

CYANOTECH CORP  
Form 10-Q  
November 10, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For Quarterly Period Ended September 30, 2010**

**Or**

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

**For the Transition Period From                      to**

**Commission File Number 0-14602**

**CYANOTECH CORPORATION**

(Exact name of registrant as specified in its charter)

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NEVADA  
(State or other jurisdiction  
of incorporation or organization)

91-1206026  
(IRS Employer  
Identification Number)

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

(Address of principal executive offices)

(808) 326-1353

(Registrant's telephone number)

Not Applicable

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Number of common shares outstanding as of November 10, 2010:

| Title of Class                  | Shares Outstanding |
|---------------------------------|--------------------|
| Common stock - \$0.02 par value | 5,391,968          |



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FORM 10-Q

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## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

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

(Unaudited)

|   | September 30,<br>2010 | March 31,<br>2010 |
|---|-----------------------|-------------------|
| <b>ASSETS</b>   |                       |                   |
| Current assets:   |                       |                   |
| Cash and cash equivalents   | \$ 783                | \$ 817            |
| Accounts receivable, net of allowance for doubtful accounts of \$10 at September 30, 2010 and March 31, 2010  | 2,130                 | 2,064             |
| Inventories, net  | 4,613                 | 3,933             |
| Prepaid expenses and other assets   | 155                   | 400               |
| Total current assets  | 7,681                 | 7,214             |
| Equipment and leasehold improvements, net   | 4,709                 | 4,681             |
| Other assets  | 263                   | 253               |
| Total assets  | \$ 12,653             | \$ 12,148         |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                       |                   |
| Current liabilities:  |                       |                   |
| Current maturities of long-term debt  | \$ 200                | \$ 276            |
| Line of credit  | 150                   | 150               |
| Customer deposits   | 10                    |                   |
| Accounts payable  | 688                   | 1,125             |
| Accrued expenses  | 683                   | 721               |
| Total current liabilities   | 1,731                 | 2,272             |
| Long-term debt, less current maturities   | 656                   | 756               |
| Total liabilities   | 2,387                 | 3,028             |
| Commitments and contingencies   |                       |                   |
| Stockholders' equity:   |                       |                   |
| Common stock of \$0.02 par value, shares authorized 7,500,000; 5,391,968 shares issued and outstanding at September 30, 2010 and 5,252,572 shares at March 31, 2010 | 108                   | 105               |
| Additional paid-in capital  | 27,763                | 27,545            |
| Accumulated deficit   | (17,605)              | (18,530)          |
| Total stockholders' equity  | 10,266                | 9,120             |

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|   |    |        |    |        |
|---|----|--------|----|--------|
| Total liabilities and stockholders equity | \$ | 12,653 | \$ | 12,148 |
|---|----|--------|----|--------|

See accompanying Notes to Condensed Consolidated Financial Statements.

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## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share amounts)

(Unaudited)

|  | Three Months Ended<br>September 30, |          | Six Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|-----------------------------------|----------|
|  | 2010                                | 2009     | 2010                              | 2009     |
| NET SALES  | \$ 3,834                            | \$ 3,925 | \$ 7,690                          | \$ 7,946 |
| COST OF PRODUCT SALES  | 2,182                               | 2,163    | 4,379                             | 4,451    |
| Gross profit   | 1,652                               | 1,762    | 3,311                             | 3,495    |
| <b>OPERATING EXPENSES:</b>                                     |                                     |          |                                   |          |
| General and administrative                                     | 643                                 | 778      | 1,406                             | 1,674    |
| Sales and marketing  | 393                                 | 303      | 776                               | 624      |
| Research and development                                       | 62                                  | 42       | 146                               | 123      |
| Total operating expenses                                       | 1,098                               | 1,123    | 2,328                             | 2,421    |
| Income from operations   | 554                                 | 639      | 983                               | 1,074    |
| <b>OTHER INCOME (EXPENSE):</b>                                 |                                     |          |                                   |          |
| Interest expense, net  | (18)                                | (28)     | (39)                              | (57)     |
| Other income, net  |                                     |          | 1                                 | 17       |
| Total other expense, net                                       | (18)                                | (28)     | (38)                              | (40)     |
| Income before provision for income taxes                       | 536                                 | 611      | 945                               | 1,034    |
| PROVISION FOR INCOME TAXES                                     | 10                                  | 12       | 20                                | 22       |
| NET INCOME   | \$ 526                              | \$ 599   | \$ 925                            | \$ 1,012 |
| <b>NET INCOME PER SHARE:</b>                                   |                                     |          |                                   |          |
| Basic  | \$ .10                              | \$ .11   | \$ .17                            | \$ .19   |
| Diluted  | \$ .10                              | \$ .11   | \$ .17                            | \$ .19   |
| <b>SHARES USED IN CALCULATION OF NET<br/>INCOME PER SHARE:</b> |                                     |          |                                   |          |
| Basic  | 5,374                               | 5,247    | 5,314                             | 5,246    |
| Diluted  | 5,390                               | 5,308    | 5,333                             | 5,300    |

See accompanying Notes to Condensed Consolidated Financial Statements.

