

LANDEC CORP \CA\  
Form 10-Q  
January 05, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

**For the Fiscal Quarter Ended November 26, 2006, or**

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

**For the Transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number: 0-27446**

**LANDEC CORPORATION**

(Exact name of registrant as specified in its charter)

**California**

(State or other jurisdiction of  
incorporation or organization)

**94-3025618**

(IRS Employer  
Identification Number)

**3603 Haven Avenue**

**Menlo Park, California 94025**

(Address of principal executive offices)

Registrant's telephone number, including area code:

**(650) 306-1650**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days.

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of December 19, 2006, there were 25,142,414 shares of Common Stock outstanding.

**LANDEC CORPORATION**  
FORM 10-Q For the Fiscal Quarter Ended November 26, 2006  
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**LANDEC CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands)

|  | November<br>26,<br>2006<br>(Unaudited) | May 28,<br>2006 |
|--|--|-----------------|
| <b>ASSETS</b>  |  |                 |
| Current Assets:  |  |                 |
| Cash and cash equivalents  | \$ 11,751                              | \$ 15,164       |
| Accounts receivable, less allowance for doubtful accounts of \$351 and \$245 at November 26, 2006 and May 28, 2006                                       | 16,355                                 | 15,288          |
| Accounts receivable, related party   | 368                                    | 561             |
| Inventory  | 8,331                                  | 6,134           |
| Notes and advances receivable  | 1,568                                  | 376             |
| Notes receivable, related party  |  | 14              |
| Prepaid expenses and other current assets  | 1,033                                  | 1,237           |
| Assets held for sale (Note 12)   | 35,048                                 | 31,838          |
| <br>   |  |                 |
| Total Current Assets   | 74,454                                 | 70,612          |
| Property, plant and equipment, net   | 19,625                                 | 16,882          |
| Goodwill, net  | 21,248                                 | 21,248          |
| Trademarks, net  | 8,228                                  | 8,228           |
| Notes receivable   | 525                                    | 631             |
| Other assets   | 1,838                                  | 1,424           |
| <br>   |  |                 |
| Total Assets   | \$ 125,918                             | \$ 119,025      |
| <br>   |  |                 |
| Current Liabilities:   |  |                 |
| Accounts payable   | \$ 13,072                              | 12,443          |
| Related party payables   | 79                                     | 533             |
| Accrued compensation   | 1,823                                  | 2,764           |
| Other accrued liabilities  | 1,995                                  | 1,968           |
| Deferred revenue   | 440                                    | 811             |
| Current maturities of long term debt   | 39                                     | 2,018           |
| Liabilities assumed by buyer of FCD (Note 12)  | 20,298                                 | 11,668          |
| <br>   |  |                 |
| Total Current Liabilities  | 37,746                                 | 32,205          |
| Minority interest  | 1,602                                  | 1,771           |
| <br>   |  |                 |
| Total Liabilities  | 39,348                                 | 33,976          |
| Shareholders' Equity:  |  |                 |
| Common stock and additional paid in capital, \$0.001 par value; 50,000,000 shares authorized; 25,141,164 and 24,917,298 shares issued and outstanding at | 127,687                                | 126,288         |

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November 26, 2006 and May 28, 2006, respectively

|  |            |            |
|--|------------|------------|
| Accumulated deficit                        | (41,117)   | (41,239)   |
| Total Shareholders' Equity                 | 86,570     | 85,049     |
| Total Liabilities and Shareholders' Equity | \$ 125,918 | \$ 119,025 |

*See accompanying notes.*

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

|   | Three Months Ended      |                         | Six Months Ended        |                         |
|---|-------------------------|-------------------------|-------------------------|-------------------------|
|   | November<br>26,<br>2006 | November<br>27,<br>2005 | November<br>26,<br>2006 | November<br>27,<br>2005 |
| Revenues:   |                         |                         |                         |                         |
| Product sales   | \$ 53,584               | \$ 52,560               | \$ 103,631              | \$ 100,888              |
| Services revenue, related party                               | 831                     | 922                     | 1,674                   | 2,093                   |
| License fees  | 681                     | 172                     | 881                     | 294                     |
| Royalty revenues, related party                               | 71                      | 58                      | 121                     | 134                     |
| Research, development and royalty revenues                    | 27                      |                         | 35                      | 8                       |
| <b>Total revenues</b>   | <b>55,194</b>           | <b>53,712</b>           | <b>106,342</b>          | <b>103,417</b>          |
| Cost of revenue:  |                         |                         |                         |                         |
| Cost of product sales   | 45,557                  | 44,861                  | 88,845                  | 85,706                  |
| Cost of product sales, related party                          | 673                     | 1,166                   | 2,222                   | 2,829                   |
| Cost of services revenue                                      | 688                     | 596                     | 1,442                   | 1,203                   |
| <b>Total cost of revenue</b>                                  | <b>46,918</b>           | <b>46,623</b>           | <b>92,509</b>           | <b>89,738</b>           |
| Gross profit  | 8,276                   | 7,089                   | 13,833                  | 13,679                  |
| Operating costs and expenses:                                 |                         |                         |                         |                         |
| Research and development                                      | 840                     | 820                     | 1,624                   | 1,579                   |
| Selling, general and administrative                           | 7,289                   | 7,154                   | 12,191                  | 13,335                  |
| <b>Total operating costs and expenses</b>                     | <b>8,129</b>            | <b>7,974</b>            | <b>13,815</b>           | <b>14,914</b>           |
| Operating income (loss)                                       | 147                     | (885)                   | 18                      | (1,235)                 |
| Interest income   | 177                     | 130                     | 413                     | 250                     |
| Interest expense  | (121)                   | (177)                   | (191)                   | (250)                   |
| Minority interest expense                                     | (97)                    | (101)                   | (115)                   | (316)                   |
| Other income (expense)  | 2                       | (4)                     | (3)                     | (7)                     |
| <b>Net income (loss)</b>                                      | <b>\$ 108</b>           | <b>\$ (1,037)</b>       | <b>\$ 122</b>           | <b>\$ (1,558)</b>       |
| Basic net income (loss) per share                             | \$ 0.00                 | \$ (0.04)               | \$ 0.00                 | \$ (0.06)               |
| Diluted net loss per share (Note 4)                           | \$ (0.00)               | \$ (0.04)               | \$ (0.01)               | \$ (0.06)               |
| Shares used in computing basic and diluted net loss per share | 25,039                  | 24,350                  | 24,988                  | 24,233                  |

*See accompanying notes.*

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**LANDEC CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(In thousands)**

|  | Six Months Ended        |                         |
|--|-------------------------|-------------------------|
|  | November<br>26,<br>2006 | November<br>27,<br>2005 |
| Cash flows from operating activities:  |                         |                         |
| Net income (loss)  | \$ 122                  | \$ (1,558)              |
| Adjustments to reconcile net loss to net cash used in operating activities:  |                         |                         |
| Depreciation and amortization  | 1,766                   | 1,529                   |
| Stock-based compensation expense   | 382                     |                         |
| Loss on sale of property and equipment   | 29                      | 16                      |
| Minority interest  | 123                     | 316                     |
| Investment in unconsolidated business  | (481)                   |                         |
| Changes in current assets and current liabilities, net of effects of acquisition of assets of Heartland Hybrids, Inc.: |                         |                         |
| Accounts receivable, net   | (532)                   | (2,562)                 |
| Inventory  | (9,553)                 | (8,890)                 |
| Issuance of notes and advances receivable  | (1,427)                 | (1,064)                 |
| Collection of notes and advances receivable  | 221                     | 329                     |
| Prepaid expenses and other current assets  | 1                       | 498                     |
| Accounts payable   | 1,920                   | (1,143)                 |
| Related party payables   | (465)                   | (395)                   |
| Accrued compensation   | (1,123)                 | 282                     |
| Other accrued liabilities  | (1)                     | 120                     |
| Deferred revenue   | 2,248                   | 2,511                   |
| Net cash used in operating activities  | (6,770)                 | (10,011)                |
| Cash flows from investing activities:  |                         |                         |
| Purchases of property, plant and equipment   | (4,651)                 | (1,533)                 |
| Purchase of marketable securities  |                         | (991)                   |
| Proceeds from maturities of marketable securities  |                         | 2,959                   |
| Issuance of notes and advances receivable  | (27)                    | (18)                    |
| Collection of notes and advances receivable  | 161                     | 172                     |
| Acquisition of assets of Heartland Hybrids, Inc., net of cash acquired   | (1,050)                 | (3,630)                 |
| Net cash used in investing activities  | (5,567)                 | (3,041)                 |
| Cash flows from financing activities:  |                         |                         |
| Proceeds from sale of common stock   | 1,017                   | 501                     |
| Proceeds from the exercise of subsidiary options   | 10                      |                         |
| Decrease in other assets   | 67                      | 199                     |
| Borrowings on lines of credit  | 4,941                   | 11,103                  |



|   |           |          |
|---|-----------|----------|
| Payments on lines of credit   |           | (3,831)  |
| Payments on long term debt  | (1,979)   | (1,011)  |
| Distributions to minority interest                                  | (302)     | (329)    |
| Net cash provided by financing activities                           | 3,754     | 6,632    |
| Net decrease in cash and cash equivalents                           | (8,583)   | (6,420)  |
| Cash and cash equivalents at beginning of period, including FCD     | 20,519    | 12,871   |
| Cash and cash equivalents at end of period, including FCD           | 11,936    | 6,451    |
| Less: Cash included in assets held for sale                         | (185)     |          |
| Cash and cash equivalents at end of period                          | \$ 11,751 | \$ 6,451 |
| Supplemental schedule of noncash operating activities:              |           |          |
| Preferred stock received from investment in unconsolidated business | \$ 481    | \$       |

*See accompanying notes.*

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**LANDEC CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. Basis of Presentation**

Landec Corporation and its subsidiaries ( Landec or the Company ) design, develop, manufacture, and sell temperature-activated and other specialty polymer products for a variety of food products, agricultural products, and licensed partner applications. The Company sells Intellicoat® coated seed products through its Landec Ag, Inc. ( Landec Ag ) subsidiary and specialty packaged fresh-cut vegetables and whole produce to retailers and club stores, primarily in the United States and Asia through its Apio, Inc. ( Apio ) subsidiary.

The accompanying unaudited consolidated financial statements of Landec have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) have been made which are necessary to present fairly the financial position at November 26, 2006 and the results of operations and cash flows for all periods presented. Although Landec believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in financial statements and related footnotes prepared in accordance with U.S. accounting principles generally accepted have been condensed or omitted per the rules and regulations of the Securities and Exchange Commission. The accompanying financial data should be reviewed in conjunction with the audited financial statements and accompanying notes included in Landec's Annual Report on Form 10-K for the fiscal year ended May 28, 2006.

The results of operations for the three and six months ended November 26, 2006 are not necessarily indicative of the results that may be expected for an entire fiscal year. For instance, due to the cyclical nature of the corn seed industry, Fielder's Choice Direct (FCD), Landec's former direct sales and marketing seed company which was sold on December 1, 2006 (see Note 12) and Landec Ag realize virtually no revenues during the first six months of each fiscal year and therefore recognize substantial losses during the first half of Landec's fiscal year.

