

CYANOTECH CORP
Form 10-Q
November 13, 2008
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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, 2008

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 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 September 30, 2008:

| Title of Class | Shares Outstanding |
|---------------------------------|--------------------|
| Common stock - \$0.02 par value | 5,242,270 |

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CYANOTECH CORPORATION

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Part 1. FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

CYANOTECH CORPORATION

CONSOLIDATED CONDENSED BALANCE SHEETS

(Dollars in thousands except per share amounts)

(unaudited)

| | September 30, 2008 | March 31, 2008 |
|---|-----------------------|-------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 989 | \$ 1,090 |
| Accounts receivable, net of allowance for doubtful accounts of \$15 at September 30, 2008 and \$23 at March 31, 2008 | 2,052 | 1,934 |
| Inventories | 2,613 | 1,601 |
| Prepaid expenses and other | 98 | 263 |
| Total current assets | 5,752 | 4,888 |
| Equipment and leasehold improvements, net | 4,204 | 4,269 |
| Other assets | 499 | 623 |
| Total assets | \$ 10,455 | \$ 9,780 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Current maturities of long-term debt | \$ 588 | \$ 567 |
| Customer deposits | 124 | 104 |
| Accounts payable | 1,211 | 805 |
| Accrued expenses | 448 | 320 |
| Total current liabilities | 2,371 | 1,796 |
| Long-term debt, less current maturities | 1,205 | 1,505 |
| Other | | 100 |
| Total liabilities | 3,576 | 3,401 |
| Commitments and contingencies (Note 5) | | |
| Stockholders' equity: | | |
| Common stock of \$0.02 par value, shares authorized 7,500,000; 5,242,270 shares issued and outstanding at September 30, 2008 and March 31, 2008 | 105 | 105 |
| Additional paid-in capital | 27,403 | 27,337 |
| Accumulated deficit | (20,629) | (21,063) |
| Total stockholders' equity | 6,879 | 6,379 |

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| | | | | |
|---|----|--------|----|-------|
| Total liabilities and stockholders equity | \$ | 10,455 | \$ | 9,780 |
|---|----|--------|----|-------|

See accompanying Notes to Consolidated Condensed Financial Statements.

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CYANOTECH CORPORATION
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share amounts)

(Unaudited)

| | Three Months Ended September 30, | | Six Months Ended September 30, | |
|---|-------------------------------------|-----------|-----------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| NET SALES | \$ 3,274 | \$ 2,604 | \$ 6,975 | \$ 5,187 |
| COST OF PRODUCT SALES | 1,896 | 1,836 | 4,293 | 3,673 |
| Gross profit | 1,378 | 768 | 2,682 | 1,514 |
| OPERATING EXPENSES: | | | | |
| Research and development | 54 | 36 | 90 | 83 |
| Sales and marketing | 255 | 337 | 522 | 705 |
| General and administrative | 864 | 709 | 1,573 | 1,381 |
| Total operating expenses | 1,173 | 1,082 | 2,185 | 2,169 |
| Income (loss) from operations | 205 | (314) | 497 | (655) |
| OTHER INCOME (EXPENSE): | | | | |
| Interest income | 2 | 6 | 5 | 17 |
| Interest expense | (44) | (38) | (89) | (79) |
| Other income (expense), net | | 2 | 10 | 1 |
| Total other expense, net | (42) | (30) | (74) | (61) |
| Income (loss) before income tax (benefit) expense | 163 | (344) | 423 | (716) |
| INCOME TAX (BENEFIT) EXPENSE | | | (11) | 10 |
| NET INCOME (LOSS) | \$ 163 | \$ (344) | \$ 434 | \$ (726) |
| NET INCOME (LOSS) PER SHARE: | | | | |
| Basic | \$.03 | \$ (0.07) | \$.08 | \$ (0.14) |
| Diluted | \$.03 | \$ (0.07) | \$.08 | \$ (0.14) |
| SHARES USED IN CALCULATION OF NET INCOME (LOSS) PER SHARE: | | | | |
| Basic | 5,242 | 5,234 | 5,242 | 5,234 |
| Diluted | 5,242 | 5,234 | 5,242 | 5,234 |
| COMPREHENSIVE INCOME (LOSS): | | | | |
| Net income (loss) | \$ 163 | \$ (344) | \$ 434 | \$ (726) |
| Other comprehensive income (loss) | | 1 | | (4) |
| | \$ 163 | \$ (343) | \$ 434 | \$ (730) |

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See accompanying Notes to Consolidated Condensed Financial Statements.

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CYANOTECH CORPORATION

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

| | 2008 | Six Months Ended September 30, | 2007 |
|--|------|-----------------------------------|----------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | \$ | 434 | \$ (726) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation | | 216 | 269 |
| Decrease in allowance for doubtful accounts | | (8) | |
| Amortization of debt issue costs and other assets | | 27 | 18 |
| Stock option compensation expense | | 66 | |
| Net (increase) decrease in: | | | |
| Accounts receivable | | (110) | 174 |
| Refundable income taxes | | | 10 |
| Inventories | | (1,012) | (401) |
| Prepaid expenses and other assets | | 262 | (146) |
| Net increase (decrease) in: | | | |
| Customer deposits | | (80) | |
| Accounts payable | | 406 | 411 |
| Accrued expenses | | 128 | (54) |
| Net cash provided by (used in) operating activities | | 329 | (445) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Investment in equipment and leasehold improvements | | (151) | (48) |
| Cash used in investing activities | | (151) | (48) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Principal payments on long-term debt | | (279) | (193) |
| Cash used in financing activities | | (279) | (193) |
| Net decrease in cash and cash equivalents | | (101) | (686) |
| Cash and cash equivalents at beginning of period | | 1,090 | 1,444 |
| Cash and cash equivalents at end of period | \$ | 989 | \$ 758 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | | |
| Cash paid during the period for: | | | |
| Interest | \$ | 81 | \$ 68 |
| Income taxes | \$ | | \$ 2 |

See accompanying Notes to Consolidated Condensed Financial Statements.