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## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)  
(Unaudited)

|   | 2010 | Six Months Ended<br>September 30, | 2009     |
|---|------|-----------------------------------|----------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |      |                                   |          |
| Net income  | \$   | 925                               | \$ 1,012 |
| Adjustments to reconcile net income to net cash provided by operating activities: |      |                                   |          |
| Depreciation and amortization   |      | 279                               | 242      |
| Amortization of debt issue costs and other assets                                 |      | 14                                | 29       |
| Issuance of common stock for services   |      | 21                                | 10       |
| Stock based compensation expense  |      | 15                                | 138      |
| Net (increase) decrease in assets:  |      |                                   |          |
| Accounts receivable   |      | (66)                              | (45)     |
| Inventories   |      | (680)                             | (397)    |
| Prepaid expenses and other assets   |      | (30)                              | (93)     |
| Net increase (decrease) in liabilities:   |      |                                   |          |
| Customer deposits   |      | 10                                | 2        |
| Accounts payable  |      | (436)                             | (269)    |
| Accrued expenses  |      | (38)                              | 309      |
| Net cash provided by operating activities   |      | 14                                | 938      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |      |                                   |          |
| Investment in equipment and leasehold improvements                                |      | (307)                             | (509)    |
| Proceeds from return of restricted cash   |      | 250                               |          |
| Net cash used in investing activities   |      | (57)                              | (509)    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |      |                                   |          |
| Principal payments on long-term debt  |      | (176)                             | (306)    |
| Stock options exercised   |      | 185                               |          |
| Net cash provided by (used in) financing activities                               |      | 9                                 | (306)    |
| Net (decrease) increase in cash and cash equivalents                              |      | (34)                              | 123      |
| Cash and cash equivalents at beginning of period                                  |      | 817                               | 977      |
| Cash and cash equivalents at end of period  | \$   | 783                               | \$ 1,100 |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>                          |      |                                   |          |
| Cash paid during the period for:  |      |                                   |          |
| Interest  | \$   | 25                                | \$ 35    |
| Income taxes  | \$   | 12                                | \$ 30    |

See accompanying Notes to Condensed Consolidated Financial Statements.





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## CYANOTECH CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As of September 30, 2010  
(Unaudited)

**1. BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The condensed consolidated balance sheet as of March 31, 2010 was derived from the audited financial statements. These consolidated condensed financial statements and notes should be read in conjunction with the Company's consolidated financial statements for the year ended March 31, 2010, contained in the Company's report on Form 10-K as filed on June 24, 2010.

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

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

**2. INVENTORIES**

Inventories are stated at the lower of cost (which approximates first-in, first-out) or market. Market is defined as sales price less cost to dispose and a normal profit margin. Inventories consist of the following:

|                   | September 30, 2010 |       | March 31, 2010 |       |
|-------------------|--------------------|-------|----------------|-------|
|                   | (in thousands)     |       |                |       |
| Raw materials     | \$                 | 389   | \$             | 392   |
| Work in process   |                    | 291   |                | 303   |
| Finished goods(1) |                    | 3,780 |                | 3,062 |
| Supplies          |                    | 153   |                | 176   |
|                   | \$                 | 4,613 | \$             | 3,933 |

(1) Net of reserve for obsolescence of \$85,000 at September 30, 2010 and \$54,000 at March 31, 2010.

The Company recognizes abnormal production costs including fixed cost variances from normal production capacity as an expense in the period incurred. No fixed production related costs were charged to cost of sales for the three and six months ended September 30, 2010 and 2009, respectively.

**3. EQUIPMENT AND LEASEHOLD IMPROVEMENTS**

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

|                        |                |
|------------------------|----------------|
| Equipment              | 3 to 10 years  |
| Furniture and fixtures | 7 years        |
| Leasehold improvements | 10 to 20 years |

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Equipment and leasehold improvements consist of the following:

|  | September 30, 2010 |         | March 31, 2010 |
|--|--------------------|---------|----------------|
|  | (in thousands)     |         |                |
| Equipment(1)                                   | \$                 | 6,634   | \$ 6,350       |
| Leasehold improvements                         |                    | 7,386   | 7,298          |
| Furniture and fixtures                         |                    | 83      | 88             |
|  |                    | 14,103  | 13,736         |
| Less accumulated depreciation and amortization |                    | (9,522) | (9,243)        |
| Construction-in-progress                       |                    | 128     | 188            |
| Equipment and leasehold improvements, net      | \$                 | 4,709   | \$ 4,681       |

(1) Includes \$97,000 of equipment under capital lease with accumulated depreciation of \$10,000 and \$0 at September 30, 2010 and March 31, 2010, respectively. (See note 6)

Management reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amount to forecasted undiscounted future cash flows expected to be generated by the asset. If the carrying amount exceeds its estimated future cash flows, then an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Management has determined no asset impairment existed as of September 30, 2010.

#### 4. ACCRUED EXPENSES

Accrued expenses consist of the following:

|                                  | September 30, 2010 |     | March 31, 2010 |
|----------------------------------|--------------------|-----|----------------|
|                                  | (in thousands)     |     |                |
| Wages, commissions and royalties | \$                 | 335 | \$ 334         |
| Customer rebates                 |                    | 115 |                |
| Bonuses                          |                    | 61  | 140            |
| Other accrued expenses           |                    | 172 | 247            |
|                                  | \$                 | 683 | \$ 721         |

#### 5. LINE OF CREDIT

The Company has a line of credit agreement with First Hawaiian Bank in the amount of \$350,000 for a term of one year. The amount of the line was increased from \$150,000 on March 25, 2010, the date that the line of credit agreement was renewed. The obligation is secured by the Company's U.S. accounts receivable and bears a variable interest rate based on prime (3.25% at September 30, 2010) plus 2%. The outstanding balance as of September 30, 2010 and March 31, 2010 was \$150,000. The credit agreement requires the Company to meet certain financial

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covenants. The Company was in compliance with these financial covenants at September 30, 2010. The line of credit balance of \$150,000 was paid in full on October 7, 2010.