**Use of Estimates**

The preparation of financial statements in conformity with U.S. accounting principles generally accepted requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported results of operations during the reporting period. Actual results could differ materially from those estimates.

For instance, the carrying value of notes and advances receivable, are impacted by current market prices for the related crops, weather conditions and the fair value of the underlying security obtained by the Company, such as, liens on property and crops. The Company recognizes losses when it estimates that the fair value of the related crops or security is insufficient to cover the advance or note receivable.

**Investments**

Equity investments in non-public companies with no readily available market value are carried on the balance sheet at cost as adjusted for impairment losses, if any. If reductions in the market value of the investments to an amount that is below cost are deemed by management to be other than temporary, the reduction in market value will be realized, with the resulting loss in market value reflected on the income statement (see Note 2).

**Goodwill and Other Intangibles**

The Company is required under SFAS 142 to review goodwill and indefinite lived intangible assets at least annually. During the six months ended November 26, 2006, the Company completed its annual impairment review. The review is performed by grouping the net book value of all long-lived assets for reporting entities, including goodwill and other intangible assets, and comparing this value to the related estimated fair value. The determination

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of fair value is based on estimated future discounted cash flows related to these long-lived assets. The discount rate used was based on the risks associated with the reporting entities. The determination of fair value was performed by management using the services of an independent appraiser. The review concluded that the fair value of the reporting entities exceeded the carrying value of their net assets and thus no impairment charge was warranted as of November 26, 2006.

**Recent Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* ( FIN No. 48 ), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition and defines the criteria that must be met for the benefits of a tax position to be recognized. The provisions of FIN No. 48 will be effective for the Company commencing at the start of fiscal 2008, May 28, 2007. The Company is currently evaluating the impact of adopting FIN No. 48 on its consolidated financial statements.

**Reclassifications**

Certain reclassifications have been made to prior period financial statements to conform to the current period presentation. The assets of FCD and the liabilities assumed by the buyer of FCD have been reclassified in the accompanying Consolidated Balance Sheets (see Note 12).

**2. License Agreements**

In December 2005, Landec entered into an exclusive licensing agreement with Aesthetic Sciences Corporation. At that time Landec received cash and preferred stock in Aesthetic Sciences. As part of the original agreement, Landec was to receive additional shares upon the completion of a specific milestone. On November 22, 2006, that milestone was met and as a result Landec received an additional 800,000 shares of preferred stock valued at \$481,000. Landec currently has a 19.9% ownership interest in Aesthetic Sciences. The \$481,000 is included in other assets in the accompanying Consolidated Balance Sheet and is recorded as licensing revenue in the accompanying Consolidated Statements of Operations since Landec has no further obligations under this agreement.

**3. Stock-Based Compensation**

On May 29, 2006, the Company adopted SFAS 123R, which is a revision of SFAS No. 123 *Accounting for Stock-Based Compensation* ( SFAS 123 ), and supersedes APB No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ). Among other items, SFAS 123R requires companies to record compensation expense for stock-based awards issued to employees and directors in exchange for services provided. The amount of the compensation expense is based on the estimated fair value of the awards on their grant dates and is recognized over the required service periods. The Company's stock-based awards include stock option grants and restricted stock unit awards (RSUs).

Prior to the adoption of SFAS 123R, the Company applied the intrinsic value method set forth in APB 25 to calculate the compensation expense for stock-based awards. The Company has historically set the exercise price for its stock options equal to the market value on the grant date. As a result, the options had no intrinsic value on their grant dates, and therefore the Company did not record any compensation expense unless the terms of the stock options were subsequently modified. For RSUs, the calculation of compensation expense under APB 25 and SFAS 123R is similar except for the accounting treatment for forfeitures as discussed below.

The Company adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard to (i) all stock-based awards issued on or after May 29, 2006 and (ii) any outstanding stock-based awards that were issued but not vested as of May 29, 2006. Accordingly, the Company's condensed consolidated financial statements as of November 27, 2005, and for the three and six months then-ended, were accounted for under the provisions of APB 25. In the three and six months ended November 26, 2006, the

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Company recognized stock-based compensation expense of \$136,000 and \$382,000 or \$0.01 and \$0.02 per basic and diluted share, respectively, which included \$42,000 and \$75,000 for restricted stock unit awards and \$94,000 and \$307,000 for stock option grants, respectively.

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

|  | <b>Three Months<br/>Ended<br/>November 26,<br/>2006</b> | <b>Six Months<br/>Ended<br/>November 26,<br/>2006</b> |
|--|---|---|
| Research and development                       | \$ 23,000   | \$ 42,000   |
| Sales, general and administrative              | \$ 113,000  | \$ 340,000  |
| Total amortization of stock-based compensation | \$ 136,000  | \$ 382,000  |

The estimated fair value for stock options, which determines the Company's calculation of compensation expense, is based on the Black-Scholes pricing model. Upon the adoption of SFAS 123R, the Company changed its method of calculating and recognizing the fair value of stock-based compensation arrangements to the straight-line, single-option method. Compensation expense for all stock option and restricted stock awards granted prior to May 29, 2006 will continue to be recognized using the straight-line, multiple-option method. In addition, SFAS 123R requires the estimation of the expected forfeitures of stock-based awards at the time of grant. As a result, the Company uses historical data to estimate pre-vesting forfeitures and records stock-based compensation expense only for those awards that are expected to vest and revises those estimates in subsequent periods if the actual forfeitures differ from the prior estimates. In the pro-forma information required under SFAS 123 for periods prior to May 29, 2006, the Company accounted for forfeitures as they occurred.

**Valuation Assumptions**

As of November 26, 2006 and November 27, 2005, the fair value of stock option grants was estimated using the Black-Scholes option pricing model. The following weighted average assumptions were used:

|                         | Three Months Ended      |                         | Six Months Ended        |                         |
|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
|                         | November<br>26,<br>2006 | November<br>27,<br>2005 | November<br>26,<br>2006 | November<br>27,<br>2005 |
| Stock Option plan:      |                         |                         |                         |                         |
| Risk-Free interest rate |                         | 4.23%                   | 5.08%                   | 4.11%                   |
| Dividend Yield          |                         | 0%                      | 0%                      | 0%                      |
| Volatility              |                         | 54%                     | 51%                     | 54%                     |
| Expected term in years  |                         | 4.01                    | 4.27                    | 4.61                    |

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For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the service period of the options using the straight-line method. The Company's pro forma information follows (in thousands except for per share data):

|  | Three<br>Months<br>Ended<br>November<br>27,<br>2005 | Six Months<br>Ended<br>November<br>27,<br>2005 |
|--|---|--|
| Net loss   | \$ (1,037)  | \$ (1,558)                                     |
| Deduct:  |   |  |
| Stock-based employee expense determined under SFAS 123 | (428)   | (665)  |
| Pro forma net loss                                     | \$ (1,465)  | \$ (2,223)                                     |
| Basic and diluted net loss per share as reported       | \$ (0.04)   | \$ (0.06)                                      |
| Basic and diluted pro forma net loss per share         | \$ (0.06)   | \$ (0.09)                                      |

**Stock-Based Compensation Activity**

|                              | Restricted Stock Outstanding                        |                                      |   | Stock Options Outstanding     |  |
|------------------------------|---|--------------------------------------|---|-------------------------------|--|
|                              | RSUs<br>and<br>Options<br>Available<br>for<br>Grant | Number<br>of<br>Restricted<br>Shares | Weighted<br>Average<br>Grant<br>Date<br>Fair<br>Value | Number of<br>Stock<br>Options | Weighted<br>Average<br>Exercise<br>Price |
| Balance at May 28, 2006      | 857,705   | 833                                  | \$ 7.53   | 3,117,516                     | \$ 4.85                                  |
| Granted                      | (153,335)   | 38,335                               | \$ 8.86   | 115,000                       | \$ 8.86                                  |
| Exercised                    |   |                                      |   | (207,368)                     | \$ 4.51                                  |
| Forfeited                    |   |                                      |   | (5,417)                       | \$ 4.80                                  |
| Balance at November 26, 2006 | 704,370   | 39,168                               | \$ 8.83   | 3,019,731                     | \$ 5.02                                  |

The following table summarizes information concerning stock options outstanding and exercisable at November 26, 2006:

| Range of<br>Exercise | Options Outstanding |   |                                 | Options Exercisable    |                     |                                 |
|----------------------|---------------------|---|---------------------------------|------------------------|---------------------|---------------------------------|
|                      | Number of<br>Shares | Weighted<br>Average<br>Remaining<br>Contractual | Weighted<br>Average<br>Exercise | Aggregate<br>Intrinsic | Number of<br>Shares | Weighted<br>Average<br>Exercise |

| <b>Prices</b>        | <b>Outstanding<br/>(in years)</b> | <b>Life<br/>(in<br/>years)</b> | <b>Price</b> | <b>Value</b>  | <b>Exercisable</b> | <b>Price</b> | <b>Intrinsic<br/>Value</b> |
|----------------------|-----------------------------------|--------------------------------|--------------|---------------|--------------------|--------------|----------------------------|
| \$1.660 -<br>\$3.180 | 408,459                           | 5.71                           | \$ 2.61      | \$ 2,973,582  | 397,283            | \$ 2.61      | \$ 2,892,220               |
| \$3.250 -<br>\$3.400 | 414,850                           | 3.78                           | \$ 3.38      | \$ 2,700,674  | 412,349            | \$ 3.38      | \$ 2,684,392               |
| \$3.470 -<br>\$4.938 | 408,385                           | 4.06                           | \$ 4.30      | \$ 2,282,872  | 406,196            | \$ 4.31      | \$ 2,266,574               |
| \$5.000 -<br>\$5.000 | 641,128                           | 1.09                           | \$ 5.00      | \$ 3,135,116  | 641,128            | \$ 5.00      | \$ 3,135,116               |
| \$5.250 -<br>\$6.125 | 109,909                           | 3.17                           | \$ 5.83      | \$ 446,231    | 102,096            | \$ 5.84      | \$ 413,489                 |
| \$6.130 -<br>\$6.130 | 308,000                           | 5.58                           | \$ 6.13      | \$ 1,158,080  | 214,250            | \$ 6.13      | \$ 805,580                 |
| \$6.250 -<br>\$6.750 | 387,500                           | 4.75                           | \$ 6.66      | \$ 1,251,625  | 387,500            | \$ 6.66      | \$ 1,251,625               |
| \$6.790 -<br>\$8.860 | 341,500                           | 7.46                           | \$ 7.71      | \$ 744,470    | 265,798            | \$ 7.40      | \$ 661,830                 |
| \$1.660 -<br>\$8.860 | 3,019,731                         | 4.21                           | \$ 5.02      | \$ 14,692,650 | 2,826,600          | \$ 4.90      | \$ 14,110,826              |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company's closing stock price of \$9.89 on November 24, 2006, which would have been received by holders of stock options had all holders of stock options exercised their stock options that were in-the-money as of that date. The total number of in-the-money stock options exercisable as of November 26, 2006, was approximately 2.8

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million shares. The aggregate intrinsic value of stock options exercised during the three and six months ended November 26, 2006, was \$822,000 and \$1.1 million, respectively.

