

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Fiscal Quarter Ended November 25, 2018, or

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

For the Transition period for _____ to _____.

Commission file number: **0-27446**

LANDEC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

94-3025618

(IRS Employer Identification Number)

5201 Great America Parkway, Suite 232

Santa Clara, California 95054

(Address of principal executive offices)

Registrant's telephone number, including area code:

(650) 306-1650

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Common Stock

Name of each exchange on which registered

The NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act:

None

(Title of Class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Act 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 the past 90 days. Yes No

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

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

Large Accelerated Filer Accelerated Filer

Non Accelerated Filer Smaller Reporting Company

Emerging Growth Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

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

As of December 20, 2018, there were 29,170,248 shares of Common Stock outstanding.

LANDEC CORPORATION

FORM 10-Q

For the Fiscal Quarter Ended November 25, 2018

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LANDEC CORPORATION
CONSOLIDATED BALANCE SHEETS
(In thousands except par value)

| | November 25, 2018 (unaudited) | May 27, 2018 |
|--|----------------------------------|--------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 1,514 | \$ 2,899 |
| Accounts receivable, less allowance for doubtful accounts | 53,420 | 53,877 |
| Inventories | 31,628 | 31,819 |
| Prepaid expenses and other current assets | 5,904 | 7,958 |
| Other current assets, discontinued operations | — | 510 |
| Total Current Assets | 92,466 | 97,063 |
| Investment in non-public company, fair value | 68,100 | 66,500 |
| Property and equipment, net | 170,517 | 159,624 |
| Goodwill | 54,510 | 54,510 |
| Trademarks/tradenames, net | 16,028 | 16,028 |
| Customer relationships, net | 5,338 | 5,814 |
| Other assets | 4,695 | 5,164 |
| Total Assets | \$ 411,654 | \$ 404,703 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 31,719 | \$ 34,668 |
| Accrued compensation | 6,824 | 9,978 |
| Other accrued liabilities | 9,922 | 8,706 |
| Deferred revenue | 1,717 | 2,625 |
| Line of credit | 42,000 | 27,000 |
| Current portion of long-term debt | 4,940 | 4,940 |
| Other current liabilities, discontinued operations | — | 458 |
| Total Current Liabilities | 97,122 | 88,375 |
| Long-term debt, net | 34,889 | 37,360 |
| Capital lease obligation, less current portion | 3,589 | 3,641 |
| Deferred taxes, net | 17,707 | 17,485 |
| Other non-current liabilities | 4,774 | 5,280 |
| Total Liabilities | 158,081 | 152,141 |
| Stockholders' Equity: | | |
| Common stock, \$0.001 par value; 50,000 shares authorized; 27,785 and 27,702 shares issued and outstanding at November 25, 2018 and May 27, 2018, respectively | 28 | 28 |
| Additional paid-in capital | 143,506 | 142,087 |
| Retained earnings | 108,904 | 109,299 |
| Accumulated other comprehensive income | 1,135 | 1,148 |
| Total Stockholders' Equity | 253,573 | 252,562 |
| Total Liabilities and Stockholders' Equity | \$ 411,654 | \$ 404,703 |

See accompanying notes to the consolidated financial statements.

LANDEC CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME
(Unaudited)
(In thousands, except per share amounts)