### 6. LONG-TERM DEBT

Long-term debt consists of the following:

|  | September 31, 2010 |       | March 31, 2010 |       |
|--|--------------------|-------|----------------|-------|
|  | (in thousands)     |       |                |       |
| Term loans                                   | \$                 | 856   | \$             | 1,032 |
| Less current maturities                      |                    | (200) |                | (276) |
| Long-term debt, excluding current maturities | \$                 | 656   | \$             | 756   |

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*Term Loan Agreement*

In April 2000, the Company executed a Term Loan Agreement ( Term Loan A ) with a lender providing for \$3.5 million in aggregate credit facilities, secured by the Company s assets. Term Loan A had a maturity date of May 1, 2010. The balance under this loan was \$0 and \$80,000 at September 30, 2010 and March 31, 2010, respectively. A warrant to purchase 5,000 shares of the Company s common stock was issued in conjunction with this Term Loan. The warrant expires in April 2011 and has an exercise price of \$10.20 per share. The warrant may only be exercised after the Company has repaid the Term Loan in full. A \$250,000 restricted cash deposit was held to secure these loans and was released to the Company in May 2010 upon maturity of Term Loan A. The \$250,000 restricted cash deposit is included in other current assets in the accompanying consolidated condensed balance sheet at March 31, 2010.

In February 2008, the Company executed a Term Loan Agreement ( Term Loan B ) with the same lender providing for \$1.1 million in aggregate credit facilities, secured by the Company s assets. Term Loan B has a maturity date of March 1, 2015 and is payable in 84 equal monthly principal payments plus interest. The interest rate under Term Loan B, in the absence of a default under the agreement, is the prime rate in effect as of the close of business on the first day of each calendar quarter, plus 1%. As of September 30, 2010, the prime rate was 3.25%. The balance under this loan was \$735,000 and \$808,000 at September 30, 2010 and March 31, 2010, respectively. The Company is prohibited from declaring any common stock dividends without the lender s prior written consent. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at September 30, 2010.

In March 2009, the Company executed a Term Loan Agreement with John Deere credit providing for \$29,340 in equipment, secured by the equipment financed. The Term Loan has a maturity date of March 25, 2013 and is payable in 48 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$18,000, less the unamortized discount of \$1,000 at September 30, 2010 and \$22,000, less the unamortized discount of \$2,000 at March 31, 2010.

In January 2010, the Company executed a Term Loan Agreement with John Deere credit providing for \$27,217 in equipment, secured by the equipment financed. The Term Loan has a maturity date of December 28, 2012 and is payable in 36 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$22,000, less the unamortized discount of \$1,000 at September 30, 2010 and \$27,000, less the unamortized discount of \$2,000 at March 31, 2010.

In March 2010, the Company executed a capital lease agreement with Thermo Fisher Financial providing for \$97,000 in equipment, secured by the equipment financed. The capital lease has a maturity date of March 2013 and is payable in 36 equal monthly payments. The interest rate under this capital lease is 6.6%. The balance under this lease was \$82,000 at September 30, 2010 and \$97,000 at March 31, 2010.

Future principal payments under the term loan agreements as of September 30, 2010 are as follows:

| <b>Payments Due</b> | <b>(in thousands)</b> |     |
|---------------------|-----------------------|-----|
| Next 12 Months      | \$                    | 200 |

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|                          |    |     |
|--------------------------|----|-----|
| Year 2                   |    | 208 |
| Year 3                   |    | 188 |
| Year 4                   |    | 172 |
| Year 5                   |    | 88  |
| Thereafter through 2015  |    |     |
| Total principal payments | \$ | 856 |

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The Company leases facilities, equipment and land under operating leases expiring between 2010 and 2026. The land lease provides for contingent rental in excess of minimum rental commitments based on a percentage of the Company's sales. Management has accrued for the estimated contingent rent as of September 30, 2010.

Future minimum lease payments under all non-cancelable operation leases at September 30, 2010 are as follows:

| <b>Payments Due</b>          | <b>(in thousands)</b> |       |
|------------------------------|-----------------------|-------|
| Next 12 Months               | \$                    | 162   |
| Year 2                       |                       | 157   |
| Year 3                       |                       | 157   |
| Year 4                       |                       | 157   |
| Year 5                       |                       | 152   |
| Thereafter through 2026      |                       | 1,517 |
| Total minimum lease payments | \$                    | 2,302 |

**8. SHARE-BASED COMPENSATION**

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

***Stock Options***

As of September 30, 2010, the Company had the following two shareholder approved stock plans under which shares were available for equity based awards: The 2005 Stock Option Plan (the 2005 Plan) wherein 700,000 shares of common stock are reserved for issuance until the Plan terminates on August 21, 2015, and; The Independent Director Stock Option and Stock Grant Plan (the 2004 Directors Plan) wherein 75,000 shares of common stock are reserved for issuance until the plan terminates in 2014.



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Under the 2005 Plan, eligible employees and certain independent consultants may be granted options to purchase shares of the Company's common stock. The shares issuable under the 2005 Plan will either be shares of the Company's authorized but previously unissued common stock or shares reacquired by the Company, including shares purchased on the open market. As of September 30, 2010, 371,204 options remain available for grant under the 2005 Plan.

Under the 2004 Directors Plan, upon election to the Board of Directors, a newly elected non-employee director is granted a ten-year option to purchase 1,000 shares of the Company's common stock. Options granted vest and become exercisable six months from the date of grant. In addition, on the date of each Annual Meeting of Stockholders, each non-employee director continuing in office is automatically issued 875 shares of common stock, non-transferable for nine months following the date of grant. The 2004 Directors Plan was amended effective March 24, 2010, to increase the number of shares of common stock issued to each non-employee director to 2,000 shares and an additional 2,000 shares to the director serving as Chairman of the Board. As of September 30, 2010, 39,123 options remain available for grant under the 2004 Directors Plan.