**Shares Subject to Vesting**

The following table summarizes the activity relating to unvested stock option grants and RSUs during the six month period ended November 26, 2006:

|                               | <b>Stock Options</b> |  | <b>Restricted Stock</b> |  |
|-------------------------------|----------------------|--|-------------------------|--|
|                               |                      | <b>Weighted<br/>Average<br/>Fair<br/>Value</b> |                         | <b>Weighted<br/>Average<br/>Fair<br/>Value</b> |
|                               | <b>Shares</b>        | <b>Value</b>                                   | <b>Shares</b>           | <b>Value</b>                                   |
| Unvested at May 28, 2006      | 182,586              | \$ 2.43  | 833                     | \$ 7.53  |
| Granted                       | 115,000              | \$ 4.05  | 38,335                  | \$ 8.32  |
| Vested/Awarded                | (99,038)             | \$ 2.73  |                         |  |
| Forfeited                     | (5,417)              | \$ 4.80  |                         |  |
| Unvested at November 26, 2006 | 193,131              | \$ 3.18  | 39,168                  | \$ 8.30  |

As of November 26, 2006, there was \$939,000 of total unrecognized compensation expense related to unvested equity compensation awards granted under the Company's incentive stock plans. Total expense is expected to be recognized over the weighted-average period of 1.51 years.

As of November 26, 2006 the Company has reserved 3.8 million shares of common stock for future issuance under its current and former stock plans.

**4. Net Income Per Diluted Share**

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

|  | <b>Three<br/>Months<br/>Ended<br/>November<br/>26,<br/>2006</b> | <b>Six Months<br/>Ended<br/>November<br/>26,<br/>2006</b> |
|--|---|---|
| Numerator:   |   |   |
| Net income   | \$ 108  | \$ 122  |
| Less: Minority interest income of subsidiary           | (228)   | (341)   |
| Net loss for diluted net loss per share                | \$ (120)  | \$ (219)  |
| Denominator:   |   |   |
| Weighted average shares for diluted net loss per share | 25,039  | 24,988  |
| Diluted net loss per share                             | \$ (0.00)   | \$ (0.01)   |

For the three months ended November 26, 2006 and November 27, 2005, the computation of the diluted net loss per share excludes the impact of options to purchase 1,446,608 shares and 1,647,824 shares of Common Stock, respectively, as such impacts would be antidilutive for these periods.

For the six months ended November 26, 2006 and November 27, 2005, the computation of the diluted net loss per share excludes the impact of options to purchase 1,412,325 shares and 1,833,452 shares of Common Stock, respectively, as such impacts would be antidilutive for these periods.





**Table of Contents****5. Debt**

On August 29, 2006, Landec Ag amended and restated its revolving line of credit with Old National Bank which increased the line from \$7.5 million to \$10 million. The interest rate on the revolving line of credit was reduced from prime plus 0.375% to prime minus 0.50% (7.75% at November 26, 2006). The line of credit contained certain restrictive covenants, which, among other things, restricted the ability of Landec Ag to make payments on debt owed by Landec Ag to Landec. Landec Ag was in compliance with all of the loan covenants during the first six months of fiscal year 2007. Landec had pledged substantially all of the assets of Landec Ag to secure the line of credit. At November 26, 2006, \$4.9 million was outstanding under Landec Ag's revolving line of credit. In conjunction with the sale of FCD to American Seeds, Inc. (ASI) on December 1, 2006 (see Note 12) Landec Ag's line of credit was paid in full and subsequently terminated.

**6. Inventories**

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

|                 | November<br>26,<br>2006 | May 28,<br>2006 |
|-----------------|-------------------------|-----------------|
| Raw material    | \$ 6,148                | \$ 3,764        |
| Finished goods  | 2,183                   | 2,193           |
| Work in process |                         | 177             |
| <b>Total</b>    | <b>\$ 8,331</b>         | <b>\$ 6,134</b> |

**7. Related Party**

Apio provides cooling and distributing services for farms in which the Chief Executive Officer of Apio (the Apio CEO) has a financial interest and purchases produce from those farms. Apio also purchases produce from Beachside Produce LLC (formerly known as Apio Fresh) for sale to third parties. Beachside Produce is owned by a group of entities and persons that supply produce to Apio. One of the owners of Beachside Produce is the Apio CEO. Revenues, cost of product sales and the resulting payable, and the note receivable from advances for ground lease payments, and crop and harvesting costs are classified as related party in the accompanying financial statements as of November 26, 2006 and May 28, 2006 and for the three and six months ended November 26, 2006 and November 27, 2005.

Apio leases, for approximately \$535,000 on an annual basis, agricultural land that is either owned, controlled or leased by the Apio CEO. Apio, in turn, subleases that land at cost to growers who are obligated to deliver product from that land to Apio for value added products. There is generally no net statement of operations impact to Apio as a result of these leasing activities but Apio creates a guaranteed source of supply for the value added business. Apio has loss exposure on the leasing activity to the extent that it is unable to sublease the land. For the three and six months ended November 26, 2006 the Company subleased all of the land leased from the Apio CEO and received sublease income of \$121,000 and \$232,000, respectively, which is equal to the amount the Company paid to lease that land for the period.

Apio's domestic commodity vegetable business was sold to Beachside Produce, effective June 30, 2003. The Apio CEO is a 12.5% owner in Beachside Produce. During the three and six months ended November 26, 2006, the Company recognized revenues of \$16,000 and \$21,000, respectively, from the sale of products to Beachside Produce and royalty revenue of \$71,000 and \$121,000, respectively, from the use by Beachside Produce of Apio's trademarks. The related accounts receivable from Beachside Produce are classified as related party in the accompanying financial statements as of November 26, 2006 and May 28, 2006.

In addition, the Apio CEO has a 6% ownership interest in Apio Cooling LP, a limited partnership in which Apio is the general partner with a 60% ownership interest. Included in the minority interest liability as of November 26, 2006 and May 28, 2006 is \$205,000 and \$237,000, respectively, owed to the Apio CEO.



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

**8. Insurance Settlement**

On August 25, 2006 the Company received a cash payment of \$1.6 million from the settlement of insurance claims associated with a fire that occurred at its Dock Resins facility in February 2000. The settlement resulted in the Company recording a reduction to selling, general and administrative expenses of \$1.3 million, net of expenses, during the Company's first quarter of fiscal year 2007. In addition, \$381,000 had been placed in escrow pending the outcome of certain disputed professional fees. In September 2006, the Company resolved the fee dispute and paid professional fees of \$227,000 from the escrow and received the balance of \$154,000 which the Company recorded as a reduction to selling, general and administrative expenses during the three months ended November 26, 2006.

**9. Comprehensive Income (Loss)**

The comprehensive net income (loss) of Landec is the same as the net income (loss).

**10. Shareholders' Equity**

During the three and six months ended November 26, 2006, 152,972 and 223,866 shares of Common Stock, respectively, were issued upon the exercise of options under the Company's stock option plans and the Company's former Employee Stock Purchase Plan.

**Table of Contents****11. Business Segment Reporting**

Landec operates in two business segments: the Food Products Technology segment and the Agricultural Seed Technology segment. The Food Products Technology segment markets and packs specialty packaged whole and fresh-cut vegetables that incorporate the BreatheWay<sup>®</sup> specialty packaging for the retail grocery, club store and food services industry. The Agricultural Seed Technology segment markets and distributes hybrid seed corn and seed coatings using Landec's patented Intellicoat<sup>®</sup> seed coatings to the farming industry. The Food Products Technology and Agricultural Seed Technology segments include charges for corporate services allocated from the Corporate and Other segment. Corporate and other amounts include non-core operating activities and corporate operating costs. All of the assets of the Company are located within the United States of America.

Operations by Business Segment (in thousands):

|                                      | Food<br>Products<br>Technology | Agricultural<br>Seed<br>Technology | Corporate<br>and Other | TOTAL      |
|--------------------------------------|--------------------------------|------------------------------------|------------------------|------------|
| Three months ended November 26, 2006 |                                |                                    |                        |            |
| Net revenues                         | \$ 54,469                      | \$ 17                              | \$ 708                 | \$ 55,194  |
| International sales                  | \$ 17,964                      | \$ ¾                               | \$ ¾                   | \$ 17,964  |
| Gross profit                         | \$ 7,641                       | \$ (73)                            | \$ 708                 | \$ 8,276   |
| Net income (loss)                    | \$ 3,329                       | \$(3,558)                          | \$ 337                 | \$ 108     |
| Interest expense                     | \$ 4                           | \$ 117                             | \$ ¾                   | \$ 121     |
| Interest income                      | \$ 153                         | \$ 4                               | \$ 20                  | \$ 177     |
| Depreciation and amortization        | \$ 660                         | \$ 194                             | \$ 25                  | \$ 879     |
| Three months ended November 27, 2005 |                                |                                    |                        |            |
| Net revenues                         | \$ 53,403                      | \$ 20                              | \$ 289                 | \$ 53,712  |
| International sales                  | \$ 19,921                      | \$ ¾                               | \$ ¾                   | \$ 19,921  |
| Gross profit                         | \$ 6,869                       | \$ 19                              | \$ 201                 | \$ 7,089   |
| Net income (loss)                    | \$ 2,398                       | \$(3,188)                          | \$ (247)               | \$ (1,037) |
| Interest expense                     | \$ 75                          | \$ 101                             | \$ 1                   | \$ 177     |
| Interest income                      | \$ 109                         | \$ 14                              | \$ 7                   | \$ 130     |
| Depreciation and amortization        | \$ 624                         | \$ 173                             | \$ 23                  | \$ 820     |
| Six months ended November 26, 2006   |                                |                                    |                        |            |
| Net revenues                         | \$ 105,295                     | \$ 131                             | \$ 916                 | \$ 106,342 |
| International sales                  | \$ 31,774                      | \$ ¾                               | \$ ¾                   | \$ 31,774  |
| Gross profit                         | \$ 12,995                      | \$ (78)                            | \$ 916                 | \$ 13,833  |
| Net income (loss)                    | \$ 5,051                       | \$(6,447)                          | \$ 1,518               | \$ 122     |
| Interest expense                     | \$ 74                          | \$ 117                             | \$ ¾                   | \$ 191     |
| Interest income                      | \$ 345                         | \$ 45                              | \$ 23                  | \$ 413     |
| Depreciation and amortization        | \$ 1,332                       | \$ 383                             | \$ 51                  | \$ 1,766   |
| Six months ended November 27, 2005   |                                |                                    |                        |            |
| Net revenues                         | \$ 102,901                     | \$ 20                              | \$ 496                 | \$ 103,417 |
| International sales                  | \$ 36,642                      | \$ ¾                               | \$ ¾                   | \$ 36,642  |
| Gross profit                         | \$ 13,330                      | \$ 19                              | \$ 330                 | \$ 13,679  |
| Net income (loss)                    | \$ 4,282                       | \$(5,313)                          | \$ (527)               | \$ (1,558) |
| Interest expense                     | \$ 148                         | \$ 101                             | \$ 1                   | \$ 250     |
| Interest income                      | \$ 198                         | \$ 26                              | \$ 26                  | \$ 250     |
| Depreciation and amortization        | \$ 1,200                       | \$ 279                             | \$ 50                  | \$ 1,529   |

During the six months ended November 26, 2006 and November 27, 2005, sales to the Company's top five customers accounted for approximately 50% and 47%, respectively, of revenues, with the Company's top customers from the Food Products Technology segment, Costco Wholesale Corp., accounting for approximately 20% and 15%, respectively, and Pomina Enterprise Co. LTD, accounting for approximately 9% and 11%, respectively of revenues. The Company expects that, for the foreseeable future, a limited number of customers may continue to account for a significant portion of its net revenues. Virtually all of the Company's international sales are to Asia.