| | Three Months Ended | | Six Months Ended | |
|---|----------------------|----------------------|----------------------|----------------------|
| | November 25, 2018 | November 26, 2017 | November 25, 2018 | November 26, 2017 |
| Product sales | \$ 124,912 | \$ 122,461 | \$ 249,580 | \$ 238,242 |
| Cost of product sales | 108,319 | 107,540 | 216,650 | 204,519 |
| Gross profit | 16,593 | 14,921 | 32,930 | 33,723 |
| Operating costs and expenses: | | | | |
| Research and development | 2,533 | 3,372 | 5,366 | 6,091 |
| Selling, general and administrative | 14,666 | 12,244 | 28,617 | 25,602 |
| Total operating costs and expenses | 17,199 | 15,616 | 33,983 | 31,693 |
| Operating (loss) income | (606) | (695) | (1,053) | 2,030 |
| Dividend income | 412 | 412 | 825 | 825 |
| Interest income | 33 | 42 | 79 | 73 |
| Interest expense | (746) | (480) | (1,504) | (884) |
| Other income | 600 | 1,300 | 1,600 | 2,200 |
| Net (loss) income from continuing operations before tax | (307) | 579 | (53) | 4,244 |
| Income tax expense | (277) | (165) | (342) | (1,475) |
| Net (loss) income from continuing operations | \$ (584) | \$ 414 | \$ (395) | \$ 2,769 |
| Discontinued operations: | | | | |
| Income (loss) from discontinued operations | \$ — | \$ 141 | \$ — | \$ (62) |
| Income tax (expense) benefit | — | (42) | — | 18 |
| Income (loss) from discontinued operations, net of tax | — | 99 | — | (44) |
| Consolidated net (loss) income | (584) | 513 | (395) | 2,725 |
| Non-controlling interest expense | — | (26) | — | (92) |
| Net (loss) income applicable to common stockholders | \$ (584) | \$ 487 | \$ (395) | \$ 2,633 |
| Basic net (loss) income per share: | | | | |
| (Loss) income from continuing operations | \$ (0.02) | \$ 0.02 | \$ (0.01) | \$ 0.10 |
| Income (loss) from discontinued operations | — | — | — | — |
| Total basic net (loss) income per share | \$ (0.02) | \$ 0.02 | \$ (0.01) | \$ 0.10 |
| Diluted net (loss) income per share | | | | |
| (Loss) income from continuing operations | \$ (0.02) | \$ 0.02 | \$ (0.01) | \$ 0.10 |
| Income (loss) from discontinued operations | — | — | — | — |
| Total diluted net (loss) income per share | \$ (0.02) | \$ 0.02 | \$ (0.01) | \$ 0.10 |
| Shares used in per share computation | | | | |
| Basic | 27,764 | 27,518 | 27,751 | 27,512 |
| Diluted | 27,764 | 27,875 | 27,751 | 27,866 |
| Other comprehensive income (loss), net of tax: | | | | |
| Net unrealized gains (losses) on interest rate swaps (net of tax effect of \$53, \$140, \$(25), and \$85) | \$ 76 | \$ 239 | \$ (13) | \$ 136 |
| Other comprehensive income (loss), net of tax | 76 | 239 | (13) | 136 |
| Total comprehensive (loss) income | \$ (508) | \$ 726 | \$ (408) | \$ 2,769 |

See accompanying notes to the consolidated financial statements.

LANDEC CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)
(in thousands, except per share amounts)

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Total Stockholders' Equity |
|---|--------------|--------|----------------------------------|----------------------|---|----------------------------------|
| | Shares | Amount | | | | |
| Balance at May 27, 2018 | 27,702 | \$ 28 | \$ 142,087 | \$ 109,299 | \$ 1,148 | \$ 252,562 |
| Issuance of common stock at \$6.82 to \$14.39 per share, net of taxes paid by Landec on behalf of employees | 8 | — | — | — | — | — |
| Issuance of common stock for vested restricted stock units ("RSUs") | 75 | — | — | — | — | — |
| Taxes paid by Company for employee stock plans | — | — | (247) | — | — | (247) |
| Stock-based compensation | — | — | 1,666 | — | — | 1,666 |
| Net loss | — | — | — | (395) | — | (395) |
| Other comprehensive loss, net of tax | — | — | — | — | (13) | (13) |
| Balance at November 25, 2018 | 27,785 | \$ 28 | \$ 143,506 | \$ 108,904 | \$ 1,135 | \$ 253,573 |

See accompanying notes to the consolidated financial statements.

