CYANOTECH CORP
Form 10-Q
August 13, 2018

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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 Quarterly Period Ended June 30, 2018

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 0-14602

CYANOTECH CORPORATION

(Exact name of registrant as specified in its charter)

NEVADA	**91-1206026**
(State or other jurisdiction of incorporation or organization)	(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," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 August 10, 2018:

Title of Class	**Shares Outstanding**
Common stock - $0.02 par value	5,788,887

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CYANOTECH CORPORATION

FORM 10-Q

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

(Unaudited)

	June 30, 2018	**March 31, 2018**
ASSETS		
Current assets:		
Cash	$935	$1,329
Accounts receivable, net of allowance for doubtful accounts of $27 at June 30, 2018 and $27 at March 31, 2018	2,804	2,664
Inventories, net	9,487	9,034
Prepaid expenses and other current assets	593	590
Total current assets	13,819	13,617
Equipment and leasehold improvements, net	15,432	15,734
Restricted cash	—	65
Other assets	280	291
Total assets	$29,531	$29,707
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Line of credit	$1,250	$500
Current maturities of long-term debt	660	655
Customer deposits	300	133
Accounts payable	3,735	3,527
Accrued expenses	1,000	892
Total current liabilities	6,945	5,707
Long-term debt, less current maturities	5,636	5,790
Other long-term liabilities	98	103
Total liabilities	12,679	11,600

Commitments and contingencies		
Stockholders’ equity:		
Preferred stock of $0.01 par value, authorized 10,000,000 shares; no shares issued and outstanding	—	—
Common stock of $0.02 par value, authorized 50,000,000 shares; 5,788,887 shares issued and outstanding at June 30, 2018 and 5,772,032 at March 31, 2018	116	115
Additional paid-in capital	32,070	32,051
Accumulated deficit	(15,334)	(14,059)
Total stockholders’ equity	16,852	18,107
Total liabilities and stockholders’ equity	$29,531	$29,707

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,	
	2018	**2017**
NET SALES	$7,145	$8,809
COST OF SALES	5,309	5,206
Gross Profit	1,836	3,603
OPERATING EXPENSES:		
General and administrative	1,372	1,352
Sales and marketing	1,423	1,489
Research and development	208	142
Total operating expenses	3,003	2,983
(Loss) income from operations	(1,167)	620
Interest expense, net	130	108
(Loss) income before income tax	(1,297)	512
INCOME TAX (BENEFIT) EXPENSE	(22)	11
NET (LOSS) INCOME	$(1,275)	$501
NET (LOSS) INCOME PER SHARE:		
Basic	$(0.22)	$0.09
Diluted	$(0.22)	$0.09
SHARES USED IN CALCULATION OF NET (LOSS) INCOME PER SHARE:		
Basic	5,785	5,685
Diluted	5,785	5,719

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30,	
	2018	**2017**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	$(1,275)	$501
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		
Depreciation and amortization	475	479
Amortization of debt issue costs and other assets	19	15
Share-based compensation expense	34	31
Net (increase) decrease in assets:		
Accounts receivable	(140)	(484)
Inventories	(453)	(9)
Prepaid expenses and other assets	(3)	138
Net increase (decrease) in liabilities:		
Customer deposits	167	(40)
Accounts payable	208	(534)
Accrued expenses	108	130
Deferred rent and other liabilities	(5)	(17)
Net cash (used in) provided by operating activities	(865)	210
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment in equipment and leasehold improvements	(173)	(56)
Net cash used in investing activities	(173)	(56)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net draws (payments) on line of credit	750	(111)
Principal payments on long-term debt	(141)	(130)
Payments on capitalized leases	(16)	(21)
Withholding on restricted stock unit vesting	(32)	—
Proceeds from stock options exercised	18	—
Net cash provided by (used in) financing activities	579	(262)
Net decrease in cash and restricted cash	(459)	(108)
Cash and restricted cash at beginning of period	1,394	1,407

Cash at end of period	$935	$1,299
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$103	$104
Income taxes	$—	$—

RECONCILIATION OF CASH AND RESTRICTED CASH AT BEGINNING OF PERIOD:		
Cash	$1,329	$1,407
Restricted cash	65	—
Total cash and restricted cash at beginning of period	$1,394	$1,407

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited 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 results of operations for the interim periods are not necessarily indicative of the results to be expected for the full fiscal year. The Condensed Consolidated Balance Sheet as of March 31, 2018 was derived from the audited consolidated financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company's audited consolidated financial statements for the year ended March 31, 2018, contained in the Company's annual report on Form 10-K as filed with the SEC on June 15, 2018.

The accompanying condensed consolidated 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 any 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.

Liquidity

As of June 30, 2018, the Company had cash of $0.9 million and working capital of $6.9 million compared to $1.3 million and $7.9 million, respectively, at March 31, 2018. On August 30, 2016, the Credit Agreement, which the Company and First Foundation Bank (the Bank) entered into on June 3, 2016, became effective. The Credit Agreement allows the Company to borrow up to $2.0 million on a revolving basis. At June 30, 2018, the Company had borrowed $1.25 million and had $0.75 million available on the line. The line of credit was renewed on August 30, 2017 and will expire on August 30, 2018. The Company intends to renew or replace it with another line of credit on or before the expiration date.

As of June 30, 2018, the Company had $6.2 million of term loans payable to the Bank that require the payment of principal and interest monthly through August 2032. Pursuant to the term loans, the Company is subject to annual financial covenants, customary affirmative and negative covenants and certain subjective acceleration clauses. As of March 31, 2018, the Company was in compliance with these financial covenants.