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CYANOTECH CORPORATION
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

As of September 30, 2008
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America 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 generally accepted accounting principles (GAAP) for complete financial statements. These consolidated condensed financial statements and notes should be read in conjunction with the Company's consolidated financial statements contained in the Company's annual report on Form 10-K for the year ended March 31, 2008 filed on June 26, 2008.

The accompanying consolidated condensed financial statements include the accounts of Cyanotech Corporation and its wholly-owned subsidiaries, Nutrex Hawaii, Inc. (Nutrex Hawaii or Nutrex) and Cyanotech Japan YK (Cyanotech Japan or CJYK). All significant intercompany balances and transactions have been eliminated in consolidation. On August 31, 2007, the Company discontinued the activity of its wholly owned Japanese subsidiary CJYK. All aquaculture feed business in Japan was absorbed through the Company's U.S. operations. CJYK remained a registered Japanese corporation until November 30, 2007, at which time it was dissolved. All CJYK assets and liabilities were absorbed into the Company as of September 1, 2007. The Company made this decision due to declining sales of approximately 40% in each of the two fiscal years 2007 and 2006. CJYK sales for the quarter ended September 30, 2007 were approximately \$20,000. Dissolution of this subsidiary has not had a significant impact on the consolidated financial statements.

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, 2008 | March 31, 2008 |
|-----------------|--------------------|----------------|
| | (in thousands) | |
| Raw materials | \$ 369 | \$ 321 |
| Work in process | 290 | 214 |
| Finished goods | 1,778 | 888 |
| Supplies | 176 | 178 |

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| | | | |
|----|-------|----|-------|
| \$ | 2,613 | \$ | 1,601 |
|----|-------|----|-------|

In accordance with SFAS No. 151, fixed production related costs of approximately \$0 and \$34,000 were not inventoried for the quarter ended September 30, 2008 and 2007, respectively, and \$20,000 and \$57,000 for the six months ended September 30, 2008 and 2007, respectively, due to below normal production capacity.

Table of Contents**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 |

Equipment and leasehold improvements consist of the following:

| | September 30, 2008 | March 31, 2008 |
|--|--------------------|----------------|
| | (in thousands) | |
| Equipment | \$ 6,396 | \$ 6,335 |
| Leasehold improvements | 7,424 | 7,348 |
| Furniture and fixtures | 115 | 94 |
| | 13,935 | 13,777 |
| Less accumulated depreciation and amortization | (9,816) | (9,600) |
| Construction-in-progress | 85 | 92 |
| Equipment and leasehold improvements, net | \$ 4,204 | \$ 4,269 |

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. Upon such an occurrence, recoverability of these assets is determined by comparing the forecasted undiscounted net cash flows from the related assets, to its carrying amount. If the carrying value exceeds the related cash flows, then the carrying value of the long-lived assets are compared to the asset's fair value using discounted cash flow. Management has determined no asset impairment occurred during the three or six months ended September 30, 2008.

4. LONG-TERM DEBT

Long-term debt consists of the following:

| | September 30, 2008 | March 31, 2008 |
|--|--------------------|----------------|
| | (in thousands) | |
| Term loans | \$ 1,793 | \$ 2,072 |
| Less current maturities | (588) | (567) |
| Long-term debt, excluding current maturities | \$ 1,205 | \$ 1,505 |

Term Loan Agreements

In February 2008, the Company executed a Term Loan Agreement (Term Loan A) with a lender providing for \$1.1 million in aggregate credit facilities, secured by the Company s assets. Term Loan A has a maturity date of March 1, 2015 and is payable in 84 equal monthly principal and interest payments. The interest rate under Term Loan A, 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, 2008 the prime rate was 5.00%. The Company is prohibited from declaring any common stock dividends without the lender s prior written consent. Borrowings outstanding under Term Loan A were \$1,016,523 and \$1,078,400 at September 30, 2008 and March 31, 2008, respectively.

In April 2000, the Company executed a Term Loan Agreement (Term Loan B) with a lender providing for \$3.5 million in aggregate credit facilities, secured by the Company s assets. Term Loan B has a maturity date of May 1, 2010 and is payable in 120 equal monthly principal and interest payments. 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, 2008, the prime rate was 5.00%. The Company is prohibited from declaring any common stock dividends without the lender s prior written consent. A warrant to purchase 5,000 shares of the Company s common stock was issued in conjunction with Term Loan B. 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 Term Loan B in full. Borrowings outstanding under Term Loan B were \$776,744 and \$993,376 at September 30, 2008 and March 31, 2008, respectively.

The Company is required to comply with certain covenants in connection with its loan agreements. At September 30, 2008, the Company was in compliance with these covenants.

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These Term Loans are additionally secured by a \$250,000 restricted cash deposit which is included in Other Assets in the accompanying consolidated condensed balance sheets at September 30, 2008 and March 31, 2008.

Future principal payments under the Term Loan Agreements are as follows:

| Year Ending March 31 | (in thousands) | |
|--------------------------|-------------------|-------|
| 2009 (6 Months) | \$ | 290 |
| 2010 | | 606 |
| 2011 | | 225 |
| 2012 | | 153 |
| 2013 | | 163 |
| Thereafter through 2015 | | 356 |
| Total principal payments | \$ | 1,793 |

5. LEASES

The Company leases facilities, equipment and land under operating leases expiring between 2008 and 2025. The land lease provides for contingent rental in excess of minimum rental commitments based on a percentage of the Company's annual sales. Contingent rental for six months ended September 30, 2008 and 2007 were \$27,000 and \$23,000, respectively.

