

CYANOTECH CORP  
Form 10-Q  
November 09, 2012  
[Table of Contents](#)

**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          |



Table of Contents

CYANOTECH CORPORATION

FORM 10-Q

INDEX

**PART I. FINANCIAL INFORMATION**

|                |  |    |
|----------------|--|----|
| <u>Item 1.</u> | <u>Financial Statements (unaudited)</u>  | 3  |
|                | <u>Condensed Consolidated Balance Sheets as of September 30, 2012 and March 31, 2012</u>                                     | 3  |
|                | <u>Condensed Consolidated Statements of Operations for the three and six month periods ended September 30, 2012 and 2011</u> | 4  |
|                | <u>Condensed Consolidated Statements of Cash Flows for the six month periods ended September 30, 2012 and 2011</u>           | 5  |
|                | <u>Notes to Condensed Consolidated Financial Statements</u>  | 6  |
| <u>Item 2.</u> | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                 | 13 |
| <u>Item 3.</u> | <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 19 |
| <u>Item 4.</u> | <u>Controls and Procedures</u>   | 19 |

**PART II. OTHER INFORMATION**

|                   |  |    |
|-------------------|--|----|
| <u>Item 1.</u>    | <u>Legal Proceedings</u>   | 19 |
| <u>Item 2.</u>    | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 20 |
| <u>Item 3.</u>    | <u>Defaults upon Senior Securities</u>                             | 20 |
| <u>Item 5.</u>    | <u>Other Information</u>   | 20 |
| <u>Item 6.</u>    | <u>Exhibits</u>  | 20 |
| <u>SIGNATURES</u> |  | 21 |

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements** (Unaudited)

## 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.

Table of Contents

## 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.

Table of Contents

## 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.

Table of Contents

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 |

Table of Contents

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.

Table of Contents

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.

Table of Contents

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          |

Table of Contents

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 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 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:

| <b>Option Activity</b>            | <b>Shares</b> | <b>Weighted Average<br/>Exercise Price</b> | <b>Weighted Average<br/>Remaining<br/>Contractual Term</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|-----------------------------------|---------------|--|--|--|
| 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  |  |