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**Table of Contents****12. Subsequent Events**

On December 1, 2006, Landec sold its direct marketing and sales seed company Fielder's Choice Direct (FCD), which included the Fielder's Choice Direct® and Heartland Hybrid® brands, to American Seeds, Inc. (ASI), a wholly owned subsidiary of Monsanto Company. The acquisition price for FCD was \$50 million in cash paid at the close with an additional earn-out amount of up to \$5 million based on FCD results for the twelve months ended May 31, 2007. Landec will record during its fiscal third quarter income from the sale, net of expenses and estimated taxes, of approximately \$20 million to \$21 million. The income, before expenses and estimated taxes, that will be recorded is equal to the difference between the fair value of FCD and its net book value. In accordance with generally accepted accounting principles, any portion of the \$50 million of proceeds in excess of the fair value of FCD will be allocated to the technology license agreement described below and will be recognized as revenue ratably over the five year term of the technology license agreement. The determination of fair value was performed by management using the services of an independent appraiser. Based on the appraisal, it was determined that the fair market value of FCD was \$40 million which is \$10 million less than the \$50 million received at close. Therefore, the \$10 million will be recognized as revenue and income ratably over the term of the technology license agreement or \$2 million per year.

On December 1, 2006, Landec also entered into a five-year co-exclusive technology license and polymer supply agreement with Monsanto Company for the use of Landec's Intellicoat polymer seed coating technology. In addition, Monsanto will pay all operating costs, including research and development funding, over the term of the agreement. This agreement provides for a fee payable to Landec of \$4 million if Monsanto elects to terminate the agreement or a fee payable to Landec of \$8 million if Monsanto elects to buyout the technology. Accordingly, if the agreement is eventually terminated, Landec will receive minimum guaranteed payments of \$17 million for license fees and polymer supply payments over five years or \$21 million in maximum payments if Monsanto elects to buyout the licensed technology. The minimum guaranteed payments will result in Landec recognizing revenue and operating income of \$3.4 million per year for five years. If Monsanto elects to purchase the technology, an additional \$4 million of license fee revenue will be recognized at the time of payment.

If the purchase option is exercised before the fifth anniversary of the Intellicoat agreement, all annual license fees and supply payments that have not been paid to Landec will become due upon the purchase. If Monsanto does not exercise its purchase option by the fifth anniversary of the Intellicoat agreement, Landec will receive the termination fee and all rights to the Intellicoat seed coating technology will revert to Landec. If Monsanto exercises its purchase option, Landec and Monsanto will enter into a new long-term supply agreement in which Landec will continue to be the exclusive supplier of Intellicoat polymer materials to Monsanto.

In exchange for the annual payments, Monsanto receives (1) a co-exclusive right to use Landec's Intellicoat temperature activated seed coating technology worldwide during the license period, (2) the right to be the exclusive global sales and marketing agent for the Intellicoat seed coating technology, and (3) the right to purchase the technology any time during the five year term of the Intellicoat agreement. In addition, Monsanto will fund all operating costs, including all Intellicoat research and development, product development and non-replacement capital costs during the five year agreement period.

In conjunction with the sale of FCD, Landec purchased all of the outstanding common stock and options of Landec Ag not owned by Landec at the fair market value of each share of Landec Ag as if all options had been exercised as of December 1, 2006. As a result, Landec paid \$7.3 million of the proceeds from the sale of FCD to purchase all of the common stock and options of Landec Ag not owned by Landec. After the purchase, Landec Ag became a wholly owned subsidiary of Landec. In accordance with SFAS 123R, this purchase will not result in an expense to the Company because all of the stock and options purchased were fully vested at the time of the purchase and were purchased for fair value on the date of the purchase.

FCD revenues for the three and six months ended November 26, 2006 and November 27, 2005 were \$131,000 and \$20,000, respectively. The net losses for FCD for the three and six months ended November 26, 2006 and November 27, 2005 were \$6.0 million and \$4.8 million, respectively. FCD had cash balances at November 26, 2006 and May 28, 2006 of \$185,000 and \$5.4 million, respectively.

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

The following discussion should be read in conjunction with the unaudited consolidated financial statements and accompanying notes included in Part I Item 1 of this Form 10-Q and the audited consolidated financial statements and accompanying notes and Management's Discussion and Analysis of Financial Condition and Results of Operations included in Landec's Annual Report on Form 10-K for the fiscal year ended May 28, 2006.

Except for the historical information contained herein, the matters discussed in this report are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Potential risks and uncertainties include, without limitation, those mentioned in this report and, in particular the factors described below under Additional Factors That May Affect Future Results, and those mentioned in Landec's Annual Report on Form 10-K for the fiscal year ended May 28, 2006. Landec undertakes no obligation to update or revise any forward-looking statements in order to reflect events or circumstances that may arise after the date of this report.

**Critical Accounting Policies and Use of Estimates**

There have been no material changes to the Company's critical accounting policies which are included and described in the Form 10-K for the fiscal year ended May 28, 2006 filed with the Securities and Exchange Commission on July 27, 2006 with the exception of the adoption of SFAS No. 123(R).

*Accounting for Stock-Based Compensation*

Effective May 29, 2006, we measure compensation expense for our stock-based compensation plans using the fair value method as defined in SFAS No. 123(R). Under SFAS 123R, stock-based compensation expense is calculated based on the value of the award on the date of grant and is recognized as expense on a straight line basis over the vesting period. Determining the fair value of stock-based awards on the grant date requires judgment, including estimating the variables necessary to determine the fair value of awards granted. To the extent actual results or updated estimates differ from our prior estimates, such amounts will be recorded as a cumulative adjustment in the period that any such estimates are revised. If actual results differ significantly from what we previously estimated, our stock-based compensation expense and our results of operations could be materially impacted.

**The Company**

Landec Corporation and its subsidiaries ( Landec or the Company ) design, develop, manufacture and sell temperature-activated and other specialty polymer products for a variety of food products, agricultural products, and licensed partner applications. This proprietary polymer technology is the foundation, and a key differentiating advantage, upon which Landec has built its business.

Landec's core polymer products are based on its patented proprietary Intelimer<sup>®</sup> polymers, which differ from other polymers in that they can be customized to abruptly change their physical characteristics when heated or cooled through a pre-set temperature switch. For instance, Intelimer polymers can change within the range of one or two degrees Celsius from a non-adhesive state to a highly tacky, adhesive state; from an impermeable state to a highly permeable state; or from a solid state to a viscous state. These abrupt changes are repeatedly reversible and can be tailored by Landec to occur at specific temperatures, thereby offering substantial competitive advantages in Landec's target markets.

Landec has historically had two core businesses Food Products Technology and Agricultural Seed Technology, in addition to our Technology Licensing/Research and Development business which is included in Corporate and Other for segment disclosure purposes (see Note 11 of Notes to Consolidated Financial Statements).

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Our Food Products Technology business is operated through a subsidiary, Apio, Inc., and combines our proprietary food packaging technology with the capabilities of a large national food supplier and value-added produce processor. Value-added processing incorporates Landec's proprietary packaging technology with produce that is processed by washing, and in some cases cutting and mixing, resulting in packaged produce to achieve increased shelf life and reduced shrink (waste) and to eliminate the need for ice during the distribution cycle. This combination was consummated in 1999 when the Company acquired Apio, Inc. and certain related entities (collectively, Apio).

Our Agricultural Seed Technology business is operated through a subsidiary, Landec Ag, Inc., (Landec Ag) and combines our proprietary Intellicoat® seed coating technology with our unique e-commerce, direct marketing and consultative selling capabilities which we obtained when we acquired Fielder's Choice Direct (FCD). FCD was sold to American Seeds, Inc. (ASI), a wholly owned subsidiary of Monsanto Corporation, on December 1, 2006 (see Note 12 of Notes to Consolidated Financial Statements).

In addition to our two core businesses, the Company also operates a Technology Licensing/Research and Development business that licenses and/or supplies products outside of our core businesses to industry leaders such as Air Products and Chemicals, Inc.

Landec was incorporated in California on October 31, 1986. We completed our initial public offering in 1996 and our Common Stock is listed on the Nasdaq National Market under the symbol LNDC. Our principal executive offices are located at 3603 Haven Avenue, Menlo Park, California 94025 and our telephone number is (650) 306-1650.

**Description of Core Business**

Landec has historically participated in two core business segments Food Products Technology and Agricultural Seed Technology. In addition to these two core segments, we license technology and conduct ongoing research and development through our Technology Licensing/Research and Development Business.

***Food Products Technology Business***

The Company began marketing in early 1996 our proprietary Intelimer-based specialty packaging for use in the fresh-cut produce market, one of the fastest growing segments in the produce industry. Our proprietary packaging technology, when combined with produce that is processed by washing, and in some cases cut and mixed, results in packaged produce with increased shelf life, reduced shrink (waste) and without the need for ice during the distribution cycle, which we refer to as our value-added products. In 1999, we acquired Apio, our largest customer at that time in the Food Products Technology business and one of the nation's leading marketers and packers of produce and specialty packaged fresh-cut vegetables. Apio provides year-round access to produce, utilizes state-of-the-art fresh-cut produce processing technology, distributes products to the top U.S. retail grocery chains, major club stores and the foodservice industry. Our proprietary Intelimer-based packaging business has been combined with Apio. This vertical integration within the Food Products Technology business gives Landec direct access to the large and growing fresh-cut produce market.

Based in Guadalupe, California, Apio, when acquired in 1999, consisted of two major businesses first, the fee-for-service selling and marketing of whole produce and second, the specialty packaged fresh-cut and whole value-added processed products that are washed and packaged in our proprietary BreatheWay® packaging.



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The fee-for-service business historically included field harvesting and packing, cooling and marketing of vegetables and fruit on a contract basis for growers in California's Santa Maria, San Joaquin and Imperial Valleys as well as in Arizona and Mexico. The Company exited this business and certain assets associated with the business were sold in June 2003 to Beachside Produce LLC (formerly known as Apio Fresh) (Beachside). Beachside is owned by a group of entities and persons that supply produce to Apio, including Nicholas Tompkins, Apio's President and Chief Executive Officer. Under the terms of the sale, Beachside purchased certain equipment and carton inventory from Apio in exchange for approximately \$410,000. In connection with the sale, Beachside pays Apio an on-going royalty fee per carton sold for the use of Apio's brand names and Beachside and its growers entered into a long-term supply agreement with Apio to supply produce to Apio for its fresh-cut value-added products. The fresh-cut value-added processed products business markets a variety of fresh-cut and whole vegetables to the top retail grocery chains and club stores. During the fiscal year ended May 28, 2006, Apio shipped more than seventeen million cartons of produce to leading supermarket retailers, wholesalers, foodservice suppliers and club stores throughout the United States and internationally, primarily in Asia.

There are five major distinguishing characteristics of Apio that provide competitive advantages in the Food Products Technology market:

**Value-Added Supplier:** Apio has structured its business as a marketer and seller of fresh-cut and whole value-added produce. It is focused on selling products under its Eat Smart® brand and other brands for its fresh-cut and whole value-added products. As retail grocery and club store chains consolidate, Apio is well positioned as a single source of a broad range of products.

