-BASED COMPENSATION**

The Company accounts for share-based payment arrangements using fair value. If an award vests or becomes exercisable based on the achievement of a condition other than service, such as for meeting certain performance or market conditions, the award is classified as a liability. Liability-classified awards are remeasured to fair value at each balance sheet date until the award is settled. The Company currently has no liability-classified awards. Equity- classified awards, including grants of employee stock options, are measured at the grant-date fair value of the award and are not subsequently remeasured unless an award is modified. The cost of equity-classified awards is recognized in the statement of operations over the period during which an employee is required to provide the service in exchange for the award, or the vesting period. All of the Company's stock options are service-based awards, and because the Company's stock options are plain vanilla, as defined by the U.S. Securities and Exchange Commission in Staff Accounting Bulletin No. 107, they are reflected only in Equity and Compensation Expense accounts.

*Stock Options*

As of September 30, 2012, the Company had the following two shareholder approved plans under which shares were available for equity based awards: The 2005 Stock Option Plan (the 2005 Plan ) wherein 2,075,000 shares of common stock are reserved for issuance until the Plan terminates on August 21, 2015, and; The Independent Director Stock Option and Stock Grant Plan (the 2004 Directors Plan ) wherein 200,000 shares of common stock are reserved for issuance until the plan terminates in 2014.



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Under the 2005 Plan, eligible employees and certain independent consultants may be granted options to purchase shares of the Company's common stock. The shares issuable under the 2005 Plan will either be shares of the Company's authorized but previously unissued common stock or shares reacquired by the Company, including shares purchased on the open market. As of September 30, 2012, there were 455,578 options available for grant under the 2005 Plan.

Under the 2004 Directors Plan, upon election to the Board of Directors at an annual stockholders meeting, a newly elected non-employee director will be granted a ten-year option to purchase 6,000 shares of the Company's common stock. Options vest and become exercisable six months from the date of grant. In addition, on the date of each annual stockholders meeting, each non-employee director continuing in office is automatically issued 4,000 shares of the Company's common stock, and an additional 1,000 shares to the director serving as Chairman of the Board, non-transferable for six months following the date of grant. As of September 30, 2012, there were 130,123 shares available for grant under the 2004 Directors Plan.

The following table presents shares authorized, available for future grant and outstanding under each of the Company's plans:

|                     | <b>Authorized</b> | <b>As of September 30, 2012<br/>Available</b> | <b>Outstanding</b> |
|---------------------|-------------------|---|--------------------|
| 2005 Plan           | 2,075,000         | 455,578                                       | 1,440,206          |
| 2004 Directors Plan | 200,000           | 130,123                                       | 25,000             |
| Total               | 2,275,000         | 585,701                                       | 1,465,206          |

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All stock option grants made under the 2005 Plan and the 2004 Directors Plan were at exercise prices no less than the Company's closing stock price on the date of grant. Options under the 2005 Plan and 2004 Directors Plan were determined by the Board of Directors or the Stock Option and Compensation Committee of the Board in accordance with the provisions of the respective plans. The terms of each option grant including vesting, exercise and other conditions are set forth in a Stock Option Agreement evidencing each grant. No option can have a life in excess of ten (10) years. The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model requires various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term which ranges from 4 to 7 years. Compensation expense recognized for options issued under the 2005 Plan was \$173,000 and \$295,000 for the three and six months ended September 30, 2012, respectively. Compensation expense recognized for options issued under the 2005 Plan was \$115,000 and \$165,000 for the three and six months ended September 30, 2011, respectively. Compensation expense recognized for options issued under the 2004 Directors Plan was \$77,000 for the three and six months ended September 30, 2012. Compensation expense recognized for options issued under the 2004 Directors Plan was \$35,000 for the three and six months ended September 30, 2011, respectively. All share-based compensation has been classified as General and Administrative expense.

A summary of option activity under the Company's stock plans for the six months ended September 30, 2012 is presented below:

| Option Activity                   | Shares    | Weighted Average<br>Exercise Price | Weighted Average<br>Remaining<br>Contractual Term | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------|-----------|------------------------------------|---|---------------------------------|
| Outstanding at March 31, 2012     | 1,251,166 | \$ 3.54                            | 9.0 years   | \$ 8,243,956                    |
| Granted                           | 226,000   | 6.42                               |   |                                 |
| Exercised                         | (9,520)   | \$ 2.30                            |   |                                 |
| Forfeited or expired              | (2,440)   | \$ 3.19                            |   |                                 |
| Outstanding at September 30, 2012 | 1,465,206 | \$ 3.97                            | 8.7 years   | \$ 2,923,598                    |
| Exercisable at September 30, 2012 | 248,740   | \$ 3.08                            | 7.95 years  | \$ 701,970                      |

The aggregate intrinsic value of September 30, 2012 in the table above is before applicable income taxes and represents the excess amount over the exercise price optionees would have received if all options had been exercised on the last business day of the period indicated, based on the Company's closing stock price of \$5.90 for such day.

