

# LANDEC CORP \CA\

## FORM 10-Q (Quarterly Report)

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SIC Code 2821 - Plastics Materials, Synthetic Resins, and Nonvulcanizable Elastomers  
Industry Chemicals - Plastics & Rubber  
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## Table of Contents

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-Q**

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

For the Fiscal Quarter Ended February 26, 2006 , or

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

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

Commission file number: 0-27446

**LANDEC CORPORATION**

(Exact name of registrant as specified in its charter)

**California**

(State or other jurisdiction of  
incorporation or organization)

**94-3025618**

(IRS Employer  
Identification Number)

**3603 Haven Avenue**

**Menlo Park, California 94025**

(Address of principal executive offices)

Registrant's telephone number, including area code:

**(650) 306-1650**

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

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non Accelerated Filer

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

Yes  No

As of March 20, 2006, there were 24,869,423 shares of Common Stock outstanding.

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**LANDEC CORPORATION**

FORM 10-Q for the Fiscal Quarter Ended February 26, 2006

**INDEX**

Index	2
<b>Part I. Financial Information</b>	
Item 1. a) Consolidated Balance Sheets as of February 26, 2006 and May 29, 2005	3
b) Consolidated Statements of Operations for the Three Months and Nine Months Ended February 26, 2006 and February 27, 2005	4
c) Consolidated Statements of Cash Flows for the Nine Months Ended February 26, 2006 and February 27, 2005	5
d) Notes to Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	13
Item 3. Quantitative and Qualitative Disclosures About Market Risk	30
Item 4. Controls and Procedures	30
<b>Part II. Other Information</b>	31
Item 1. Legal Proceedings	31
Item 1A. Risk Factors	31
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	31
Item 3. Defaults Upon Senior Securities	31
Item 4. Submission of Matters to a Vote of Security Holders	31
Item 5. Other Information	31
Item 6. Exhibits	31
Signatures	32
EXHIBIT 31.1	
EXHIBIT 31.2	
EXHIBIT 32.1	
EXHIBIT 32.2	

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

**LANDEC CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands)

	February 26, 2006 (Unaudited)	May 29, 2005*
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 20,095	\$ 12,871
Marketable securities	—	1,968
Accounts receivable, less allowance for doubtful accounts of \$314 and \$313 at February 26, 2006 and May 29, 2005	12,957	15,405
Accounts receivable, related party	297	476
Inventory	20,899	9,917
Notes and advances receivable	536	419
Notes receivable, related party	35	89
Prepaid expenses and other current assets	1,876	2,042
Assets held for sale	—	1,190
Total Current Assets	<u>56,695</u>	<u>44,377</u>
Property and equipment, net	17,500	17,275
Goodwill, net	29,694	25,987
Trademarks, net	13,270	11,570
Other intangibles, net	173	58
Notes receivable	631	426
Notes receivable, related party	—	7
Other assets	1,059	375
Total Assets	<u>\$ 119,022</u>	<u>\$100,075</u>
Current Liabilities:		
Accounts payable	\$ 15,100	17,513
Related party payables	94	793
Accrued compensation	2,413	1,907
Other accrued liabilities	2,085	2,141
Deferred revenue	17,591	557
Current maturities of long term debt	155	548
Total Current Liabilities	<u>37,438</u>	<u>23,459</u>
Long term debt, less current maturities	1,949	2,540
Other liabilities	—	550
Minority interest	1,549	1,466
Total Liabilities	<u>40,936</u>	<u>28,015</u>
Shareholders' Equity:		
Common stock, \$0.001 par value; 50,000,000 shares authorized; 24,869,423 and 24,086,368 shares issued and outstanding at February 26, 2006 and May 29, 2005, respectively	126,019	121,950
Accumulated deficit	<u>(47,933)</u>	<u>(49,890)</u>
Total Shareholders' Equity	<u>78,086</u>	<u>72,060</u>
Total Liabilities and Shareholders' Equity	<u>\$ 119,022</u>	<u>\$100,075</u>

\* Amounts as of May 29, 2005 are derived from the May 29, 2005 audited consolidated financial statements.

*See accompanying notes.*

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

	Three Months Ended		Nine Months Ended	
	February 26, 2006	February 27, 2005	February 26, 2006	February 27, 2005
<b>Revenues:</b>				
Product sales	\$ 55,170	\$ 50,605	\$ 156,058	\$ 145,858
Services revenue, related party	690	754	2,783	2,792
License fees	1,321	22	1,616	66
Royalty revenues, related party	54	54	187	182
Research, development and royalty revenues	14	96	22	159
<b>Total revenues</b>	<b>57,249</b>	<b>51,531</b>	<b>160,666</b>	<b>149,057</b>
<b>Cost of revenue:</b>				
Cost of product sales	44,697	40,678	130,404	121,914
Cost of product sales, related party	714	1,176	3,543	4,571
Cost of services revenue	422	379	1,624	1,538
<b>Total cost of revenue</b>	<b>45,833</b>	<b>42,233</b>	<b>135,571</b>	<b>128,023</b>
<b>Gross profit</b>	<b>11,416</b>	<b>9,298</b>	<b>25,095</b>	<b>21,034</b>
<b>Operating costs and expenses:</b>				
Research and development	701	705	2,280	2,195
Selling, general and administrative	7,195	6,158	20,530	17,478
<b>Total operating costs and expenses</b>	<b>7,896</b>	<b>6,863</b>	<b>22,810</b>	<b>19,673</b>
<b>Operating income</b>	<b>3,520</b>	<b>2,435</b>	<b>2,285</b>	<b>1,361</b>
Interest income	145	88	395	107
Interest expense	(112)	(127)	(362)	(332)
Minority interest expense	(80)	(103)	(397)	(343)
Other income	41	—	36	—
<b>Net income</b>	<b>\$ 3,514</b>	<b>\$ 2,293</b>	<b>\$ 1,957</b>	<b>\$ 793</b>
<b>Basic net income per share</b>	<b>\$ 0.14</b>	<b>\$ 0.10</b>	<b>\$ 0.08</b>	<b>\$ 0.03</b>
<b>Diluted net income per share</b>	<b>\$ 0.13</b>	<b>\$ 0.09</b>	<b>\$ 0.06</b>	<b>\$ 0.02</b>
<b>Shares used in per share computation:</b>				
Basic	24,849	23,990	24,438	23,594
Diluted	25,719	24,928	25,315	24,492

*See accompanying notes.*

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

	Nine Months Ended	
	February 26, 2006	February 27, 2005
Cash flows from operating activities:		
Net income	\$ 1,957	\$ 793
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,336	2,723
(Gain) loss on sale of property and equipment	(129)	214
Minority interest	397	343
Changes in current assets and current liabilities, net of effects of acquisition of assets of Heartland Hybrids, Inc.:		
Accounts receivable, net	2,976	3,692
Inventory	(10,064)	(3,180)
Issuance of notes and advances receivable	(1,531)	(231)
Collection of notes and advances receivable	1,472	783
Prepaid expenses and other current assets	192	(444)
Accounts payable	(4,650)	(3,737)
Related party payables	(699)	(92)
Accrued compensation	506	(23)
Other accrued liabilities	(93)	463
Deferred revenue	16,484	10,774
Net cash provided by operating activities	<u>9,154</u>	<u>12,078</u>
Cash flows from investing activities:		
Purchases of property and equipment	(2,359)	(3,050)
Purchase of marketable securities	(991)	—
Proceeds from maturities of marketable securities	2,959	—
Issuance of notes and advances receivable	(425)	(453)
Collection of notes and advances receivable	223	388
Proceeds from the sale of property and equipment	1,350	22
Acquisition of assets of Heartland Hybrids, Inc., net of cash acquired	(3,630)	—
Net cash used in investing activities	<u>(2,873)</u>	<u>(3,093)</u>
Cash flows from financing activities:		
Proceeds from sale of common stock	3,109	4,964
Increase in other assets	(802)	(47)
Borrowings on lines of credit	14,904	59,441
Payments on lines of credit	(14,904)	(63,901)
Payments on long term debt	(1,050)	(1,651)
Proceeds from issuance of long term debt	—	1,200
Distributions to minority interest	(314)	(550)
Net cash provided by (used in) financing activities	<u>943</u>	<u>(544)</u>
Net increase in cash and cash equivalents	7,224	8,441
Cash and cash equivalents at beginning of period	12,871	6,458
Cash and cash equivalents at end of period	<u>\$ 20,095</u>	<u>\$ 14,899</u>
Supplemental schedule of noncash investing and financing activities:		
Sale of assets and services for notes receivable	\$ —	\$ 425
Purchase of asset for a liability	\$ —	\$ 813
Preferred shares received under license agreement	\$ 900	\$ —