**Reduced Farming Risks:** Apio reduces its farming risk by not taking ownership of farmland, and instead, contracts with growers for produce. The year-round sourcing of produce is a key component to the fresh-cut and whole value-added processing business.

**Lower Cost Structure:** Apio has strategically invested in the rapidly growing fresh-cut and whole value-added business. Apio's 96,000 square foot value-added processing plant, which was recently expanded from 60,000 square feet, is automated with state-of-the-art vegetable processing equipment. Virtually all of Apio's value-added products utilize Apio's proprietary BreatheWay packaging technology. Apio's strategy is to operate one large central processing facility in one of California's largest, lowest cost growing regions (Santa Maria Valley) and use packaging technology to allow for the nationwide delivery of fresh produce products.

**Export Capability:** Apio is uniquely positioned to benefit from the growth in export sales to Asia and Europe over the next decade with its export business, CalEx. Through CalEx, Apio is currently one of the largest U.S. exporters of broccoli to Asia and is selling its iceless products to Asia using proprietary BreatheWay packaging technology.

**Expanded Product Line Using Technology:** Apio, through the use of its BreatheWay packaging technology, is introducing on average fifteen new value-added products each year. These new product offerings range from various sizes of fresh-cut bagged products, to vegetable trays, to whole produce, to a meal line of products.

During the last twelve months, Apio has introduced 21 new products.

***Agricultural Seed Technology Business***

Following the sale of FCD, Landec Ag's strategy is to work closely with Monsanto to further develop its patented, functional polymer coating technology that can be broadly sold and/or licensed to the seed industry. In accordance with its license, supply and R&D agreement with Monsanto, Landec Ag is currently focused on commercializing products for the corn and soybean markets and then plans to broaden its applications to other seed crops.

Landec Ag's Intellicoat seed coating applications are designed to control seed germination timing, increase crop yields, reduce risks and extend crop-planting windows. These coatings are currently available on hybrid corn, soybeans and male inbred corn used for seed production. In fiscal year 2000, Landec Ag launched its first commercial product, Pollinator Plus® coatings, which is a coating application used by seed companies as a



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method for spreading pollination to increase yields and reduce risk in the production of hybrid seed corn. There are approximately 650,000 acres of seed production in the United States and in 2006 Pollinator Plus was used by 35 seed companies on approximately 15% of the seed production acres in the U.S.

In 2003, Landec Ag commercialized Early Plant<sup>®</sup> corn by selling the product directly to farmers through the Fielder's Choice Direct<sup>®</sup> brand. This application allows farmers to plant into cold soils without the risk of chilling injury, and enables farmers to plant as much as four weeks earlier than normal. With this capability, farmers are able to utilize labor and equipment more efficiently, provide flexibility during the critical planting period and avoid yield losses caused by late planting. In 2006, nine seed companies offered Intellicoat on their hybrid seed corn offerings.

The third commercial application is the Relay<sup>®</sup> Cropping system of wheat and Intellicoat coated soybeans, which allows farmers to plant and harvest two crops in the same year on the same ground in geographic areas where double cropping is not possible. This provides significant financial benefit especially to farmers in the corn belt who grow wheat as a single crop.

**Technology Licensing/Research and Development Businesses**

We believe our technology has commercial potential in a wide range of industrial, consumer and medical applications beyond those identified in our core businesses. For example, our core patented technology, Intelimer materials, can be used to trigger the release of small molecule drugs, catalysts, pesticides or fragrances just by changing the temperature of the Intelimer materials or to activate adhesives through controlled temperature change. In order to exploit these opportunities, we have entered into and will enter into licensing and collaborative corporate agreements for product development and/or distribution in certain fields. However, given the infrequency and unpredictability of when the Company may enter into any such licensing and research and development arrangements, the Company is unable to disclose its financial expectations in advance of entering into such arrangements.

**Results of Operations**

**Revenues** (in thousands):

|                            | <i>Three<br/>months<br/>ended<br/>11/26/06</i> | <i>Three<br/>months<br/>ended<br/>11/27/05</i> | <i>Change</i> | <i>Six months<br/>ended<br/>11/26/06</i> | <i>Six months<br/>ended<br/>11/27/05</i> | <i>Change</i> |
|----------------------------|--|--|---------------|--|--|---------------|
| <i>Apio Value Added</i>    | \$35,812                                       | \$ 30,479                                      | 17%           | \$ 70,842                                | \$ 60,136                                | 18%           |
| <i>Apio Tech</i>           | 41   | 83   | (51%)         | 54                                       | 87                                       | (38%)         |
| <i>Technology Subtotal</i> | 35,853   | 30,562   | 17%           | 70,896                                   | 60,223                                   | 18%           |
| <i>Apio Trading</i>        | 18,616   | 22,841   | (18%)         | 34,399                                   | 42,678                                   | (19%)         |
| <i>Total Apio</i>          | 54,469   | 53,403   | 2%            | 105,295                                  | 102,901                                  | 2%            |
| <i>Landec Ag</i>           | 17   | 20   | (15%)         | 131                                      | 20                                       | 555%          |
| <i>Corporate</i>           | 708  | 289  | 145%          | 916                                      | 496                                      | 85%           |
| <i>Total Revenues</i>      | \$55,194                                       | \$ 53,712                                      | 3%            | \$ 106,342                               | \$ 103,417                               | 3%            |
| <i>Apio Value Added</i>    |  |  |               |  |  |               |

Apio's value-added revenues consist of revenues generated from the sale of specialty packaged fresh-cut and whole value-added processed vegetable products that are washed and packaged in our proprietary packaging and sold under Apio's Eat Smart brand and various private labels. In addition, value-added revenues include the revenues generated from Apio Cooling, LP, a vegetable cooling operation in which Apio is the general partner with a 60% ownership position.

The increase in Apio's value-added revenues for the three and six months ended November 26, 2006 compared to the same periods last year is due to increased product offerings, increased sales to existing customers, the addition of new customers and product mix changes to higher priced products. Specifically, sales of Apio's value-added 12-ounce

specialty packaged retail product line grew 16% and 19%, respectively, during the three and six months ended November 26, 2006 compared to the same periods last year. In addition, sales of Apio's value-added vegetable tray products grew 24% and 23%, respectively, during the three and six months ended November

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26, 2006 compared to the same periods last year. Overall value-added unit sales volume increased 15% during the second quarter of fiscal year 2006 compared to the same period last year and 16% for the six months ended November 26, 2006 compared to the same period of the prior year.

*Apio Tech*

Apio Tech consists of Apio's packaging technology business using its BreatheWay membrane technology. The first commercial application included in Apio Tech is our banana packaging technology. Virtually all of the revenues currently generated from Apio Tech are revenues derived from our banana packaging program with Chiquita.

The decrease in revenues at Apio Tech during the three and six months ended November 26, 2006 compared to the same periods last year was not material to consolidated Landec revenues.

*Apio Trading*

Apio trading revenues consist of revenues generated from the purchase and sale of primarily whole commodity fruit and vegetable products to Asia through Apio's export company, Cal-Ex and from the purchase and sale of whole commodity fruit and vegetable products domestically. The export portion of trading revenues for the three and six months ended November 26, 2006 were \$18.0 million and \$31.8 million, or 96% and 92%, respectively, of total trading revenues.

The decrease in revenues in Apio's trading business for the three and six months ended November 26, 2006 compared to the same periods last year was primarily due to decreases of 78% and 56%, respectively, in domestic buy/sell commodity sales. In addition, export revenues decreased 10% and 13%, for the three and six months ended November 26, 2006, due to unit volume decreases of 18% and 21%, respectively. Export volume decreases were partially offset by a mix shift to higher valued products.

*Landec Ag*

Landec Ag revenues have historically consisted of revenues generated from the sale of hybrid seed corn to farmers under the Fielder's Choice Direct brand and from the sale of hybrid seed corn and soybeans under the Heartland Hybrids® brand (these brands and the related assets were sold to ASI on December 1, 2006, see Note 12 of Notes to Consolidated Financial Statements) and from the sale of Intellicoat coated corn and soybean seeds to farmers and seed companies. Virtually all of Landec Ag's revenues are generated during the Company's third and fourth quarters.

The change in revenues at Landec Ag during the three and six months ended November 26, 2006 compared to the same periods last year was not material to consolidated Landec revenues.

*Corporate*

Corporate revenues consist of revenues generated from partnering with others under research and development agreements and supply agreements and from fees for licensing our proprietary Intelimer technology to others and from the corresponding royalties from these license agreements.

The increase in Corporate revenues for the three and six months ended November 26, 2006 compared to the same periods of the prior year was not material to consolidated Landec revenues.

**Table of Contents****Gross Profit** (in thousands):

|                            | <i>Three<br/>months<br/>ended<br/>11/26/06</i> | <i>Three<br/>months<br/>ended<br/>11/27/05</i> | <i>Change</i> | <i>Six months<br/>ended<br/>11/26/06</i> | <i>Six months<br/>ended<br/>11/27/05</i> | <i>Change</i> |
|----------------------------|--|--|---------------|--|--|---------------|
| <i>Apio Value Added</i>    | \$6,420  | \$ 5,488                                       | 17%           | \$ 10,943                                | \$ 11,002                                | (1%)          |
| <i>Apio Tech</i>           | 16   | 60   | (73%)         | 20                                       | 62                                       | (68%)         |
| <i>Technology Subtotal</i> | 6,436  | 5,548  | 16%           | 10,963                                   | 11,064                                   | (1%)          |
| <i>Apio Trading</i>        | 1,205  | 1,321  | (9%)          | 2,032                                    | 2,266                                    | (10%)         |
| <i>Total Apio</i>          | 7,641  | 6,869  | 11%           | 12,995                                   | 13,330                                   | (3%)          |
| <i>Landec Ag</i>           | (73)   | 19   | N/M           | (78)                                     | 19                                       | N/M           |
| <i>Corporate</i>           | 708  | 201  | 252%          | 916                                      | 330                                      | 178%          |
| <i>Total Gross Profit</i>  | \$8,276  | \$ 7,089                                       | 17%           | \$ 13,833                                | \$ 13,679                                | 1%            |

*General*

There are numerous factors that can influence gross profits including product mix, customer mix, manufacturing costs, volume, sale discounts and charges for excess or obsolete inventory, to name a few. Many of these factors influence or are interrelated with other factors. Therefore, it is difficult to precisely quantify the impact of each item individually. The Company includes in cost of sales all the costs related to the sale of products in accordance with U.S. accounting principles generally accepted. These costs include the following: raw materials (including produce, seeds and packaging), direct labor, overhead (including indirect labor, depreciation, and facility related costs) and shipping and shipping related costs. The following discussion surrounding gross profits includes management's best estimates of the reasons for the changes for the three and six months ended November 26, 2006, compared to the same periods last year as outlined in the table above.