A summary of the Company's non-vested options for the six months ended September 30, 2012 is presented below:

| Nonvested Options               | Shares    | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|---------------------------------|-----------|---|
| Nonvested at March 31, 2012     | 1,109,066 | \$ 2.57   |
| Granted                         | 226,000   | 4.45  |
| Vested                          | (129,560) | 1.98  |
| Forfeited or expired            | (2,040)   | 2.15  |
| Nonvested at September 30, 2012 | 1,203,466 | \$ 2.96   |

The following table summarizes the weighted average characteristics of outstanding stock options as of September 30, 2012:

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| Range of Exercise Prices | Number of Shares | Outstanding Options    |                        | Exercisable Options |                        |
|--------------------------|------------------|------------------------|------------------------|---------------------|------------------------|
|                          |                  | Remaining Life (Years) | Weighted Average Price | Number of Shares    | Weighted Average Price |
| \$ 1.60 - \$3.70         | 451,360          | 7.9                    | \$ 2.92                | 181,760             | \$ 2.72                |
| \$ 3.71 - \$4.42         | 732,846          | 8.9                    | 3.82                   | 56,980              | 3.82                   |
| \$ 4.43 - \$5.40         | 55,000           | 9.1                    | 5.16                   | 10,000              | 5.40                   |
| \$ 5.41 - \$7.08         | 226,000          | 9.8                    | 6.42                   |                     |                        |
| Total stock options      | 1,465,206        | 8.7                    | \$ 3.97                | 248,740             | \$ 3.08                |

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There were 226,000 stock options granted during the three and six months ended September 30, 2012. There were 866,716 and 867,516 stock options granted during the three and six months ended September 30, 2011, respectively. The value assumptions related to options granted during the six months ended September 30, 2012 were as follows:

|                  | <b>2012</b>    |
|------------------|----------------|
| Exercise Price:  | \$5.61 - 7.08  |
| Volatility:      | 80.00 - 80.39% |
| Risk Free Rate:  | 0.85 - .93%    |
| Vesting Period:  | 5 - 7 years    |
| Forfeiture Rate: | 9.00%          |
| Expected Life    | 6.25 years     |
| Dividend Rate    | 0%             |

As of September 30, 2012, total unrecognized share-based compensation expense related to all unvested stock options was \$2,653,000, which is expected to be recognized over a weighted average period of 4.4 years.

Subsequent to September 30, 2012, 22,500 stock options were granted from the 2005 Plan.

**9. INCOME TAXES**

Income taxes are provided on the pretax income in the consolidated financial statements. The tax provision is based on the current quarter activity of the legal entities and jurisdictions in which the Company operates. Tax credits are recognized as a reduction to income taxes in the year the credits are earned, accordingly, the effective tax rate may vary from the customary relationship between income tax expense (benefit) and pretax income. The effective tax rate for the three and six months ended September 30, 2012 differs from the statutory rate due to utilization of net operating loss carryforwards that have been fully reserved due to the Company's inconsistent taxable income in recent years and uncertainty about taxable income in future years.

The Company is subject to taxation in the United States and two state jurisdictions. The preparation of tax returns requires management to interpret the applicable tax laws and regulations in effect in such jurisdictions, which could affect the amount of tax paid by the Company. Management, in consultation with its tax advisors, files its tax returns based on interpretations that are believed to be reasonable under the circumstances. The income tax returns, however, are subject to routine reviews by the various taxing authorities. As part of these reviews, a taxing authority may disagree with respect to the tax positions taken by management (uncertain tax positions) and therefore may require the Company to pay additional taxes. Management evaluates the requirement for additional tax accruals, including interest and penalties, which the Company could incur as a result of the ultimate resolution of its uncertain tax positions. Management reviews and updates the accrual for uncertain tax positions as more definitive information becomes available from taxing authorities, completion of tax audits, expiration of statute of limitations, or upon occurrence of other events.

As of September 30, 2012, there was no liability for income tax associated with unrecognized tax benefits. The Company recognizes accrued interest related to unrecognized tax benefits as well as any related penalties in interest expense in its consolidated condensed statements of operations, which is consistent with the recognition of these items in prior reporting periods.

With few exceptions, the Company is no longer subject to U.S. federal, state, local, and non-U.S. income tax examination by tax authorities for tax years before 2008.

**10. COMMON AND PREFERRED STOCK**

Following shareholder approval, the Company filed a Certificate of Amendment to its Articles of Incorporation to increase the total number of authorized shares from 12,500,000 to sixty million (60,000,000) shares of which fifty million (50,000,000) shares shall be common stock, par value \$0.02, and ten million (10,000,000) shares shall be preferred stock, par value \$0.01. There are no preferred shares issued or outstanding. The Amendment was declared effective as of November 2, 2012.