Funds generated by operating activities and available cash continue to be the Company’s most significant sources of liquidity for working capital requirements, debt service and funding of maintenance levels of capital expenditures. Based upon the Company’s fiscal year 2019 operating plan and related cash flow projections and the Company’s projected consolidated financial position as of March 31, 2019, cash flows expected to be generated by operating activities and available financing are expected to be sufficient to fund the Company’s operations for at least the next twelve months, and the Company’s current ratio is expected to be in compliance with the annual term loan covenant requirement as of March 31, 2019. However, no assurances can be provided that the Company will achieve its operating plan and cash flow objectives for the next fiscal year or its projected consolidated financial position as of March 31, 2019. Such estimates are subject to change based on future results and such change could cause future results to vary significantly from expected results.

Revenue Recognition

The Company records revenue based on the five-step model which includes: (1) identifying the contract with the customer; (2) identifying the performance obligations in the contract; (3) determining the transaction price; (4) allocating the transaction price to the performance obligations; and (5) recognizing revenue when the performance obligations are satisfied. Substantially all of the Company’s revenue is generated by fulfilling orders for the purchase of our micro algal nutritional supplements to retailers, wholesalers, or direct to consumers via online channels, with each order considered to be a distinct performance obligation. These orders may be formal purchase orders, verbal phone orders, e-mail orders or orders received online. Shipping and handling activities for which the Company is responsible under the terms and conditions of the order are not accounted for as performance obligations but as fulfillment costs. These activities are required to fulfill the Company’s promise to transfer the goods and are expensed when revenue is recognized. The impact of this policy election is insignificant as it aligns with our current practice.

Revenue is measured as the net amount of consideration expected to be received in exchange for fulfilling a performance obligation. The Company has elected to exclude sales, use and similar taxes from the measurement of the transaction price. The impact of this policy election is insignificant, as it aligns with our current practice. The amount of consideration expected to be received and revenue recognized includes estimates of variable consideration, which includes costs for trade promotion programs, coupons, returns and early payment discounts. Such estimates are calculated using historical averages adjusted for any expected changes due to current business conditions and experience. The Company reviews and updates these estimates at the end of each reporting period and the impact of any adjustments are recognized in the period the adjustments are identified. In assessing whether collection of consideration from a customer is probable, the Company considers the customer's ability and intent to pay that amount of consideration when it is due. Payment of invoices is due as specified in the underlying customer agreement, typically 30 days from the invoice date, which occurs on the date of transfer of control of the products to the customer.

Revenue is recognized at the point in time that the control of the ordered products is transferred to the customer. Generally, this occurs when the product is delivered, or in some cases, picked up from one of our distribution centers by the customer.

Customer contract liabilities consist of customer deposits received in advance of fulfilling an order and are shown separately on the consolidated balance sheets. During the three-month periods ended June 30, 2018 and June 30, 2017, the Company recognized $112,000 and $45,000, respectively, of revenue from deposits that were included in contract liabilities as of March 31, 2018 and March 31, 2017, respectively. The Company’s contracts have a duration of one year or less and therefore, the Company has elected the practical expedient of not disclosing revenues allocated to partially unsatisfied performance obligations.

The following table represents revenue disaggregated by product in the three months ended June 30, 2018 and June 30, 2017 (in thousands):

	Three months ended June 30, 2018		
	Astaxanthin	Spirulina	Total
Packaged products	$5,095	$ 1,068	$6,163
Bulk products	263	719	982
Total	$5,358	$ 1,787	$7,145

	Three months ended June 30, 2017		
	Astaxanthin	Spirulina	Total
Packaged products	$5,505	$ 1,927	$7,432
Bulk products	221	1,156	1,377

Total	$5,726	$ 3,083	$8,809

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Recently Adopted Accounting Pronouncements

In May 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-09, *Compensation-Stock Compensation (Topic* 718*) Scope of Modification Accounting* ("ASU No. 2017-09"). ASU No. 2017-09 will clarify and reduce both (i) diversity in practice and (ii) cost and complexity when applying the guidance in Topic 718, to a change to the terms and conditions of a share-based payment award. This guidance became effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The amendments in this ASU are applied prospectively to awards modified on or after the adoption date. The Company adopted this standard as of April 1, 2018 with no impact on its consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, "*Statement of Cash Flows (Topic* 230*): Restricted Cash"* ("ASU No. 2016-18"). This update addresses the fact that diversity exists in the classification and presentation of changes in restricted cash on the statement of cash flows under Topic 230, *Statement of Cash Flows*. ASU No. 2016-18 became effective for public companies for the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company adopted this standard as of April 1, 2018 by using the retrospective method, which required reclassification of restricted cash in the accompanying consolidated statement of cash flows as of the beginning of the period for the three months ended June 30, 2018.

In August 2016, FASB issued ASU 2016-15, "*Statement of Cash Flows (Topic* 230*)*: *Classification of Certain Cash Receipts and Cash Payments"* ("ASU No. 2016-15"). This ASU clarifies and provides specific guidance on eight cash flow classification issues that are not currently addressed by current GAAP and thereby reduces the current diversity in practice. ASU No. 2016-15 is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. The Company adopted this standard as of April 1, 2018 with no impact on its consolidated financial statements and related disclosures.

In May 2014, the FASB issued their converged standard on revenue recognition, Accounting Standards Update No. 2014-09, "*Revenue from Contracts with Customers (Topic 606)"*("ASU No. 2014-09"), updated in December 2016 with the release of ASU 2016-20. This standard outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods and services in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods and services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued ASU No 2015-14 "*Revenue from Contracts with Customers (Topic 606*): *Deferral of the Effective Date,*" which deferred the effective date of ASU No. 2014-09 to annual reporting periods beginning after December 15, 2017.