*Apio Value-Added*

The increase in gross profits for Apio's value-added specialty packaged vegetable business for the three months ended November 26, 2006 compared to the same period last year was due to an increase in value-added sales which increased 17% during the quarter. The decrease in gross profit for Apio's value-added specialty packaged vegetable business for the six months ended November 26, 2006 compared to the same period last year was primarily due to the increased costs for raw materials in the first quarter of fiscal year 2007 compared to the first quarter of last year which was attributable to weather related shortages of contracted product which required Apio to procure supplemental product on the open market at costs significantly above contracted prices. The increase in raw material costs was almost completely offset by an increase in revenues of 18% during the first six months of fiscal year 2007 compared to the first six months of last year and by changes in product mix to higher margin products coupled with improved operational efficiencies.

*Apio Trading*

Apio's trading business is a buy/sell business that realizes a commission-based margin in the 4-6% range. The decrease in gross profits during the three and six months ended November 26, 2006 compared to the same periods last year was primarily due to decreased trading revenues of 18% and 19%, respectively. The decreases in gross profits due to lower revenues were partially offset by a shift during the first half of fiscal year 2007 to higher margin export products from lower margin domestic commodity products compared to the first half of last year.

*Apio Tech and Landec Ag*

The change in gross profits for Apio Tech and Landec Ag for the three and six months ended November 26, 2006 compared to the same periods last year was not material to consolidated Landec gross profits.



**Table of Contents***Corporate*

The increase in gross profits for Corporate for the three and six months ended November 26, 2006 compared to the same periods last year was primarily due to \$481,000 in revenues recognized from the receipt of 800,000 shares of preferred stock in Aesthetic Sciences Corporation, an unconsolidated subsidiary, in November 2006.

**Operating Expenses** (in thousands):

|   | <i>Three<br/>months<br/>ended<br/>11/26/06</i> | <i>Three months<br/>ended<br/>11/27/05</i> | <i>Change</i> | <i>Six months<br/>ended<br/>11/26/06</i> | <i>Six months<br/>ended<br/>11/27/05</i> | <i>Change</i> |
|---|--|--|---------------|--|--|---------------|
| <b>Research and Development:</b>            |  |  |               |  |  |               |
| <i>Apio</i>                                 | \$ 323   | \$ 275                                     | 17%           | \$ 563                                   | \$ 541                                   | 4%            |
| <i>Landec Ag</i>                            | 129  | 154  | (16%)         | 265                                      | 307                                      | (14%)         |
| <i>Corporate</i>                            | 388  | 391  | (1%)          | 796                                      | 731                                      | 9%            |
| <b>Total R&amp;D</b>                        | \$ 840   | \$ 820                                     | 2%            | \$ 1,624                                 | \$ 1,579                                 | 3%            |
| <b>Selling, General and Administrative:</b> |  |  |               |  |  |               |
| <i>Apio</i>                                 | \$3,343  | \$ 3,497                                   | (4%)          | \$ 6,134                                 | \$ 6,918                                 | (11%)         |
| <i>Landec Ag</i>                            | 2,769  | 2,587                                      | 7%            | 5,094                                    | 4,216                                    | 21%           |
| <i>Corporate</i>                            | 1,177  | 1,070                                      | 10%           | 963                                      | 2,201                                    | (56%)         |
| <b>Total S,G&amp;A</b>                      | \$7,289  | \$ 7,154                                   | 2%            | \$ 12,191                                | \$ 13,335                                | (9%)          |

*Research and Development*

Landec's research and development expenses consist primarily of expenses involved in the development and process scale-up initiatives. Research and development efforts at Apio are focused on the Company's proprietary BreatheWay membranes used for packaging produce, with recent focus on extending the shelf life of bananas and other shelf-life sensitive vegetables and fruit. At Landec Ag, the research and development efforts are focused on the Company's proprietary Intellicoat coatings for seeds, primarily corn seed. At Corporate, the research and development efforts are focused on uses for the proprietary Intelimer polymers outside of food and agriculture.

The increase in research and development expenses for the three months and six months ended November 26, 2006 compared to the same periods last year was not material.

*Selling, General and Administrative*

Selling, general and administrative expenses consist primarily of sales and marketing expenses associated with Landec's product sales and services, business development expenses and staff and administrative expenses.

The increase in selling, general and administrative expenses for the three months ended November 26, 2006 compared to the same period last year was not material. The decrease in selling, general and administrative expenses for the six months ended November 26, 2006 compared to the same period last year was primarily due to new packaging design and marketing related costs that were incurred at Apio during the first quarter of fiscal year 2006 and the recording of the net proceeds of \$1.5 million from the insurance settlement (see Note 8 of Notes to Consolidated Financial Statements) to Corporate selling, general and administrative expenses during the first six months of fiscal year 2007. These decreases were partially offset by \$1.2 million of selling, general and administrative costs incurred at Heartland Hybrids during the first six months this year compared to \$529,000 during the first six months last year because Heartland Hybrids was not acquired until the beginning of Landec's second fiscal quarter in fiscal year 2006.





**Table of Contents****Other** (in thousands):

|                            | <i>Three<br/>months<br/>ended<br/>11/26/06</i> | <i>Three months<br/>ended<br/>11/27/05</i> | <i>Change</i> | <i>Six months<br/>ended<br/>11/26/06</i> | <i>Six months<br/>ended<br/>11/27/05</i> | <i>Change</i> |
|----------------------------|--|--|---------------|--|--|---------------|
| <b>Interest Income</b>     | \$ 177   | \$ 130                                     | 36%           | \$ 413                                   | \$ 250                                   | 65%           |
| <b>Interest Expense</b>    | (121)  | (177)                                      | (32%)         | (191)                                    | (250)                                    | (24%)         |
| <b>Minority Int. Exp.</b>  | (97)   | (101)                                      | (4%)          | (115)                                    | (316)                                    | (64%)         |
| <b>Other Income (Exp.)</b> | 2  | (4)  | N/M           | (3)                                      | (7)                                      | (57%)         |
| <b>Total Other</b>         | \$ (39)  | \$ (152)                                   | (74%)         | \$ 104                                   | \$ (323)                                 | (132%)        |

*Interest Income*

The increase in interest income for the three and six month periods ended November 26, 2006 compared to the same periods last year was due to the increase in cash available for investing and higher interest rates on the cash invested.

*Interest Expense*

The decrease in interest expense during the three and six months ended November 26, 2006 compared to the same periods last year was due to the Company's reduction of debt.

*Minority Interest Expense*

The minority interest expense consists of the minority interest associated with the limited partners' equity interest in the net income of Apio Cooling, LP.

The decrease in the minority interest for the three months ended November 26, 2006 compared to the same period of last year was not material. The decrease in the minority interest for the six months ended November 26, 2006 was due to non-recurring gains for Apio Cooling during the first quarter of fiscal year 2006.

*Other Expense*

Other consists of non-operating income and expenses.

**Liquidity and Capital Resources**

As of November 26, 2006, the Company, including FCD, had cash and cash equivalents of \$11.9 million, a net decrease of \$8.6 million from \$20.5 million at May 28, 2006.

*Cash Flow from Operating Activities*

Landec used \$6.8 million of cash flow in operating activities during the six months ended November 26, 2006 compared to using \$10.0 million from operating activities for the six months ended November 27, 2005. The primary source of cash during the six months ended November 26, 2006 was an increase in deferred revenue of \$2.2 million as a result of cash deposits for future seed corn shipments. The primary uses of cash in operating activities were from the purchase of seed corn inventory by Landec Ag of \$7.4 million and an increase in inventory at Apio of \$2.2 million primarily related to increased seasonal raw material requirements for Apio's value added business.

*Cash Flow from Investing Activities*

Net cash used in investing activities for the six months ended November 26, 2006 was \$5.6 million compared to \$3.0 million for the same period last year. The primary uses of cash for investing activities during the first six months of fiscal year 2007 were from the purchase of \$4.7 million of property, plant and equipment primarily for the further expansion and automation of Apio's value-added facility.

*Cash Flow from Financing Activities*

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Net cash provided by financing activities for the six months ended November 26, 2006 was \$3.8 million compared to \$6.6 million for the same period last year. The cash provided by financing activities during the first six months of fiscal year 2007 was primarily due to net borrowings under Landec Ag's line of credit of \$4.9 million for the purchase of seed corn and \$1.0 million of cash received from employees exercising their stock options. The cash used in financing activities during the first quarter of fiscal year 2007 was primarily used to pay off all of Apio's long-term bank debt totaling \$2.0 million.

*Capital Expenditures*

During the six months ended November 26, 2006, Landec expanded Apio's value added processing facility and purchased vegetable processing equipment to support the further automation of Apio's value added processing facility. These expenditures represented the majority of the \$4.7 million of capital expenditures.

*Debt*

On November 1, 2005, Apio amended its revolving line of credit with Wells Fargo Bank N.A. that was scheduled to expire on August 31, 2006. The line was reduced from \$10.0 million to \$7.0 million and outstanding amounts under the line of credit now bear interest at either the prime rate less 0.25% or the LIBOR adjustable rate plus 1.75% (7.07% at November 26, 2006). The revolving line of credit with Wells Fargo (collectively, the "Loan Agreement") contains certain restrictive covenants, which require Apio to meet certain financial tests, including minimum levels of net income, maximum leverage ratio, minimum net worth and maximum capital expenditures. Landec has pledged substantially all of the assets of Apio to secure the line of credit with Wells Fargo. At November 26, 2006, no amounts were outstanding under the revolving line of credit. Apio has been in compliance with all loan covenants in the Loan Agreement since the inception of this loan.

On August 29, 2006, Landec Ag amended and restated its revolving line of credit with Old National Bank which increased the line from \$7.5 million to \$10 million. The interest rate on the revolving line of credit was reduced from prime plus 0.375% to prime minus 0.50% (7.75% at November 26, 2006). The line of credit contained certain restrictive covenants, which, among other things, restricted the ability of Landec Ag to make payments on debt owed by Landec Ag to Landec. Landec Ag was in compliance with all of the loan covenants during the first six months of fiscal year 2007. Landec had pledged substantially all of the assets of Landec Ag to secure the line of credit. At November 26, 2006, \$4.9 million was outstanding under Landec Ag's revolving line of credit. In conjunction with the sale of FCD to ASI on December 1, 2006 (see Note 12 of Notes to Consolidated Financial Statements) Landec Ag's line of credit was paid in full and subsequently terminated.

At November 26, 2006, Landec's total debt, including current maturities and capital lease obligations, was \$39,000 and the total debt to equity ratio was 0% as compared to 2% at May 28, 2006. This debt was comprised of capital lease obligations.

Landec is not a party to any agreements with, or commitments to, any special purpose entities that would constitute material off-balance sheet financing other than the operating lease commitments listed above.

Landec's future capital requirements will depend on numerous factors, including the progress of its research and development programs; the development of commercial scale manufacturing capabilities; the development of marketing, sales and distribution capabilities; the ability of Landec to establish and maintain new collaborative and licensing arrangements; any decision to pursue additional acquisition opportunities; weather conditions that can affect the supply and price of produce, the timing and amount, if any, of payments received under licensing and research and development agreements; the costs involved in preparing, filing, prosecuting, defending and enforcing intellectual property rights; the ability to comply with regulatory requirements; the emergence of competitive technology and market forces; the effectiveness of product commercialization activities and arrangements; and other factors. If Landec's currently available funds, together with the internally generated cash flow from operations are not sufficient to satisfy its capital needs, Landec would be required to seek additional funding through other arrangements with collaborative partners, additional bank borrowings and public or private sales of its securities. There can be no assurance that additional funds, if required, will be available to Landec on favorable terms if at all.

