CYANOTECH CORP
Form 10-Q
November 06, 2017

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 September 30, 2017

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 November 6, 2017:

Title of Class	**Shares Outstanding**
Common stock - $0.02 par value	5,743,882

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CYANOTECH CORPORATION

FORM 10-Q

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

(Unaudited)

	September 30, 2017	**March 31, 2017**
ASSETS		
Current assets:		
Cash	$ 2,102	$ 1,407
Accounts receivable, net of allowance for doubtful accounts of $27 at September 30, 2017 and $49 at March 31, 2017	1,541	2,135
Inventories, net	9,315	7,972
Prepaid expenses and other current assets	447	565
Total current assets	13,405	12,079
Equipment and leasehold improvements, net	16,023	16,712
Other assets	251	213
Total assets	$ 29,679	$ 29,004
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Line of credit	$ 500	$ 611
Current maturities of long-term debt	626	623
Customer deposits	72	119
Accounts payable	3,473	3,666
Accrued expenses	1,012	1,013
Total current liabilities	5,683	6,032
Long-term debt, less current maturities	5,959	6,249
Other long-term liabilities	110	116
Total liabilities	11,752	12,397
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, shares authorized 50,000,000; 5,743,882 shares issued and outstanding at September 30, 2017 and 5,685,381 shares at March 31, 2017	115	114
Additional paid-in capital	31,919	31,577
Accumulated deficit	(14,107)	(15,084)
Total stockholders' equity	17,927	16,607
Total liabilities and stockholders' equity	$ 29,679	$ 29,004

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 September 30,		Six Months Ended September 30,	
	2017	**2016**	**2017**	**2016**
NET SALES	$8,055	$9,862	$16,864	$17,184
COST OF SALES	4,435	5,977	9,641	10,478
Gross profit	3,620	3,885	7,223	6,706
OPERATING EXPENSES:				
General and administrative	1,412	2,016	2,764	3,726
Sales and marketing	1,440	1,470	2,929	3,025
Research and development	149	152	291	318
Total operating expenses	3,001	3,638	5,984	7,069
Income (loss) from operations	619	247	1,239	(363)
Interest expense, net	(133)	(122)	(241)	(253)
Income (loss) before income taxes	486	125	998	(616)
INCOME TAX EXPENSE (BENEFIT)	11	26	21	(24)
NET INCOME (LOSS)	$475	$99	$977	$(592)
NET INCOME (LOSS) PER SHARE:				
Basic	$0.08	$0.02	$0.17	$(0.10)
Diluted	$0.08	$0.02	$0.17	$(0.10)
SHARES USED IN CALCULATION OF NET INCOME (LOSS) PER SHARE:				
Basic	5,709	5,657	5,697	5,645
Diluted	5,771	5,727	5,743	5,645

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Six Months Ended September 30,	
	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$977	$(592)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss (gain) on disposal of assets	32	(13)
Depreciation and amortization	938	1,007
Amortization of debt issue costs and other assets	32	28
Share-based compensation expense	341	215
Net (increase) decrease in assets:		
Accounts receivable	594	(70)
Inventories	(1,343)	397
Prepaid expenses and other assets	66	(259)
Net increase (decrease) in liabilities:		
Customer deposits	(47)	(67)
Accounts payable	(193)	184
Accrued expenses	(1)	73
Deferred rent and other liabilities	(5)	8
Net cash provided by operating activities	1,391	911
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment in equipment and leasehold improvements	(281)	(277)
Net cash used in investing activities	(281)	(277)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short term note payable	—	600
Net (payments) draws on line of credit	(111)	611
Payment of short term notes payable	—	(600)
Payments on capitalized leases	(46)	(35)
Principal payments on long-term debt	(260)	(252)
Payments in stock withheld for tax payment on issuance	—	(147)
Proceeds from stock options exercised	2	4
Net cash (used in) provided by financing activities	(415)	181
Net increase in cash	695	815

Cash at beginning of period	1,407	1,240
Cash at end of period	$2,102	$2,055
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$210	$213
Income taxes	$—	$—

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2017

(Unaudited)

1. 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, 2017 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, 2017, contained in the Company's annual report on Form 10-K as filed with the SEC on June 22, 2017.