Future minimum lease payments under all non-cancelable operation leases are as follows:

| Year ending March 31 | (in thousands) | |
|------------------------------|-------------------|-------|
| 2009 (6 Months) | \$ | 93 |
| 2010 | | 168 |
| 2011 | | 161 |
| 2012 | | 151 |
| 2013 | | 148 |
| Thereafter through 2025 | | 1,887 |
| Total minimum lease payments | \$ | 2,608 |

6. SHARE-BASED COMPENSATION

The Company has adopted the provisions of Statement of Financial Accounting Standard (SFAS) No. 123(R) (SFAS No. 123R), Share-Based Payment, for its share-based compensation plans. SFAS No. 123R requires an entity to measure the cost of employee services received in exchange for an award. 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

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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 future employee incentive stock options are plain vanilla, as defined by the U. S. Securities and Exchange Commission in Staff Accounting Bulletin No. 107, they are reflected only in Equity and Compensation Expense accounts.

Stock Options

As of September 30, 2008, 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, pursuant to a vote of the Company's stockholders on September 9, 2008, 700,000 shares of common stock are reserved for issuance until the Plan

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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. 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, 2008, 255,582 options remain available for grant under the 2005 Plan pursuant to the increase of 500,000 authorized Plan shares as approved by the stockholders of the Company on September 9, 2008. Concurrent with the 2005 Plan approval, the 1995 Stock Option Plan was terminated, except for the outstanding options issued thereunder.

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 at fair market value on the date of grant. 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 granted 875 shares of common stock, non-transferable for nine months following the date of grant. As of September 30, 2008, 70,250 options remain available for grant under the 2004 Plan. Concurrent with the 2004 Plan approval on August 16, 2004, the 1994 Non-Employee Director Stock Option and Stock Grant Plan was terminated except for the outstanding options issued thereunder.

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

| | As of September 30, 2008 | | |
|--------------|--------------------------|----------------|----------------|
| | Authorized | Available | Outstanding |
| 2005 Plan | 700,000 | 255,582 | 444,418 |
| 2004 Plan | 75,000 | 70,250 | 1,000 |
| 1995 Plan | | | 21,553 |
| 1994 Plan | | | 2,250 |
| Total | 775,000 | 325,832 | 469,221 |

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 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. Discussion relative to option granting, vesting, exercising, 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 will use 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 will be recognized ratably over the vesting term. Compensation expense recognized for options issued under the 2005 Plan was \$66,000 for the three and six months ended September 30, 2008.

A summary of option activity under Cyanotech Corporation's Stock Plans for the six months ended September 30, 2008 is presented below:

| Option Activity | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|-------------------------------|---------|------------------------------------|---|---------------------------------|
| Outstanding at March 31, 2008 | 111,447 | \$ 3.15 | 4.9 years | \$ (176,086) |
| Granted | 393,168 | 2.12 | 9.8 years | (6,553) |
| Exercised | | \$ | | |

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| | | | | | |
|-----------------------------------|----------|----|------|-----------|-------------|
| Forfeited or expired | (35,394) | \$ | 4.50 | | (92,129) |
| Outstanding at September 30, 2008 | 469,221 | \$ | 1.99 | 9.3 years | \$ (41,330) |
| Exercisable at September 30, 2008 | 29,739 | \$ | 3.97 | 1.3 years | \$ (61,597) |

The aggregate intrinsic value in the tables 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 \$1.90 per share for that day.

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A summary of Cyanotech Corporation's non-vested options for the six months ended September 30, 2008 is presented below:

| Nonvested Options | Shares | Weighted Average Grant-Date Fair Value |
|---------------------------------|---------|--|
| Nonvested at March 31, 2008 | 47,529 | \$ 1.61 |
| Granted | 393,168 | 1.88 |
| Vested | (115) | 4.40 |
| Forfeited or expired | (1,100) | 1.60 |
| Nonvested at September 30, 2008 | 439,482 | \$ 1.85 |

The following table summarizes the weighted average characteristics of outstanding stock options as of September 30, 2008:

| Range of Exercise Prices | Number of Shares | Outstanding Options Remaining Life (Years) | Weighted Average Price | Number of Shares | Exercisable Options Weighted Average Price |
|-----------------------------|---------------------|--|---------------------------|---------------------|--|
| \$1.41 - \$2.60 | 445,918 | 9.7 | \$ 1.86 | 6,500 | \$ 2.46 |
| \$4.20 - \$6.50 | 23,303 | 1.2 | 4.39 | 23,239 | 4.39 |
| Total stock options | 469,221 | 9.3 | \$ 1.99 | 29,739 | \$ 3.97 |

There were 262,112 and 393,168 stock options granted during the three and six months ended September 30, 2008. The average fair value assumptions relate to options granted during the periods ending September 30, 2008 are:

| | |
|-------------------|---------------|
| Exercise Price: | \$ 2.12 |
| Volatility: | 103.1% |
| Risk Free Rate: | 4.7% |
| Vesting Period: | Up to 3 years |
| Termination Rate: | 0.0% |
| Expected Life | 5 years |

As of September 30, 2008, total unrecognized stock-based compensation expense related to all unvested stock options was \$531,679. Of the 439,482 unvested options, 393,168 options cliff vest as follows: 131,056 of the options have an exercise price of \$1.41 and cliff vest 100% on May 16, 2009; 131,056 of the options have an exercise price of \$2.12 and cliff vest 100% on May 16, 2010; and 131,056 of the options have an exercise price of \$2.12 and cliff vest 100% on May 16, 2011. These cliff vesting options have a combined unrecognized compensation expense of \$514,061 as of September 30, 2008 that will be amortized over 7.5 months, 19 months and 31 months, respectively. The remaining 46,250 unvested options are expected to be amortized over a remaining weighted-average period of 4.0 years through February 22, 2013 with an unrecognized compensation expense of \$17,618 as of September 30, 2008.