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

|                     | Authorized     | As of September 30, 2010<br>Available | Outstanding    |
|---------------------|----------------|---------------------------------------|----------------|
| 2005 Plan           | 700,000        | 371,204                               | 197,350        |
| 2004 Directors Plan | 75,000         | 39,123                                | 1,000          |
| 1994 Plan           |                |                                       | 2,250          |
| <b>Total</b>        | <b>775,000</b> | <b>410,327</b>                        | <b>200,600</b> |

All stock option grants made under the 2005 Plan and the 2004 Directors Plan were at exercise prices no less than the Company's closing stock price on the date of grant. Options under the 2005 Plan and 2004 Directors Plan were determined by the Board of Directors or the Stock Option and Compensation Committee of the Board in accordance with the provisions of the respective plans. The terms of each option grant include vesting, exercise, and other conditions are set forth in a Stock Option Agreement evidencing each grant. No option can have a life in excess of ten (10) years. The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model requires various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options, and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term. Compensation expense recognized for options issued under the 2005 Plan was \$7,000 and \$15,000 for the three and six months ended September 30, 2010, respectively. Compensation expense recognized for options issued under the 2005 Plan was \$61,000 and \$138,000 for the three and six months ended September 30, 2009, respectively. Independent Director compensation expense of \$21,000 and \$9,000 was recognized under the 2004 Directors Plan for the three and six months ended September 30, 2010 and 2009, respectively. All stock-based compensation has been classified as General and Administrative expense.

A summary of option activity under the Company's stock plans for the six months ended September 30, 2010 is presented below:

| Option Activity                   | Shares    | Weighted Average<br>Exercise Price | Weighted Average<br>Remaining<br>Contractual Term | Aggregate<br>Intrinsic<br>Value |
|-----------------------------------|-----------|------------------------------------|---|---------------------------------|
| Outstanding at March 31, 2010     | 333,606   | \$ 1.69                            | 8.4 years   | \$ 555,281                      |
| Granted                           |           |                                    |   |                                 |
| Exercised                         | (131,396) | \$ 1.41                            |   |                                 |
| Forfeited or expired              | (1,610)   | \$ 1.87                            |   |                                 |
| Outstanding at September 30, 2010 | 200,600   | \$ 1.86                            | 8.2 years   | \$ 109,536                      |
| Exercisable at September 30, 2010 | 30,955    | \$ 1.93                            | 4.5 years   | \$ 14,964                       |

The aggregate intrinsic value in the table above is before applicable income taxes and represents the amount optionees would have received if all options had been exercised on the last business day of the period indicated, based on the Company's closing stock price of \$2.41 for such day.

A summary of the Company's non-vested options for the six months ended September 30, 2010 is presented below:

| Nonvested Options | Shares |
|-------------------|--------|
|-------------------|--------|

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|                                 |          |    | <b>Weighted<br/>Average<br/>Grant-Date<br/>Fair Value</b> |
|---------------------------------|----------|----|---|
| Nonvested at March 31, 2010     | 181,955  | \$ | .62   |
| Granted                         |          |    |   |
| Vested                          | (10,850) |    | .65   |
| Forfeited or expired            | (1,460)  |    | 1.90  |
| Nonvested at September 30, 2010 | 169,645  | \$ | .62   |

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The following table summarizes the weighted average characteristics of outstanding stock options as of September 30, 2010:

| Range of Exercise Prices | Number of Shares | Outstanding Options    |                        | Exercisable Options |                        |
|--------------------------|------------------|------------------------|------------------------|---------------------|------------------------|
|                          |                  | Remaining Life (Years) | Weighted Average Price | Number of Shares    | Weighted Average Price |
| \$ 1.41 - \$2.60         | 198,850          | 8.2                    | \$ 1.84                | 29,205              | \$ 1.78                |
| \$ 4.20 - \$4.40         | 1,750            | 2.6                    | 4.31                   | 1,750               | 4.31                   |
| Total stock options      | 200,600          | 8.2                    | \$ 1.86                | 30,955              | \$ 1.93                |

There were no stock options granted during the three and six months ended September 30, 2010. There were 113,000 stock options granted during the six months ended September 30, 2009. The fair value assumptions related to options granted during the six months ended September 30 were as follows:

|                  | 2009       |
|------------------|------------|
| Exercise Price:  | \$ 2.08    |
| Volatility:      | 88.9%      |
| Risk Free Rate:  | 3.13%      |
| Vesting Period:  | 4 years    |
| Forfeiture Rate: | 20%        |
| Expected Life    | 6.25 years |
| Dividend Rate    | 0%         |

As of September 30 2010, total unrecognized stock-based compensation expense related to all unvested stock options was \$72,506, which is expected to be expensed over a weighted average period of 2.2 years.

### **Warrant**

At September 30, 2010 and 2009, the Company had a single warrant outstanding which allows the warrant holder rights to acquire 5,000 shares of the Company's common stock. The warrant was valued at the date of grant and was amortized as premium, but was subsequently deemed to have no value as a result of a reverse split which occurred in a prior year. Accordingly, no expense was recognized in the three and six months ended September 30, 2010 or 2009. The warrant expires in April 2011 and has an exercise price of \$10.20 per share.

## **9. INCOME TAXES**

The Company is subject to taxation in the United States and two state jurisdictions. The preparation of tax returns requires management to interpret the applicable tax laws and regulations in effect in such jurisdictions, which could affect the amount of tax paid by the Company. Management, in consultation with its tax advisors, files its tax returns on interpretations that are believed to be reasonable under the circumstances. The income tax returns, however, are subject to routine reviews by the various taxing authorities in the jurisdictions in which the Company files its returns. As part of these reviews, a taxing authority may disagree with respect to the tax positions taken by management (uncertain tax positions) and therefore may require the Company to pay additional taxes. Management evaluates the requirement for additional

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tax accruals, including interest and penalties, which the Company could incur as a result of the ultimate resolution of its uncertain tax positions. Management reviews and updates the accrual for uncertain tax positions as more definitive information becomes available from taxing authorities, completion of tax audits, expiration of statute of limitations, or upon occurrence of other events.

As of September 30, 2010, there was no significant liability for income tax associated with unrecognized tax benefits. The Company recognizes accrued interest related to unrecognized tax benefits as well as any related penalties in interest income or expense in its consolidated condensed statements of operations, which is consistent with the recognition of these items in prior reporting periods.