The new revenue standard is required to be applied either retrospectively to each prior reporting period presented or prospectively with the cumulative effect of initially applying the standard recognized at the date of the initial application, supplemented with certain disclosures related to the effect of adoption on previously reported amounts, if any (the modified retrospective method). The Company adopted the standard on April 1, 2018 for contracts that were not completed before the adoption date, using the modified retrospective method. The Company has evaluated the effect of the standard and concluded it is not material to the timing or amount of revenues or expenses recognized in the Company’s historical consolidated financial statements. As a result, the Company has concluded that the application of the standard does not have a material effect that requires a retrospective adjustment to any previously reported amounts in the Company’s historical consolidated financial statements for reporting disclosure purposes.

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Recently Issued Accounting Pronouncements

In July 2018, the FASB issued ASU 2018-10 "*Codification Improvements to Topic 842, Leases*" ("ASU No. 2018-02"). This ASU affects narrow aspects of the guidance issued in the amendments in ASU No. 2016-02 including those regarding residual value guarantees, rate implicit in the lease, lessee reassessment of lease classification, lessor reassessment of lease term and purchase option, variable lease payments that depend on an index or a rate, investment tax credits, lease term and purchase option, transition guidance for amounts previously recognized in business combinations, certain transition adjustments, transition guidance for leases previously classified as capital leases under Topic 840, transition guidance for modifications to leases previously classified as direct financing or sales-type leases under Topic 840, transition guidance for sale and leaseback transactions, impairment of net investment in the lease, unguaranteed residual asset, effect of initial direct costs on rate implicit in the lease, and failed sale and leaseback transactions. The Company is currently evaluating the impact this ASU will have on its implementation of ASU No. 2016-02.

In June 2018, the FASB issued ASU 2018-07 "*Compensation - Stock Compensation (Topic 718)*" ("ASU No. 2018-07"): Improvements to Nonemployee Share-Based Payment Accounting. This ASU expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from non-employees, and as a result, the accounting for share-based payments to non-employees will be substantially aligned. ASU No. 2018-07 is effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. Early adoption is permitted but no earlier than an entity's adoption date of Topic 606. The Company is currently evaluating the impact this new guidance will have on its financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, "*Leases (Topic* 842*)*" ("ASU No. 2016-02"). The principle objective of ASU No. 2016-02 is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet. ASU No. 2016-02 continues to retain a distinction between finance and operating leases but requires lessees to recognize a right-of-use asset representing its right to use the underlying asset for the lease term and a corresponding lease liability on the balance sheet for all leases with terms greater than twelve months. ASU No. 2016-02 is effective for fiscal years and interim periods beginning after December 15, 2018. Early adoption of ASU No. 2016-02 is permitted. Entities are required to apply the amendments at the beginning of the earliest period presented using a modified retrospective approach. This guidance is applicable to the Company's fiscal year beginning April 1, 2019. In July 2018, the FASB issued ASU No. 2018-11, "*Leases (Topic 842): Targeted Improvements*," which provides an additional transition method that permits changes to be applied by means of a cumulative-effect adjustment recorded in retained earnings as of the beginning of the fiscal year of adoption. The Company has started the assessment process by evaluating the population of leases under the revised definition of what qualifies as a leased asset, and expects to have the assessment completed by March 2019. The Company is the lessee under various agreements for facilities and equipment that are currently accounted for as operating and capital leases. The Company expects this guidance will have a material impact on its consolidated balance sheets due to the recognition of lease rights and obligations as assets and liabilities, respectively. The Company does not expect this guidance to have a material effect on its consolidated results of operations and cash flows.

2. INVENTORIES

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

	June 30, 2018	**March 31, 2018**
	(in thousands)	
Raw materials	$371	$410
Work in process	3,301	2,602
Finished goods	5,663	5,878
Supplies	152	144
Inventories, net	$9,487	$9,034

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Abnormal costs related to spirulina production of $250,000 were charged to cost of sales for the quarter ended June 30, 2018. There were no abnormal production costs for the quarter ended June 30, 2017. Non-inventoriable fixed costs related to spirulina production of $125,000 were charged to cost of sales for the quarter ended June 30, 2018. Non-inventoriable fixed costs related to spirulina production of $9,000 were charged to cost of sales for the quarter ended June 30, 2017.

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3. EQUIPMENT AND LEASEHOLD IMPROVEMENTS, NET

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:

	Years
Equipment	3 to 10
Furniture and fixtures	3 to 7
Leasehold improvements	10 to 25

Equipment and leasehold improvements consist of the following:

	June 30, 2018	**March 31, 2018**
	(in thousands)	
Equipment	$18,114	$17,935
Leasehold improvements	14,287	14,248
Furniture and fixtures	348	348
	32,749	32,531
Less accumulated depreciation and amortization	(17,821)	(17,346)
Construction-in-progress	504	549
Equipment and leasehold improvements, net	$15,432	$15,734

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 June 30, 2018 and March 31, 2018, respectively.

4. LINE OF CREDIT

On August 30, 2016, the Revolving Credit Agreement (the “Credit Agreement”), which the Company and First Foundation Bank (“the Bank”) entered into on June 3, 2016, became effective after the Company and the Bank received the necessary approvals from the State of Hawaii to secure the lien on the Company’s leasehold property in Kona, Hawaii. The Credit Agreement allows the Company to borrow up to $2,000,000 on a revolving basis. Borrowings under the Credit Agreement bear interest at the Wall Street Journal prime rate (5.00% at June 30, 2018) + 2%, floating. The Credit Agreement includes various covenants as defined in the Credit Agreement. The Credit Agreement also contains standard acceleration provisions in the event of a default by the Company. At June 30, 2018, the Company had borrowed $1,250,000 under the Credit Agreement and had $750,000 available on the line. The line of credit will be subject to renewal upon expiration on August 30, 2018.