The weighted average grant date fair value of 35,394 options granted prior to April 1, 2008, and vested, expired and forfeited during the six months ended September 30, 2008 is \$159,378. The aggregate intrinsic value of the Company's 29,739 fully vested share options at September 30, 2008 is \$61,597.

Warrants

The Company had issued a warrant which allows the warrant holder rights to acquire 5,000 shares of common stock at \$10.20 per share. Warrants outstanding during the periods were granted to lenders in connection with the Term Loan B described in Note 4. The warrant was granted in April 2000 and expires in April 2011, and may only be exercised after the Company has repaid the Term Loan B in full.

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7. INCOME TAXES

The Company is subject to taxation in the United States and two state jurisdictions. No remaining or future tax liabilities are expected with respect to the dissolution of CJYK. 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 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 require the Company to pay additional taxes. As required under applicable accounting rules, management evaluates the requirement for additional tax accruals, and for the three and six months ended September 30, 2008 and 2007, no accrual was recorded based on this evaluation of potential additional tax liability, 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 a result of the implementation of Financial Accounting Standards Board (FASB) Interpretation No.48 (FIN 48) Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, the Company did not recognize a liability for unrecognized tax benefits and, accordingly, did not record any cumulative effect adjustment to beginning retained earnings, at the date of adoption, April 1, 2007. As of September 30, 2008, there was no significant liability for income tax associated with unrecognized tax benefits.

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 (loss).

The Company recognizes accrued interest related to unrecognized tax benefits as well as any related penalties in interest income or expense in its consolidated condensed statements of operations, which is consistent with the recognition of these items in prior reporting periods. With few exceptions, the Company is no longer subject to U.S. federal, state and local, and non-U.S. income tax examination by tax authorities for tax years before 2001.

8. 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, 2008 and 2007 are as follows (in thousands, except per share amounts):

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| | Three Months Ended September 30, 2008 | | | Three Months Ended September 30, 2007 | | |
|---|---------------------------------------|-------------------------|---------------------|---------------------------------------|-------------------------|---------------------|
| | Net Loss (Numerator) | Shares (Denominator) | Per Share Amount | Net Loss (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic net income (loss) per share | \$ 163 | 5,242 | \$ 0.03 | \$ (344) | 5,234 | \$ (0.07) |
| Effect of dilutive securities Common stock options and warrants | | | | | | |
| Diluted net income (loss) per share | \$ 163 | 5,242 | \$ 0.03 | \$ (344) | 5,234 | \$ (0.07) |

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Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the six months ended September 30, 2008 and 2007 are as follows (in thousands, except per share amounts):

| | Six Months Ended September 30, 2008 | | | Six Months Ended September 30, 2007 | | |
|-------------------------------------|-------------------------------------|-------------------------|---------------------|-------------------------------------|-------------------------|---------------------|
| | Net Loss (Numerator) | Shares (Denominator) | Per Share Amount | Net Loss (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic net income (loss) per share | \$ 434 | 5,242 | \$ 0.08 | \$ (726) | 5,234 | \$ (0.14) |
| Effect of dilutive securities | | | | | | |
| Common stock options and warrants | | | | | | |
| Diluted net income (loss) per share | \$ 434 | 5,242 | \$ 0.08 | \$ (726) | 5,234 | \$ (0.14) |

Basic and diluted earnings per share are the same in periods of a net loss, thus there is no effect of dilutive securities when a net loss is recorded. There were approximately 474,221 potentially dilutive securities for the three and six months ended September 30, 2008 and 67,000 potentially dilutive securities for the three and six months end September 30, 2007, that were excluded from the calculation of diluted income (loss) per share because their effect was anti-dilutive.

9. CUSTOMER DEPOSIT

The Company received a restricted security deposit of \$200,000 cash in conjunction with a sales contract dated November 1, 2007. On June 30, 2008 the contract was modified to release the restricted funds to settle outstanding accounts receivable balances and to prepay portions of new product orders from the customers. At September 30, 2008, no restricted funds are held.

10. NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair measurements. SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable;

Level 3 - Unobservable inputs that are supported by little or no market activity, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing.

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SFAS No. 157 was effective for our fiscal year beginning after April 1, 2008, except for non-financial assets and liabilities recognized or disclosed at fair value on a non-recurring basis, for which the effective date is fiscal years beginning after November 15, 2008. The adoption of SFAS No. 157 did not have an impact on the Company's consolidated results of operations, cash flows or financial condition. The Company will adopt SFAS No. 157 for non-financial assets that are recognized or disclosed on a non-recurring basis on April 1, 2009 and the Company is currently evaluating the effect, if any, on the Company's consolidated results of operations, cash flows or financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair market value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 was effective for our fiscal year beginning April 1, 2008. The adoption of this statement did not have a material impact on the company's financial position and results of operations.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*. SFAS No. 141R requires the acquiring entity in a business combination to recognize all the assets acquired and liabilities assumed in the transaction at fair value as of the acquisition date. SFAS No. 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first quarterly reporting period beginning on or after December 15, 2008. We are required to adopt SFAS No. 141R in the first quarter of calendar year 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. SFAS No. 160 amends Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. We do not expect the adoption of this statement to have a material impact on our consolidated financial statements.

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In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB Statements No. 133. This statement enhances the disclosure requirements for derivative instruments and hedging activities, and thereby is designed to improve the transparency of financial reporting. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. We do not expect the adoption of this statement to have a material impact on our consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* on September 16, 2008. We do not expect the adoption of this statement to have a material effect on our 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 on Form 10-Q 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 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 they do 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 or were made. Investors are cautioned not to place undue reliance on forward looking statements. 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 effects of competition, including locations of competitors and operating and market competition;
- worldwide economic conditions and their effects on costs, pricing and discretionary spending on health products;

- environmental restrictions, soil and water conditions, weather and other hazards;
- access to available and reasonable financing on a timely basis;
- changes in laws, including increased tax rates, regulations or accounting standards, and decisions of courts, regulators and governmental bodies;
- demand for the company's products, the quantities and qualities thereof available for sale and levels of customer satisfaction;
- changes to capital markets and access to sufficient capital on satisfactory terms;
- 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, terrorists incidents or natural disasters; and,
- other risks or uncertainties described elsewhere in this Report in our most recent annual report on Form 10-K and in other periodic reports previously and subsequently filed by the Company with the Securities and Exchange Commission.