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 and Debt Covenant Compliance

As of September 30, 2017, the Company had cash of $2.1 million and working capital of $7.7 million compared to $1.4 million and $6.0 million, respectively, at March 31, 2017. The Company has a revolving line of credit agreement with First Foundation Bank (the Bank) that allows it to borrow up to $2 million. The line is subject to renewal on August 30, 2018. As of September 30, 2017, the Company had borrowed $0.5 million and had $1.5 million available on the line.

As of September 30, 2017, the Company had $6.6 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, 2017 and 2016, the Company's current ratio of 1.92:1 and 1.97:1, respectively, fell short of the Bank's annual requirement of 2.10:1. The Bank has provided the Company with letters stating they found the Company to be in compliance with this covenant requirement and all other financial covenants as of March 31, 2017 and 2016, and do not consider these shortfalls to be defaults under the Loan Agreements.

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 2018 operating plan and related cash flow projections and the Company's projected consolidated financial position as of March 31, 2018, 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, 2018. 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, 2018. Such estimates are subject to change based on future results and such change could cause future results to vary significantly from expected results.

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As indicated above, the Bank has not considered the shortfalls as of March 31, 2017 and 2016 in the Company's current ratio relative to the covenant requirement to be violations of the Loan Agreements. However, in the event the Company has a shortfall under the Loan Agreements as of March 31, 2018 or future fiscal year ends, there is no assurance that the Bank will not consider such to be a violation of the Loan Agreements and pursue its rights under the arrangements to call for the repayment of the outstanding borrowings payable to the Bank. If this occurs, the Company may need to raise additional funds to repay the loans; however, the Company may not be able to secure such funding on acceptable terms, or at all.

Reclassification

Certain amounts in the fiscal 2017 consolidated financial statements have been reclassified to conform to the fiscal 2018 financial presentation. These reclassifications have no impact on net income (loss).

Recent 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 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 will become effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. Early adoption is permitted. The amendments in this ASU should be applied prospectively to an award modified on or after the adoption date. The Company is currently evaluating the impact of this updated standard. The Company does not believe this update will have a significant impact on its consolidated financial statements.

In December 2016, the FASB issued ASU 2016-20 *"Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers"* ("ASU No. 2016-20") and ASU 2016-19 *"Technical Corrections and Improvements"* ("ASU No. 2016-19") which contains amendments that affect a wide variety of topics in the Accounting Standards Codification ("ASC"). The amendments generally fall into one of the following four categories: (a) Amendments related to differences between original guidance and the ASC that either carry forward pre-codification guidance or subsequent amendments into the ASC or to guidance that was codified without some text, reference, or phrasing that, upon review, was deemed important to the guidance; (b) Guidance clarification and reference corrections; (c) Simplification; and (d) Minor improvements. ASU 2016-20 will take effect for public companies for the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. This guidance is applicable to the Company's fiscal year beginning April 1, 2018. The Company does not expect that the adoption of this guidance will have a significant impact on its consolidated financial position, results of operations or cash flows.

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 2016-18 will take effect for public companies for the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. This guidance is applicable to the Company's fiscal year beginning April 1, 2018. The Company does not anticipate that this guidance will have a material impact on its consolidated financial statements and related disclosures.

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, with early application permitted. This guidance is applicable to the Company's fiscal year beginning April 1, 2018. The Company does not anticipate that this guidance will have a material impact on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU 2016-09, "*Compensation – Stock Compensation (Topic 718)*: *Improvements to Employee Share-Based Payment Accounting" ("*ASU No. 2016-09*")*. This ASU makes several modifications to Topic 718 related to the accounting for forfeitures, employer tax withholding on share-based compensation, and the financial statement presentation of excess tax benefits or deficiencies. ASU No. 2016-09 also clarifies the statement of cash flows presentation for certain components of share-based awards. The standard is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods, with early adoption permitted. Amendments requiring recognition of excess tax benefits and tax deficiencies in the income statement must be applied prospectively. Amendments related to the presentation of excess tax benefits on the statement of cash flows may be applied either prospectively or retrospectively based on the Company's election. Amendments related to the statement of cash flows presentation of employee taxes paid when an employer withholds shares must be applied retrospectively. As of April 1, 2017, the Company adopted ASU 2016-09 and elected to present excess tax benefits as an operating activity prospectively and continues to estimate forfeitures rather than recognize them as they occur. The adoption of ASU 2016-09 did not have an impact on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU No. 2016-08, *"Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)"* ("ASU No. 2016-08"), which clarified the revenue recognition implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, *"Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing",* which clarified the revenue recognition guidance regarding the identification of performance obligations and the licensing implementation. In May 2016, the FASB issued ASU No. 2016-12, *"Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients",* which narrowly amended the revenue recognition guidance regarding collectability, noncash consideration, presentation of sales tax and transition. ASU No. 2016-08, ASU No. 2016-10 and ASU No. 2016-12 are effective during the same period as ASU No. 2014-09, *Revenue from Contracts with Customers*, which is effective for annual reporting periods beginning after December 15, 2017, with the option to adopt one year earlier. This guidance is applicable to the Company's fiscal year beginning April 1, 2018. The Company does not anticipate that the adoption of ASU No. 2016-08, ASU No. 2016-10 and ASU No. 2016-12 will have a material impact on its consolidated 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. 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.