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

| | Six Months Ended | |
|---|-------------------|-------------------|
| | November 25, 2018 | November 26, 2017 |
| Cash flows from operating activities: | | |
| Consolidated net (loss) income | \$ (395) | \$ 2,725 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,458 | 5,934 |
| Stock-based compensation expense | 1,666 | 2,066 |
| Deferred taxes | 226 | 1,364 |
| Change in investment in non-public company, fair value | (1,600) | (2,200) |
| Change in contingent consideration liability | (900) | — |
| Net loss (gain) on disposal of property and equipment | 1 | (45) |
| Changes in current assets and current liabilities: | | |
| Accounts receivable, net | 975 | (9,273) |
| Inventories | 191 | (5,546) |
| Prepaid expenses and other current assets | 2,267 | (904) |
| Accounts payable | (1,381) | 13,621 |
| Accrued compensation | (3,322) | (497) |
| Other accrued liabilities | 1,575 | (2,272) |
| Deferred revenue | (958) | 1,363 |
| Net cash provided by operating activities | 4,803 | 6,336 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (18,588) | (9,437) |
| Issuance of note receivable | — | (2,099) |
| Proceeds from collections of notes receivable | 195 | — |
| Proceeds from sales of fixed assets | 3 | 73 |
| Net cash used in investing activities | (18,390) | (11,463) |
| Cash flows from financing activities: | | |
| Proceeds from sale of common stock | — | 1 |
| Taxes paid by Company for employee stock plans | (247) | (256) |
| Payments on long-term debt | (2,543) | (2,543) |
| Proceeds from lines of credit | 15,000 | 14,500 |
| Payments on lines of credit | — | (7,500) |
| Payments to non-controlling interest | — | (115) |
| Other, net | — | — |
| Net cash provided by financing activities | 12,210 | 4,087 |
| Net decrease in cash, cash equivalents and restricted cash ⁽¹⁾ | (1,377) | (1,040) |
| Cash, cash equivalents and restricted cash, beginning of period ⁽¹⁾ | 3,216 | 5,734 |
| Cash, cash equivalents and restricted cash, end of period ⁽¹⁾ | \$ 1,839 | \$ 4,694 |
| Supplemental disclosure of non-cash investing and financing activities: | | |
| Purchases of property and equipment on trade vendor credit | \$ 1,319 | \$ 2,374 |

⁽¹⁾ As a result of adopting ASU 2016-18, the Company now is required to include restricted cash as part of the change in the total cash balance. Accordingly, cash and cash equivalents at the beginning-of-period and end-of-period total amounts have been adjusted to include \$325,000 of restricted cash for each of the periods presented. Refer to Note 1, "Recently Adopted Accounting Pronouncements," in the Notes to Condensed Consolidated Financial Statements for more information.

See accompanying notes to the consolidated financial statements.

LANDEC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization, Basis of Presentation, and Summary of Significant Accounting Policies

Organization

Landec Corporation and its subsidiaries (“Landec” or the “Company”) design, develop, manufacture, and sell differentiated products for food and biomaterials markets, and license technology applications to partners. The Company has two proprietary polymer technology platforms: 1) Intelimer[®] polymers, and 2) hyaluronan (“HA”) biopolymers. The Company sells specialty packaged branded Eat Smart[®] and GreenLine[®] and private label fresh-cut vegetables and whole produce to retailers, club stores, and foodservice operators, primarily in the United States, Canada, and Asia through its Apio, Inc. (“Apio”) subsidiary, and sells HA-based and non-HA biomaterials through its Lifecore Biomedical, Inc. (“Lifecore”) subsidiary. The Company’s HA biopolymers and non-HA materials are proprietary in that they are specially formulated for specific customers to meet strict regulatory requirements. The Company also sells premier California specialty olive oils and wine vinegars under its O Olive & Vinegar[®] (“O”) brand to natural food, conventional grocery and mass retail stores, primarily in the United States and Canada and sells pure plant-based soups under its Now Planting[®] brand.

The Company’s technologies, along with its customer relationships and tradenames, are the foundation and key differentiating advantages upon which Landec has built its business.

Basis of Presentation

The accompanying unaudited consolidated financial statements of Landec have been prepared in accordance with United States generally accepted accounting principles (“GAAP”) 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 of the Company at November 25, 2018 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 GAAP have been condensed or omitted in accordance with 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 27, 2018.