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

| | Three Months Ended September 30, 2008 | | Three Months Ended September 30, 2007 | | Change |
|-------------------------------|--|-------|--|-------|--------|
| Net sales: | | | | | |
| Spirulina products | \$ | 1,644 | \$ | 1,407 | 17% |
| Natural astaxanthin products | | 1,621 | | 1,176 | 38% |
| Other products | | 9 | | 21 | (57)% |
| Total sales, all products | \$ | 3,274 | \$ | 2,604 | 26% |
| Gross profit | \$ | 1,378 | \$ | 768 | 79% |
| Income (loss) from operations | \$ | 205 | \$ | (314) | |
| Net income (loss) | \$ | 163 | \$ | (344) | |

| | Six Months Ended September 30, 2008 | | Six Months Ended September 30, 2007 | | Change |
|-------------------------------|--|-------|--|-------|--------|
| Net sales: | | | | | |
| Spirulina products | \$ | 3,684 | \$ | 2,938 | 25% |
| Natural astaxanthin products | | 3,242 | | 2,173 | 49% |
| Other products | | 49 | | 76 | (36)% |
| Total sales, all products | \$ | 6,975 | \$ | 5,187 | 35% |
| Gross profit | \$ | 2,682 | \$ | 1,514 | 77% |
| Income (loss) from operations | \$ | 497 | \$ | (655) | |
| Net income (loss) | \$ | 434 | \$ | (726) | |

Sales for the second quarter of fiscal year 2009 increased from the comparable prior year period by \$670,000 or 26% due to increases in both spirulina and natural astaxanthin product sales.

Spirulina sales increased 17% over the same period of fiscal year 2008, primarily due to increased pricing of both bulk and packages products while units remained level.

Natural astaxanthin product sales increased as well over the comparable prior year period due to an increase in sales of both bulk and packaged astaxanthin products. Bulk products sales increased by 90% while packaged nutrition products increased by 50%. The Company is now focused on building market share based on nutritional brands which promote health and well-being.

Gross profit margin as a percentage of sales increased to 42% for the three months ended September, 30, 2008 from 29% for the same period a year ago. Sales for the second quarter of fiscal year 2009 increased 26% from the comparable prior year period while cost of products sold increased only 3% for the same respective period. Variable production costs increased 18% in the current period compared to one year ago primarily as a result of the impact of rising fuel costs on electrical rates and on the shipping costs of chemicals used in production. Fixed costs

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have declined by 16% compared to one year ago primarily due to reduced related headcount and production equipment becoming fully depreciated. We expect continued pressure on input costs going forward and this could cause gross margins to decline in future periods. Management is consistently researching methodology to promote and sustain production at desired capacity and quality levels.

The net income of \$163,000 for the second quarter of fiscal 2009 represents a positive improvement of \$507,000 over the comparable quarter of fiscal 2008 which had a net loss of \$344,000. The improvement is the result of increased sales volume, improved gross profit and an 8% reduction in operating expenses as a percentage of sales due to reduced sales and marketing expenses.

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Second Quarter of Fiscal 2009 Compared to Second Quarter of Fiscal 2008

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Net sales for the second quarter of fiscal 2009 increased to \$3,274,000 a 26% increase from the \$2,604,000 reported for the comparable period a year ago. Company sales of Spirulina products for the second quarter of fiscal 2009 were \$1,644,000, which is a 17% increase over sales generated in the second quarter of fiscal 2008. As a percentage of sales, Spirulina accounted for 50% of total sales in the second quarter of fiscal 2008, compared to 54% for the comparable period a year ago. Spirulina sales have declined as a percentage of total sales due to greater emphasis on sales of Natural Astaxanthin products, producing a favorable margin impact.

Natural astaxanthin product sales were \$1,622,000 during the second quarter of 2009, a 38% increase from \$1,176,000 in the second quarter of the prior year. The natural astaxanthin product lines increased to 50% of total sales from 46% of total sales in the second quarter of fiscal 2008. This increase is the result of the Company focusing its products to build nutritional brands which promote health and well-being. During fiscal year 2008, the Company closed its wholly owned Japan subsidiary CJYK, which sold to the aquaculture market, and discontinued its NatuRose animal nutrition product. The aquaculture and animal nutrition market had been experiencing declines in both demand and profit margins. Other products sales were \$9,000 during the second quarter of fiscal 2009 and \$21,000 during the second quarter of fiscal 2008, and represented less than 1% in both periods.

International sales were 52% of total sales for the second quarter of fiscal year 2009 and 44% of sales for the second quarter of fiscal year 2008. Major customers are those equaling or exceeding 10% of the Company's sales for the period. For the second quarter of fiscal 2009, two European distributors each had sales equal to 10% of the Company's total sales for the quarter. Only one distributor, with 12% of sales for the period, met or exceeded major customer sales volume in the second quarter of fiscal year 2008.

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 second quarter of fiscal 2009 was \$1,378,000, with a gross profit margin percentage of 42%. This was an increase from gross profit margin of \$768,000 and gross profit margin of 30% reported for the comparable prior year quarter. Sales for the second quarter of fiscal year 2009 increased 26% from the comparable prior year period while costs of products sold increased 3% for the same respective period, resulting in the 12% improvement in gross profit margin percentage. Variable production costs increased 5% in the current period compared to one year ago. Rising fuel costs have resulted in an increase in electrical rates, freight costs and the cost of chemicals used in production. These increases were partially offset by decreased labor costs of 12% for the current quarter compared to the quarter ended September 30, 2008 due to maintaining reduced work force levels implemented in the third quarter of fiscal year 2008. Fixed costs have declined by 15% primarily due to reduced headcount compared to the quarter prior and production equipment becoming fully depreciated. Direct cost increases are expected to continue in all areas consistent with the local and national economy.