*See accompanying notes.*

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

**1. Basis of Presentation**

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

The accompanying unaudited consolidated financial statements of Landec have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) have been made which are necessary to present fairly the financial position at February 26, 2006 and the results of operations and cash flows for all periods presented. Although Landec believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in financial statements and related footnotes prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted per the rules and regulations of the Securities and Exchange Commission. The accompanying financial data should be reviewed in conjunction with the audited financial statements and accompanying notes included in Landec’s Annual Report on Form 10-K for the fiscal year ended May 29, 2005.

The results of operations for the three and nine months ended February 26, 2006 are not necessarily indicative of the results that may be expected for an entire fiscal year. For instance, due to the cyclical nature of the corn seed industry, a significant portion of Landec Ag revenues and profits will be concentrated over a few months during the spring planting season (generally during Landec’s third and fourth fiscal quarters). In addition, Landec Ag purchases corn seed and collects cash deposits from farmers in advance of shipping the corn during the Company’s third and fourth quarters. The increased levels of inventory and deferred revenue at February 26, 2006 compared to May 29, 2005 reflect the seasonal nature of Landec Ag’s seed business.

**Use of Estimates**

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

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

**Investments**

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

**Recent Accounting Pronouncements**

In December 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment*, or SFAS No. 123R, which is a revision of SFAS No. 123, and supersedes APB Opinion 25. SFAS 123R requires all share-based payments to employees and directors, including grants of stock options, to be recognized in the statement of operations based on their fair values. On April 14, 2005, the SEC adopted a new rule that amended the compliance dates for SFAS



## Table of Contents

123R such that the Company is now allowed to adopt the new standard effective at the beginning of fiscal year 2007. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB Opinion 25's intrinsic value method and, as such, recognizes no compensation cost for employee stock options.

Under SFAS 123R, the Company must determine the appropriate fair value model and related assumptions to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include modified prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The modified prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive method would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The Company is currently evaluating the requirements of SFAS 123R as well as option valuation methodologies related to its stock option plans. Although the Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, the Company expects that the adoption of SFAS 123R may have a material impact on the Company's consolidated results of operations. The impact of adoption of SFAS 123R cannot be estimated at this time because it will depend on, among other things, the levels of share-based payments granted in the future, the method of adoption and the option valuation method used. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation costs to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption.

## Reclassifications

Certain reclassifications have been made to prior period financial statements to conform to the current period presentation.

### 2. Purchase of Heartland Hybrids Assets

On August 29, 2005, Landec Corporation, through its agricultural seed subsidiary, Landec Ag, Inc., acquired the assets of Heartland Hybrids, Inc. ("Heartland"), which is based in Dassel, MN, for \$6.0 million. The consideration at closing consisted of 152,186 shares of Landec Common Stock valued at \$1.0 million and cash of \$3.65 million. In addition, the agreement provides for future payments to the former owners of Heartland of up to \$1.35 million. These payments consist of a cash earn-out of \$1.2 million based on Heartland achieving certain financial targets for fiscal years 2006 and 2007 and a \$150,000 holdback for any post closing adjustments. Any amounts remaining in the holdback reserve will be paid out in May 2006. Heartland operations are included in Landec's consolidated results of operations commencing August 29, 2005. The purchase price has been allocated to the acquired assets and liabilities based on their relative fair market values, subject to final adjustments predominantly related to earn-out payments. These allocations are based on independent valuations and other studies.

The following is a summary of the purchase price allocation (in thousands):

Net assets and liabilities	\$ (757)
Customer base	800
Trademark	1,700
Goodwill	2,907
	<u>\$ 4,650</u>

Under Statements of Financial Accounting Standards No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests in accordance with the Statements. No pro forma information is deemed necessary as the operations of Heartland Hybrids are immaterial to Landec's annual revenues and results of operations.

### 3. License Agreement

On December 23, 2005, Landec entered into an exclusive licensing agreement with a medical device company. This company paid Landec an upfront license fee of \$250,000 for the exclusive rights to use Landec's Intelimer ®

## Table of Contents

materials technology in a specific device field worldwide. Landec will also receive royalties on the sale of products incorporating Landec's technology. In addition, the Company received shares of preferred stock valued at \$900,000 which represents a 16.7% ownership interest in the medical device company. Landec's ownership interest could increase to as high as 19.9% based on certain milestones being achieved. The \$1.15 million of value received under this agreement is recorded as licensing revenue in the accompanying Consolidated Statements of Operations since Landec has no further obligations under this agreement.

### 4. Net Income Per Diluted Share

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

	Three Months Ended February 26, 2006	Three Months Ended February 27, 2005	Nine Months Ended February 26, 2006	Nine Months Ended February 27, 2005
<b>Numerator:</b>				
Net income	\$ 3,514	\$ 2,293	\$ 1,957	\$ 793
Less: Minority interest in income of subsidiary	(165)	(127)	(390)	(211)
Net income for diluted net income per share	\$ 3,349	\$ 2,166	\$ 1,567	\$ 582
<b>Denominator:</b>				
Weighted average shares for basic net income per share	24,849	23,990	24,438	23,594
Effect of dilutive securities:				
Stock Options	870	938	877	898
Weighted average shares for diluted net income per share	25,719	24,928	25,315	24,492
Diluted net income per share	\$ 0.13	\$ 0.09	\$ 0.06	\$ 0.02

Options to purchase 442,962 and 552,812 shares of Common Stock at a weighted average exercise price of \$6.49 and \$6.90 per share were outstanding during the three months ended February 26, 2006 and February 27, 2005, respectively, but were not included in the computation of diluted net income per share because the options' exercise price were greater than the average market price of the Common Stock and, therefore, the effect would be antidilutive.

Options to purchase 480,709 and 2,564,247 shares of Common Stock at a weighted average exercise price of \$6.49 and \$5.63 per share were outstanding during the nine months ended February 26, 2006 and February 27, 2005, respectively, but were not included in the computation of diluted net income per share because the options' exercise price were greater than the average market price of the Common Stock and, therefore, the effect would be antidilutive.

### 5. Stock-Based Compensation

As permitted by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," (SFAS 123), as amended by Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure," (SFAS 148), the Company elected to continue to apply the provisions of Accounting Principle Board Opinion No. 25, "Accounting for Stock Issued to Employees," (APB 25) and related interpretations in accounting for its employee stock option and stock purchase plans. The Company is not required under APB 25 and related interpretations to recognize compensation expense in connection with its employee stock option and stock purchase plans, unless the exercise price of the Company's employee stock options is less than the market price of the underlying stock at the date of grant.

Pro forma information regarding net income and net income per share is required by SFAS 148 and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS 123. The fair value for these options was estimated at the date of grant using the Black-Scholes option valuation model with the following weighted average assumptions: risk-free interest rates ranging from 4.31% to 4.72% for the three months ended February 26, 2006, 3.60% to 3.76% for the three months February 27, 2005; 3.69% to 4.72% for the

## Table of Contents

nine months ended February 26, 2006, and 3.35% to 3.93% for the nine months ended February 27, 2005; a dividend yield of 0.0% for the three and nine months ended February 26, 2006 and February 27, 2005; a volatility factor of the expected market price of the Company's common stock of 0.53 and 0.59 as of February 26, 2006 and February 27, 2005, respectively; and a weighted average expected life of the options of 4.82 years and 4.39 years for the three and nine months ended February 26, 2006 and February 27, 2005, respectively.