The Company’s fiscal year is the 52- or 53-week period that ends on the last Sunday of May with quarters within each year ending on the last Sunday of August, November, and February; however, in instances where the last Sunday would result in a quarter being 12-weeks in length, the Company’s policy is to extend that quarter to the following Sunday. A 14th week is included in the fiscal year every five or six years to realign the Company’s fiscal quarters with calendar quarters.

In May 2018, the Company discontinued the Food Export business segment. As a result, the Food Export business segment has been reclassified as a discontinued operation under the provisions of Accounting Standards Codification (“ASC”) 205-20, *Presentation of Financial Statements - Discontinued Operations* (“ASC 205-20”) and ASC 360, *Property, Plant and Equipment* (“ASC 360”) for the six months ended November 26, 2017.

The results of operations for the six months ended November 25, 2018 are not necessarily indicative of the results that may be expected for an entire fiscal year because there is some seasonality in Apio’s food business and the order patterns of Lifecore’s customers which may lead to significant fluctuations in Landec’s quarterly results of operations.

As disclosed in the Company’s fiscal year 2018 Annual Report on Form 10-K, the Company determined that it had improperly included accrued capital expenditures in cash used in investing activities from the purchase of property and equipment in its Statements of Cash Flows for the previous annual financial statements and the quarterly financial statements for fiscal years 2018 and 2017. While the Company concluded that the impact of these errors was not material to prior annual periods, the Company concluded that the errors were material to its fiscal years’ 2018 and 2017 quarterly Statements of Cash Flows. As a result, cash used in operating and investing activities were both understated. Accordingly, the Company restated its fiscal years 2018 and 2017 quarterly Statements of Cash Flows in Note 12 – Quarterly Consolidated Financial Information (unaudited), in the Company’s fiscal year 2018 Annual Report on Form 10-K. The Statement of Cash Flows for the six months ended November 26, 2017 has been restated to reflect this error correction.

Basis of Consolidation

The consolidated financial statements are presented on the accrual basis of accounting in accordance with GAAP and include the accounts of Landec Corporation and its subsidiaries, Apio and Lifecore. All intercompany transactions and balances have been eliminated.

Arrangements that are not controlled through voting or similar rights are reviewed under the guidance for variable interest entities (“VIEs”). A company is required to consolidate the assets, liabilities, and operations of a VIE if it is determined to be the primary beneficiary of the VIE.

An entity is a VIE and subject to consolidation, if by design: a) the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any party, including equity holders, or b) as a group the holders of the equity investment at risk lack any one of the following three characteristics: (i) the power, through voting rights or similar rights to direct the activities of an entity that most significantly impact the entity’s economic performance, (ii) the obligation to absorb the expected losses of the entity, or (iii) the right to receive the expected residual returns of the entity. The Company reviewed the consolidation guidance and concluded that its equity investment in the non-public company is not a VIE.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. The accounting estimates that require management’s most significant and subjective judgments include revenue recognition; loss contingencies; sales returns and allowances; inventories; self-insurance liabilities; recognition and measurement of current and deferred income tax assets and liabilities; the assessment of recoverability of long-lived assets including intangible assets; the valuation of investments; the valuation and recognition of stock-based compensation; the valuation of financial assets and liabilities; and the valuation of contingent consideration liabilities.

These estimates involve the consideration of complex factors and require management to make judgments. The analysis of historical and future trends can require extended periods of time to resolve and are subject to change from period to period. The actual results may differ from management’s estimates.

Cash and Cash Equivalents

The Company records all highly liquid securities with three months or less from date of purchase to maturity as cash equivalents. Cash equivalents consist mainly of money market funds. The market value of cash equivalents approximates their historical cost given their short-term nature.