Pursuant to SFAS No. 151, Inventory Costs—an amendment of ARB No. 43, Chapter 4, all fixed production overhead costs were inventoriable for the current quarter. Approximately \$34,000 of fixed production overhead cost was not inventoriable during the three months ended September 30, 2007. Additionally \$126,000 of production cost was not inventoriable in the second quarter of fiscal year 2008 because such costs would have exceeded the market value of the inventory. There were no such lower of cost or market issues for the second quarter of fiscal year 2009.

Operating expenses for the second quarter of fiscal 2009 were 36% of sales or \$1,173,000, compared to 42% of sales or \$1,082,000 for the second quarter of fiscal 2008. This decrease in operating expenses as a percentage of sales in the three months ended September 30, 2008 as compared with the three months ended September 30, 2007, was primarily the result of sales and marketing expense reductions of \$82,000 or 24% offset by an \$154,000 or 22% increase in general and administrative expense and an \$18,000 or 50% increase in research and development expense for the second quarter of 2009 from the second quarter of 2008.

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 (loss). The Company's effective tax rate is reconciled to consider the tax effect of net operating losses incurred in prior periods.

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No expense or benefit from income taxes was recorded in the quarter ended September 30, 2008 or 2007. The Company does not expect any U.S. Federal or state income taxes to be recorded for the current fiscal year because of available net operating loss carry-forwards.

The Company had net income of \$163,000 or \$0.03 per diluted share, for the three months ended September 30, 2008 compared to a net loss of \$344,000, or (\$0.07) per diluted share for the three months ended September 30, 2007.

Six Months Ended September 30, 2008 Compared to Six Months Ended September 30, 2007

Net sales for the six months ended September 30, 2008 were \$6,975,000, an increase of 35% from sales of \$5,187,000 reported for the comparable period a year ago. The increase in sales over the prior year's six-month period was largely the result of increased sales of both spirulina and natural astaxanthin products. International sales represented 46% of net sales for the six months ended September 30, 2008 compared to 43% for the same period a year ago. For the six months ended September 30, 2008 and September 30, 2007, our European distributors accounted for 13% and 11% of total sales respectively.

For the six months ended September 30, 2008, cost of sales decreased as a percentage of sales by 13% from the comparable prior year period. For the six months ended September 30, 2008, variable production costs increased 12% and were fully inventoriable due to increased production compared with non-inventoriable period costs of approximately \$43,000 for the six months ended September 30, 2007. For the six months ended September 30, 2008 fixed cost overhead increased 8%. Pursuant to SFAS No. 151, \$20,000 and \$57,000 of fixed overhead costs were not inventoriable during the six months ended September 30, 2008 and 2007 respectively because production levels were below normal capacity. No market value adjustment was required for inventory at September 30, 2008. However, production costs associated with the Company's inventory totaling approximately \$156,000 incurred during the six months ended September 30, 2007 were not inventoriable because such costs would have exceeded the market value for such inventory. As a result of the increase in sales and improved production volumes, gross profit margins as a percentage of sales increased to 38% for the six months ended September 30, 2008 as compared to 29% for the comparable prior year period.

Operating expenses for the six months ended September 30, 2008 were \$2,185,000, an increase of \$16,000 or 1% from the comparable prior year period. Sales and marketing expense decreased by \$183,000 or 26% as a result of cost reduction measures taken in the third quarter of fiscal year 2008. General and administrative expense increased \$192,000 due to \$66,000 of stock related compensation and inflationary increases rather than additional spending in the six month period. While it is our goal to contain discretionary operating spending it may become necessary for the Company to selectively increase spending in some or all of these areas to remain competitive and to comply with regulatory requirements.

Net other expense, which includes interest on the Company's debt, for the six months ended September 30, 2008 increased by 21% to \$74,000 from \$61,000 for the same prior year period. The current year increase represents interest on the additional long-term debt secured in the fourth quarter of fiscal year 2008.

For the six months ended September 30, 2008, the Company recorded an income tax receivable of \$11,000 related to Federal and state tax credits. An income tax expense of \$10,000 was recorded for the same period of the prior year. The Company does not expect any additional United States income taxes for the current fiscal year as a result of available net operating loss carry-forwards.

The Company recorded net income of \$434,000 or \$0.08 per diluted share for the six month period ended September 30, 2008. For the same period a year ago the Company reported a net loss of \$726,000 or (\$0.14) per diluted share.

Variability of Results

The Company has experienced significant quarterly fluctuations in operating results and anticipates that these fluctuations may continue in future periods. As described in previous paragraphs, operating results have fluctuated as a result of changes in sales levels to our customers, competition (both pricing, new products and other market trends) and production difficulties, including increased production costs and variable production results. The Company has also, during its history, experienced production difficulties as a result of inclement weather, changes in the mix between sales of bulk and packaged consumer products 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 Company's control such as

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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 meaningfully adjust spending in certain areas, or the inability to adjust spending quickly enough, as in personnel and administrative costs, to compensate for a sales shortfall. 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 decreased \$101,000 or 9% to \$989,000 at September 30, 2008, from \$1.1 million at March 31, 2008. This decrease in cash resulted from cash used in investing activities of \$151,000, and cash used in financing activities of \$279,000 offset by cash provided by operating activities of \$329,000. Cash provided by operating activities for the six months ended September 30, 2008 represents the results of operations adjusted for non-cash depreciation, amortization 2nd stock option compensation expenses of \$309,000, increases in accounts payable and accrued expenses of \$534,000 offset by increases in inventory of \$1,012,000 and other less significant changes. Cash flows used in investing activities reflect capital expenditures during the second six months of fiscal 2008. Cash flows used in financing activities are attributable to debt payments during that period.