5. ACCRUED EXPENSES

Accrued expenses consist of the following:

	June 30, 2018	**March 31, 2018**
	(in thousands)	
Wages, commissions, bonus and profit sharing	$807	$ 707
Rent and utilities	69	69
Other accrued expenses	124	116
Total accrued expenses	$1,000	$ 892

6. LONG-TERM DEBT

Long-term debt consists of the following:

	June 30, 2018	**March 31, 2018**
	(in thousands)	
Long-term debt	$6,520	$6,678
Less current maturities	(660)	(655)
Long-term debt, excluding current maturities	5,860	6,023
Less unamortized debt issuance costs	(224)	(233)
Total long-term debt, net of current maturities and unamortized debt issuance costs	$5,636	$5,790

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Term Loans

The Company executed a loan agreement with a lender providing for $2,500,000 in aggregate credit facilities (the "2015 Loan") secured by substantially all the Company's assets, pursuant to a Term Loan Agreement dated July 30, 2015 (the "2015 Loan Agreement"). The 2015 Loan Agreement is evidenced by a promissory note in the amount of $2,500,000, the repayment of which is partially guaranteed under the provisions of a United States Department of Agriculture ("USDA") Rural Development Guarantee program. The proceeds of the 2015 Loan were used to pay off a $500,000 short term note payable that matured on September 18, 2015, and to acquire new processing equipment and leasehold improvements at the Company's Kona, Hawaii facility.

The provisions of the 2015 Loan Agreement require the payment of principal and interest until its maturity on September 1, 2022, the obligation fully amortizes over seven (7) years. Interest on the 2015 Loan accrues on the outstanding principal balance at an annual variable rate equal to the published Wall Street Journal prime rate (5.00% at June 30, 2018) plus 2.0% 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 6.00%. The 2015 Loan has a prepayment penalty of 5% for any prepayment made prior to the first anniversary of the date of the 2015 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 the 2015 Loan was $1,644,000 and $1,726,000 at June 30, 2018 and March 31, 2018, respectively.

The 2015 Loan includes a one-time origination and guaranty fee totaling $113,900 and an annual renewal fee payable in the amount of 0.50% of the USDA guaranteed portion of the outstanding principal balance as of December 31 of each year, beginning December 31, 2015. The USDA has guaranteed 80% of all amounts owing under the 2015 Loan. The Company is subject to financial covenants and customary affirmative and negative covenants.

The Company executed 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, including a mortgage on the Company's interest in its lease at the National Energy Laboratory of Hawaii Authority, 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 USDA Rural Development Guarantee. The proceeds of the Loan have been used to acquire new processing equipment and leasehold improvements at the Company's Kona, Hawaii facility.

The provisions of the Loan required 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 (5.00% at June 30, 2018) 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 balance under this Loan was $4,596,000 and $4,648,000 at June 30, 2018 and March 31, 2018, respectively.

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.

On October 6, 2017, the Company entered into an Equipment Finance Agreement (the “Equipment Agreement”) with a lender, which provides up to $175,000 of financing for equipment. The interest rate on this loan is 4.75%. The provisions of the Equipment Agreement require the payment of principal and interest until its maturity on October 31, 2022, the obligation fully amortizes over five (5) years. The balance under this loan was $149,000 and $156,000 at June 30, 2018 and March 31, 2018, respectively.

Capital Leases

The Company has three capital leases providing for $278,000 in equipment, secured by the equipment financed. The capital leases mature at various dates between May 2019 and March 2021 and are payable in 60 equal monthly payments, except for one which is payable in 36 equal monthly payments. The interest rates under these capital leases range from 4.18% to 12.90%. The aggregate balance under these leases was $131,000 and $148,000 at June 30, 2018 and March 31, 2018, respectively.

Future principal payments under the term loan and capital lease agreements as of June 30, 2018 are as follows:

Payments Due	**(in thousands)**
Next 12 Months	$ 660
Year 2	684
Year 3	685
Year 4	716
Year 5	398
Thereafter	3,377
Total principal payments	$ 6,520

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7. OPERATING LEASES

The Company leases facilities, equipment and land under operating leases expiring through 2035. The land lease provides for contingent rentals 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 June 30, 2018.

Future minimum lease payments under all non-cancelable operating leases at June 30, 2018 are as follows:

Payments Due	**(in thousands)**
Next 12 Months	$ 628
Year 2	611
Year 3	537
Year 4	533
Year 5	397
Thereafter	3,741
Total minimum lease payments	$ 6,447

8. OTHER COMMITMENTS AND CONTINGENCIES

From time to time, the Company may be involved in litigation and investigations relating to claims and matters arising out of its operations in the normal course of business. The Company believes that it currently is not a party to any legal proceedings or claims which, individually or in aggregate, would have a material effect on its consolidated financial position, results of operations or cash flows.

9. 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.

As of June 30, 2018, the Company had two equity-based compensation plans: the 2016 Equity Incentive Plan (the 2016 Plan) and the 2014 Independent Director Stock Option and Restricted Stock Grant Plan (the “2014 Directors Plan”). The Company has also issued stock options, which remain outstanding as of June 30, 2018, under two equity-based compensation plans which have expired according to their terms: the 2005 Stock Option Plan (the “2005 Plan”) and the 2004 Independent Director Stock Option and Stock Grant Plan (the “2004 Directors Plan”). These plans allowed the Company to award stock options and shares of restricted common stock to eligible employees, certain outside consultants and independent directors. No additional awards will be issued under the 2005 Plan or the 2004 Directors Plan.