In November 2015, the FASB issued ASU No. 2015-17, "*Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes"*. This guidance simplifies the presentation of deferred income taxes and requires that deferred tax assets and liabilities be classified as noncurrent in the classified statement of financial position. ASU 2015-17 will take effect for public companies for the fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. As required, the Company adopted this standard as of April 1, 2017 and accordingly all deferred tax assets and liabilities are classified as non-current. Prior periods were retrospectively adjusted.

In August 2015, the FASB issued ASU 2015-14, *"Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date"*, which defers the effective date of ASU 2014-09 by one year to December 15, 2017 for interim and annual reporting periods beginning after that date, and permitted early adoption of the standard, but not before the original effective date.

In July 2015, the FASB issued ASU No. 2015-11, *"Inventory: Simplifying the Measurement of Inventory"*, that requires inventory not measured using either the last in, first out (LIFO) or the retail inventory method to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable cost of completion, disposal, and transportation. Prior to the issuance of the standard, inventory was measured at the lower of cost or market (where market was defined as replacement cost, with a ceiling of net realizable value and floor of net realizable value less a normal profit margin). The new standard will be effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, and will be applied prospectively. Early adoption is permitted. As required, the Company adopted this standard as of April 1, 2017. The adoption of this standard did not have a material impact on the Company's financial position or results of operations.

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In May 2014, The FASB issued ASU No 2014-09, *"Revenue from Contracts with Customers (Topic 606)"*. This guidance, as amended by subsequent ASUs on the topic, supersedes current guidance on revenue recognition in topic 605, Revenue Recognition. This guidance will be effective for annual periods beginning after December 15, 2017, including interim reporting periods. Early application of the guidance is permitted for annual periods beginning after December 31, 2016. This guidance is applicable to our fiscal year beginning April 1, 2018. The Company plans to adopt this guidance when effective in the first quarter of the fiscal year ended March 31, 2019. The Company has begun to consider the alternatives of adoption of this ASU and has started its review of the likely impact to the existing portfolio of customers contracts entered into prior to adoption. The Company will also continue to evaluate the effect of adopting this guidance upon the its results of operations, cash flows and financial position. The Company expects to complete this evaluation in December 2017.

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, 2017	**March 31, 2017**
	(in thousands)	
Raw materials	$326	$347
Work in process	2,504	2,323
Finished goods (1)	6,335	5,173
Supplies	150	129
Inventories, net	$9,315	$7,972

(1) Net of reserve for obsolescence of $3,000 at September 30, 2017 and March 31, 2017, respectively.

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Non-inventoriable fixed costs related to spirulina production of $75,000 and $84,000 were charged to cost of sales for the three and six months ended September 30, 2017, respectively. Non-inventoriable fixed costs related to astaxanthin production of $73,000 and $101,000 were charged to cost of sales for the three and six months ended September 30, 2016, respectively

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:

	September 30, 2017	**March 31, 2017**
	(in thousands)	
Equipment	$17,623	$17,492
Leasehold improvements	14,239	13,892
Furniture and fixtures	348	380
	32,210	31,764
Less accumulated depreciation and amortization	(16,631)	(15,835)
Construction-in-progress	444	783
Equipment and leasehold improvements, net	$16,023	$16,712

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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, 2017 and 2016, 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 (4.25% at September 30, 2017) + 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. As of September 30, 2017, the Company had borrowed $500,000 and had $1,500,000 available on the line. The line of credit is subject to annual renewal and was renewed on August 30, 2017 and will be subject to renewal upon expiration on August 30, 2018.