**11. EARNINGS PER SHARE**

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the potentially dilutive effect of outstanding stock options using the treasury stock method.

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Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the three months ended September 30, 2012 and 2011 are as follows:

|  | Three Months Ended September 30, 2012       |                         |                     |
|--|---|-------------------------|---------------------|
|  | Net Income<br>(Numerator)<br>(in thousands) | Shares<br>(Denominator) | Per Share<br>Amount |
| Basic income per share                             | \$ 476                                      | 5,450                   | \$ 0.09             |
| Effect of dilutive securities Common stock options |   | 185                     | (0.01)              |
|  | \$ 476                                      | 5,635                   | \$ 0.08             |

|  | Three Months Ended September 30, 2011       |                         |                     |
|--|---|-------------------------|---------------------|
|  | Net Income<br>(Numerator)<br>(in thousands) | Shares<br>(Denominator) | Per Share<br>Amount |
| Basic income per share                             |   |                         |                     |
| Effect of dilutive securities Common stock options | \$ 875                                      | 5,398                   | \$ 0.16             |
| Diluted income per share                           |   | 75                      |                     |
|  | \$ 875                                      | 5,473                   | \$ 0.16             |

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the six months ended September 30, 2012 and 2011 are as follows:

|  | Six Months Ended September 30, 2012         |                         |                     |
|--|---|-------------------------|---------------------|
|  | Net Income<br>(Numerator)<br>(in thousands) | Shares<br>(Denominator) | Per Share<br>Amount |
| Basic income per share                             | \$ 969                                      | 5,445                   | \$ 0.18             |
| Effect of dilutive securities Common stock options |   | 313                     | (0.01)              |
| Diluted income per share                           | \$ 969                                      | 5,758                   | \$ 0.17             |

|  | Six Months Ended September 30, 2011         |                         |                     |
|--|---|-------------------------|---------------------|
|  | Net Income<br>(Numerator)<br>(in thousands) | Shares<br>(Denominator) | Per Share<br>Amount |
| Basic income per share                             | \$ 1,361                                    | 5,397                   | \$ 0.25             |
| Effect of dilutive securities Common stock options |   | 74                      |                     |
| Diluted income per share                           | \$ 1,361                                    | 5,471                   | \$ 0.25             |

Diluted earnings per share does not include the impact of common stock options totaling 650,916 and 1,097,466 for the three months ended September 30, 2012 and 2011, respectively, and 258,000 and 1,098,266 for the six months ended September 30, 2012 and 2011, respectively, as the effect of their inclusion would be anti-dilutive.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**FORWARD-LOOKING STATEMENTS**

This Report and other presentations made by Cyanotech Corporation ( CYAN ) and its subsidiary contain forward-looking statements, which include statements that are predictive in nature, depend upon or refer to future events or conditions, and usually include words such as expects, anticipates, intends, plan, believes, predicts, estimates or similar expressions. In addition, any statement concerning future financial performance, ongoing business strategies or prospects and possible future actions are also forward-looking statements. Forward-looking statements are based upon current expectations and projections about future events and are subject to risks, uncertainties and the accuracy of assumptions concerning CYAN and its subsidiaries (collectively, the Company), the performance of the industry in which CYAN does business, and economic and market factors, among other things. **These forward-looking statements are not guarantees of future performance. You should not place undue reliance on forward-looking statements.**

Forward-looking statements speak only as of the date of the Report, presentation or filing in which they are made. Except to the extent required by the Federal Securities Laws, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Our forward-looking statements in this Report include, but are not limited to:

- Statements relating to our business strategy;
- Statements relating to our business objectives; and
- Expectations concerning future operations, profitability, liquidity and financial resources.

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These forward-looking statements are subject to risk, uncertainties and assumptions about us and our operations that are subject to change based on various important factors, some of which are beyond our control. The following factors, among others, could cause our financial performance to differ significantly from the goals, plans, objectives, intentions and expectations expressed in our forward-looking statements:

- Environmental restrictions, soil and water conditions, levels of sunlight and seasonal weather patterns, particularly heavy rain, wind and other hazards;
  
- Consumer perception of our products due to adverse scientific research or findings, publicity regarding nutritional supplements, litigation, regulatory investigations or other events, conditions and circumstances involving the Company which receive national media coverage;
  
- The effects of competition, including tactics and locations of competitors and operating and market competition;
  
- Demand for our products, the quantities and qualities thereof available for sale and levels of customer satisfaction, including significant unforeseen fluctuations in global demand for products similar to our products;
  
- Our dependence on the experience, continuity and competence of our executive officers and other key employees;
  
- The added risks associated with the current local, national and world economic crises, including but not limited to, the volatility of crude oil prices, inflation and currency fluctuations;
  
- Changes in domestic and/or foreign laws, regulations or standards, affecting nutraceutical products or our methods of operation;
  
- Access to available and reasonable financing on a timely basis;
  
- Changes in laws, corporate governance requirements and tax rates, regulations, accounting standards and the application to us or the nutritional products industry of new decisions by courts, regulators or other government authorities;
  
- The risk associated with the geographic concentration of our business;



- Acts of war, terrorist incidents or natural disasters; and

Other risks or uncertainties described elsewhere in this Report and in other periodic reports previously and subsequently filed by us with the Securities and Exchange Commission.