As of September 30, 2008, the Company's net accounts receivable increased \$110,000 to \$2,052,000 from \$1,934,000 as of March 31, 2008. The increase in accounts receivable is primarily the result of the timing of sales and collections on the customer's accounts. Management believes that its accounts receivable are collectible net of the allowance for doubtful accounts of \$15,000 at September 30, 2008.

The Company's net inventory increased \$1,012,000 or 63% to \$2,613,000 as of September 30, 2008 compared to \$1,601,000 as of March 31, 2008. The increase in inventory during the first six months of fiscal 2008 is primarily due to increased production levels of both spirulina and astaxanthin during the six months with little or no rainfall and longer daylight hours. Management considers this buildup of inventory prudent entering the winter quarters with historically lower production resulting from fewer daylight hours and seasonal rain. Spirulina production was 14% higher in the six months ending September 30, 2008 as compared to the six months ended March 31, 2008. Astaxanthin production was 140% higher in the six months ending September 30, 2008 as compared to the six months ended March 31, 2008. The increase is the result of the Company's focus on astaxanthin production in order to expand its *BioAstin*® based health and nutrition products.

Liquidity and Capital Resources

At September 30, 2008, the Company's working capital was \$3,381,000, an increase of \$289,000 compared to \$3,092,000 at March 31, 2008. Cash and cash equivalents at September 30, 2008 totaled \$989,000, a decrease of \$101,000 from \$1,090,000 at March 31, 2008.

The Company has two Term Loan Agreements (Term Loans) with a lender. These provided up to \$4.6 million in combined credit facilities and are secured by substantially all the assets of the Company. The outstanding combined balance under the Term Loans as of September 30, 2008 is approximately \$1,793,000. The Term Loans have maturity dates of May 1, 2010 as to \$777,000 and March 1, 2015 as to \$1,017,000 and are payable in equal monthly principal and interest payments of totaling approximately \$57,000.

The interest rate under the Term Loans, 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 5.00% at September 30, 2008). The Company is prohibited by the Term Loan from declaring any cash dividends without the lender's prior written consent. A \$250,000 restricted cash deposit is held in an interest-bearing restricted cash account per the terms of the Term Loan and is included in other assets in the consolidated balance sheet at September 30, 2008.

The Company has, as previously reported, experienced a number of factors that have negatively impacted its balance sheet and liquidity, including the following:

- The Company has experienced significant recurring net losses. At September 30, 2008, the Company had an accumulated deficit of \$20,629,000 compared to an accumulated deficit of \$21,063,000 at March 31, 2008. The accumulated deficit decreased by \$163,000 for the quarter ended September 30, 2008. As discussed earlier, and as required under SFAS No. 144, Accounting for the Impairment and Disposal of Long-Lived Assets, as of March 31, 2007 the Company recorded a non-cash impairment charge reducing, by \$4.5 million, the values of certain production equipment and leasehold improvement assets. This non-cash charge did not impact liquidity.

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- The Company's business did not generate positive cash from operating activities in seven of the eight quarters during fiscal years ended March 31, 2008 and 2007. The first two quarters of the fiscal year ended March 31, 2009 did generate positive cash from operating activities.
- Material weaknesses in its internal controls, as previously reported, have caused the Company to experience delays in completing its consolidated financial statements and filing periodic reports with the SEC on a timely basis. Accordingly, the Company continues to devote substantial additional internal resources, and to experience higher than expected fees for audit services. At present the Company has concluded that more rigorous emphasis on improving the capabilities of existing systems, procedures, and existing personnel, will correct the material weakness.
- In addition to the foregoing item, to conserve liquidity and reduce costs as previously announced, the Company cut its workforce by approximately 20% in early December 2007. The lay-offs have not had a negative impact on productivity and are not expected to do so. However, to achieve and sustain improved sales and enhanced production efficiency and effectiveness, it has been necessary for the Company to increase its operations workforce in subsequent quarters.
- Finally, as part of its request to the senior debt holder for additional funding, the Company has undertaken an aggressive plan to de-emphasize new product introductions and related sales and marketing expenses, and to aggressively reduce administrative and sales and marketing expenses in general. However, to achieve and sustain improved sales and enhanced production efficiency and effectiveness, it may be necessary to increase such expenses in future quarters.

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, and planned capital expenditures, for the next 12 months. Management expects liquidity in the remainder of fiscal 2009 to be generated from operating cash flows.

Capital Resources

The Company does not currently have any material commitments for capital expenditures. The Company expects fiscal 2009 capital expenditures to be under \$250,000 and to be funded by operating cash flows. This includes capital expenditures in support of the Company's 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.

Cyanotech Corporation's strategic direction has always been to position itself 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 2009, we will put greater emphasis on our Nutrex Hawaii consumer products. Our focus going forward will 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, www.nutrex-hawaii.com. Consumer products can also be purchased online at www.nutrex-hawaii.com.

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We are currently experiencing an upward trend in sales with unit sales increasing during the first six months of fiscal 2009 as compared to the first six months of fiscal 2008. The most significant impact was due to an increase in the astaxanthin bulk product line. The Company expects spirulina sales to remain essentially level since the product has reached a mature life cycle stage. A portion of the upward trend in sales is attributable to filling orders we could not fill during the third and fourth quarters of fiscal year 2008 due to insufficient inventory. Accordingly, sales may trend down or remain level in future periods depending on the rate orders are backlogged and fulfilled. Significant sales variability between periods and even across several periods can be expected based on historical results.