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

	Three Months Ended		Nine Months Ended	
	February 26, 2006	February 27, 2005	February 26, 2006	February 27, 2005
Net income	\$ 3,514	\$ 2,293	\$ 1,957	\$ 793
Deduct:				
Stock-based employee expense determined under SFAS 123	(230)	(222)	(894)	(849)
Basic Pro forma net income (loss)	3,284	2,071	1,063	(56)
Less: Minority interest in income of subsidiary	(165)	(127)	(390)	(211)
Diluted pro forma net income (loss)	\$ 3,119	\$ 1,944	\$ 673	\$ (267)
Basic net income per share — as reported	\$ 0.14	\$ 0.10	\$ 0.08	\$ 0.03
Diluted net income per share — as reported	\$ 0.13	\$ 0.09	\$ 0.06	\$ 0.02
Basic pro forma net income (loss) per share	\$ 0.13	\$ 0.09	\$ 0.04	\$ (0.00)
Diluted pro forma net income (loss) per share	\$ 0.12	\$ 0.08	\$ 0.03	\$ (0.01)

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. These amounts do not necessarily represent the effects of employee stock options on reported net income (loss) for future years.

## 6. Goodwill and Other Intangibles

The Company is required under SFAS 142 to review goodwill and indefinite lived intangible assets at least annually. During the nine months ended February 26, 2006, the Company completed its annual impairment review. The review is performed by grouping the net book value of all long-lived assets for reporting entities, including goodwill and other intangible assets, and comparing this value to the related estimated fair value. The determination of fair value is based on estimated future discounted cash flows related to these long-lived assets. The discount rate used was based on the risks associated with the reporting entities. The determination of fair value was performed by management using the services of an independent appraiser. The review concluded that the fair value of the reporting entities exceeded the carrying value of their net assets and thus no charge was warranted as of February 26, 2006.

## 7. Inventories

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

	February 26, 2006	May 29, 2005
Finished goods	\$ 15,875	\$ 6,132
Raw material	5,024	3,655
Work in process	—	130
Total	\$ 20,899	\$ 9,917

## 8. Purchase and Sale of Fruit Land

On January 14, 2005, the Company entered into an agreement to purchase approximately 155 acres of fruit land from an individual for \$812,500. This amount was paid to the seller through the funding of an escrow account on March 23, 2005. In a separate unrelated transaction, on January 31, 2005, the Company entered into an agreement to sell approximately 45 acres of grape land to an individual for \$452,500. Upon entering into the agreement, the Company received \$28,000 in cash and promissory notes receivable for \$424,500. The sale closed on January 3, 2006. As of February 26, 2006, payments on the notes receivable totaled \$56,000 with the remaining balance to be paid from net profits from the sale of grapes produced from this property with a final payment due on December 31, 2009, if not previously paid off. Interest accrues at the prime rate and is payable quarterly. In another transaction which closed on January 17, 2006, the Company sold to an individual the remaining 110 acres for \$936,000 in cash, net of sales commissions. The Company recorded a gain of \$160,000 during the three months ended February 26, 2006 on these sales.

## 9. Debt

On November 1, 2005, Apio amended its revolving line of credit that was scheduled to expire on August 31, 2006, with Wells Fargo Bank N.A. The line was reduced from \$10.0 million to \$7.0 million and outstanding amounts under the line of credit now bear interest at either the prime rate less 0.25% or the LIBOR adjustable rate plus 1.75% (6.36% at February 26, 2006). The line of credit contains certain restrictive covenants, which require Apio to meet certain financial tests including minimum levels of net income, maximum leverage ratio, minimum net worth and maximum capital expenditures. The line of credit also affects the ability of Landec to receive payments on debt owed by Apio to Landec. Landec has pledged substantially all of the assets of Apio to secure the line with Wells Fargo Bank. At February 26, 2006, no amounts were outstanding under Apio's line of credit.

## 10. Licensing and Supply Agreement

In July 2005, the Company amended the supply agreement with Alcon, Inc. to change the expiration date of the agreement from November 1, 2012 to May 28, 2006. As a result, all of the deferred revenue has been reclassified to current liabilities in the accompanying Consolidated Balance Sheets. In addition, in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition (a replacement of SAB 101)*, the entire amount of the deferred revenue of \$638,000 as of May 29, 2005, will be recognized as "recycled" revenue during fiscal year 2006. For the three and nine months ended February 26, 2006, \$172,000 and \$466,000, respectively, of the related deferred revenue was recognized as "recycled" license revenue.

## 11. Related Party

Apio provides cooling and distributing services for farms in which the Chief Executive Officer of Apio (the "Apio CEO") has a financial interest and purchases produce from those farms. Apio also purchases produce from Beachside Produce LLC (formerly known as Apio Fresh) for sale to third parties. Beachside Produce is owned by a group of entities and persons that supply produce to Apio. One of the owners of Beachside Produce is the Apio CEO. Revenues, cost of product sales and the resulting payable and the note receivable from advances for ground lease payments, crop and harvesting costs, are classified as related party in the accompanying financial statements as of February 26, 2006 and May 29, 2005 and for the three and nine months ended February 26, 2006 and February 27, 2005.

Apio leases, for approximately \$429,000 on an annual basis, agricultural land that is either owned, controlled or leased by the Apio CEO. Apio, in turn, subleases that land at cost to growers who are obligated to deliver product from that land to Apio for value added products. There is generally no net statement of operations impact to Apio as a result of these leasing activities but Apio creates a guaranteed source of supply for the value added business. Apio has loss exposure on the leasing activity to the extent that it is unable to sublease the land. For the three and nine months ended February 26, 2006 the Company subleased all of the land leased from the Apio CEO and received sublease income of \$115,000 and \$436,000, respectively, which is equal to the amount the Company paid to lease that land for the period.

Apio's domestic commodity vegetable business was sold to Beachside Produce, effective June 30, 2003. The Apio CEO is a 12.5% owner in Beachside Produce. During the three and nine months ended February 26, 2006, the Company recognized revenues of \$16,000 and \$86,000, respectively, from the sale of products to Beachside Produce

## Table of Contents

and royalty revenue of \$54,000 and \$187,000, respectively, from the use by Beachside Produce of Apio's trademarks. The related accounts receivable from Beachside Produce are classified as related party in the accompanying financial statements as of February 26, 2006 and May 29, 2005.

In addition, the Apio CEO has a 6% ownership interest in Apio Cooling LP, a limited partnership in which Apio is the general partner with a 60% ownership interest. Included in the minority interest liability as of February 26, 2006 and May 29, 2005 is \$218,000 and \$201,000, respectively, owed to the Apio CEO.

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

### 12. Comprehensive Income

The comprehensive income of Landec is the same as the net income.

### 13. Shareholders' Equity

During the three and nine months ended February 26, 2006, 485,469 and 630,869 shares of Common Stock, respectively, were issued upon the exercise of options under the Company's stock option plans and the Company's Employee Stock Purchase Plan. In addition, the Company issued to the former owners of Heartland 152,186 shares of Landec Common Stock on August 29, 2005 in connection with the purchase of Heartland assets (see Note 2).

On October 14, 2005, following shareholder approval at the Annual Meeting of Shareholders of the Company, the 2005 Stock Incentive Plan (the "Plan") became effective and replaced the Company's four then existing equity plans. Employees (including officers), consultants and directors of the Company and its subsidiaries and affiliates are eligible to participate in the Plan.