Income taxes are provided on the earnings in the consolidated financial statements. The provision is based on the current quarter activity of the legal entities and jurisdictions in which the Company operates. Tax credits, such as Hawaii capital goods excise tax credits, are recognized as a reduction to income taxes in the year the credits are earned. Accordingly, the effective tax rate may vary from the customary relationship between income tax expense (benefit) and pre-tax income. The effective tax rate for the three months ended September 30, 2010 differs from the statutory rate due to utilization of net operating loss carryforwards that have been fully reserved due to the Company's inconsistent taxable income in recent years and uncertainty about taxable income in future years.

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With few exceptions, the Company is no longer subject to U.S. federal, state and local, and non-U.S. income tax examination by tax authorities for tax years before 2002.

**10. EARNINGS PER SHARE**

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the potentially dilutive effect of outstanding stock options and warrants using the treasury stock method and convertible securities using the if-converted method.

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the three months ended September 30, 2010 and September 30, 2009 are as follows:

|  | Three Months Ended September 30, 2010 |                         |                     |
|--|---------------------------------------|-------------------------|---------------------|
|  | Net Income<br>(Numerator)             | Shares<br>(Denominator) | Per Share<br>Amount |
|  | (in thousands)                        |                         |                     |
| Basic income per share                               | \$ 526                                | 5,374                   | \$ 0.10             |
| Effect of dilutive securities - Common stock options |                                       | 16                      |                     |
| Diluted income per share                             | \$ 526                                | 5,390                   | \$ 0.10             |

|  | Three Months Ended September 30, 2009 |                         |                     |
|--|---------------------------------------|-------------------------|---------------------|
|  | Net Income<br>(Numerator)             | Shares<br>(Denominator) | Per Share<br>Amount |
|  | (in thousands)                        |                         |                     |
| Basic income per share                               | \$ 599                                | 5,247                   | \$ 0.11             |
| Effect of dilutive securities - Common stock options |                                       | 61                      |                     |
| Diluted income per share                             | \$ 599                                | 5,308                   | \$ 0.11             |

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the six months ended September 30, 2010 and September 30, 2009 are as follows:

|  | Six Months Ended September 30, 2010 |                         |                     |
|--|-------------------------------------|-------------------------|---------------------|
|  | Net Income<br>(Numerator)           | Shares<br>(Denominator) | Per Share<br>Amount |
|  | (in thousands)                      |                         |                     |
| Basic income per share                               | \$ 925                              | 5,314                   | \$ 0.17             |
| Effect of dilutive securities - Common stock options |                                     | 19                      |                     |
| Diluted income per share                             | \$ 925                              | 5,333                   | \$ 0.17             |

|  | Six Months Ended September 30, 2009 |                         |                     |
|--|-------------------------------------|-------------------------|---------------------|
|  | Net Income<br>(Numerator)           | Shares<br>(Denominator) | Per Share<br>Amount |

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| (in thousands)                |                      |    |       |       |         |
|-------------------------------|----------------------|----|-------|-------|---------|
| Basic income per share        |                      | \$ | 1,012 | 5,246 | \$ 0.19 |
| Effect of dilutive securities | Common stock options |    |       | 54    |         |
| Diluted income per share      |                      | \$ | 1,012 | 5,300 | \$ 0.19 |

Diluted earnings per share does not include the impact of common stock options totaling 114,750 and 382,362 for the three months ended September 30, 2010 and 2009, respectively, and 114,917 and 474,221 for the six months ended September 30, 2010 and 2009, respectively, as the effect of their inclusion would be anti-dilutive.

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**11. NEW ACCOUNTING PRONOUNCEMENTS**

In January 2010, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2010-06, Improving Disclosures about Fair Value Measurements, an amendment to Accounting Standards Codification ( ASC ) 820, Fair Value Measurements and Disclosures. The standard requires disclosure for transfers in and out of Level 1 and Level 2, as well as the disclosure of Level 3 activity on a gross, rather than net, basis. The guidance also requires enhancements to certain existing disclosures. The amendments are effective as of the beginning of our fiscal year 2011, or April 1, 2010, except for the new requirements regarding Level 3 activity, which is deferred until the beginning of fiscal year 2012. The guidance is not expected to have an impact on the Company's consolidated financial statements.



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

**FORWARD LOOKING STATEMENTS**

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

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

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

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

- The added risks associated with the current local, national and world economic crisis, including but not limited to, the volatility of crude oil prices and currency fluctuations;
- The effects of competition, including locations of competitors and operating and market competition;

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- Demand for the company's products, the quantities and qualities thereof available for sale and levels of customer satisfaction;
- Changes in domestic and/or foreign laws, regulations or standards, affecting nutraceutical products or the Company's methods of operation;
- Environmental restrictions, soil and water conditions, variations in daylight hours and seasonal weather patterns, particularly heavy rain, wind and other hazards;
- Access to available and reasonable financing on a timely basis;
- Changes in laws, including new corporate governance requirements and increased tax rates, regulations or accounting standards, and decisions of courts, regulators and governmental bodies;
- Our dependence on the experience and competence of our executive officers and other key employees;
- The risk associated with the geographic concentration of the company's business;
- Acts of war, terrorist incidents or natural disasters; and
- Other risks or uncertainties described elsewhere in this Report and in other periodic reports previously and subsequently filed by the Company with the Securities and Exchange Commission.