Reconciliation of Cash and Cash Equivalents and Restricted Cash as presented on the Statements of Cash Flows

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within the consolidated balance sheets that sum to the total of the same such amounts shown in the consolidated statements of cash flows (in thousands):

| | November 25, 2018 | May 27, 2018 | November 26, 2017 | May 28, 2017 |
|--|----------------------|-----------------|----------------------|-----------------|
| Cash and cash equivalents | \$ 1,514 | \$ 2,899 | \$ 4,602 | \$ 5,998 |
| Restricted cash | 325 | 325 | 325 | 325 |
| Cash, discontinued operations | — | (8) | (233) | (589) |
| Cash, cash equivalents and restricted cash | <u>\$ 1,839</u> | <u>\$ 3,216</u> | <u>\$ 4,694</u> | <u>\$ 5,734</u> |

Restricted Cash

The Company was required to maintain \$325,000 of restricted cash as of both November 25, 2018 and May 27, 2018, related to certain collateral requirements for obligations under its workers’ compensation programs. The restricted cash is included in Other assets in the Company’s accompanying Consolidated Balance Sheets.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or net realizable value and consist of the following (in thousands):

| | November 25, 2018 | May 27, 2018 |
|------------------|-------------------|------------------|
| Raw materials | \$ 14,607 | \$ 15,286 |
| Work in progress | 3,092 | 3,672 |
| Finished goods | 13,929 | 12,861 |
| Total | <u>\$ 31,628</u> | <u>\$ 31,819</u> |

If the cost of the inventories exceeds their net realizable value, provisions are recorded currently to reduce them to net realizable value. The Company also records a provision for slow moving and obsolete inventories based on the estimate of demand for its products.

Related Party Transactions

The Company sells products to and earns license fees from Windset Holdings 2010 Ltd. (“Windset”). During the three months ended November 25, 2018 and November 26, 2017, the Company recognized revenues of \$109,000 and \$91,000, respectively. During the six months ended November 25, 2018 and November 26, 2017, the Company recognized revenues of \$244,000 and \$195,000, respectively. These amounts have been included in product sales in the accompanying Consolidated Statements of Comprehensive (Loss) Income. The related receivable balances of \$207,000 and \$334,000 are included in accounts receivable in the accompanying Consolidated Balance Sheets as of November 25, 2018 and May 27, 2018, respectively.

Additionally, unrelated to the revenue transactions above, the Company purchases produce from Windset for sale to third parties. During the three and six months ended November 25, 2018, the Company recognized cost of product sales of \$0 and \$6,000, respectively, in the accompanying Consolidated Statements of Comprehensive (Loss) Income, from the sale of products purchased from Windset.

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

Debt Issuance Costs

The Company records its line of credit debt issuance costs as an asset, and as such, \$120,000 and \$218,000 were recorded as prepaid expenses and other current assets, and other assets, respectively, as of November 25, 2018, and \$120,000 and \$278,000, respectively, as of May 27, 2018. The Company records its term debt issuance costs as a contra-liability, and as such, \$60,000 and \$110,000 was recorded as current portion of long-term debt, and long-term debt, net, respectively, as of November 25, 2018 and \$60,000 and \$140,000, respectively, as of May 27, 2018. See Note 7 – Debt, of the Notes to Consolidated Financial Statements for further information.

Financial Instruments

The Company’s financial instruments are primarily composed of commercial-term trade payables, grower advances, notes receivable, and debt instruments. For short-term instruments, the historical carrying amount approximates the fair value of the instrument. The fair value of long-term debt approximates its carrying value.

Cash Flow Hedges

The Company has entered into interest rate swap contracts to manage interest rate risk. These derivative instruments may offset a portion of the changes in interest expense. The Company designates these derivative instruments as cash flow hedges. The Company's derivative instruments are subject to master netting arrangements. These arrangements include provisions to setoff positions with the same counterparties in the event of default by one of the parties. The Company accounts for its derivative instruments as either an asset or a liability and carries them at fair value in Other assets or Other non-current liabilities in the accompanying Consolidated Balance Sheets. The accounting for changes in the fair value of derivative instruments depends on the intended use of the derivative instrument and the resulting designation.

For derivative instruments that hedge the exposure to variability in expected future cash flows that are designated as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is reported as a component of Accumulated Other Comprehensive Income ("AOCI") in Stockholders' Equity and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument, if any, is recognized in earnings in the current period. To receive hedge accounting treatment, cash flow hedges must be highly effective in offsetting changes to expected future cash flows on hedged transactions.