The Plan provides for the grant of stock options (both nonstatutory and incentive stock options), stock grants, stock units and stock appreciation rights. Awards under the Plan will be evidenced by an agreement with the Plan participant. Under the Plan 861,038 shares of the Company's Common Stock ("Shares") are available for awards. Under the Plan no recipient may be awarded any of the following during any fiscal year: (i) stock options covering in excess of 500,000 Shares; (ii) stock grants and stock units covering in excess of 250,000 Shares in the aggregate; or (iii) stock appreciation rights covering more than 500,000 Shares. In addition, awards to non-employee directors are discretionary. However, a non-employee director may not be granted awards covering in excess of 30,000 Shares in the aggregate during any fiscal year.

**14. Business Segment Reporting**

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

Operations by Business Segment (in thousands):

	Food Products Technology	Agricultural Seed Technology	Corporate and Other	TOTAL
<b>Three months ended February 26, 2006</b>				
Net revenues	\$ 47,435	\$ 8,353	\$ 1,461	\$ 57,249
International sales	\$ 6,272	\$ —	\$ —	\$ 6,272
Gross profit	\$ 7,391	\$ 2,621	\$ 1,404	\$ 11,416
Net income (loss)	\$ 3,154	\$ (751)	\$ 1,111	\$ 3,514
Interest expense	\$ 79	\$ 33	\$ —	\$ 112
Interest income	\$ 126	\$ 1	\$ 18	\$ 145
Depreciation and amortization	\$ 717	\$ 65	\$ 28	\$ 810
<b>Three months ended February 27, 2005</b>				
Net revenues	\$ 41,650	\$ 9,722	\$ 159	\$ 51,531
International sales	\$ 5,943	\$ —	\$ —	\$ 5,943
Gross profit	\$ 5,299	\$ 3,859	\$ 140	\$ 9,298
Net income	\$ 1,170	\$ 978	\$ 145	\$ 2,293
Interest expense	\$ 90	\$ 37	\$ —	\$ 127
Interest income	\$ 62	\$ 12	\$ 14	\$ 88
Depreciation and amortization	\$ 809	\$ 119	\$ 27	\$ 955
<b>Nine months ended February 26, 2006</b>				
Net revenues	\$150,336	\$ 8,373	\$ 1,957	\$160,666
International sales	\$ 42,914	\$ —	\$ —	\$ 42,914
Gross profit	\$ 20,720	\$ 2,640	\$ 1,735	\$ 25,095
Net income (loss)	\$ 7,436	\$ (6,063)	\$ 584	\$ 1,957
Interest expense	\$ 227	\$ 134	\$ 1	\$ 362
Interest income	\$ 324	\$ 27	\$ 44	\$ 395
Depreciation and amortization	\$ 1,917	\$ 344	\$ 75	\$ 2,336
<b>Nine months ended February 27, 2005</b>				
Net revenues	\$138,920	\$ 9,827	\$ 310	\$149,057
International sales	\$ 42,126	\$ —	\$ —	\$ 42,126
Gross profit	\$ 16,820	\$ 3,955	\$ 259	\$ 21,034
Net income (loss)	\$ 3,978	\$ (3,376)	\$ 191	\$ 793
Interest expense	\$ 223	\$ 109	\$ —	\$ 332
Interest income	\$ 76	\$ 14	\$ 17	\$ 107
Depreciation and amortization	\$ 2,294	\$ 351	\$ 78	\$ 2,723

During the nine months ended February 26, 2006 and February 27, 2005, sales to the Company’s top five customers accounted for approximately 45% and 41%, respectively, of revenues, with the Company’s top customers from the Food Products Technology segment, Costco Wholesale Corp., accounting for approximately 16% and 15%, respectively, and Sam’s Club, accounting for approximately 10% and 9%, respectively of revenues. The Company expects that, for the foreseeable future, a limited number of customers may continue to account for a significant portion of its net revenues. Virtually all of the Company’s international sales are to Asia.

**15. Subsequent Events**

On March 14, 2006, Landec entered into an exclusive license and research and development agreement with Air Products and Chemicals, Inc. Landec received an upfront licensing fee of \$800,000 at close and will receive up to an additional \$1.6 million of license payments that will be paid in quarterly installments of \$200,000 each during years two and three of the agreement for the exclusive rights to use Landec's Intelimer materials technology in specific fields worldwide. In addition, Landec received at close \$100,000 for technology transfer work to be performed by Landec during Landec's fourth quarter of fiscal year 2006. Landec will provide research and development support to Air Product for three years with a mutual option for two additional years. The license fees will be recognized as license revenue over a three year period beginning March 2006. In addition, in accordance with the agreement, occurring after March 14, 2007, Landec will receive 40% of the gross profits generated from the sale of products by Air Products that incorporate Landec's Intelimer materials.

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

The following discussion should be read in conjunction with the unaudited consolidated financial statements and accompanying notes included in Part I—Item 1 of this Form 10-Q and the audited consolidated financial statements and accompanying notes and Management's Discussion and Analysis of Financial Condition and Results of Operations included in Landec's Annual Report on Form 10-K for the fiscal year ended May 29, 2005.

Except for the historical information contained herein, the matters discussed in this report are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Potential risks and uncertainties include, without limitation, those mentioned in this report and, in particular the factors described below under "Additional Factors That May Affect Future Results," and those mentioned in Landec's Annual Report on Form 10-K for the fiscal year ended May 29, 2005. Landec undertakes no obligation to update or revise any forward-looking statements in order to reflect events or circumstances that may arise after the date of this report.

**Critical Accounting Policies and Use of Estimates**

There have been no material changes to the Company's critical accounting policies which are included and described in the Form 10-K for the fiscal year ended May 29, 2005 filed with the Securities and Exchange Commission on August 2, 2005.

**The Company**

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

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

Landec has two core businesses – Food Products Technology and Agricultural Seed Technology, in addition to our Technology Licensing/Research and Development business which is included in Corporate and Other for segment disclosure purposes (see note 14).

Our Food Products Technology business is operated through a subsidiary, Apio, Inc., and combines our proprietary food packaging technology with the capabilities of a large national food supplier and value-added produce processor. Value-added processing incorporates Landec's proprietary packaging technology with produce that is



## Table of Contents

processed by washing, and in some cases cutting and mixing, resulting in packaged produce to achieve increased shelf life and reduced shrink (waste) and to eliminate the need for ice during the distribution cycle. This combination was consummated in December 1999 when the Company acquired Apio, Inc. and certain related entities (collectively, “Apio”).

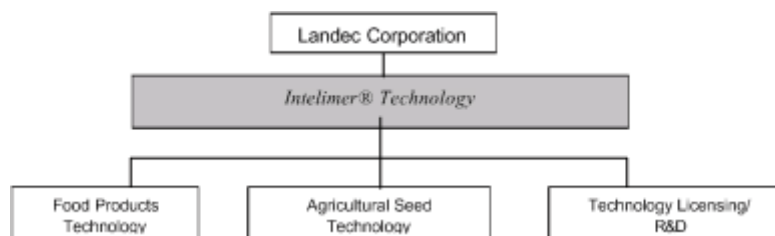
Our Agricultural Seed Technology business is operated through a subsidiary, Landec Ag, Inc., (“Landec Ag”) and combines our proprietary Intellicoat<sup>®</sup> seed coating technology with our unique e-commerce, direct marketing and consultative selling capabilities which we obtained when we acquired Fielder’s Choice Direct (“Fielder’s Choice”), a direct marketer of hybrid seed corn, in September 1997.

In addition to our two core businesses, the Company also operates a Technology Licensing/Research and Development business that licenses and/or supplies products outside of our core businesses to industry leaders such as Akzo Nobel and L’Oreal of Paris.