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Landec believes that its debt facilities, cash from operations, along with existing cash, cash equivalents and existing borrowing capacities will be sufficient to finance its operational and capital requirements for the foreseeable future.

### **Additional Factors That May Affect Future Results**

Landec desires to take advantage of the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995 and of Section 21E and Rule 3b-6 under the Securities Exchange Act of 1934. Specifically, Landec wishes to alert readers that the following important factors, as well as other factors including, without limitation, those described elsewhere in this report, could in the future affect, and in the past have affected, Landec's actual results and could cause Landec's results for future periods to differ materially from those expressed in any forward-looking statements made by or on behalf of Landec. Landec assumes no obligation to update such forward-looking statements.

### ***Our Future Operating Results Are Likely to Fluctuate Which May Cause Our Stock Price to Decline***

In the past, our results of operations have fluctuated significantly from quarter to quarter and are expected to continue to fluctuate in the future. Historically, Landec Ag has been the primary source of these fluctuations, as its revenues and profits are concentrated over a few months during the spring planting season (generally during our third and fourth fiscal quarters). In addition, Apio can be heavily affected by seasonal and weather factors which have impacted quarterly results, such as the high cost of sourcing product in March/April 2005 and June/July 2006 due to a shortage of essential value-added produce items. Our earnings may also fluctuate based on our ability to collect accounts receivables from customers and note receivables from growers and on price fluctuations in the fresh vegetables and fruits markets. Other factors that affect our food and/or agricultural operations include:

- the seasonality of our supplies;

- our ability to process produce during critical harvest periods;

- the timing and effects of ripening;

- the degree of perishability;

- the effectiveness of worldwide distribution systems;

- total worldwide industry volumes;

- the seasonality of consumer demand;

- foreign currency fluctuations; and

- foreign importation restrictions and foreign political risks.

As a result of these and other factors, we expect to continue to experience fluctuations in quarterly operating results.

### ***We May Not Be Able to Achieve Acceptance of Our New Products in the Marketplace***

Our success in generating significant sales of our products will depend in part on the ability of us and our partners and licensees to achieve market acceptance of our new products and technology. The extent to which, and rate at which, we achieve market acceptance and penetration of our current and future products is a function of many variables including, but not limited to:

- price;

- safety;

- efficacy;

reliability;

conversion costs;

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marketing and sales efforts; and

general economic conditions affecting purchasing patterns.

We may not be able to develop and introduce new products and technologies in a timely manner or new products and technologies may not gain market acceptance. We are in the early stage of product commercialization of certain Intelimer-based specialty packaging, Intellicoat seed coatings and other Intelimer polymer products and many of our potential products are in development. We believe that our future growth will depend in large part on our ability to develop and market new products in our target markets and in new markets. In particular, we expect that our ability to compete effectively with existing food products, agricultural, industrial and medical companies will depend substantially on successfully developing, commercializing, achieving market acceptance of and reducing the cost of producing our products. In addition, commercial applications of our temperature switch polymer technology are relatively new and evolving. Our failure to develop new products or the failure of our new products to achieve market acceptance would have a material adverse effect on our business, results of operations and financial condition.

***We Face Strong Competition in the Marketplace***

Competitors may succeed in developing alternative technologies and products that are more effective, easier to use or less expensive than those which have been or are being developed by us or that would render our technology and products obsolete and non-competitive. We operate in highly competitive and rapidly evolving fields, and new developments are expected to continue at a rapid pace. Competition from large food products, agricultural, industrial and medical companies is expected to be intense. In addition, the nature of our collaborative arrangements may result in our corporate partners and licensees becoming our competitors. Many of these competitors have substantially greater financial and technical resources and production and marketing capabilities than we do, and may have substantially greater experience in conducting clinical and field trials, obtaining regulatory approvals and manufacturing and marketing commercial products.

***We Have a Concentration of Manufacturing in One Location for Apio and May Have to Depend on Third Parties to Manufacture Our Products***

Any disruptions in our primary manufacturing operation at Apio's facility in Guadalupe, California would reduce our ability to sell our products and would have a material adverse effect on our financial results. Additionally, we may need to consider seeking collaborative arrangements with other companies to manufacture our products. If we become dependent upon third parties for the manufacture of our products, our profit margins and our ability to develop and deliver those products on a timely basis may be affected. Failures by third parties may impair our ability to deliver products on a timely basis and impair our competitive position. We may not be able to continue to successfully operate our manufacturing operations at acceptable costs, with acceptable yields, and retain adequately trained personnel.

***Our Dependence on Single-Source Suppliers and Service Providers May Cause Disruption in Our Operations Should Any Supplier Fail to Deliver Materials***

We may experience difficulty acquiring materials or services for the manufacture of our products or we may not be able to obtain substitute vendors. We may not be able to procure comparable materials at similar prices and terms within a reasonable time. Several services that are provided to Apio are obtained from a single provider. Several of the raw materials we use to manufacture our products are currently purchased from a single source, including some monomers used to synthesize Intelimer polymers and substrate materials for our breathable membrane products. Any interruption of our relationship with single-source suppliers or service providers could delay product shipments and materially harm our business.

**Table of Contents*****We May Be Unable to Adequately Protect Our Intellectual Property Rights***

We may receive notices from third parties, including some of our competitors, claiming infringement by our products of patent and other proprietary rights. Regardless of their merit, responding to any such claim could be time-consuming, result in costly litigation and require us to enter royalty and licensing agreements which may not be offered or available on terms acceptable to us. If a successful claim is made against us and we fail to develop or license a substitute technology, we could be required to alter our products or processes and our business, results of operations or financial position could be materially adversely affected. Our success depends in large part on our ability to obtain patents, maintain trade secret protection and operate without infringing on the proprietary rights of third parties. Any pending patent applications we file may not be approved and we may not be able to develop additional proprietary products that are patentable. Any patents issued to us may not provide us with competitive advantages or may be challenged by third parties. Patents held by others may prevent the commercialization of products incorporating our technology. Furthermore, others may independently develop similar products, duplicate our products or design around our patents.

***Our Operations Are Subject to Regulations that Directly Impact Our Business***

Our food packaging products are subject to regulation under the Food, Drug and Cosmetic Act (the FDC Act). Under the FDC Act, any substance that when used as intended may reasonably be expected to become, directly or indirectly, a component or otherwise affect the characteristics of any food may be regulated as a food additive unless the substance is generally recognized as safe. We believe that food packaging materials are generally not considered food additives by the FDA because these products are not expected to become components of food under their expected conditions of use. We consider our breathable membrane product to be a food packaging material not subject to regulation or approval by the FDA. We have not received any communication from the FDA concerning our breathable membrane product. If the FDA were to determine that our breathable membrane products are food additives, we may be required to submit a food additive petition for approval by the FDA. The food additive petition process is lengthy, expensive and uncertain. A determination by the FDA that a food additive petition is necessary would have a material adverse effect on our business, operating results and financial condition.

Federal, state and local regulations impose various environmental controls on the use, storage, discharge or disposal of toxic, volatile or otherwise hazardous chemicals and gases used in some of the manufacturing processes. Our failure to control the use of, or to restrict adequately the discharge of, hazardous substances under present or future regulations could subject us to substantial liability or could cause our manufacturing operations to be suspended and changes in environmental regulations may impose the need for additional capital equipment or other requirements.

Our agricultural operations are subject to a variety of environmental laws including, the Food Quality Protection Act of 1966, the Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act, the Federal Insecticide, Fungicide and Rodenticide Act, and the Comprehensive Environmental Response, Compensation and Liability Act. Compliance with these laws and related regulations is an ongoing process. Environmental concerns are, however, inherent in most agricultural operations, including those we conduct. Moreover, it is possible that future developments, such as increasingly strict environmental laws and enforcement policies could result in increased compliance costs.

The Company is subject to the Perishable Agricultural Commodities Act (PACA) law. PACA regulates fair trade standards in the fresh produce industry and governs all the products sold by Apio. Our failure to comply with the PACA requirements could among other things, result in civil penalties, suspension or revocation of a license to sell produce, and in the most egregious cases, criminal prosecution, which could have a material adverse effect on our business.

***Adverse Weather Conditions and Other Acts of God May Cause Substantial Decreases in Our Sales and/or Increases in Our Costs***

Our Food Products business is subject to weather conditions that affect commodity prices, crop yields, and decisions by growers regarding crops to be planted. Crop diseases and severe conditions, particularly weather conditions such as floods, droughts, frosts, windstorms, earthquakes and hurricanes, may adversely affect the supply of vegetables and fruits used in our business, which could reduce the sales volumes and/or increase the unit production





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costs. Because a significant portion of the costs are fixed and contracted in advance of each operating year, volume declines due to production interruptions or other factors could result in increases in unit production costs which could result in substantial losses and weaken our financial condition.

***We Depend on Strategic Partners and Licenses for Future Development***

Our strategy for development, clinical and field testing, manufacture, commercialization and marketing for some of our current and future products includes entering into various collaborations with corporate partners, licensees and others. We are dependent on our corporate partners to develop, test, manufacture and/or market some of our products. Although we believe that our partners in these collaborations have an economic motivation to succeed in performing their contractual responsibilities, the amount and timing of resources to be devoted to these activities are not within our control. Our partners may not perform their obligations as expected or we may not derive any additional revenue from the arrangements. Our partners may not pay any additional option or license fees to us or may not develop, market or pay any royalty fees related to products under the agreements. Moreover, some of the collaborative agreements provide that they may be terminated at the discretion of the corporate partner, and some of the collaborative agreements provide for termination under other circumstances. Our partners may pursue existing or alternative technologies in preference to our technology. Furthermore, we may not be able to negotiate additional collaborative arrangements in the future on acceptable terms, if at all, and our collaborative arrangements may not be successful.

***Both Domestic and Foreign Government Regulations Can Have an Adverse Effect on Our Business Operations***

Our products and operations are subject to governmental regulation in the United States and foreign countries. The manufacture of our products is subject to periodic inspection by regulatory authorities. We may not be able to obtain necessary regulatory approvals on a timely basis or at all. Delays in receipt of or failure to receive approvals or loss of previously received approvals would have a material adverse effect on our business, financial condition and results of operations. Although we have no reason to believe that we will not be able to comply with all applicable regulations regarding the manufacture and sale of our products and polymer materials, regulations are always subject to change and depend heavily on administrative interpretations and the country in which the products are sold. Future changes in regulations or interpretations relating to matters such as safe working conditions, laboratory and manufacturing practices, environmental controls, and disposal of hazardous or potentially hazardous substances may adversely affect our business.

We are subject to USDA rules and regulations concerning the safety of the food products handled and sold by Apio, and the facilities in which they are packed and processed. Failure to comply with the applicable regulatory requirements can, among other things, result in:

    fines, injunctions, civil penalties, and suspensions,

    withdrawal of regulatory approvals,

    product recalls and product seizures, including cessation of manufacturing and sales,

    operating restrictions, and

    criminal prosecution.

We may be required to incur significant costs to comply with the laws and regulations in the future which may have a material adverse effect on our business, operating results and financial condition.