Accumulated Other Comprehensive Income (AOCI)

Comprehensive income consists of two components, net income and Other Comprehensive Income ("OCI"). OCI refers to revenue, expenses, and gains and losses that under GAAP are recorded as a component of stockholders' equity but are excluded from the determination of net income. The Company's AOCI consists of net deferred gains and losses on its interest rate swap contracts accounted for as cash flow hedges. The components of AOCI, net of tax, are as follows (in thousands):

| | AOCI |
|--|----------|
| Accumulated OCI, net, as of May 27, 2018 | \$ 1,148 |
| Unrealized losses on interest rate swap contracts, net of tax effect | (13) |
| Amounts reclassified from OCI | — |
| Accumulated OCI, net, as of November 25, 2018 | \$ 1,135 |

The Company does not expect any transactions or other events to occur that would result in the reclassification of any significant gains or losses into earnings in the next 12 months.

Investment in Non-Public Company

On February 15, 2011, the Company made its initial investment in Windset which is reported as an Investment in non-public company, fair value, in the accompanying Consolidated Balance Sheets as of November 25, 2018 and May 27, 2018. The Company has elected to account for its investment in Windset under the fair value option. See Note 3 – Investment in Non-public Company, for further information.

Intangible Assets

The Company's intangible assets are comprised of customer relationships with a finite estimated useful life of eleven to thirteen years, and trademarks, tradenames and goodwill with indefinite useful lives.

Finite-lived intangible assets are reviewed for possible impairment whenever events or changes in circumstances occur that indicate that the carrying amount of an asset (or asset group) may not be recoverable. Indefinite lived intangible assets are reviewed for impairment at least annually. For goodwill and other indefinite-lived intangible assets, the Company performs a qualitative impairment analysis in accordance with ASC 350-30-35.

Partial Self-Insurance on Employee Health and Workers Compensation Plans

The Company provides health insurance benefits to eligible employees under self-insured plans whereby the Company pays actual medical claims subject to certain stop loss limits and self-insures its workers compensation claims. The Company records self-insurance liabilities based on actual claims filed and an estimate of those claims incurred but not reported. Any projection of losses concerning the Company's liability is subject to a high degree of variability. Among the causes of this variability are unpredictable external factors such as inflation rates, changes in severity, benefit level changes, medical costs, and claims settlement patterns. This self-insurance liability is included in Other accrued liabilities in the accompanying Consolidated Balance Sheets and represents management's best estimate of the amounts that have not been paid as of November 25, 2018 and May 27, 2018. It is reasonably possible that the expense the Company ultimately incurs could differ and adjustments to future reserves may be necessary.

Fair Value Measurements

The Company uses fair value measurement accounting for financial assets and liabilities and for financial instruments and certain other items measured at fair value. The Company has elected the fair value option for its investment in a non-public company. See Note 3 – Investment in Non-public Company for further information. The Company also measures its contingent consideration liability at fair value. See Note 2 – Acquisition of *O* for further information. The Company has not elected the fair value option for any of its other eligible financial assets or liabilities.

The accounting guidance established a three-tier hierarchy for fair value measurements, which prioritizes the inputs used in measuring fair value as follows:

Level 1 – observable inputs such as quoted prices for identical instruments in active markets.

Level 2 – inputs other than quoted prices in active markets that are observable either directly or indirectly through corroboration with observable market data.

Level 3 – unobservable inputs in which there is little or no market data, which would require the Company to develop its own assumptions.

As of November 25, 2018 and May 27, 2018, the Company held certain assets and liabilities that are required to be measured at fair value on a recurring basis, including its interest rate swap contracts, its minority interest investment in Windset and its contingent consideration liability from the acquisition of *O*.

The fair value of the Company’s interest rate swap contracts is determined based on model inputs that can be observed in a liquid market, including yield curves, and is categorized as a Level 2 fair value measurement and is included in Other assets or Other non-current liabilities in the accompanying Consolidated Balance Sheets.

The fair value of the Company’s contingent consideration liability from the acquisition of *O* utilizes significant unobservable inputs, including projected earnings before interest, taxes, depreciation and amortization (“EBITDA”) and discount rates. As a result, the Company’s contingent consideration liability associated with the *O* acquisition is considered a Level 3 measurement liability and is included in Other non-current liabilities in the accompanying Consolidated Balance Sheets.