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

### Description of Core Business

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



### Food Products Technology Business

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

Based in Guadalupe, California, Apio, when acquired in December 1999, consisted of two major businesses – first, the “fee-for-service” selling and marketing of whole produce and second, the specialty packaged fresh-cut and whole value-added processed products that are washed and packaged in our proprietary BreatheWay<sup>™</sup> packaging. The “fee-for-service” business historically included field harvesting and packing, cooling and marketing of vegetables and fruit on a contract basis for growers in California’s Santa Maria, San Joaquin and Imperial Valleys as well as in Arizona and Mexico. The Company exited this business and certain assets associated with the business were sold in June 2003 to Beachside Produce, LLC (formerly known as Apio Fresh). Beachside Produce is owned by a group of entities and



## Table of Contents

persons that supply produce to Apio, including Nicholas Tompkins, Apio's President and Chief Executive Officer. Under the terms of the sale, Beachside Produce purchased certain equipment and carton inventory from Apio in exchange for approximately \$410,000. In connection with the sale, Beachside Produce pays Apio an on-going royalty fee per carton sold for the use of Apio's brand names and Beachside Produce and its growers entered into a long-term supply agreement with Apio to supply produce to Apio for its fresh-cut value-added products. The fresh-cut value-added processed products business markets a variety of fresh-cut and whole vegetables to the top retail grocery chains and club stores. During the fiscal year ended May 29, 2005, Apio shipped more than sixteen million cartons of produce to leading supermarket retailers, wholesalers, foodservice suppliers and club stores throughout the United States and internationally, primarily in Asia.

There are five major distinguishing characteristics of Apio that provide competitive advantages for its Food Products Technology business:

- **Value-Added Supplier:** Apio has structured its business as a marketer and seller of fresh-cut and whole value-added produce. It is focused on selling products under its Eat Smart<sup>®</sup> brand and other brands for its fresh-cut and whole value-added products. As retail grocery and club store chains consolidate, Apio is well positioned as a single source of a broad range of products.
- **Reduced Farming Risks:** Apio reduces its farming risk by not taking ownership of farmland, and instead, contracts with growers for produce. The year-round sourcing of produce is a key component to the fresh-cut and whole value-added processing business.
- **Lower Cost Structure:** Apio has strategically invested in the rapidly growing fresh-cut and whole value-added business. Apio's 60,000 square foot value-added processing plant is automated with state-of-the-art vegetable processing equipment. Virtually all of Apio's value-added products utilize Apio's proprietary BreatheWay packaging technology. Apio's strategy is to operate one large central processing facility in one of California's largest, lowest cost growing regions (Santa Maria Valley) and use packaging technology to allow for the nationwide delivery of fresh produce products.
- **Export Capability:** Apio is uniquely positioned to benefit from the growth in export sales to Asia and Europe over the next decade with its export business, CalEx. Through CalEx, Apio is currently one of the largest U.S. exporters of broccoli to Asia and is selling its iceless products to Asia using proprietary BreatheWay packaging technology.
- **Expanded Product Line Using Technology:** Apio, through the use of its BreatheWay packaging technology, is introducing on average twelve new value-added products each year. These new product offerings range from various sizes of fresh-cut bagged products, to vegetable trays, to whole produce products. During the last twelve months, Apio has introduced 15 new products.

### *Agricultural Seed Technology Business*

Landec Ag's strategy is to build a vertically integrated seed technology company based on Intellicoat seed coating technology and its e-commerce, direct marketing and consultative selling capabilities.

For the coating technology the strategy is to develop a patented, functional polymer coating technology that will be broadly licensed to the seed industry. The company will initially commercialize products for the corn and soybean markets and then broaden its applications to other seed crops. Landec Ag will use its Fielder's Choice Direct marketing and sales company to launch its applications for corn to build awareness for this technology and then broadly license its applications to the rest of the industry.

Landec Ag's Intellicoat seed coating applications are designed to control seed germination timing, increase crop yields, reduce risks and extend crop-planting windows. These coatings are currently available on hybrid corn, soybeans and male inbred corn used for seed production. In fiscal year 2000, Landec Ag launched its first commercial product, Pollinator Plus<sup>®</sup> coatings, which is a coating application used by seed companies as a method for spreading pollination to increase yields and reduce risk in the production of hybrid seed corn. There are approximately 650,000 acres of seed production in the United States and in 2005 Pollinator Plus was used by 38 seed companies on approximately 15% of the seed production acres in the U.S.

## Table of Contents

In 2003, Landec Ag commercialized Early Plant ® corn by selling the product directly to farmers through its Fielder's Choice Direct ® brand. This application allows farmers to plant into cold soils without the risk of chilling injury, and enables farmers to plant as much as four weeks earlier than normal. With this capability, farmers are able to utilize labor and equipment more efficiently, provide flexibility during the critical planting period and avoid yield losses caused by late planting. In 2005, nine seed companies offered Intellicoat on their hybrid seed corn offerings and sales increased by 20% over 2004.

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

Based in Monticello, Indiana, Fielder's Choice Direct offers a comprehensive line of corn hybrids and alfalfa to more than 12,000 farmers in over forty states through direct marketing programs. The success of Fielder's Choice comes, in part, from its expertise in selling directly to the farmer, bypassing the traditional and costly farmer-dealer system. We believe that this direct channel of distribution provides up to a 35% cost advantage compared to the farmer-dealer system.

In order to support its direct marketing programs, Fielder's Choice has developed a proprietary e-commerce, direct marketing, and consultative selling information technology that enables state-of-the-art methods for communicating with a broad array of farmers. This proprietary direct marketing information technology includes a current database of over 104,000 farmers.

On August 29, 2005, Landec Ag closed the acquisition of Heartland Hybrids, Inc., the second largest direct marketer of seed corn after Landec Ag's Fielder's Choice Direct brand. With complementary strengths in geographic areas and sales channels, the new combined organization has the opportunity to develop the most efficient and effective sales, marketing and distribution system in the seed industry, expanding Landec Ag's sales of both uncoated seed and Intellicoat coated seed.

Due to the cyclical nature of the corn seed industry, a significant portion of Landec Ag revenues and profits will be concentrated over a few months during the spring planting season (generally during Landec's third and fourth fiscal quarters). In addition, Landec Ag purchases corn seed and collects cash deposits from farmers in advance of shipping the corn during the Company's third and fourth quarters.

### **Technology Licensing/Research and Development Businesses**

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

### **Results of Operations**

**Revenues** (in thousands):

	<i>Three months ended 2/26/06</i>	<i>Three months ended 2/27/05</i>	<i>Change</i>	<i>Nine months ended 2/26/06</i>	<i>Nine months ended 2/27/05</i>	<i>Change</i>
<b>Apio Value Added</b>	\$ 39,517	\$ 33,977	16%	\$ 99,653	\$ 89,201	12%
<b>Apio Trading</b>	7,415	7,673	(3%)	50,093	49,719	1%
<b>Apio Tech</b>	503	—	N/M	590	—	N/M
<b>Total Apio</b>	47,435	41,650	14%	150,336	138,920	8%
<b>Landec Ag</b>	8,353	9,722	(14%)	8,373	9,827	(15%)
<b>Corporate</b>	1,461	159	819%	1,957	310	531%
<b>Total Revenues</b>	\$ 57,249	\$ 51,531	11%	\$ 160,666	\$ 149,057	8%

## Table of Contents

### *Apio Value Added*

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

The increase in Apio's value-added revenues for the three and nine months ended February 26, 2006 compared to the same periods last year is due to increased product offerings, increased sales to existing customers, the addition of new customers and product mix changes to higher priced products. Specifically, sales of Apio's value-added 12-ounce specialty packaged retail product line grew 20% and 15%, respectively, during the three and nine months ended February 26, 2006 compared to the same periods last year. In addition, sales of Apio's value-added vegetable tray products grew 24% and 23%, respectively, during the three and nine months ended February 26, 2006 compared to the same periods last year. Overall value-added unit sales volume increased 13% during the third quarter of fiscal year 2006 compared to the same period last year and 7% for the nine months ended February 26, 2006 compared to the same period of the prior year.