**Overview:**

We are a world leader in the production of high value natural products derived from microalgae. Incorporated in 1983, we are guided by the principle of providing beneficial, quality microalgal products for health and human nutrition in a sustainable, reliable and environmentally sensitive operation. We are ISO 9001:2008 compliant and GMP (Good Manufacturing Practices) certified by the Natural Products Association, reinforcing our commitment to quality in our products, quality in our relationships (with our customers, suppliers, co-workers and the communities we live in), and quality of the environment in which we work. Our products include:

- Hawaiian *Spirulina Pacifica*® - a nutrient-rich dietary supplement used for extra energy, a strengthened immune system, cardiovascular benefits and as a source of antioxidant carotenoids; and
- Hawaiian *BioAstin*® natural astaxanthin - a powerful dietary antioxidant shown to support and maintain the body's natural inflammatory response, to enhance skin, and to support eye and joint health. It has expanding applications as a human nutraceutical and functional food ingredient

Microalgae are a diverse group of microscopic plants that have a wide range of physiological and biochemical characteristics and contain, among other things, high levels of natural protein, amino acids, vitamins, pigments and enzymes. Microalgae have the following properties that make commercial production attractive: (1) microalgae grow much faster than land grown plants, often up to 100 times faster; (2) microalgae have uniform cell structures with no bark, stems, branches or leaves, permitting easier extraction of products and higher utilization of the microalgae cells; and (3) the cellular uniformity of microalgae makes it practical to control the growing environment in order to optimize a particular cell characteristic. Efficient and effective cultivation of microalgae requires consistent light, warm temperatures, low rainfall and proper chemical balance in a very nutrient-rich environment, free of environmental contaminants and unwanted organisms. This is a challenge that has motivated us to design, develop and implement proprietary production and harvesting technologies, systems and processes in order to provide human nutritional products derived from microalgae.

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Our production of these products at the 90-acre facility on the Kona Coast of the island of Hawaii provides several benefits. We selected the Keahole Point location in order to take advantage of relatively consistent warm temperatures, sunshine and low levels of rainfall needed for optimal cultivation of microalgae. This location also offers us access to cold deep ocean water, drawn from an offshore depth of 2,000 feet, which we use in our *Ocean-Chill Drying* system to eliminate the oxidative damage caused by standard drying techniques and as a source of trace nutrients for microalgal cultures. The area is also designated a Biosecure Zone, free of pesticides and herbicides. We believe that our technology, systems, processes and favorable growing location generally permit year-round harvest of our microalgal products in a cost-effective manner.

**Recent Developments**

*Material Definitive Agreements*

On September 7, 2012, we entered into a Term Loan agreement with a lender providing for \$5,500,000 in aggregate credit facilities. The loan is partially guaranteed under the provisions of a United States Department of Agriculture ( USDA ) Rural Development Guarantee program. The proceeds of the loan will be used to fund new processing equipment and leasehold improvements at our Kona, Hawaii facility.

Upon initial funding of the loan we entered into an agreement with Uhde for the purchase of supercritical carbon dioxide extraction equipment to be used in the processing of our natural astaxanthin ( Equipment Pursuant to the terms of the agreement, Uhde will build, ship and provide assistance in installing the Equipment, which is required to be delivered in approximately 14 months from the date of the agreement. The purchase price of the equipment is \$3.2 million, payable in progress payments.

*Increase in Authorized Shares*

Following shareholder approval, we filed a Certificate of Amendment to our Articles of Incorporation to increase the total number of authorized shares from 12,500,000 shares to 60,000,000 shares, of which 50,000,000 shares are common stock, par value \$0.02, and 10,000,000 shares are preferred stock, par value \$0.01. The Amendment was effective as of November 2, 2012.