On August 25, 2016, the Company’s shareholders approved the 2016 Plan as a successor to the 2005 Plan, authorizing the Board of Directors to provide incentive to the Company’s officers, employees and certain independent consultants through equity based compensation in the form of stock options, restricted stock, restricted stock units, stock appreciation rights and other stock based awards (together, “Stock Awards”) and performance shares and performance units (together “Performance Awards”). Awards under the 2016 Plan are limited to the authorized amount of 1,300,000 shares, up to 600,000 of which are available for issuance in connection with Performance Awards and Stock Awards. As of June 30, 2018, there were 1,131,483 shares available for grant under the 2016 Plan.

On August 28, 2014, the Company’s shareholders approved the 2014 Directors Plan authorizing the Board of Directors to provide incentive to the Company’s independent directors through equity based compensation in the form of stock options and restricted stock. Awards under the 2014 Directors Plan are limited to the authorized amount of 350,000 shares. As of June 30, 2018, there were 231,623 shares available for grant under the 2014 Directors Plan.

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

	As of June 30, 2018 Authorized	Available	Outstanding
2016 Plan	1,300,000	1,131,483	152,514
2014 Directors Plan	350,000	231,623	12,000
2005 Plan	—	—	437,400
2004 Directors Plan	—	—	12,000
Total	1,650,000	1,363,106	613,914

Stock Options

All stock option grants made under the equity-based compensation plans were issued at exercise prices no less than the Company's closing stock price on the date of grant. Options under the 2005 Plan and 2014 Directors Plan were determined by the Board of Directors or the Compensation Committee of the Board of Directors in accordance with the provisions of the respective plans. The terms of each option grant include 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. Compensation expense recognized for options issued under all Plans was $18,000 and $15,000 for the three months ended June 30, 2018 and 2017, respectively. All stock-based compensation has been classified as general and administrative expense in the condensed consolidated statement of operations.

A summary of option activity under the Company's stock plans for the three months ended June 30, 2018 is presented below:

Option Activity	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at March 31, 2018	589,400	$ 4.06	4.9	$ 675,300

Granted	—	—		
Exercised	(6,000)	$ 2.85		
Forfeited	(2,000)	$ 5.61		
Outstanding at June 30, 2018	581,400	$ 4.07	4.7	$ 158,724
Exercisable at June 30, 2018	461,400	$ 4.21	3.6	$ 114,324

The aggregate intrinsic value 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 $3.90 for such day.

A summary of the Company’s non-vested options for the three months ended June 30, 2018 is presented below:

Nonvested Options	**Shares**	**Weighted Average Grant-Date Fair Value**
Nonvested at March 31, 2018	120,000	$ 1.81
Granted	—	—
Vested	—	—
Forfeited	—	—
Nonvested at June 30, 2018	120,000	$ 1.81

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The following table summarizes the weighted average characteristics of outstanding stock options as of June 30, 2018:

	Outstanding Options			Exercisable Options	
Range of Exercise Prices	Number of Shares	Remaining Life (Years)	Weighted Average Price	Number of Shares	Weighted Average Price
$1.60 - $3.70	166,800	5.1	$ 3.06	91,800	$ 2.82
$3.71 - $4.42	239,100	4.5	3.83	194,100	3.83
$4.43 - $5.40	95,000	4.9	5.00	95,000	5.00
$5.41 - $7.08	80,500	4.4	5.77	80,500	5.77
Total stock options	581,400	4.7	$ 4.07	461,400	$ 4.21

The range of fair value assumptions related to options granted during the year ended March 31, 2018 were as follows:

	2018
Exercise Price	$3.83
Volatility	51.91 %
Risk Free Rate	2.50 %
Vesting Period (years)	3.0
Forfeiture Rate	0.00 %
Expected Life (in years)	6.00
Dividend Rate	0 %

As of June 30, 2018, total unrecognized stock-based compensation expense related to all unvested stock options was $163,000, which is expected to be expensed over a weighted average period of 2.0 years.

Restricted Stock Units ("RSUs")

RSUs are service-based awards granted to eligible employees under the 2016 Plan. Compensation expense recognized for RSUs issued under the 2016 Plan was $16,000 and $16,000 for the three months ended June 30, 2018 and 2017, respectively.

On April 5, 2018, 1,474 RSUs were awarded to employees of the Company. This award is valued at $5.25 per share, the closing market price of Cyanotech common stock on the grant date, and vests over a period of two years.

The following table summarizes information related to awarded RSUs:

Nonvested Restricted Stock Units	**Shares**	**Weighted Average Grant Price**
Nonvested restricted stock units at March 31, 2018	39,675	$ 3.89
Granted	1,474	5.25
Vested	(7,670)	3.92
Forfeited	(965)	4.29
Nonvested restricted stock units at June 30, 2018	32,514	$ 3.93

As of June 30, 2018, total unrecognized stock-based compensation expense related to unvested restricted stock units was $110,000, which is expected to be expensed over a weighted average period of 1.8 years.

Subsequent to June 30, 2018, 22,449 restricted stock units were granted from the 2016 Plan to employees and officers of the Company.