Table of Contents**Overview**

Comparisons of selected consolidated statements of operations data as reported herein follow for the periods indicated (dollars in thousands):

|                              | Three Months Ended |                    | Change |
|------------------------------|--------------------|--------------------|--------|
|                              | September 30, 2010 | September 30, 2009 |        |
| Net sales:                   |                    |                    |        |
| Spirulina products           | \$ 1,868           | \$ 1,958           | (5)%   |
| Natural astaxanthin products | 1,965              | 1,956              | 0%     |
| Other products               | 1                  | 11                 | (91)%  |
| Total sales, all products    | \$ 3,834           | \$ 3,925           | (2)%   |
| Gross profit                 | \$ 1,652           | \$ 1,762           | (6)%   |
| Income from operations       | \$ 554             | \$ 639             | (13)%  |
| Net income                   | \$ 526             | \$ 599             | (12)%  |

|                              | Six Months Ended   |                    | Change |
|------------------------------|--------------------|--------------------|--------|
|                              | September 30, 2010 | September 30, 2009 |        |
| Net sales:                   |                    |                    |        |
| Spirulina products           | \$ 3,821           | \$ 3,876           | (1)%   |
| Natural astaxanthin products | 3,865              | 4,057              | (5)%   |
| Other products               | 4                  | 13                 | (69)%  |
| Total sales, all products    | \$ 7,690           | \$ 7,946           | (3)%   |
| Gross profit                 | \$ 3,311           | \$ 3,495           | (5)%   |
| Income from operations       | \$ 983             | \$ 1,074           | (8)%   |
| Net income                   | \$ 925             | \$ 1,012           | (9)%   |

**Results of Operations***Second Quarter of Fiscal 2011 Compared to Second Quarter of Fiscal 2010*

Net sales for the second quarter of fiscal 2011 were \$3,834,000, a 2% decrease from the \$3,925,000 reported for the comparable period a year ago. Spirulina sales decreased overall in the current quarter compared to last year due to a decrease in bulk product sales offset by increases in packaged product sales. As a percentage of sales, Spirulina accounted for 49% of total sales in the second quarter of fiscal 2011, compared to 50% for the comparable period a year ago.

Natural astaxanthin product sales increased slightly over the second quarter of the prior year due to an increase in bulk product sales offset by a decrease in packaged product sales. Packaged astaxanthin sales decreased primarily due to reduced sales to foreign private label customers as compare to prior year. Natural astaxanthin product sales increased to 51% of total sales from 50% of total sales in the second quarter of fiscal 2010.

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International sales were 41% of total sales for the second quarter of fiscal year 2011 and 37% in the second quarter of 2010. The increase in international sales as a percentage of total sales is due to an increase of \$118,000 in international sales, offset by a decrease of \$ 207,000 in domestic sales from the same period in the prior year. Major customers are those equaling or exceeding 10% of our sales for the period. For the second quarter of fiscal 2011 there were no customers who had sales equal to or greater than 10% of our total sales for the quarter. For the second quarter of fiscal 2010, one customer had sales equal to or greater than 10% of our total sales for the quarter.

Gross profit, derived from net sales less the cost of product sales, includes the cost of materials, direct labor, manufacturing overhead and depreciation. Gross profit for the three months ended September 30, 2010 and 2009 was \$1,652,000 and \$1,762,000, respectively. The decrease of \$110,000 is the direct result of reduced sales, lower production and increase in the inventory reserve. Gross profit margin, as a percentage of sales, was 43% for the three months ended September 30, 2010, compared to 45% for the comparable period in the prior year.

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Variable production costs decreased by 7% in the current period compared to one year ago. Increases in supplies and repair and maintenance costs were offset by decreases in nutrients and packaging expenses. Fixed costs have increased approximately 2% primarily due to depreciation expense associated with additions to production equipment. Spirulina production decreased 14% and astaxanthin production decreased 16% over the same quarter one year ago reflecting planned production yields. Total variable and fixed costs spread over decreased production units raised the individual unit production costs over the same period last year

Operating expenses were \$1,098,000 in the three months ended September 30, 2010 compared to \$1,123,000 in the quarter ended September 30, 2009, a decrease of \$25,000. As a percentage of sales, operating expenses were 29% in the quarters ended September 30, 2010 and 2009.

The decrease in operating expenses in the three months ended September 30, 2010 as compared with the three months ended September 30, 2009, was primarily the result of reduced general and administrative expense offset by increases in both sales and marketing expense and research and development expense. General and administrative expense for the second quarter 2011 decreased by \$135,000, down 17% from the second quarter of 2010. The decrease is primarily the result of reduced bonus, stock option and other compensation expenses associated with not having a permanent CEO. Sales and marketing expense for the second quarter of 2011 increased by \$90,000 or 30% over the second quarter of 2010. The increase is due primarily to the initiation of broker training and new marketing programs for packaged products. Research and development expense for the second quarter of 2011 increased by \$20,000, up 48% from the second quarter of 2010. The increase is due primarily to increased employee compensation and lab supplies.

We recorded an income tax expense of \$10,000 related to federal and state alternative minimum tax for the three months ended September 30, 2010 compared to \$12,000 for the three months ended September 30, 2009. We do not expect any material U.S. federal or state income taxes to be recorded for the current fiscal year because of available net operating loss carry-forwards.

In summary, we reported net income of \$526,000 or \$0.10 per diluted share for the three months ended September 30, 2010 compared to net income of \$599,000 or \$0.11 per diluted share for the three months ended September 30, 2009. The decrease is the result of reduced sales, reduced gross profit margin percentage and increase in our inventory reserve.

*Six Months Ended September 30, 2010 Compared to Six Months Ended September 30, 2009*

Net sales for the six months ended September 30, 2010 were \$7,690,000, a decrease of 3% from sales of \$7,946,000 reported for the comparable period a year ago. The decrease in sales over the prior year's six-month period was the result of decreased sales of both spirulina, (1% decrease) and natural astaxanthin products (5% decrease). Spirulina bulk sales decreased 6% while packaged spirulina products increased 5%. Astaxanthin bulk sales decreased 1% while packaged astaxanthin product sales decreased 14%, primarily the result of reduced private label sales.