The Credit Agreement grants the Bank the following security interests in the Company's property: (a) a lien on the Company's leasehold interest in its Kona facility; (b) an assignment of the Company's interest in leases and rents on its Kona facility; and (c) a security interest in all fixtures, furnishings and equipment related to or used by the Company at the Kona facility. Each security interest is further subject to the terms of the Credit Agreement.

5. ACCRUED EXPENSES

Accrued expenses consist of the following:

	September 30, 2017	**March 31, 2017**
	(in thousands)	
Wages, commissions, bonus and profit sharing	$812	$793
Rent and utilities	98	69
Other accrued expenses	102	151

Total accrued expenses	$1,012	$1,013

6. LONG-TERM DEBT

Long-term debt consists of the following:

	September 30, 2017	March 31, 2017
	(in thousands)	
Long-term debt	$6,835	$7,139
Less current maturities	(626)	(623)
Long-term debt, excluding current maturities	6,209	6,516
Less unamortized debt issuance costs	(250)	(267)
Total long-term debt, net of current maturities and unamortized debt issuance costs	$5,959	$6,249

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 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 (4.25% at September 30, 2017) 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 $1,890,000 and $2,049,000 at September 30, 2017 and March 31, 2017, respectively.

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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 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 (4.25% at September 30, 2017) 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 $4,754,000 and $4,854,000 at September 30, 2017 and March 31, 2017, respectively. Proceeds from the Loan were 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’s current ratio of 1.92 to 1 and 1.97 to 1 as of March 31, 2017 and 2016, respectively, fell short of the bank’s requirement of 2.10 to 1; however, the Company has received letters from its bank stating that they found the Company to be in compliance with this and all other financial covenants as of March 31, 2017 and 2016, and do not consider these shortfalls to be a defaults under the Loan Agreements.

On October 6, 2017 the Company entered into an Equipment Finance Agreement (the “Equipment Agreement”), which provides up to $175,000 of financing for equipment with repayment terms of 36 to 60 months. As of November 6, 2017, there was no advance of funds or balance outstanding.

Capital Leases

The Company has four capital leases providing for $364,000 in equipment, secured by the equipment financed. The capital leases mature at various dates between March 2018 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 balance under these leases was $191,000 and $236,000 at September 30, 2017 and March 31, 2017, respectively.

Future principal payments under the term loans and capital lease agreements as of September 30, 2017 are as follows:

Payments Due	**(in thousands)**
Next 12 Months	$ 626
Year 2	640
Year 3	656
Year 4	655
Year 5	688
Thereafter	3,570
Total principal payments	$ 6,835

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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 September 30, 2017.

Future minimum lease payments under all non-cancelable operating leases at September 30, 2017 are as follows:

Payments Due	**(in thousands)**
Next 12 Months	$ 616
Year 2	619
Year 3	583
Year 4	528
Year 5	533
Thereafter	4,023
Total minimum lease payments	$ 6,902

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 September 30, 2017, 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 September 30, 2017, 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 September 30, 2017, there were 1,174,216 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 September 30, 2017, 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 September 30, 2017		
	Authorized	Available	Outstanding
2016 Plan	1,300,000	1,174,216	125,784
2014 Directors Plan	350,000	231,623	12,000
2005 Plan	—	—	476,500
2004 Directors Plan	—	—	12,000
Total	1,650,000	1,405,839	626,284

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 $19,000 and $34,000 for the three and six months ended September 30, 2017, respectively. Compensation expense recognized for options issued under all Plans was $59,000 and $137,000 for the three and six months ended September 30, 2016, respectively. Compensation expense recognized for restricted stock issued under the 2014 Directors Plan was $276,000 for the three and six months ended September 30, 2017. Compensation expense recognized for restricted stock issued under the 2014 Directors Plan was $78,000 for the three and six months ended September 30, 2016. 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 six months ended September 30, 2017 is presented below:

Option Activity	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in	Aggregate Intrinsic Value

			years)	
Outstanding at March 31, 2017	503,000	$ 4.10	4.7	$ 145,946
Granted	75,000	$ 3.35		
Exercised	(1,000)	$ 1.60		
Forfeited	(1,500)	$ 3.11		
Outstanding at September 30, 2017	575,500	$ 4.01	4.9	$ 261,755
Exercisable at September 30, 2017	496,000	$ 4.10	4.1	$ 208,550

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 $4.06 for such day.