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***Our International Operations and Sales May Expose Our Business to Additional Risks***

For the six months ended November 26, 2006, approximately 30% of our total revenues were derived from product sales to international customers. A number of risks are inherent in international transactions. International sales and operations may be limited or disrupted by any of the following:

regulatory approval process,

government controls,

export license requirements,

political instability,

price controls,

trade restrictions,

changes in tariffs, or

difficulties in staffing and managing international operations.

Foreign regulatory agencies have or may establish product standards different from those in the United States, and any inability to obtain foreign regulatory approvals on a timely basis could have a material adverse effect on our international business, and our financial condition and results of operations. While our foreign sales are currently priced in dollars, fluctuations in currency exchange rates may reduce the demand for our products by increasing the price of our products in the currency of the countries to which the products are sold. Regulatory, geopolitical and other factors may adversely impact our operations in the future or require us to modify our current business practices.

***Cancellations or Delays of Orders by Our Customers May Adversely Affect Our Business***

During the first six months of fiscal year 2007, sales to our top five customers accounted for approximately 50% of our revenues, with our largest customers, Costco Wholesale Corp. accounting for approximately 20% of our revenues. We expect that, for the foreseeable future, a limited number of customers may continue to account for a substantial portion of our net revenues. We may experience changes in the composition of our customer base as we have experienced in the past. We do not have long-term purchase agreements with any of our customers. The reduction, delay or cancellation of orders from one or more major customers for any reason or the loss of one or more of our major customers could materially and adversely affect our business, operating results and financial condition. In addition, since some of the products processed by Apio at its Guadalupe, California facility are sole sourced to its customers, our operating results could be adversely affected if one or more of our major customers were to develop other sources of supply. Our current customers may not continue to place orders, orders by existing customers may be canceled or may not continue at the levels of previous periods or we may not be able to obtain orders from new customers.

***Our Sale of Some Products May Increase Our Exposure to Product Liability Claims***

The testing, manufacturing, marketing, and sale of the products we develop involve an inherent risk of allegations of product liability. If any of our products were determined or alleged to be contaminated or defective or to have caused a harmful accident to an end-customer, we could incur substantial costs in responding to complaints or litigation regarding our products and our product brand image could be materially damaged. Either event may have a material adverse effect on our business, operating results and financial condition. Although we have taken and intend to continue to take what we believe are appropriate precautions to minimize exposure to product liability claims, we may not be able to avoid significant liability. We currently maintain product liability insurance. While we believe the coverage and limits are consistent with industry standards, our coverage may not be adequate or may not continue to be available at an acceptable cost, if at all. A product liability claim, product recall or other claim with respect to uninsured liabilities or in excess of insured liabilities could have a material adverse effect on our business, operating

results and financial condition.

***Our Stock Price May Fluctuate in Accordance with Market Conditions***

The following events may cause the market price of our common stock to fluctuate significantly:

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technological innovations applicable to our products,  
our attainment of (or failure to attain) milestones in the commercialization of our technology,  
our development of new products or the development of new products by our competitors,  
new patents or changes in existing patents applicable to our products,  
our acquisition of new businesses or the sale or disposal of a part of our businesses,  
development of new collaborative arrangements by us, our competitors or other parties,  
changes in government regulations applicable to our business,  
changes in investor perception of our business,  
fluctuations in our operating results and  
changes in the general market conditions in our industry.

These broad fluctuations may adversely affect the market price of our common stock.

***Since We Order Cartons and Film for Our Products from Suppliers in Advance of Receipt of Customer Orders for Such Products, We Could Face a Material Inventory Risk***

As part of our inventory planning, we enter into negotiated orders with vendors of cartons and film used for packing our products in advance of receiving customer orders for such products. Accordingly, we face the risk of ordering too many cartons and film since orders are generally based on forecasts of customer orders rather than actual orders. If we cannot change or be released from the orders, we may incur costs as a result of inadequately predicting cartons and film orders in advance of customer orders. Because of this, we may have an oversupply of cartons and film and face the risk of not being able to sell such inventory and our anticipated reserves for losses may be inadequate if we have misjudged the demand for our products. Our business and operating results could be adversely affected as a result of these increased costs.

***Recently Enacted Changes in Securities Laws and Regulations Have and Will Continue to Increase Our Costs***

The Sarbanes-Oxley Act of 2002 (the Act) that became law in July 2002 required changes in some of our corporate governance, public disclosure and compliance practices. In addition, Nasdaq has made revisions to its requirements for companies, such as Landec, that are listed on The NASDAQ Global Market. These developments have increased our legal and financial compliance costs. These changes could make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These developments could make it more difficult for us to attract and retain qualified members for our board of directors, particularly to serve on our audit committee.

***Our Controlling Shareholders Exert Significant Influence over Corporate Events that May Conflict with the Interests of Other Shareholders***

Our executive officers and directors and their affiliates own or control approximately 23% of our common stock (including options exercisable within 60 days). Accordingly, these officers, directors and shareholders may have the ability to exert significant influence over the election of our Board of Directors, the approval of amendments to our articles and bylaws and the approval of mergers or other business combination transactions requiring shareholder approval. This concentration of ownership may have the effect of delaying or preventing a merger or other business combination transaction, even if the transaction or amendments would be beneficial to our other shareholders. In addition, our controlling shareholders may approve amendments to our articles or bylaws to implement anti-takeover or management friendly provisions that may not be beneficial to our other shareholders.



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***We May Be Exposed to Employment Related Claims and Costs that Could Materially Adversely Affect Our Business***

We have been subject in the past, and may be in the future, to claims by employees based on allegations of discrimination, negligence, harassment and inadvertent employment of illegal aliens or unlicensed personnel, and we may be subject to payment of workers' compensation claims and other similar claims. We could incur substantial costs and our management could spend a significant amount of time responding to such complaints or litigation regarding employee claims, which may have a material adverse effect on our business, operating results and financial condition.

***We Are Dependent on Our Key Employees and if One or More of Them Were to Leave, We Could Experience Difficulties in Replacing Them and Our Operating Results Could Suffer***

The success of our business depends to a significant extent upon the continued service and performance of a relatively small number of key senior management, technical, sales, and marketing personnel. The loss of any of our key personnel would likely harm our business. In addition, competition for senior level personnel with knowledge and experience in our different lines of business is intense. If any of our key personnel were to leave, we would need to devote substantial resources and management attention to replace them. As a result, management attention may be diverted from managing our business, and we may need to pay higher compensation to replace these employees.

***We May Issue Preferred Stock with Preferential Rights that Could Affect Your Rights***

Our Board of Directors has the authority, without further approval of our shareholders, to fix the rights and preferences, and to issue shares, of preferred stock. In November 1999, we issued and sold shares of Series A Convertible Preferred Stock and in October 2001 we issued and sold shares of Series B Convertible Preferred Stock. The Series A Convertible Preferred Stock was converted into 1,666,670 shares of Common Stock on November 19, 2002 and the Series B Convertible Preferred Stock was converted into 1,744,102 shares of Common Stock on May 7, 2004.

The issuance of new shares of preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding stock, and the holders of such preferred stock could have voting, dividend, liquidation and other rights superior to those of holders of our Common Stock.

***We Have Never Paid any Dividends on Our Common Stock***

We have not paid any cash dividends on our Common Stock since inception and do not expect to do so in the foreseeable future. Any dividends may be subject to preferential dividends payable on any preferred stock we may issue.

***Our Profitability Could Be Materially And Adversely Affected if it Is Determined that the Book Value of Goodwill is Higher than Fair Value***

Our balance sheet includes an amount designated as goodwill that represents a portion of our assets and our shareholders' equity. Goodwill arises when an acquirer pays more for a business than the fair value of the tangible and separately measurable intangible net assets. Under Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets, beginning in fiscal year 2002, the amortization of goodwill has been replaced with an impairment test which requires that we compare the fair value of goodwill to its book value at least annually and more frequently if circumstances indicate a possible impairment. If we determine at any time in the future that the book value of goodwill is higher than fair value then the difference must be written-off, which could materially and adversely affect our profitability.

**Table of Contents****Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The following table presents information about the Company's debt obligations and derivative financial instruments that are sensitive to changes in interest rates. The table presents principal amounts and related weighted average interest rates by year of expected maturity for the Company's debt obligations. The carrying value of the Company's debt obligations approximates the fair value of the debt obligations as of November 26, 2006.

|  | Remainder<br>of 2007 | 2008 | 2009 | 2010 | 2011 | There-<br>after | Total   |
|--|----------------------|------|------|------|------|-----------------|---------|
| <b>Liabilities (in 000's)</b>                |                      |      |      |      |      |                 |         |
| Lines of Credit                              | \$4,941              | \$   | \$   | \$   | \$   | \$              | \$4,941 |
| Avg. Int. Rate                               | 7.75%                |      |      |      |      |                 | 7.75%   |
| Long term debt,<br>including current portion |                      |      |      |      |      |                 |         |
| Fixed Rate                                   | \$ 39                | \$   | \$   | \$   | \$   | \$              | \$ 39   |
| Avg. Int. Rate                               | 5.90%                |      |      |      |      |                 | 5.90%   |

**Item 4. Controls and Procedures****Evaluation of Disclosure Controls and Procedures**

Our management evaluated, with participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission, and to provide reasonable assurance that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal controls over financial reporting during the quarter ended November 26, 2006 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

The Company is involved in litigation arising in the normal course of business. The Company is currently not a party to any legal proceedings which would result in the payment of any amounts that would be material to the business or financial condition of the Company.

**Item 1A. Risk Factors**

Not applicable.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

At the Company's Annual Meeting of Shareholders held on October 12, 2006 the following proposals were adopted by the margins indicated:

|  | Number of Shares |          |         |
|--|------------------|----------|---------|
|  | Voted For        | Withheld |         |
| 1. Four Class I directors were elected by the margins indicated to serve for a term of office to expire at the second succeeding annual meeting of shareholders at which their successors will be elected and qualified:   |                  |          |         |
| Frederick Frank  | 21,719,268       | 285,203  |         |
| Stephen E. Halprin   | 21,668,489       | 335,982  |         |
| Richard S. Schneider, Ph.D.  | 21,666,573       | 337,898  |         |
| Kenneth E. Jones   | 21,718,583       | 285,888  |         |
| The Class II directors were not up for election at the Annual Meeting. The four current Class II directors, Gary T. Steele, Nicholas Tompkins, Duke Bristow, Ph.D. and Robert Tobin will serve as Class II directors until the next Annual Meeting, when their successors will be elected and qualified. |                  |          |         |
|  | Voted            | Voted    |         |
|  | For              | Against  | Abstain |
| 2. To ratify the appointment of Ernst & Young LLP as independent public accountants of the Company for the 2007 fiscal year.   | 21,901,057       | 91,245   | 12,169  |



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**Item 5. Other Information**

None.

**Item 6. Exhibits**

Exhibit

Number Exhibit Title:

31.1+ CEO Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

31.2+ CFO Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

32.1+ CEO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

32.2+ CFO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

+ Filed herewith.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

LANDEC CORPORATION

By: /s/ Gregory S. Skinner  
Gregory S. Skinner  
Vice President, Finance and Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: January 5, 2007

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**Exhibit Index**

| Exhibit<br>Number | Exhibit Title:   |
|-------------------|--|
| 31.1+             | CEO Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2+             | CFO Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1+             | CEO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2+             | CFO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002. |
| +                 | Filed herewith.  |