### *Apio Trading*

Apio trading revenues consist of revenues generated from the purchase and sale of primarily whole commodity fruit and vegetable products to Asia through Apio's export company, Cal Ex, and from the purchase and sale of whole commodity fruit and vegetable products domestically to Wal-Mart. The export portion of trading revenues for the three and nine months ended February 26, 2006 were \$6.3 million and \$42.9 million, respectively, or 85% and 86%, respectively, of total trading revenues.

The decrease in revenues in Apio's trading business for the three ended February 26, 2006 compared to the same period last year was primarily due to a 40% decrease in buy/sell commodity volumes sold to Wal-Mart partially offset by an increase in export unit volumes of 7%. The increase in revenues in Apio's trading business for the nine months ended February 26, 2006 compared to the same period last year was primarily due to a 2% increase in export unit volumes.

### *Apio Tech*

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

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

### *Landec Ag*

Landec Ag revenues consist of revenues generated from the sale of hybrid seed corn to farmers under the Fielder's Choice Direct brand and from the sale of hybrid seed corn and soybeans under the Heartland Hybrids<sup>®</sup> brand and from the sale of Intellicoat coated corn and soybean seeds to farmers and seed companies. Virtually all of Landec Ag's revenues are generated during the Company's third and fourth quarters.

The decrease in revenues at Landec Ag during the three and nine months ended February 26, 2006 compared to the same periods last year was due to Landec Ag shipping only 24% of projected fiscal year 2006 sales during this year's third quarter compared to shipping 38% of fiscal year 2005 sales during last year's third quarter.

### *Corporate*

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

## Table of Contents

The increase in Corporate revenues for the three and nine months ended February 26, 2006 compared to the same periods of the prior year was due to the \$1.15 million in revenues received from the license of our Intelimer technology in a specific field to a medical device company in December 2005.

### Gross Profit (in thousands):

	<i>Three months ended 2/26/06</i>	<i>Three months ended 2/27/05</i>	<i>Change</i>	<i>Nine months ended 2/26/06</i>	<i>Nine months ended 2/27/05</i>	<i>Change</i>
<b>Apio Value Added</b>	\$ 6,435	\$ 4,880	32%	\$ 17,436	\$ 14,118	24%
<b>Apio Trading</b>	455	419	9%	2,721	2,702	1%
<b>Apio Tech</b>	501	—	N/M	563	—	N/M
<b>Total Apio</b>	7,391	5,299	39%	20,720	16,820	23%
<b>Landec Ag</b>	2,621	3,859	(32%)	2,640	3,955	(33%)
<b>Corporate</b>	1,404	140	903%	1,735	259	570%
<b>Total Gross Profit</b>	\$ 11,416	\$ 9,298	23%	\$ 25,095	\$ 21,034	19%

### General

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

### Apio Value-Added

The increase in gross profits for Apio's value-added specialty packaged vegetable business for the three and nine months ended February 26, 2006 compared to the same periods last year was due to (1) the increase in value-added sales which increased 16% for the quarter and 12% for the first nine months of fiscal year 2006, (2) product mix changes to higher margin products and (3) improved operational efficiencies driven largely by improved raw material quality during the first nine months of fiscal year 2006 compared to the same period last year.

### Apio Trading

Apio's trading business is a buy/sell business that realizes a commission-based margin in the 4-6% range. The increase in gross profits during the three and nine months ended February 26, 2006 compared to the same periods last year was primarily due to a mix change to higher margin vegetable exports from lower margin fruit exports and lower margin domestic commodity sales to Wal-Mart.

### Apio Tech

The increase in gross profits for Apio Tech for the three and nine months ended February 26, 2006 compared to the same periods last year was due to the revenues received from our banana packaging agreement with Chiquita.

### Landec Ag

The decrease in gross profits for Landec Ag for the three and nine months ended February 26, 2006 compared to the same periods last year was due to (1) a decrease in revenues of 14% during the third quarter and 15% for the first nine months of fiscal year 2006 compared to the same periods last year due to a delay in corn shipments this year and (2) the increase in promotional discounts offered this year in order to remain competitive in the industry which experienced unusually high discounts this selling season as compared to past seasons.

## Table of Contents

### Corporate

The increase in gross profits for Corporate for the three and nine months ended February 26, 2006 compared to the same periods last year was due to \$1.15 million of gross profits from the medical device licensing agreement entered into in December 2005.

### Operating Expenses (in thousands):

	<i>Three months ended 2/26/06</i>	<i>Three months ended 2/27/05</i>	<i>Change</i>	<i>Nine months ended 2/26/06</i>	<i>Nine months Ended 2/27/05</i>	<i>Change</i>
<b>Research and Development:</b>						
<i>Apio</i>	\$ 193	\$ 230	(16%)	\$ 733	\$ 773	(5%)
<i>Landec Ag</i>	163	194	(16%)	470	613	(23%)
<i>Corporate</i>	345	281	23%	1,077	809	33%
<b>Total R&amp;D</b>	<b>\$ 701</b>	<b>\$ 705</b>	<b>(1%)</b>	<b>\$ 2,280</b>	<b>\$ 2,195</b>	<b>4%</b>

### Selling, General and Administrative:

<i>Apio</i>	\$ 3,406	\$ 3,039	12%	\$ 10,324	\$ 9,537	8%
<i>Landec Ag</i>	2,704	2,350	15%	6,920	5,719	21%
<i>Corporate</i>	1,085	769	41%	3,286	2,222	48%
<b>Total S,G&amp;A</b>	<b>\$ 7,195</b>	<b>\$ 6,158</b>	<b>17%</b>	<b>\$ 20,530</b>	<b>\$ 17,478</b>	<b>17%</b>

### Research and Development

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

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

### Selling, General and Administrative

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

The increase in selling, general and administrative expenses for the three months and nine months ended February 26, 2006 compared to the same periods last year was primarily due to (1) increases in selling and marketing expenses at Apio and Landec Ag to generate current and future increases in revenues, (2) selling, general and administrative expenses of \$658,000 and \$1.2 million, respectively, at Heartland Hybrids which was acquired at the beginning of the second fiscal quarter, (3) accrued bonuses at Apio and Corporate based on meeting or exceeding our plan which is currently being exceeded (whereas in the prior fiscal year, bonuses were not recorded until the end of the fiscal year due to uncertainty) and (4) an increase in general and administrative expenses at Corporate for business development consulting fees, legal fees and Sarbanes-Oxley related accounting fees.

## Table of Contents

Other (in thousands):

	<i>Three months ended 2/26/06</i>	<i>Three months ended 2/27/05</i>	<i>Change</i>	<i>Nine months ended 2/26/06</i>	<i>Nine months ended 2/27/05</i>	<i>Change</i>
<b>Interest Income</b>	\$ 145	\$ 88	65%	\$ 395	\$ 107	269%
<b>Interest Expense</b>	(112)	(127)	(12%)	(362)	(332)	9%
<b>Minority Int. Exp</b>	(80)	(103)	(22%)	(397)	(343)	16%
<b>Other Income</b>	41	—	N/M	36	—	N/M
<b>Total Other</b>	\$ (6)	\$ (142)	(96%)	\$ (328)	\$ (568)	(42%)

### *Interest Income*

The increase in interest income for the three and nine month periods ended February 26, 2006 compared to the same periods last year was due to the increase in cash available for investing and higher average interest rates on those investments.

### *Interest Expense*

The change in interest expense during the three and nine months ended February 26, 2006 compared to the same periods last year was not material.

### *Minority Interest Expense*

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

The change in the minority interest for the three months and nine months ended February 26, 2006 compared to the same periods last year was not material.

### *Other Income*

Other consists of non-operating income and expenses.

The change in other income for the three months and nine months ended February 26, 2006 compared to the same periods last year was not material.

## Liquidity and Capital Resources

As of February 26, 2006, the Company had cash and cash equivalents of \$20.1 million, a net increase of \$7.2 million from \$12.9 million at May 29, 2005.