A summary of the Company's non-vested options for the six months ended September 30, 2017 is presented below:

Nonvested Options	**Shares**	**Weighted Average Grant-Date Fair Value**
Nonvested at March 31, 2017	19,500	$ 2.93
Granted	75,000	1.71
Vested	(15,000)	2.73
Forfeited	—	—
Nonvested at September 30, 2017	79,500	$ 1.82

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The following table summarizes the weighted average characteristics of outstanding stock options as of September 30, 2017:

	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	198,620	5.2	$ 2.97	123,620	$ 2.74
$3.71 - $4.42	197,380	4.1	$ 3.83	197,380	$ 3.83
$4.43 - $5.40	95,000	5.7	$ 5.00	90,500	$ 4.98
$5.41 - $7.08	84,500	5.1	$ 5.77	84,500	$ 5.77
Total stock options	575,500	4.9	$ 4.01	496,000	$ 4.10

The range of fair value assumptions related to options granted during the six months ended September 30, 2017 were as follows:

	2017
Exercise Price	$3.35
Volatility	52.50 %
Risk Free Rate	1.99 %
Vesting Period (years)	3.0
Forfeiture Rate	0.00 %
Expected Life (in years)	6.00
Dividend Rate	0 %

As of September 30, 2017, total unrecognized stock-based compensation expense related to all unvested stock options was $121,000, which is expected to be expensed over a weighted average period of 2.7 years.

Restricted Stock Units ("RSUs")

RSUs are service-based awards granted to eligible employees under the 2016 Plan.

On March 31, 2017, 25,000 restricted stock units (“RSUs”) were awarded to the CEO. This award is valued at $3.85 per share, the closing market price of Cyanotech common stock on the grant date, and vest over a period of three years.

On April 5, 2017, 28,074 RSUs were awarded to employees of the Company. This award is valued at $3.92 per share, the closing market price of Cyanotech common stock on the grant date, and vests over a period of three 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, 2017	25,000	$ 3.85
Granted	28,074	3.92
Vested	—	—
Exercised	—	—
Forfeited	(2,290)	3.92
Nonvested restricted stock units at September 30, 2017	50,784	$ 3.89

As of September 30, 2017, total unrecognized stock-based compensation expense related to unvested restricted stock units was $162,000, which is expected to be expensed over a weighted average period of 2.5 years.

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10. INCOME TAXES

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 expense of $11,000 and $26,000 for the three months ended September 31, 2017 and 2016, respectively. We recorded income tax expense of $21,000 and income tax benefit of ($24,000) for the six months ended September 30, 2017 and 2016, respectively. Our effective tax rate was 2.2% and 2.1% for the three and six months ended September 30, 2017, respectively, and 21.0% and (3.9%) for the three and six months ended September 30, 2016, respectively. The effective tax rate for the three and six months ended September 30, 2017 differs from the statutory rate of 34% 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.

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

As of September 30, 2017, 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 2012.

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 per share computations for the three months ended September 30, 2017 and 2016 are as follows:

	Three Months Ended September 30, 2017		
	Net Income (Numerator)	**Shares (Denominator)**	**Per Share Amount**
	(in thousands)		
Basic income per share	$475	5,709	$ 0.08
Effect of dilutive securities—Common stock options	—	62	—
Diluted income per share	$475	5,771	$ 0.08

	Three Months Ended September 30, 2016		
	Net Income (Numerator)	**Shares (Denominator)**	**Per Share Amount**
	(in thousands)		
Basic income per share	$99	5,657	$ 0.02
Effect of dilutive securities — Common stock options	—	70	—
Diluted income per share	$99	5,727	$ 0.02

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Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the six months ended September 30, 2017 and 2016 are as follows:

	Six Months Ended September 30, 2017		
	Net Income (Numerator)	**Shares (Denominator)**	**Per Share Amount**
	(in thousands)		
Basic income per share	$977	5,697	$ 0.17
Effect of dilutive securities—Common stock options	—	46	—
Basic and diluted loss per share	$977	5,743	$ 0.17

	Six Months Ended September 30, 2016		
	Net Income (Numerator)	**Shares (Denominator)**	**Per Share Amount**
	(in thousands)		
Basic and diluted loss per share	$(592)	5,645	$ (0.10)

Basic and diluted earnings 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 75,000 and 6,000 for the three months ended September 30, 2017 and 2016, respectively, and 75,000 and 6,000 for the six months ended September 30, 2017 and 2016, 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.