**Results of Operations**

The following tables present selected consolidated financial data for each of the periods indicated (\$ in thousands):

|                    | Three Months Ended |                    | Six Months Ended   |                    |
|--------------------|--------------------|--------------------|--------------------|--------------------|
|                    | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| Net sales          | \$ 6,936           | \$ 5,989           | \$ 13,442          | \$ 11,939          |
| Net sales increase | 15.8%              |                    | 12.6%              |                    |

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|                                      |    |         |    |       |    |         |    |       |
|--------------------------------------|----|---------|----|-------|----|---------|----|-------|
| Gross profit                         | \$ | 2,812   | \$ | 2,790 | \$ | 5,386   | \$ | 4,894 |
| Gross profit as % of net sales       |    | 40.5%   |    | 46.6% |    | 40.1%   |    | 41.0% |
| Operating expenses                   | \$ | 2,258   | \$ | 1,877 | \$ | 4,317   | \$ | 3,465 |
| Operating expenses as % of net sales |    | 32.6%   |    | 31.3% |    | 32.1%   |    | 29.0% |
| Operating income                     | \$ | 554     | \$ | 913   | \$ | 1,069   | \$ | 1,429 |
| Operating income as % of net sales   |    | 8.0%    |    | 15.2% |    | 8.0%    |    | 12.0% |
| Income tax expense                   | \$ | 10      | \$ | 28    | \$ | 20      | \$ | 44    |
| Net income                           | \$ | 476     | \$ | 875   | \$ | 969     | \$ | 1,361 |
| Net sales by product                 |    |         |    |       |    |         |    |       |
| Bulk sales                           |    |         |    |       |    |         |    |       |
| Spirulina bulk                       | \$ | 668     | \$ | 1,386 | \$ | 1,890   | \$ | 2,731 |
| Spirulina bulk sales decrease        |    | (51.8)% |    |       |    | (30.8)% |    |       |
| Astaxanthin bulk                     | \$ | 3,284   | \$ | 2,413 | \$ | 5,917   | \$ | 5,174 |
| Astaxanthin bulk sales increase      |    | 36.1%   |    |       |    | 14.4%   |    |       |
| Total Bulk sales                     | \$ | 3,952   | \$ | 3,799 | \$ | 7,807   | \$ | 7,905 |
| Total Bulk sales increase (decrease) |    | 4.0%    |    |       |    | (1.2)%  |    |       |
| Packaged sales                       |    |         |    |       |    |         |    |       |
| Spirulina packaged                   | \$ | 1,266   | \$ | 990   | \$ | 2,404   | \$ | 1,845 |
| Spirulina packaged sales increase    |    | 27.9%   |    |       |    | 30.3%   |    |       |
| Astaxanthin packaged                 | \$ | 1,718   | \$ | 1,200 | \$ | 3,231   | \$ | 2,189 |
| Astaxanthin packaged sales increase  |    | 43.2%   |    |       |    | 47.6%   |    |       |
| Total Packaged sales                 | \$ | 2,984   | \$ | 2,190 | \$ | 5,635   | \$ | 4,034 |
| Total Packaged sales increase        |    | 36.3%   |    |       |    | 39.7%   |    |       |

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**Comparison of the Three Months Ended September 30, 2012 and 2011**

**Net Sales** The net sales growth of 16% for the quarter was driven by a 36% increase in our packaged products consistent with our focus and investment in the consumer packaged goods side of our business. Within this growth, sales of spirulina increased 28% and sales of astaxanthin increased 43%. Sales of our bulk products increased only 4% as a result of the lower production of spirulina. Within this increase, sales of bulk spirulina decreased 52% as a result of low production during the quarter and sales of bulk astaxanthin increased 36%. International sales represented 34% of net sales for the three months ended September 30, 2012 compared to 27% for the same period a year ago. There were no customers with sales equaling or exceeding 10% of our total sales for the three months ended September 30, 2012 and 2011.

**Gross Profit** Our gross profit percent of net sales decreased by 6.1 points in the second quarter. Gross profit was impacted by lower spirulina production which resulted in the recognition of abnormal production costs of approximately \$481,000 and \$218,000, in the second quarter of fiscal years 2013 and 2012, respectively. The abnormal costs were driven by spirulina production that was below expectations for the quarter due to difficulties in harvesting resulting from smaller cell sizes driven by years of continuous culturing and production. While the quality of our spirulina remains very high, with nutrient levels at or above our high standards, the physical size of the cells has impacted our harvest levels. We've taken steps to improve our harvest efficiency and maintain a large size cell. Our harvest level has improved and stabilized at a significantly higher level through the first month of the third quarter but has not yet reached targeted levels.

**Operating Expenses** Operating expenses increased by \$381,000 for the second quarter compared to the same period in 2012. Included in this is an increase in Sales and Marketing expenses of \$271,000, or 44.5%, due to an increase in brand development costs, advertising programs for our packaged products and added management level staffing. General and administrative expenses increased \$168,000, or 15%, due to increases in costs associated with stock options granted to key employees and increased legal costs.

**Income Taxes** We recorded income tax expense of \$10,000 in the current quarter compared to \$28,000 for the same period in 2012. Our effective tax rate was 2.0% for the current quarter and 3.3% for the same period last year. We do not expect any material federal or state income taxes to be recorded in the current fiscal year due to our available net operating loss carry forwards.