### *Cash Flow from Operating Activities*

Landec generated \$9.2 million of cash flow from operating activities during the nine months ended February 26, 2006 compared to \$12.1 million from operating activities for the nine months ended February 27, 2005. The primary sources of cash during the nine months ended February 26, 2006 were from (1) net income and non-cash items, such as depreciation, of \$4.6 million and (2) an increase in deferred revenue of \$16.5 million as a result of cash deposits for seed corn to be shipped during our fourth fiscal quarter. The primary uses of cash in operating activities were from (1) the purchase of inventory, primarily seed corn, by Landec Ag, of \$10.1 million and (2) a \$4.7 million reduction in accounts payable due to the seasonality of our businesses.

### *Cash Flow from Investing Activities*

Net cash used in investing activities for the nine months ended February 26, 2006 was \$2.9 million compared to \$3.1 million for the same period last year. The primary source of cash from investing activities during the nine months ended February 26, 2006 was from the net maturities of \$2.0 million of marketable securities. The primary uses of cash from investing activities during the first nine months of fiscal year 2006 were for the purchase of the assets of Heartland Hybrids for \$3.6 million and the purchase of \$2.4 million of property and equipment primarily for the further automation of Apio's value-added facility.

## Table of Contents

### *Cash Flow from Financing Activities*

Net cash provided by financing activities for the nine months ended February 26, 2006 was \$943,000 compared to net cash used in financing activities of \$544,000 for the same period last year. The cash provided by financing activities during the first nine months of fiscal year 2006 was from the sale of \$3.1 million of common stock to employees upon the exercise of stock options. The primary use of cash from financing activities during the first nine months of fiscal year 2006 was from the pay down of \$1.1 million of long-term debt.

### *Capital Expenditures*

During the nine months ended February 26, 2006, Landec purchased vegetable processing equipment to support the expansion of Apio's value added business. These expenditures represented the majority of the \$2.4 million of equipment purchased.

### *Debt*

On November 1, 2005, Apio amended its revolving line of credit with Wells Fargo Bank N.A. that was scheduled to expire on August 31, 2006. The line was reduced from \$10.0 million to \$7.0 million and outstanding amounts under the line of credit now bear interest at either the prime rate less .25% or the LIBOR adjustable rate plus 1.75% (6.36% at February 26, 2006). The revolving line of credit, the equipment line of credit and the term note with Wells Fargo (collectively, the "Loan Agreement") contains certain restrictive covenants, which require Apio to meet certain financial tests, including minimum levels of net income, maximum leverage ratio, minimum net worth and maximum capital expenditures. Landec has pledged substantially all of the assets of Apio to secure the lines with Wells Fargo. At February 26, 2006, no amounts were outstanding under the revolving line of credit or the equipment line of credit. Apio has been in compliance with all loan covenants in the Loan Agreement since the inception of this loan.

Landec Ag has a revolving line of credit which allows for borrowings of up to \$7.5 million, based on Landec Ag's inventory levels. The interest rate on the revolving line of credit is the prime rate plus 0.375% (7.875% at February 26, 2006). The line of credit contains certain restrictive covenants, which, among other things, restrict the ability of Landec Ag to make payments on debt owed by Landec Ag to Landec. Landec Ag was in compliance with all of the loan covenants during the first nine months of fiscal year 2006. Landec has pledged substantially all of the assets of Landec Ag to secure the line of credit. At February 26, 2006, no amounts were outstanding under Landec Ag's revolving line of credit.

At February 26, 2006, Landec's total debt, including current maturities and capital lease obligations, was \$2.1 million and the total debt to equity ratio was 3% compared to 4% at May 29, 2005. This debt was comprised of term debt and capital lease obligations of \$2.1 million, \$2.0 million of which is mortgage debt on Apio's manufacturing facilities. The amount of debt outstanding on the Company's revolving lines of credit fluctuates over time. Borrowings on Landec's lines of credit are expected to vary with seasonal requirements of the Company's businesses.



## Table of Contents

### Contractual Obligation

The Company's material contractual obligations for the next five years and thereafter as of February 26, 2006, are as follows (in thousands):

Obligation	Due in Fiscal Year Ended May						
	Total	Remainder of 2006	2007	2008	2009	2010	Thereafter
Lines of Credit	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Long-term Debt	2,049	81	111	119	127	136	1,475
Capital Leases	55	7	22	23	3	—	—
Interest Expense	1,106	141	136	127	120	111	471
Operating Leases	1,635	181	473	445	361	172	3
Licensing Obligation	600	0	100	100	100	100	200
Purchase Commitments	1,409	423	986	—	—	—	—
Total	<u>\$ 6,854</u>	<u>\$ 833</u>	<u>\$ 1,828</u>	<u>\$ 814</u>	<u>\$ 711</u>	<u>\$ 519</u>	<u>\$ 2,149</u>

Interest expense was determined based on the assumption that the Company has no future borrowings under its lines of credit and that the interest expense on long term notes and lease obligations is based on the payment schedules and interest rates from the relevant agreements.

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

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

Landec believes that its debt facilities, cash from operations, along with existing cash, cash equivalents and existing borrowing capacities will be sufficient to finance its operational and capital requirements through at least the next twelve months.



**Additional Factors That May Affect Future Results**

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

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

In the past, our results of operations have fluctuated significantly from quarter to quarter and are expected to continue to fluctuate in the future. Historically, our direct marketer of hybrid corn seed, Landec Ag, has been the primary source of these fluctuations, as its revenues and profits are concentrated over a few months during the spring planting season (generally during our third and fourth fiscal quarters). In addition, Apio can be heavily affected by seasonal and weather factors which have impacted quarterly results, such as the high cost of sourcing product in December 2003, January 2004 and March/April 2005 due to a shortage of essential value-added produce items. Our earnings may also fluctuate based on our ability to collect accounts receivables from customers and note receivables from growers. Our earnings from our Food Products Technology business are sensitive to price fluctuations in the fresh vegetables and fruits markets. Excess supplies can cause intense price competition. Other factors that affect our food and/or agricultural operations include:

- the seasonality of our supplies;
- our ability to process produce during critical harvest periods;
- the timing and effects of ripening;
- the degree of perishability;
- the effectiveness of worldwide distribution systems;
- total worldwide industry volumes;
- the seasonality of consumer demand;
- foreign currency fluctuations; and
- foreign importation restrictions and foreign political risks.

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

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

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

- price;
- safety;
- efficacy;
- reliability;
- conversion costs;
- marketing and sales efforts; and
- general economic conditions affecting purchasing patterns.

We may not be able to develop and introduce new products and technologies in a timely manner or new products and technologies may not gain market acceptance. We are in the early stage of product commercialization of certain

## **Table of Contents**

Intelimer-based specialty packaging, Intellicoat seed coatings and other Intelimer polymer products and many of our potential products are in development. We believe that our future growth will depend in large part on our ability to develop and market new products in our target markets and in new markets. In particular, we expect that our ability to compete effectively with existing food products, agricultural, industrial and medical companies will depend substantially on successfully developing, commercializing, achieving market acceptance of and reducing the cost of producing our products. In addition, commercial applications of our temperature switch polymer technology are relatively new and evolving. Our failure to develop new products or the failure of our new products to achieve market acceptance would have a material adverse effect on our business, results of operations and financial condition.

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

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

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

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

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

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

### ***We May Be Unable to Adequately Protect Our Intellectual Property Rights***

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

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

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

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

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

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

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

Our Food Products and Agricultural Seed Technology businesses are subject to weather conditions that affect commodity prices, crop yields, and decisions by growers regarding crops to be planted. Crop diseases and severe conditions, particularly weather conditions such as floods, droughts, frosts, windstorms, earthquakes and hurricanes, may adversely affect the supply of vegetables and fruits used in our business, which could reduce the sales volumes and/or increase the unit production costs. Because a significant portion of the costs are fixed and contracted in advance of each operating year, volume declines due to production interruptions or other factors could result in increases in unit production costs which could result in substantial losses and weaken our financial condition.