In determining the fair value of the Company’s contingent consideration liability, the Company utilizes the following significant unobservable inputs in the discounted cash flow models:

| | At November 25, 2018 | At May 27, 2018 |
|---------------------------------|----------------------|-----------------|
| Cost of debt | 5.3% to 5.7% | 4.7% to 5.2% |
| Market price of risk adjustment | 20% | 20% |
| EBITDA volatility | 24% | 25% |

The fair value of our contingent consideration liability is sensitive to change in forecasts and discount rates. The discounted cash flow valuation model used by the Company has the following sensitivity to changes in inputs and assumptions (in thousands):

| | Impact on value of Contingent consideration liability as of November 25, 2018 |
|---------------------------------|--|
| 10% increase in EBITDA forecast | \$ 300 |

The Company has elected the fair value option of accounting for its investment in Windset. The calculation of fair value utilizes significant unobservable inputs, including projected cash flows, growth rates, and discount rates. As a result, the Company’s investment in Windset is considered to be a Level 3 measurement investment. The change in the fair value of the Company’s investment in Windset for the six months ended November 25, 2018 was due to the Company’s 26.9% minority interest in the change in the fair market value of Windset during the period.

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In determining the fair value of the investment in Windset, the Company utilizes the following significant unobservable inputs in the discounted cash flow models:

| | At November 25, 2018 | At May 27, 2018 |
|----------------------|----------------------|-----------------|
| Revenue growth rates | 6% | 6% |
| Expense growth rates | 6% | 6% |
| Income tax rates | 15% | 15% |
| Discount rates | 12% | 12% |

The revenue growth, expense growth, and income tax rate assumptions are considered the Company's best estimate of the trends in those items over the discount period. The discount rate assumption takes into account the risk-free rate of return, the market equity risk premium, and the company's specific risk premium and then applies an additional discount for lack of liquidity of the underlying securities. The discounted cash flow valuation model used by the Company has the following sensitivity to changes in inputs and assumptions (in thousands):

| | | Impact on value of investment in Windset as of November 25, 2018 |
|--------------------------------------|----|--|
| 10% increase in revenue growth rates | \$ | 9,800 |
| 10% increase in expense growth rates | \$ | (9,300) |
| 10% increase in income tax rates | \$ | (500) |
| 10% increase in discount rates | \$ | (3,700) |

Imprecision in estimating unobservable market inputs can affect the amount of gain or loss recorded for a particular position. The use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The following table summarizes the fair value of the Company's assets and liabilities that are measured at fair value on a recurring basis (in thousands):

| | Fair Value at November 25, 2018 | | | Fair Value at May 27, 2018 | | |
|------------------------------------|---------------------------------|----------|-----------|----------------------------|----------|-----------|
| | Level 1 | Level 2 | Level 3 | Level 1 | Level 2 | Level 3 |
| Assets: | | | | | | |
| Interest rate swap contracts | \$ — | \$ 1,512 | \$ — | \$ — | \$ 1,529 | \$ — |
| Investment in non-public company | — | — | 68,100 | — | — | 66,500 |
| Total assets | \$ — | \$ 1,512 | \$ 68,100 | \$ — | \$ 1,529 | \$ 66,500 |
| Liabilities: | | | | | | |
| Contingent consideration liability | — | — | 3,100 | — | — | 4,000 |
| Total liabilities | \$ — | \$ — | \$ 3,100 | \$ — | \$ — | \$ 4,000 |

The following table reflects the fair value rollforward reconciliation of Level 3 assets and liabilities measured at fair value for the six months ended November 25, 2018 (in thousands):

| | Windset Investment | Contingent Consideration Liability |
|---------------------------------|--------------------|------------------------------------|
| Balance as of May 27, 2018 | \$ 66,500 | \$ 4,000 |
| Fair value change | 1,600 | (900) |
| Balance as of November 25, 2018 | \$ 68,100 | \$ 3,100 |

Revenue Recognition

See Note 9 – Business Segment Reporting, for a discussion about the Company's three business segments; namely, Natural Foods, Biomaterials, and Other.