10. INCOME TAXES

On December 22, 2017 H.R. 1, originally known as the Tax Cuts and Jobs Act, (the “Tax Act”) was enacted. Among the significant changes to the U.S. Internal Revenue Code, the Tax Act lowers the U.S. federal corporate income tax rate (“Federal Tax Rate”) from 34% to 21% effective January 1, 2018. The Company will compute its income tax expense for the March 31, 2019 fiscal year using a Federal Tax Rate of 21%. The 21% Federal Tax Rate will apply to fiscal years ending March 31, 2019 and each year thereafter. The Company has completed the accounting for the income tax effects of the Tax Act as of March 31, 2018 and has determined that the amount identified as provisional in the quarter ended December 31, 2018 was a materially correct amount. As a result, no measurement period adjustments have been recorded.

We utilize our estimated annual effective tax rate to determine our provision (benefit) for income taxes for interim periods. The income tax provision (benefit) is computed by multiplying the estimated annual effective tax rate by the year to date pre-tax book income (loss). We recorded income tax benefit of ($22,000) and income tax expense of $11,000 for the three months ended June 30, 2018 and 2017, respectively. Our effective tax rate was 1.7% and 2.1% for the quarters ended June 30, 2018 and June 30, 2017, respectively. The effective tax rate for the three months ended June 30, 2018 differs from the statutory rate of 21% as a result of state taxes (net of federal benefit) and the net change in valuation allowance against the net deferred tax asset the Company believes is not more likely than not to be realized.

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The Company is subject to taxation in the United States and six 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 June 30, 2018, 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 income or 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 2013.

11. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings (loss) 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.

Reconciliations between the numerator and the denominator of the basic and diluted earnings (loss) per share computations for the three months ended June 30, 2018 and 2017 are as follows:

	Three Months Ended June 30, 2018		
	Net Loss	**Shares**	**Per Share**
	(Numerator)	**(Denominator)**	**Amount**
	(in thousands)		

Basic and diluted loss per share	$(1,275)	5,785	$ (0.22)

	Three Months Ended June 30, 2017		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
	(in thousands)		
Basic income per share	$501	5,685	$ 0.09
Effect of dilutive securities-Common stock options	—	34	—
Diluted income per share	$501	5,719	$ 0.09

Basic and diluted loss per share are the same in periods of a net loss, because common share equivalents are anti-dilutive when a net loss is recorded. Diluted earnings per share does not include the impact of common stock options totaling 120,000 and 0 for the three months ended June 30, 2018 and 2017, respectively, as the effect of their inclusion would be anti-dilutive. Restricted stock units become dilutive within the period granted and remain dilutive until the units vest and are issued as common stock. Diluted earnings per share does not include the impact of restricted stock units totaling 1,206 and 27,344 for the three months ended June 30, 2018 and 2017, as the effect of their inclusion would be anti-dilutive.

12. CONCENTRATIONS OF RISK

Concentration of Accounts Receivable and Revenues

At June 30, 2018, 79% of the Company's accounts receivable was comprised of two customer balances of 42% and 37%, respectively. At March 31, 2018, 77% of the Company's accounts receivable was comprised of three customer balances of 49%, 17% and 11%, respectively. There were two customers with sales representing 31% and 27% of our total net sales for the three months ended June 30, 2018. There were two customers with sales representing 32% and 13% of our total net sales for the three months ended June 30, 2017.

13. RELATED PARTY TRANSACTIONS AND BALANCES

During the three months ended June 30, 2018, the Company entered into a consulting agreement with an effective date of May 5, 2018 with a vendor that employs one of our independent directors. The Company's independent director is not named in or involved in the performance of the consulting agreement. The contract amount is $120,000. $46,000 of the contract amount is reflected in general and administrative expense as of June 30, 2018 and no payments have been made against the contract during the three months ended June 30, 2018.

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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", "esti 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 subsidiary (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.

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;

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 or attributed to the current local, national and world economic conditions, 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;

The Company’s inability to generate enough revenues to meet its obligations or repay maturing indebtedness;

Failure of capital projects to operate as expected or meet expected results;

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;

Legal costs associated with any legal proceedings, and the potential direct and indirect cost and other effects on our business or financial condition resulting from any legal proceedings.

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.

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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 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, employees and the communities we live in), and quality of the environment in which we work. Our products include:

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; and

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

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 commercially produce human nutritional products derived from microalgae.

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, with tight control of organisms allowed into the area and free of genetically modified organisms (GMO's). 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.

Results of Operations

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

	Three Months Ended June 30, 2018	June 30, 2017
Net sales	$7,145	$8,809
Net sales decrease	(18.9)%	
Gross profit	$1,836	$3,603
Gross profit as % of net sales	25.7 %	40.9 %
Operating expenses	$3,003	$2,983
Operating expenses as % of net sales	42.0 %	33.9 %
Operating (loss) income	$(1,167)	$620
Operating (loss) income as % of net sales	(16.3)%	7.0 %
Income tax (benefit) expense	$(22)	$11
Net (loss) income	$(1,275)	$501
Net sales by product		
Packaged sales		
Astaxanthin packaged	$5,095	$5,505
Astaxanthin packaged sales decrease	(7.4)%	
Spirulina packaged	$1,068	$1,927
Spirulina packaged sales decrease	(44.6)%	
Total Packaged sales	$6,163	$7,432
Total Packaged sales decrease	(17.1)%	
Bulk sales		
Astaxanthin bulk	$263	$221
Astaxanthin bulk sales increase	19.0 %	
Spirulina bulk	$719	$1,156
Spirulina bulk sales decrease	(37.8)%	
Total Bulk sales	$982	$1,377
Total Bulk sales decrease	(28.7)%	

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Comparison of the Three Months Ended June 30, 2018 and 2017

Net Sales Net sales decreased 19% for the quarter, driven by a 17% decrease in our packaged products and a 29% decrease in bulk sales. The decrease in sales of our spirulina packaged products was the result of lower supply of spirulina, and the decrease in sales of our astaxanthin package products was the result of the quarterly variance year to year in the timing of international orders. The decrease in sales of our bulk products is primarily the result of the lack of available spirulina supply. International sales represented 20% of net sales for the current quarter compared to 27% for the same period last year.