12. CONCENTRATIONS OF RISK

Concentration of Accounts Receivable and Revenues

At September 30, 2017, 33% of the Company's accounts receivable was comprised of two customer balances of 20% and 13%, respectively. At March 31, 2017, 59% of the Company's accounts receivable was comprised of three customer balances of 38%, 12% and 9%, respectively. Two customers accounted for 46% of total net sales for the three months ended September 30, 2017 comprised of 32% and 14%, respectively. One customer accounted for 28% of total net sales for the three months ended September 30, 2016. Two customers accounted for 45% of total net sales for the six months ended September 30, 2017 comprised of 32% and 13%, respectively. One customer accounted for 24% of total net sales for the six months ended September 30, 2016.

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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 (collectively, the “Company”) contain “forward-looking statements,” which include statements that are predictive in nature, depend upon or refer to future events or conditions, and usually include words such as “expects,” “anticipates,” “intends,” “plan,” “believes,” “predicts”, “estimates” or similar expressions. In addition, any statement concerning future financial performance, ongoing business strategies or prospects and possible future actions are also forward-looking statements. Forward-looking statements are based upon current expectations and projections about future events and are subject to risks, uncertainties and the accuracy of assumptions concerning the Company the performance of the industry in which the Company 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;

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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.

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 operate under GMP (Good Manufacturing Practices), 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.

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Results of Operations

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

	Three Months Ended		Six Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Net sales	$8,055	$9,862	$16,864	$17,184
Net sales decrease	(18.3)%		(1.9)%	
Gross profit	$3,620	$3,885	$7,223	$6,706
Gross profit as % of net sales	44.9 %	39.4 %	42.8 %	39.0 %
Operating expenses	$3,001	$3,638	$5,984	$7,069
Operating expenses as % of net sales	37.3 %	36.9 %	35.5 %	41.1 %
Operating income (loss)	$619	$247	$1,239	$(363)
Operating income (loss) as % of net sales	7.7 %	2.5 %	7.3 %	(2.1)%
Income tax expense (benefit)	$11	$26	$21	$(24)
Net income (loss)	$475	$99	$977	$(592)
Net sales by product				
Packaged sales				
Astaxanthin packaged	$4,399	$5,987	$9,904	$9,635
Astaxanthin packaged sales (decrease) increase	(26.5)%		2.8 %	
Spirulina packaged	$2,365	$2,087	$4,292	$3,668
Spirulina packaged sales increase	13.3 %		17.0 %	
Total Packaged sales	$6,764	$8,074	$14,196	$13,303
Total Packaged sales (decrease) increase	(16.2)%		6.7 %	
Bulk sales				
Astaxanthin bulk	$209	$216	$430	$634
Astaxanthin bulk sales decrease	(3.2)%		(32.2)%	
Spirulina bulk	$1,082	$1,572	$2,238	$3,247
Spirulina bulk sales decrease	(31.2)%		(31.1)%	
Total Bulk sales	$1,291	$1,788	$2,668	$3,881
Total Bulk sales decrease	(27.8)%		(31.3)%	

Comparison of the Three Months Ended September 30, 2017 and 2016

Net Sales The net sales decrease of 18% for the quarter was driven by a 16% decrease in sales of our packaged products and a 28% decrease in sales of our bulk products. The 16% decrease in packaged sales this quarter is related to the quarterly variance year to year in the timing of orders, as well as the shift away from lower margin channels into

higher margin ones. The 28% decrease in bulk sales is due primarily to a lack of available supply of spirulina driven by lower production during the quarter, as well as increased demand for packaged products. International sales represented 19% of net sales for the three months ended September 30, 2017 compared to 27% for the same period a year ago.