International sales represented 44% of net sales for the six months ended September 30, 2010 compared to 43% for the same period a year ago. For the six months ended September 30, 2010 and September 30, 2009, one customer had sales equal to or greater than 10% of our total sales.

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Gross profit for the six months ended September 30, 2010 and September 30, 2009 was \$3,311,000 and \$3,495,000 respectively. The decrease of \$184,000 is the direct result of reduced sales, reduced profit margin and increase in the inventory reserve.

For the six months ended September 30, 2010, variable production costs decreased 6%. Increases in supplies and utilities costs were offset by decreases in nutrients, packaging and repairs and maintenance expenses. For the six months ended September 30, 2010, fixed cost overhead increased 1% primarily due to depreciation expense associated with additions to production equipment. Spirulina and astaxanthin production remained consistent over the same six month period one year ago.

Operating expenses for the six months ended September 30, 2010 were \$2,328,000, a decrease of \$93,000 or 4% from the comparable prior year period. General and administrative expense decreased \$268,000 or 16%. The decrease is primarily the result of reduced bonus, stock option and other compensation expenses associated with not having a permanent CEO. Sales and marketing expense increased by \$152,000 or 24% as a result of the initiation of broker training and new marketing programs for packaged products to expand consumer awareness. Research and development expense increased \$23,000 or 19% from the comparable prior period, primarily due to increased employee compensation and lab supplies. While it is our goal to contain discretionary operating spending, it may become necessary for us to selectively increase spending in some or all of these areas to remain competitive and to comply with regulatory requirements.

For the six months ended September 30, 2010, we recorded income tax expense of \$20,000 related to Federal and state alternative minimum tax, compared to \$22,000 for the six months ended September 30, 2009. We do not expect any material United States income taxes for the current fiscal year as a result of available net operating loss carry-forwards.

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We recorded net income of \$925,000 or \$0.17 per diluted share for the six month period ended September 30, 2010. For the same period a year ago we reported net income of \$1,012,000 or \$0.19 per diluted share.

**Variability of Results**

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

**Financial Condition**

Cash and cash equivalents remained fairly consistent with levels at March 31, 2010 decreasing \$34,000, or 4%, to \$783,000 at September 30, 2010. Cash provided by operating activities of \$14,000 decreased \$924,000 from the same six month period of last fiscal year. The decrease is due to the decrease in net income of \$87,000, plus the decrease of non-cash expenses of \$90,000 and the net changes in current assets and liabilities using cash of \$747,000 over the same six month period of last fiscal year. The net change in current assets and liabilities was largely due to increased inventory and reduced payables and accrued expenses. Net cash used in investing activities decreased by \$452,000 over the same six month period of last fiscal year mainly due to the return of restricted cash in the amount of \$250,000 and \$202,000 decrease in investment in capital projects.

As of September 30, 2010, our accounts receivable, net increased \$66,000 to \$2,130,000 from \$2,064,000 as of March 31, 2010. The increase in accounts receivable is primarily the result of some extended payment terms on sales for the quarter. Management believes that its accounts receivable are collectible, net of the allowance for doubtful accounts of \$10,000, at September 30, 2010.

Our net inventory increased \$680,000 or 17% to \$4,613,000 as of September 30, 2010 compared to \$3,933,000 as of March 31, 2010. The increase in inventory during the first six months of fiscal 2011 is primarily due to increased production as the hours of daylight increase in the summer months and slightly reduced sales.

Cash flows used in investing activities reflect capital expenditures which totaled \$307,000 during the first six months of fiscal 2011 compared to \$509,000 one year ago. Cash flows used in financing activities are attributable to debt payments during that period which were \$176,000 and \$306,000 for the first six months of fiscal 2011 and 2010, respectively.

**Liquidity and Capital Resources**

At September 30, 2010, our working capital was \$5,950,000, an increase of \$1,008,000 compared to \$4,942,000 at March 31, 2010. The increase in working capital is primarily due to the increase in inventory and reduction of liabilities. Cash and cash equivalents at September 30, 2010 totaled \$783,000, a decrease of \$34,000 from \$817,000 at March 31, 2010.

We had two Term Loan Agreements ( Term Loans ) with a lender. These provided up to \$4.6 million in combined credit facilities which are secured by substantially all the assets of the Company. One of the Term Loans was paid in full on its maturity date of May 1, 2010. The outstanding balance under the remaining Term Loan as of September 30, 2010 is approximately \$735,000 with a maturity date of March 1, 2015 and is payable in equal monthly principal payments plus interest totaling approximately \$15,000. The interest rate under the Term Loan, in absence of a default under the agreement, is the prime rate, as defined, in effect as of the close of business on the first day of each calendar quarter, plus 1% (the prime rate was 3.25% at September 30, 2010). We are prohibited by the Term Loan from declaring any cash dividends without the lender s prior written consent.



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We have a line of credit agreement with First Hawaiian Bank in the amount of \$350,000 for a term of one year. The amount of the line was increased from \$150,000 on March 25, 2010, the date that the line of credit agreement was renewed. The obligation is secured by the Company's U.S. accounts receivable and bears a variable interest rate based on prime, (3.25% at September 30, 2010), plus 2%. The outstanding balance as of September 30, 2010 and March 31, 2010 was \$150,000, respectively. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at September 30, 2010. The line of credit balance of \$150,000 was paid in full on October 7, 2010.

We have, as previously reported, experienced a number of factors that have negatively impacted our balance sheet and liquidity. At September 30, 2010, we had an accumulated deficit of \$17,605,000 compared to an accumulated deficit of \$18,530,000 at March 31, 2010. The accumulated deficit decreased by \$925,000 for the six months ended September 30, 2010.

***Sufficiency of Liquidity***

Based upon our current operating plan, analysis of our consolidated financial position and projected future results of operations, we believe that our operating cash flows, cash balances, and working capital, together with a moderate amount of additional borrowing, will be sufficient to finance current operating requirements, debt service requirements, and planned capital expenditures, for the next twelve (12) months. We expect liquidity in the remainder of fiscal 2011 to be generated from operating cash flows.