**Comparison of the Six Months Ended September 30, 2012 and 2011**

**Net Sales** The net sales growth of 13% for the first six months of fiscal 2013 was driven by a 40% increase in our packaged products consistent with our focus and investment in the consumer packaged goods side of our business. Within this growth, sales of spirulina increased 30% and sales of astaxanthin increased 48%. Sales of our bulk products decreased 1%, driven by lower production of spirulina in the second quarter. Within this decrease, sales of bulk spirulina decreased 31% and sales of bulk astaxanthin increased 14%. International sales represented 35% of net sales for the six months ended September 30, 2012 compared to 34% for the same period a year ago. There were no customers with sales equaling or exceeding 10% of our total sales for the six months ended September 30, 2012 and 2011.

**Gross Profit** Our gross profit percent of net sales decreased by 0.9 points in the first six months of fiscal 2013. Gross profit was impacted by the reduction in spirulina production which resulted in the recognition of abnormal production costs of approximately \$714,000 and \$416,000, for the six months ended September 30, 2012 and 2011, respectively. The abnormal costs were driven by spirulina production that was below expectations for quarter ended September 30, 2012 due to difficulties in harvesting resulting from smaller cell sizes driven by years of

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continuous culturing and production. While the quality of our spirulina remains very high, with nutrient levels at or above our high standards, the physical size of the cells has impacted our harvest levels. We've taken steps to improve our harvest efficiency and maintain a large size cell. Our harvest level has improved and stabilized at a significantly higher level through the first month of the third quarter but has not yet reached targeted levels. Improved mix through an increase in sales of our higher margin consumer products, along with a higher percentage of astaxanthin sales, offset a large part of the unfavorable impact of the abnormal production costs.

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**Operating Expenses** Operating expenses increased by \$852,000 for the six months ended September 30, 2012, compared to the same period in 2011. Included in this is an increase in Sales and Marketing expenses of \$542,000, or 46%, due to an increase in brand development costs, advertising programs for our packaged products and added management level staffing. General and administrative expenses increased \$368,000, or 18%, due to increases in costs associated with stock options granted to key employees and increased legal costs.

**Income Taxes** We recorded income tax expense of \$20,000 for the first six months of fiscal 2013 compared to \$44,000 for the same period last year. Our effective tax rate was 2.0% for the first six months of fiscal 2013 compared to 3.3% for the same period last year. We do not expect any material federal or state income taxes to be recorded in the current fiscal year due to our available net operating loss carry forwards.

**Variability of Results**

We have experienced significant quarterly fluctuations in operating results and such fluctuations could occur in future periods. We have, during our history, experienced fluctuations in operating results due to the following: changes in sales levels to our customers; competition including pricing, new products and shifts in market trends; production difficulties from environmental influences; increased production costs and variable production results due to inclement weather; and start up costs associated with new product introductions, new facilities and expansion into new markets. In addition, future operating results may fluctuate as a result of factors beyond our control such as foreign exchange fluctuations, changes in government regulations, and economic changes in the regions we have customers. A portion of our operating expenses are relatively fixed and the timing of increases in expense levels is based in large part on forecasts of future sales. Therefore, if net sales are below expectations in any given period, the adverse impact on results of operations may be magnified by our inability to effectively adjust spending in certain areas, or to adjust spending in a timely manner, as in personnel and administrative costs. We may also choose to reduce prices or increase spending in response to market conditions, and these decisions may have a material adverse effect on financial condition and results of operations.

**Liquidity and Capital Resources**

**Cash Flows** The following table summarizes our cash flows for the period indicated (\$ in thousands):

|  | <b>Six months ended September 30</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2012</b>                          | <b>2011</b> |
| Total cash is (used in) provided by:             |                                      |             |
| Operating activities                             | \$ 648                               | \$ 2,779    |
| Investing activities                             | (3,554)                              | (716)       |
| Financing activities                             | 1,448                                | (34)        |
| (Decrease) increase in cash and cash equivalents | \$ (1,458)                           | \$ 2,029    |

Cash provided by operating activities decreased \$2,131,000 compared to the same period last year due primarily to lower income and an increase in receivables of \$1,435,000 compared to a decrease of \$117,000 last year. This increase is a function of higher sales and the timing of those sales.

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Cash used in investing activities in the current period includes the addition of \$2,250,000 in restricted cash from loan proceeds that can only be used to acquire certain new processing equipment and leasehold improvements. In addition, we expended \$1,304,000 on leasehold improvements and equipment acquisitions at our Kona facility compared to \$716,000 during the same period last year.

Cash provided by (used in) financing activities in the period consists of proceeds from long-term debt offset by payoff of existing long-term debt and debt issuance cost for the new loan. The prior year result is the net of receipt of proceeds from long-term debt and principal payments in the normal course of business.