Gross Profit Our gross profit as a percent of net sales decreased by 15.2 percentage points compared to the same period last year. In April 2018, we undertook a complete re-inoculation of our spirulina ponds. During the re-inoculation period, which was completed mid-May, there was no spirulina production. Since then, production has steadily increased and we have recently returned to normal production levels. The lower spirulina production levels in both Q4 of fiscal 2018 (-63% compared to Q4 of fiscal 2017) and in Q1 of the current fiscal year (-76% compared to Q1 of fiscal 2018) had a negative impact on the current quarter's performance. In addition to decreased sales volume, the lower production levels resulted in a $1.1 million increase in costs in the current quarter and impacted gross margin by -14.9 points. Additionally, spirulina inventory on hand at the end of the quarter includes $0.6 million of higher overhead costs that will be amortized in the next quarter and negatively impact gross profit and margin.

Operating Expenses Operating expenses remained flat, increasing by 1% for the first quarter of fiscal 2019 compared to the same period in fiscal 2018.

Income Taxes We recorded an income tax benefit of $(22,000) in the current quarter with an effective tax rate of 1.7%, compared to an expense of $11,000 for the same period in fiscal 2018 with an effective tax rate of 2.1%. We continue to carry a full valuation allowance on our deferred tax asset.

Liquidity and Capital Resources

As of June 30, 2018, we had cash of $0.9 million and working capital of $6.9 million compared to $1.3 million and $7.9 million, respectively, at March 31, 2018. On August 30, 2016, the Credit Agreement, which we and First Foundation Bank (the Bank) entered into on June 3, 2016, became effective. The Credit Agreement allows us to borrow up to $2.0 million on a revolving basis. At June 30, 2018, we had borrowed $1.25 million and had $0.75 million available on the line. The line of credit is subject to renewal on August 30, 2018 and we are working with the Bank to renew the line of credit or replace it with another line of credit on or before the expiration date.

As of June 30, 2018, we had $6.2 million of term loans payable to the Bank that require the payment of principal and interest monthly through August 2032. Pursuant to the term loans, we are subject to annual financial covenants, customary affirmative and negative covenants and certain subjective acceleration clauses. We were in compliance with these financial covenants at March 31, 2018.

Funds generated by operating activities and available cash continue to be our most significant sources of liquidity for working capital requirements, debt service and funding of maintenance levels of capital expenditures. Based upon our fiscal year 2019 operating plan and related cash flow projections and our projected consolidated financial position as of March 31, 2019, cash flows expected to be generated by operating activities and available financing are expected to be sufficient to fund our operations for at least the next twelve months, and our current ratio is expected to be in compliance with the annual term loan covenant requirement as of March 31, 2019. However, no assurances can be provided that we will achieve our operating plan and cash flow objectives for the fiscal year ended March 31, 2019 or our projected consolidated financial position as of March 31, 2019. Such estimates are subject to change based on future results and such change could cause future results to vary significantly from expected results.

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

	Three months ended June 30	
	2018	**2017**
Total cash (used in) provided by:		
Operating activities	$(865)	$210
Investing activities	(173)	(56)
Financing activities	579	(262)
(Decrease) increase in cash	$(459)	$(108)

Cash used in operating activities for the three months ended June 30, 2018 was the result of a net loss, excluding non-cash charges, of $0.8 million and an increase in working capital of $0.1 million.

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Cash used in investing activities for the three months ended June 30, 2018 includes costs for leasehold improvements and equipment acquisitions at our Kona facility.

Cash provided by financing activities for the three months ended June 30, 2018 includes a $0.8 million increase in our line of credit balance, offset by $0.2 million in principal payments on debt in the normal course of business.

Sources and Uses of Capital

At June 30, 2018, our working capital was $6.9 million, a decrease of $1.0 million compared to March 31, 2018. The decrease is due primarily to the increase in short term debt.

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.

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 2019, our primary focus is on building our consumer brands, increasing our astaxanthin production volume and improving the consistency of our production for both astaxanthin and spirulina. We will continue to put emphasis on our Nutrex Hawaii consumer products to introduce them to a broader consumer market, and 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 and softgel caplet form. Information about our Company and our products can be viewed at www.cyanotech.com and www.nutrex-hawaii.com. Consumer products can also be purchased online at 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 these lines to meet the demand of consumers. Our recent re-inoculation of our spirulina ponds was a necessary step toward sustaining long-term production levels. We will continue to promote the nutritional superiority of Hawaiian grown microalgae to maintain and expand market share. Significant sales variability between periods and even across several periods can be expected based on historical results.

Gross profit margin percentages going forward will be impacted by production volumes and 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 higher margin consumer products that promote health and well-being. 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; changes in health and growing conditions of our astaxanthin and spirulina products; 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 Part II, Item 1A of this quarterly report and in Part I, Item 1A of our Form 10-K report for the year ended March 31, 2018.

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.

Off-Balance Sheet Arrangements

As of June 30, 2018, we had no off-balance sheet arrangements or obligations.

Impact of Inflation

Inflationary factors such as increases in the costs of materials and labor directly affect the Company's operations. Most of the Company's leases provide for cost-of-living adjustments and require it to pay for insurance and maintenance expenses, all of which are subject to inflation. Additionally, the Company’s future lease cost for new facilities may include potentially escalating costs of real estate and construction. There is no assurance that the Company will be able to pass on increased costs to its customers.