**Capital Resources**

We expect fiscal 2011 capital expenditures to be approximately \$900,000 and to be funded from operating cash flows. This includes capital expenditures in support of our normal operations, and expenditures that we may incur in conjunction with initiatives to improve gross margins and reduce expenses.

**Outlook**

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

Our strategic direction has been to position the Company as a world leader in the production and marketing of high-value natural products from microalgae. We are vertically aligned, producing raw materials in the form of microalgae processed at our 90-acre facility in Hawaii, and integrating those raw materials into finished products. In fiscal 2011, we are putting increased emphasis on our Nutrex Hawaii consumer products to introduce them to a broader consumer market than in prior years. Our focus going forward will continue to be to leverage our experience and reputation for quality, building nutritional brands which promote health and well-being. The foundation of our nutritional products is naturally cultivated Spirulina Pacifica® in powder, flake and tablet form; and BioAstin® natural astaxanthin antioxidant in extract, softgel caplet and micro-encapsulated beadlet form. Information about our Company and our products can be viewed at [www.cyanotech.com](http://www.cyanotech.com) and [www.nutrex-hawaii.com](http://www.nutrex-hawaii.com). Consumer products can also be purchased online at [www.nutrex-hawaii.com](http://www.nutrex-hawaii.com).

We are focused on sustainability of its production levels in order to promote growth in its astaxanthin product line. In fiscal year 2010 we expanded our BioAstin based MD Formulas Hawaii line in order to provide all vegetarian condition specific alternatives to consumers. Our introduction of Spirulina Pacifica Multivitamins in fiscal year 2010, is expected to allow spirulina sales to increase even though spirulina has reached a mature life cycle stage. We will continue to promote the nutritional superiority of Hawaiian grown spirulina to maintain and expand market share. Significant sales variability between periods and even across several periods can be expected based on historical results.

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

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

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

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

Our future results of operations and the other forward-looking statements contained in this Outlook, in particular the statements regarding revenues, gross margin and capital spending, involve a number of risks and uncertainties. In addition to the factors discussed above, any of the following could cause actual results to differ materially: business conditions and growth in the natural products industry and in the general economy; changes in customer order patterns; changes in demand for natural products in general; changes in weather conditions; competitive factors, such as increased production capacity from competing spirulina and astaxanthin producers and the resulting impact, if any, on world market prices for these products; government actions and increased regulations both domestic and foreign; shortage of manufacturing capacity; and other factors beyond our control. Risk factors are discussed in detail in Item 1A in our Form 10-K report for the year ended March 31, 2010.

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

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

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

We have one term loan which adjusts quarterly based on the prime rate, and one revolving line of credit which adjust upon change of the prime rate. As such, we are exposed to the interest rate risk whereby a 1% increase in the prime rate would lead to an increase of approximately \$9,000 in interest expense for the year ending March 31, 2011 (based on September 30, 2010 amounts outstanding).

**Item 4. Controls and Procedures**

(a) **Disclosure Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15 (d)-15(e) under the Exchange Act that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Security and Exchange Commission's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure.

This Form 10-Q should be read in conjunction with Item 9A Controls and Procedures of the Company's Form 10-K for the fiscal year ended March 31, 2010, filed June 24, 2010. There were no material changes in controls and procedures during the current quarter. As of September 30, 2010, management believes systems and procedures were in place to reasonably ensure accurate financial data.

As noted in prior years' Forms 10-K, errors were identified in the calculations and applications of certain accounting practices relating to the carrying value of inventory. Accordingly, the Company has taken measures over the past few years to correct the identified weakness: (1) The Company engaged the services of qualified independent consultants to advise the Company on improvements to internal controls and procedures; (2) the Company added to its staff of educated and experienced accounting personnel; and (3) consultants independent from those who assisted with improvements and procedures have tested the Company's internal controls over financial reporting concurrent with this Form 10-Q. Based on these measures, management believes systems and procedures are in place to reasonably ensure accurate financial data. However, these controls and procedures continue to rely heavily on manual transfers of data, manual calculations and supervisory review of the work product. It is not practical to believe that such manual activities will eliminate the possibility of a material misstatement of the annual or interim financial statements.

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

There was no change in our internal control over financial reporting during the current quarter that has materially affected or is reasonably likely to materially affect, our internal control over financial reporting. We have undertaken to upgrade our resource management software to provide a single source for all financial data; establish access controls to data and transactions; and to automate allocations, calculations and periodic reports. All critical manual processes are expected to be automated prior to March 31, 2011. Additional functionality will continue to be added to our resource management system throughout fiscal 2012 in order to provide additional assurances of the accuracy of our financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

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

None.

**Item 3. Defaults upon Senior Securities**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

a) The following exhibits are furnished with this report:

- |      |   |
|------|---|
| 10.1 | Amended, Reformed and Restated 2004 Independent Director Stock Option and Restricted Stock Grant Plan adopted November 5, 2010.                                 |
| 10.2 | Restated 2005 Stock Option Plan adopted November 5, 2010.   |
| 31.1 | Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 10, 2010.                             |
| 31.2 | Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of November 10, 2010.                             |
| 32   | Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of November 10, 2010. |



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SIGNATURES

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

CYANOTECH CORPORATION  
(Registrant)

November 10, 2010  
(Date)

By:

/s/ David I. Rosenthal  
David I. Rosenthal  
*Interim President and Chief Executive Officer and  
Director  
(Performing the Functions of Principal Executive  
Officer)*

November 10, 2010  
(Date)

By:

/s/ Deanna L. Spooner  
Deanna L. Spooner  
*Vice President Finance & Administration and CFO  
(Principal Financial and Accounting Officer)*

EXHIBIT INDEX

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