Gross Profit Our gross profit margin increased by 5.5 percentage points compared to the same period last year. The current period was favorably impacted by the higher mix of packaged sales this quarter, which deliver a higher gross profit margin. Additionally, the current quarter reflects lower astaxanthin production costs resulting from improved production beginning with the fourth quarter of fiscal 2017, including a 29% increase in production this quarter compared to the same period last year. These production improvements are the result of new cultivation techniques and farm management practices that have been integrated over the last two years which have resulted in stabilized open pond cultivation and improved consistency of our production over recent quarters. Gross profit this quarter was unfavorably impacted by $0.07 million of non-inventoriable costs due to a decrease in spirulina production compared to the same period last year. This decrease was due to a short-term change in cultivation methods associated with local water restrictions and self-imposed water conservation efforts. These restrictions have since been lifted as of the end of the quarter.

Operating Expenses Operating expenses decreased by $0.6 million for the second quarter compared to the same period in last year. Included in this is a decrease in general and administrative costs of $0.6 million, primarily due to a reduction in legal fees of $0.9 million, offset by a $0.1 million increase in labor costs and a $0.1 million increase in incentive expense that have been accrued based on pretax profit earned to date.

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Income Taxes We recorded an income tax expense of $11,000 in the current quarter compared to income tax expense of $26,000 for the same period last year. Our effective tax rate was 2.2% for the current quarter and 21.0% for the same period last year. The change in effective tax rate and tax expense is primarily due to changes in the estimate of pretax income used in the prior year. We continue to carry a full valuation allowance on our deferred tax assets.

Net Income Net income for the three months ended September 30, 2017 was $0.5 million, or 5.9% of net sales, compared to net income of $0.1 million, or 1.0% of net sales, for the same period last year, an increase of $0.4 million or 380%. This increase is primarily the result of lower legal expenses and lower production costs.

Comparison of the Six Months Ended September 30, 2017 and 2016

Net Sales The net sales decrease of 2% for the first six months of this year was driven by a 31% decrease in sales of our bulk products, offset by a 7% increase in sales of our packaged products which is the result of our continued focus on Costco and Amazon, up $1.3 million and $2.2 million, respectively, compared to the same period last year. The 31% decrease in sales of our bulk products was the result of lack of available spirulina supply due to lower production in the last quarter of fiscal 2017 and the second quarter of this current year. International sales represented 23% of net sales for the six months ended September 30, 2017 compared to 31% for the same period a year ago.

Gross Profit Our gross profit margin increased by 3.8 percentage points in the first six months of this year, as a result of a higher mix of packaged sales, which deliver a higher gross profit margin, and lower astaxanthin costs. Astaxanthin production for the first six months of the year increased 25% compared to the same period last year. Spirulina production for the quarter was 15% below the same period last year. Gross profit was unfavorably impacted by $0.1 million in non-inventoriable costs related to spirulina production in the current fiscal year.

Operating Expenses Operating expenses decreased by $1.1 million for the six months ended September 30, 2017, compared to the same period last year. Included in this is a decrease in general and administrative expenses of $1.0 million, or 26%, due to a decrease in legal costs of $1.3 million offset by increased labor costs of $0.2 million and a $0.3 increase in incentive expenses that have been accrued based on pretax profit earned to date. Sales and marketing expenses decreased $0.1 million, or 3%, due primarily to lower labor costs.

Income Taxes We recorded an income tax expense of $21,000 for the first six months of this year compared to a benefit of $24,000 for the same period last year. Our effective tax rate was 2.1% for the first six months compared to (3.9%) for the same period last year. The change in effective tax rate and tax expense is primarily due to the net loss in the prior year. We continue to carry a full valuation allowance on our deferred tax asset.

Net Income Net income for the six months ended September 30, 2017 was $1.0 million, or 5.8% of net sales, compared to a net loss of $0.6 million, or (3.4%) of net sales, for the same period last year, an increase of $1.6 million. This increase is primarily the result of lower legal expenses and lower production costs.

Liquidity and Capital Resources

As of September 30, 2017, we had cash of $2.1 million and working capital of $7.7 million compared to $1.4 million and $6.0 million, respectively, at March 31, 2017. 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. The line of credit was renewed on August 30, 2017 and will expire on August 30, 2018. At September 30, 2017, we had borrowed $0.5 million and had $1.5 million available on the line.

As of September 30, 2017, we had $6.6 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. As of March 31, 2017 and 2016, our current ratio of 1.92:1 and 1.97:1, respectively, fell short of the Bank's annual requirement of 2.10:1. The Bank has provided us with letters stating they found us to be in compliance with this covenant requirement and all other financial covenants as of March 31, 2017 and 2016, and do not consider these shortfalls to be defaults under the Loan Agreement.