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

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

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

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

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

- fines, injunctions, civil penalties, and suspensions,
- withdrawal of regulatory approvals,
- product recalls and product seizures, including cessation of manufacturing and sales,
- operating restrictions, and
- criminal prosecution.

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

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

For the nine months ended February 26, 2006, approximately 27% of our total revenues were derived from product sales to international customers. A number of risks are inherent in international transactions. International sales and operations may be limited or disrupted by any of the following:

- regulatory approval process,
- government controls,
- export license requirements,
- political instability,
- price controls,
- trade restrictions,
- changes in tariffs, or
- difficulties in staffing and managing international operations.

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

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

During the first nine months of fiscal year 2006, sales to our top five customers accounted for approximately 45% of our revenues, with our largest customers, Costco Wholesale Corp. and Sam's Club, accounting for approximately 16% and 10%, respectively of our revenues. We expect that, for the foreseeable future, a limited number of customers may continue to account for a substantial portion of our net revenues. We may experience changes in the composition of our customer base, as Apio and Landec Ag have experienced in the past. We do not have long-term purchase agreements with any of our customers. The reduction, delay or cancellation of orders from one or more major customers for any reason or the loss of one or more of our major customers could materially and adversely affect our business, operating results and financial condition. In addition, since some of the products processed by Apio at its Guadalupe, California facility are sole sourced to its customers, our operating results could be adversely affected if one or more of our major customers were to develop other sources of supply. Our current customers may not continue to place orders, orders by existing customers may be canceled or may not continue at the levels of previous periods or we may not be able to obtain orders from new customers.

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

The testing, manufacturing, marketing, and sale of the products we develop involves an inherent risk of allegations of product liability. If any of our products were determined or alleged to be contaminated or defective or to have caused a harmful accident to an end-customer, we could incur substantial costs in responding to complaints or litigation regarding our products and our product brand image could be materially damaged. Either event may have a material adverse effect on our business, operating results and financial condition. Although we have taken and intend to continue to take what we believe are appropriate precautions to minimize exposure to product liability claims, we may not be able to avoid significant liability. We currently maintain product liability insurance with limits in the amount of \$41.0 million per occurrence and \$42.0 million in the annual aggregate. Our coverage may not be adequate or may not continue to be available at an acceptable cost, if at all. A product liability claim, product recall or other claim with respect to uninsured liabilities or in excess of insured liabilities could have a material adverse effect on our business, operating results and financial condition.

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

Over the past several years the stock market has experienced extreme price and volume fluctuations. The following events may cause the market price of our common stock to fluctuate significantly:

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

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

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

As part of our inventory planning, we enter into negotiated orders with vendors of cartons and film used for packing our products in advance of receiving customer orders for such products. Accordingly, we face the risk of ordering too many cartons and film since orders are generally based on forecasts of customer orders rather than actual orders. If we cannot change or be released from the orders, we may incur costs as a result of inadequately predicting cartons and film orders in advance of customer orders. Because of this, we may currently have an oversupply of cartons

## **Table of Contents**

and film and face the risk of not being able to sell such inventory and our anticipated reserves for losses may be inadequate if we have misjudged the demand for our products. Our business and operating results could be adversely affected as a result of these increased costs.

### ***Our Seed Products May Fail to Germinate Properly and We May Be Subject to Claims for Reimbursement or Damages for Losses from Customers Who Use Such Products***

Farmers plant seed products sold by Landec Ag with the expectation that they will germinate under normal growing conditions. If our seed products do not germinate at the appropriate time or fail to germinate at all, our customers may incur significant crop losses and seek reimbursement or bring claims against us for such damages. Although insurance is generally available to cover such claims, the costs for premiums of such policies are prohibitively expensive and we currently do not maintain such insurance. Any claims brought for failure of our seed products to properly germinate could materially and adversely affect our operating and financial results.

### ***Recently Enacted Changes in Securities Laws and Regulations Are Likely to Increase Our Costs***

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

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

Our executive officers and directors and their affiliates own or control approximately 24% of our common stock (including options exercisable within 60 days). Accordingly, these officers, directors and shareholders may have the ability to exert significant influence over the election of our Board of Directors, the approval of amendments to our articles and bylaws and the approval of mergers or other business combination transactions requiring shareholder approval. This concentration of ownership may have the effect of delaying or preventing a merger or other business combination transaction, even if the transaction or amendments would be beneficial to our other shareholders. In addition, our controlling shareholders may approve amendments to our articles or bylaws to implement anti-takeover or management friendly provisions that may not be beneficial to our other shareholders.

### ***Terrorist Attacks and Risk of Contamination May Negatively Impact All Aspects of Our Operations, Revenues, Costs and Stock Price***

The September 2001 terrorist attacks in the United States, as well as future events occurring in response or connection to them, including, future terrorist attacks against United States targets, rumors or threats of war, actual conflicts involving the United States or its allies, or trade disruptions impacting our domestic suppliers or our customers, may impact our operations and may, among other things, cause decreased sales of our products. More generally, these events have affected, and are expected to continue to affect, the general economy and customer demand for our products. While we do not believe that our employees, facilities, or products are a target for terrorists, there is a remote risk that terrorist activities could result in contamination or adulteration of our products. Although we have systems and procedures in place that are designed to prevent contamination and adulteration of our products, a disgruntled employee or third party could introduce an infectious substance into packages of our products, either at our manufacturing plants or during shipment of our products. Were our products to be tampered with, we could experience a material adverse effect in our business, operations and financial condition.

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

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



## **Table of Contents**

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

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

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

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

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

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

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

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

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

## Table of Contents

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

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

	Remainder of 2006	2007	2008	2009	2010	There- after	Total
<b>Liabilities (in 000's)</b>							
Lines of Credit	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Avg. Int. Rate							
Long term debt, including current portion							
Variable Rate	\$ 88	\$ 133	\$ 142	\$ 130	\$ 136	\$1,475	\$2,104
Avg. Int. Rate	6.93%	6.98%	6.99%	7.16%	7.20%	7.11%	7.10%

### Item 4. Controls and Procedures

- (a) Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q (the "Evaluation Date"), Landec's principal executive officer and principal financial officer concluded that, as of the Evaluation Date, Landec's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), were effective and designed to ensure that information required to be disclosed by Landec in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.
- (b) There was no change in Landec's internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.



**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

Not applicable.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

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+ Filed herewith.

**SIGNATURES**

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

LANDEC CORPORATION

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

Date: April 4, 2006

## Table of Contents

### Exhibit Index

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+ Filed herewith.



## CERTIFICATION

I, Gary T. Steele, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Landec Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation, and
  - (d) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 4, 2006

/s/ Gary T. Steele  
Gary T. Steele  
Chief Executive Officer



## CERTIFICATION

I, Gregory S. Skinner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Landec Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles ;
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
  - (d) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 4, 2006

/s/ Gregory S. Skinner

Gregory S. Skinner  
Chief Financial Officer





CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Landec Corporation (the "Company") on Form 10-Q for the period ending February 26, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gary T. Steele, Chief Executive Officer and President of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: April 4, 2006

/s/ Gary T. Steele  
Gary T. Steele  
*Chief Executive Officer and President*  
*(Principal Executive Officer)*

\* The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and is not being filed as part of the Form 10-Q or as a separate disclosure document.



CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Landec Corporation (the "Company") on Form 10-Q for the period ending February 26, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gregory S. Skinner, Vice President of Finance and Administration and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: April 4, 2006

/s/ Gregory S. Skinner  
Gregory S. Skinner  
*Vice President and Chief Financial Officer*  
*(Principal Accounting Officer)*

- \* The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) and is not being filed as part of the Form 10-Q or as a separate disclosure document.