As discussed in Note 1 to Consolidated Condensed Financial Statements, the Company has discontinued all business activity of its wholly owned Japanese subsidiary CJYK. Management made this decision due to declining sales of approximately 40% in each of the prior two fiscal years. Discontinuance of this subsidiary has not had a significant impact on our consolidated financial statements.

Overall costs have been increasing in part because of increasing utility, chemical, and transportation costs which reflect and respond to oil prices. We feel that these conditions will likely continue, and consequently, we are putting greater focus on cost controls and expense avoidance.

Gross profit margin percentages in fiscal year 2009 will be impacted by continued pressure on input costs and this could cause margins to decline in future periods. Management will continue its focus on health and well-being, promoting higher gross margin items. Management is also focused on improvements in process and production methods to stabilize and increase production levels for the future.

With the adoption of SFAS 151, the Company recognizes costs associated with abnormal amounts of idle facility expense, freight, handling costs and wasted materials (such as spoilage) as current-period charges in cost of sales. When production costs exceed historical averages, management evaluates whether such costs are current-period charges or are inventoriable costs. In addition, the allocation of fixed production overheads (such as depreciation and general insurance) to inventories is determined based on normal production capacity. When the Company's production volumes are below normal capacity limits, certain fixed production overhead costs cannot be inventoried and are recorded immediately in cost of sales. 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 the Company's control.

To manage its cash resources effectively, the Company will continue to balance production in light of sales demand, minimizing the cost associated with build-ups in inventory when appropriate. The Company has experienced other significant cash outflows and may need to utilize other cash resources to meet working capital needs if prolonged net losses are incurred in future periods. A prolonged downturn in sales could impair the Company's ability to generate sufficient cash for operations and minimize the Company's ability to attract additional capital investment which could become necessary in order to expand into new markets or increase product offerings.

The Company expects operating expense spending to remain consistent fiscal year 2008 levels. However, by March 31, 2010, the Company is required to be in full compliance with the Sarbanes-Oxley Act and Rules issued thereunder by the SEC, including Section 404 Compliance Standards established by the Public Companies Accounting Oversight Board. The cost of attaining and maintaining such compliance could materially decrease reported net income or increase reported net losses in future periods.

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The Company's 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; 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, 2008.

Management believes that our technology, systems, processes and favorable growing location generally permit year-round harvest of our microalgal products in a cost-effective manner. However, imbalances in astaxanthin production in fiscal year 2007 and spirulina production in 2008, together with increasing energy costs, suggest a need for continuing caution. We cannot, and do not attempt to, provide any form of assurance with regard to our technology, systems, processes, location, or cost-effectiveness.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

We have never entered 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 a term loan agreement that adjusts quarterly based on 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 \$18,000 in interest expense for the year ending March 31, 2009 (based on September 30, 2008 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 Commissions' 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(T) Controls and Procedures of the Company's Form 10-K for the fiscal year ended March 31, 2008 filed June 26, 2008. There were no material changes in controls and Procedures during the current quarter. As of September 30, 2008, management believes systems and procedures were in place to reasonably ensure accurate financial data. However, these controls and procedures have not been in place for a sufficient amount of time to demonstrate a high level of assurance of the effectiveness and to conclude that the material weakness previously identified has been remediated.

As discussed in the Company's Form 10-K for the year ended March 31, 2008, errors were identified in the application of certain accounting practices and procedures related to accounting for certain fixed costs such as portions of depreciation, general insurance and minor compensation costs which should be included in the carrying value of inventory. The Company has taken extensive measures over the past year 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) In January 2008, the Company hired a Controller, replacing the former controller and controller of cost accounting. and (3) Consultants independent from those who assisted with improvements and procedures have tested the Company's internal controls over financial reporting. In addition to those measures, management is re-evaluating its overall information technology (IT) systems as it relates to the weakness and its remediation, and will make sufficient upgrades in the future to improve the efficiency and effectiveness of system information.

(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.

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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 4. Submission of Matters to a Vote of Security Holders

Submission of Matters to a Vote of Security Holders

On September 9, 2008, the following matters were submitted and voted by stockholders entitled to vote at the Company's Annual Meeting of Stockholders:

a) The following directors were elected to serve until the next Annual Meeting or until their successors are elected.

| | For Votes | Withheld Votes |
|--------------------|------------------|-----------------------|
| Gerald R. Cysewski | 3,758,661 | 112,933 |
| Michael A. Davis | 3,764,225 | 107,368 |
| Andrew H. Jacobson | 3,762,361 | 109,233 |
| Gregg W. Robertson | 3,757,421 | 190,010 |
| David I. Rosenthal | 3,756,821 | 114,733 |
| John T. Waldron | 3,763,950 | 107,643 |

b) Amendment of the 2005 Stock Option Plan to increase by 500,000 shares to a total of 700,000 shares the amount of the Company's common stock available for issuance under the 2005 Stock Option Plan. The vote to approve was 1,762,174 for; 301,545 against; 12,835 abstain; and 1,885,041 non-votes.

c) Ratification of the selection of Grant Thornton LLP as the Company's Independent Registered Public Accounting Firm for the fiscal year ending March 31, 2009. The vote on the ratification was 3,624,479 for, 229,596 against, and 17,520 abstaining.

Item 5. Other Information

None.

Item 6. Exhibits

a) The following exhibits are furnished with this report:

- | | |
|------|---|
| 31.1 | Certification by the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act |
| 31.2 | Certification by the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act |
| 32.1 | Certification by the Chief Executive Officer pursuant to 18 U. S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification by the Chief Financial Officer pursuant to 18 U. S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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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 13, 2008

(Date)

By: /s/ Andrew H. Jacobson

Andrew H. Jacobson
President and Chief Executive
Officer

November 13, 2008

(Date)

By: /s/ William R. Maris

William R. Maris
Vice President Finance & Administration,
Chief Financial Officer
(Principal Financial and Accounting Officer)