### *Sources and Uses of Capital*

At September 30, 2012, our working capital was \$7.9 million, a decrease of \$200,000 compared to March 31, 2012. Cash and cash equivalents at September 30, 2012 totaled \$3,603,000, a decrease of \$1,458,000 compared to March 31, 2012.

On September 7, 2012, the Company completed a Term Loan Agreement with a lender providing for \$5,500,000 in aggregate credit facilities pursuant to a Term Loan Agreement dated August 14, 2012. The Term Loan Agreement is evidenced by promissory notes in the amounts of \$2,250,000 and \$3,250,000, and was secured under the provisions of a United States Department of Agriculture ( USDA ) Rural Development Guarantee program. The proceeds of the Term Loan can only be used for specific new processing equipment and leasehold improvements at its Kona, Hawaii facility. Until their disbursement for approved projects, the funds advanced are classified as restricted cash.

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Our results of operations and financial condition can be affected by numerous factors, many of which are beyond our control and could cause future results of operations to fluctuate materially as it has in the past. Future operating results may fluctuate as a result of changes in sales volumes to our largest customers, weather patterns, increased competition, increased materials, nutrient and energy costs, government regulations and other factors beyond our control.

A significant portion of our expense levels are relatively fixed, so the timing of increases in expenses is based in large part on forecasts of future sales. If net sales are below expectations in any given period, the adverse impact on results of operations may be magnified by our inability to adjust spending quickly enough to compensate for the sales shortfall. We may also choose to reduce prices or increase spending in response to market conditions, which may have a material adverse effect on financial condition and results of operations.

Based upon our current operating plan, analysis of our consolidated financial position and projected future results of operations, we believe that our operating cash flows, cash balances, and working capital will be sufficient to finance current operating requirements, debt service requirements, and routine planned capital expenditures, for the next twelve (12) months. We expect liquidity in the remainder of fiscal 2013 to be generated from operating cash flows.

**Outlook**

*This outlook section contains a number of forward-looking statements, all of which are based on current expectations. Actual results may differ materially.*

Our strategic direction has been to position the Company as a world leader in the production and marketing of high-value natural products from microalgae. We are vertically aligned, producing raw materials in the form of microalgae processed at our 90-acre facility in Hawaii, and integrating those raw materials into finished products. In fiscal 2013, our primary focus has been to put a scalable foundation in place, improving our processes, systems, facilities and organization. We will continue putting increased emphasis on our Nutrex Hawaii consumer products to introduce them to a broader consumer market than in prior years. Our focus going forward will continue to be to leverage our experience and reputation for quality, building nutritional brands which promote health and well-being. The foundation of our nutritional products is naturally cultivated Hawaiian Spirulina Pacifica® in powder and tablet form; and BioAstin® Hawaiian Astaxanthin antioxidant in extract, softgel caplet and micro-encapsulated beadlet form. Information about our Company and our products can be viewed at [www.cyanotech.com](http://www.cyanotech.com) and [www.nutrex-hawaii.com](http://www.nutrex-hawaii.com). Consumer products can also be purchased online at [www.nutrex-hawaii.com](http://www.nutrex-hawaii.com).

We are focused on sustainability of production levels in order to promote growth in our astaxanthin and spirulina product lines. We will continue to improve and expand this line to meet the demand of consumers. Cyanotech filed a New Dietary Ingredient (NDI) notice with the US FDA to allow a 12 mg dosage of BioAstin Natural Astaxanthin to cover the broad spectrum of potential users. The NDI was reviewed by the FDA without comment and Cyanotech's BioAstin® Natural Astaxanthin is now permitted at 12 mg per day. This compares to other brands whose allowed levels range from 4 mg - 7.8 mg per daily serving. The Company has now introduced a new 12 mg BioAstin softgel capsule which is available as a bulk gelcap product and as a finished consumer product through Nutrex Hawaii. We will continue to promote the nutritional superiority of Hawaiian grown spirulina to maintain and expand market share. Significant sales variability between periods and even across several periods can be expected based on historical results.



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Rising crude oil prices in prior years resulted in increased nutrient, utility and transportation costs which reflect and respond to oil prices. We feel that these conditions are likely to continue and/or reoccur from time to time in the future, and consequently, we are putting greater focus on prudent cost controls and expense avoidance.

Gross profit margin percentages going forward will be impacted by continued pressure on input costs and greater competition in the market place. This could cause margins to decline in future periods. We will continue to focus on health and well-being, promoting higher gross margin items. We are dedicated to continuous improvements in process and production methods to stabilize and increase production levels for the future.