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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 2018 operating plan and related cash flow projections and our projected consolidated financial position as of March 31, 2018, 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, 2018. However, no assurances can be provided that we will achieve our operating plan and cash flow objectives for the next fiscal year ended March 31, 2018 or our projected consolidated financial position as of March 31, 2018. Such estimates are subject to change based on future results and such change could cause future results to vary significantly from expected results.

As indicated above, the Bank has not considered the shortfalls as of March 31, 2017 and 2016 in our current ratio relative to the covenant requirement to be violations of the Loan Agreements. However, in the event we have a shortfall under the Loan Agreements as of March 31, 2018 or future fiscal year ends, there is no assurance that the Bank will not consider such to be a violation of the Loan Agreements and pursue its rights under the arrangements to call for the repayment of the outstanding borrowings payable to the Bank. If this occurs, we may need to raise additional funds to repay the loans; however, we may not be able to secure such funding on acceptable terms, or at all.

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

	Six months ended September 30	
	2017	**2016**
Total cash provided by (used in):		
Operating activities	$1,391	$911
Investing activities	(281)	(277)
Financing activities	(415)	181
Increase in cash	$695	$815

Cash provided by operating activities for the six months ended September 30, 2017 was the result of $1 million in net earnings and non-cash charges of $1.3 million, totaling $2.3 million. This was offset by an increase in working capital of $0.9 million. The increase in working capital was primarily the result of a $1.3 million increase in inventory, primarily in astaxanthin, and a $0.6 million decrease in accounts receivable due to a decrease in days sales outstanding.

Cash provided by operating activities for the six months ended September 30, 2016 was the result of a $0.6 million net loss and non-cash charges of $1.2 million, totaling $0.6 million. In addition, there was a decrease in working capital

of $0.3 million. The decrease in working capital was primarily the result of a $0.4 million decrease in inventory levels.

Cash used in investing activities for the six months ended September 30, 2017 and September 30, 2016 includes costs for leasehold improvements and equipment acquisitions at our Kona facility.

Cash used in financing activities for the six months ended September 30, 2017 consists of $0.3 million in principal payments on debt in the normal course of business and a $0.1 million reduction in our outstanding credit line balance.

Cash provided by financing activities for the six months ended September 30, 2016 consists of a $0.6 million advance against our line of credit, offset by $0.3 million in principal payments on debt in the normal course of business and $0.15 million in taxes paid upon issuance of stock connected with the severance agreement of our former CEO.

Sources and Uses of Capital

At September 30, 2017, our working capital was $7.7 million, an increase of $1.7 million compared to March 31, 2017. The increase is due primarily to an increase in inventory levels.

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.

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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. (See forward-looking statements on page 17)

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 2018, 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. 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.

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.

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Our future results of operations and the other forward-looking statements contained in this Outlook, in particular the statements regarding revenues, gross margin and capital spending, involve a number of risks and uncertainties. In addition to the factors discussed above, any of the following could cause actual results to differ materially: business conditions and growth in the natural products industry and in the general economy; changes in customer order patterns; changes in demand for natural products in general; changes in weather conditions; competitive factors, such as increased production capacity from competing spirulina and astaxanthin producers and the resulting impact, if any, on world market prices for these products; government actions and increased regulations both domestic and foreign; shortage of manufacturing capacity; and other factors beyond our control. Risk factors are discussed in detail in 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, 2017.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

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 September 30, 2017. 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 September 30, 2017.

Changes to Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarterly period ended September 30, 2017 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.

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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, 2017, filed June 22, 2017.

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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 September 30, 2017.

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, 2017, 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 November 6, 2017.
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 6, 2017.
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of November 6, 2017.
99.1	Press Release dated November 6, 2017
101	The following financial statements from Cyanotech Corporation’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements.

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SIGNATURES

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

CYANOTECH CORPORATION
(Registrant)

November 6, 2017	By: /s/ Gerald R. Cysewski
(Date)	Gerald R. Cysewski
	Chief Executive Officer; Director

November 6, 2017	By: /s/ Jole Deal
(Date)	Jole Deal
	Vice President — Finance & Administration and CFO
	(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

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