Depreciation expense is based on the historical cost to the Company of its fixed assets, and is therefore potentially less than it would be if it were based on current replacement cost. While property and equipment acquired in prior years will ultimately have to be replaced at higher prices, it is expected that replacement will be a gradual process over many years.

Critical Accounting Policies and Estimates

Our critical accounting policies and estimates are disclosed in the “Management’s Discussion and Analysis of Financial Condition and Results of Operations” section of our Annual Report on Form 10-K for the year ended March 31, 2018 filed with the SEC on June 15, 2018. In the three months ended June 30, 2018, there were changes to the application of critical accounting policies previously disclosed in our most recent Annual Report on Form 10-K related to the adoption of ASU 2014-09 on April 1, 2018, as described below.

Revenue Recognition

The Company records revenue based on the five-step model which includes: (1) identifying the contract with the customer; (2) identifying the performance obligations in the contract; (3) determining the transaction price; (4) allocating the transaction price to the performance obligations; and (5) recognizing revenue when the performance obligations are satisfied. Substantially all of the Company’s revenue is generated by fulfilling orders for the purchase of our micro algal nutritional supplements to retailers, wholesalers, or direct to consumers via online channels, with each order considered to be a distinct performance obligation. These orders may be formal purchase orders, verbal phone orders, e-mail orders or orders received online. Shipping and handling activities for which the Company is responsible under the terms and conditions of the order are not accounted for as performance obligations but as fulfillment costs. These activities are required to fulfill the Company’s promise to transfer the goods and are expensed when revenue is recognized. The impact of this policy election is insignificant as it aligns with our current practice.

Revenue is measured as the net amount of consideration expected to be received in exchange for fulfilling a performance obligation. The Company has elected to exclude sales, use and similar taxes from the measurement of the transaction price. The impact of this policy election is insignificant, as it aligns with our current practice. The amount of consideration expected to be received and revenue recognized includes estimates of variable consideration, which includes costs for trade promotion programs, coupons, returns and early payment discounts. Such estimates are calculated using historical averages adjusted for any expected changes due to current business conditions and experience. The Company reviews and updates these estimates at the end of each reporting period and the impact of any adjustments are recognized in the period the adjustments are identified. In assessing whether collection of consideration from a customer is probable, the Company considers the customer's ability and intent to pay that amount of consideration when it is due. Payment of invoices is due as specified in the underlying customer agreement, typically 30 days from the invoice date, which occurs on the date of transfer of control of the products to the customer.

Revenue is recognized at the point in time that the control of the ordered products is transferred to the customer. Generally, this occurs when the product is delivered, or in some cases, picked up from one of our distribution centers by the customer.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes to our market risk during the three months ended June 30, 2018. For additional information, refer to our Annual Report on Form 10-K for the year ended March 31, 2018.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our chief executive officer (“CEO”) and chief financial officer (“CFO”), we have evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15(d)-15(e) of the Exchange Act as of the end of the period covered by this Report. Based on that evaluation, our CEO and CFO have concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information we are required to disclose in reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosures.

Management’s Report on Internal Control over Financial Reporting

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act). The Company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our management evaluated the effectiveness of our internal control over financial reporting as of June 30, 2018. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in “Internal Control - Integrated Framework” (2013 Framework). Based on that assessment, management concluded that our internal control over financial reporting was effective as of June 30, 2018.

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Changes to Internal Control Over Financial Reporting

On April 1, 2018, we adopted *Topic 606* (see Note 1). We implemented internal controls to ensure we adequately evaluate our contracts and properly assess the impact of the new accounting standards on our condensed consolidated financial statements. Although adoption of the new revenue standard had no impact on April 1, 2018 retained earnings or financial statement activity for the quarter ended June 30, 2018, and is not expected to have a material impact on our ongoing financial statements, we implemented changes to our business processes related to revenue recognition and the control activities within them. The changes included training within management, as well as new processes for ongoing contract review and monitoring to ensure completeness and accuracy of the information for new disclosures.

There were no other changes 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 June 30, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Limitations on the Effectiveness of Controls

Our management, including our Chief Executive Officer and Chief Financial Officer, do not expect that our disclosure controls and procedures or our internal controls over financial reporting will prevent all errors and all fraud. A control system no matter how well designed and implemented, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within a company are detected.

The inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistakes. Controls can also be circumvented by the individual acts of some persons, or by collusion of two or more people. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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, 2018, filed June 15, 2018.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time the Company may become party to lawsuits and claims that arise in the ordinary course of business relating to employment, intellectual property, and other matters. There were no significant legal matters outstanding at June 30, 2018.

Item 1A. Risk Factors

For a discussion of the risk factors relating to our business, please refer to Part I, Item 1A of our Form 10-K for the year ended March 31, 2018, which is incorporated by reference herein.

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

None.

Item 3. Defaults upon Senior Securities

None.

Item 5. Other Information

None.

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Item 6. Exhibits

a) The following exhibits are furnished with this report:

31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of August 13, 2018.
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of August 13, 2018.
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of August 13, 2018.
99.1	Press Release dated August 13, 2018.
101	The following financial statements from Cyanotech Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018, 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)
August 13, 2018 (Date)	By: /s/ Mawae R. Morton Mawae R. Morton *Chief Executive Officer; Director*
August 13, 2018 (Date)	By: /s/ Jole E. Deal Jole E. Deal *Vice President — Finance & Administration and CFO* *(Principal Financial and Accounting Officer)*

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