Producing the highest quality microalgae is a complex biological process which requires balancing numerous factors including microalgal strain variation, temperature, acidity, nutrient and other environmental considerations, some of which are not within our control. An imbalance or unexpected event can occur resulting in production levels below normal capacity. The allocation of fixed production overheads (such as depreciation, rent and general insurance) to inventories is determined based on normal production capacity. When our production volumes are below normal capacity limits, certain fixed production overhead costs cannot be inventoried and are recorded immediately in cost of sales. In addition, when production costs exceed historical averages, we evaluate whether such costs are one-time-period charges or an ongoing component of inventory cost.

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To manage our cash resources effectively, we will continue to balance production in light of sales demand, minimizing the cost associated with build-ups in inventory when appropriate. We could experience unplanned cash outflows and may need to utilize other cash resources to meet working capital needs. A prolonged downturn in sales could impair our ability to generate sufficient cash for operations and minimize our ability to attract additional capital investment which could become necessary in order to expand facilities, enter into new markets or maintain optimal production levels.

Our future results of operations and the other forward-looking statements contained in this Outlook, in particular the statements regarding revenues, gross margin and capital spending, involve a number of risks and uncertainties. In addition to the factors discussed above, any of the following could cause actual results to differ materially: business conditions and growth in the natural products industry and in the general economy; changes in customer order patterns; changes in demand for natural products in general; changes in weather conditions; competitive factors, such as increased production capacity from competing spirulina and astaxanthin producers and the resulting impact, if any, on world market prices for these products; government actions and increased regulations both domestic and foreign; shortage of manufacturing capacity; and other factors beyond our control. Risk factors are discussed in detail in Item 1A in our Form 10-K report for the year ended March 31, 2012.

We believe that our technology, systems, processes and favorable growing location generally permit year-round harvest of our microalgal products in a cost-effective manner. However, previously experienced imbalances in the highly complex biological production systems, together with volatile energy costs and rapidly changing world markets, suggest a need for continuing caution with respect to variables beyond our reasonable control. Therefore, we cannot, and do not attempt to, provide any definitive assurance with regard to our technology, systems, processes, location, or cost-effectiveness.

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

We do not enter into any transactions using derivative financial instruments or derivative commodity instruments and believe that our exposure to market risk associated with other financial instruments is not material.

**Item 4. Controls and Procedures**

**(a) Disclosure Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15 (d)-15(e) under the Exchange Act that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Security and Exchange Commission's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective to meet the objective for which they were designed and operate at the reasonable assurance level.

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This Form 10-Q should be read in conjunction with Item 9A Controls and Procedures of the Company's Form 10-K for the fiscal year ended March 31, 2012, filed June 21, 2012.

### (b) Changes to Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarterly period ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

We are subject to legal proceedings and claims from time to time in the ordinary course of business. Although we cannot predict with certainty the ultimate resolution of legal proceedings and claims asserted against us, we do not believe that any currently pending legal proceeding to which we are a party is likely to have a material adverse effect on our business, results of operations, cash flows or financial condition.

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**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults upon Senior Securities**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

a) The following exhibits are furnished with this report:

3.1 Restated Articles of Incorporation dated November 2, 2012

4.1 Term Loan Agreement between Pacific Rim Bank ( Bank ) and both Registrant and Nutrex Hawaii, Inc. ( Nutrex ); Promissory Notes in favor of Bank in the amounts of \$2,250,000 and \$3,250,000, issued by Registrant and Nutrex, dated September 7, 2012; Mortgage, Security Agreement and Financing Statement between Registrant and Bank; Assignment of Lessor's Interest in Leases and Rents between Registrant and Bank; Security Agreement and UCC Financing Statement between Registrant and Bank; United States Department of Agriculture Rural Development ( USDA ) Conditional Commitments; Hazardous Substances Certificate and Indemnity Agreement; Assignment of Construction Contract between Registrant and No Eau Construction LLC; Sublessor's Consent to Mortgage of Sublease K-4; Estoppel Certificate and Subordination Agreement, given by the Natural Energy Laboratory of Hawaii Authority, State of Hawaii, as Sublessor; Security Agreement and UCC Financing Statement between Nutrex and Bank.

10.1 Agreement between the Registrant and Uhde Corporation of America dated September 12, 2012 [portions of this Exhibit have been omitted pursuant to an Application for Confidential Treatment, filed with the Secretary of the Commission].

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31.1 Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 9, 2012.

31.2 Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 9, 2012.

32 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of November 9, 2012.

101 The following financial statements from Cyanotech Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements

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**SIGNATURES**

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CYANOTECH CORPORATION  
(Registrant)

November 9, 2012  
(Date)

By: */s/ Brent D. Bailey*  
*Brent D. Bailey*  
*President and Chief Executive Officer and*  
*Director*

November 9, 2012  
(Date)

By: */s/ Jole Deal*  
*Jole Deal*  
*Vice President Finance & Administration*  
*and CFO*  
*(Principal Financial and Accounting Officer)*

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EXHIBIT INDEX

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