The Company follows the five step, principles-based model to recognize revenue upon the transfer of promised goods or services to customers and in an amount that reflects the consideration for which the Company expects to be entitled in exchange for those goods or services. Revenue, net of estimated allowances and returns, is recognized when the Company has completed its performance obligations under a contract and control of the product is transferred to the customer. Substantially all revenue is recognized at the time shipment is made or upon delivery as control of the product is transferred to the customer.

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The revenue streams within the Company are consistent with those disclosed within Note 9 – Business Segment Reporting. For descriptions of the Company’s product offerings and segments refer to Note 11 – Business Segment Reporting in our annual report on Form 10-K for the year ended May 27, 2018.

The Company’s standard terms of sale are included in its contracts, purchase orders, and invoices. As such, all revenue is considered revenue recognized from contracts with customers. The Company has elected to account for shipping and handling as fulfillment activities, and not a separate performance obligation. The Company’s standard payment terms with its customers range from 30 days to 90 days. Certain customers may receive cash-based incentives (including: volume rebates, discounts, and slotting fees), which are accounted for as variable consideration to the Company’s variable consideration. The Company estimates these sales incentives based on the expected amount to be provided to its customers and reduces revenues recognized towards its performance obligations. The Company does not anticipate significant changes in its estimates for variable consideration.

Occasionally, the Company enters into bill-and-hold arrangements, where it invoices the customer for products even though it retains possession of the products until a point-in-time in the future when the products will be shipped to the customer. In these contracts, the primary performance obligation is satisfied, and revenue is generally recognized, at a point-in-time when the product is segregated from the Company’s general inventory, it’s ready for shipment to the customer, and the Company does not have the ability to use the product or re-deploy it to another customer.

The Company disaggregates its revenue by segment product lines based on how it markets its products and reviews results of operations. The following tables disaggregate segment revenue by major product lines (in thousands):

| | Three Months Ended | | Six Months Ended | |
|-----------------------|----------------------|----------------------|----------------------|----------------------|
| | November 25, 2018 | November 26, 2017 | November 25, 2018 | November 26, 2017 |
| Natural Foods: | | | | |
| Salads | \$ 41,950 | \$ 44,578 | \$ 91,030 | \$ 86,626 |
| Core vegetables | 64,492 | 61,906 | 126,242 | 121,549 |
| Other | 3,024 | 1,864 | 4,245 | 3,790 |
| Total | <u>\$ 109,466</u> | <u>\$ 108,348</u> | <u>\$ 221,517</u> | <u>\$ 211,965</u> |

| | Three Months Ended | | Six Months Ended | |
|----------------------|----------------------|----------------------|----------------------|----------------------|
| | November 25, 2018 | November 26, 2017 | November 25, 2018 | November 26, 2017 |
| Biomaterials: | | | | |
| Aseptic | \$ 8,128 | \$ 7,591 | \$ 13,894 | \$ 14,618 |
| Fermentation | 1,915 | 2,865 | 4,985 | 5,655 |
| Development services | 5,403 | 3,657 | 9,184 | 6,004 |
| Total | <u>\$ 15,446</u> | <u>\$ 14,113</u> | <u>\$ 28,063</u> | <u>\$ 26,277</u> |

Shipping and Handling

Shipping and handling costs are incurred to move the Company’s products from production and storage facilities to the customer. Handling costs are incurred from the point the product is segregated from the Company’s general inventory until it is provided to the shipper and generally include costs to store, move and prepare the products for shipment. The cost of shipping and handling services is recognized in Cost of product sales. When the costs of shipping and handling are passed on to a customer, the related amount is recorded in revenue.

Legal Contingencies

In the ordinary course of business, the Company is involved in various legal proceedings and claims.

The Company makes a provision for a liability relating to legal matters when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least each fiscal quarter and adjusted to reflect the impacts of negotiations, estimate settlements, legal rulings, advice of legal counsel and other information and events pertaining to a particular matter. Legal fees are expensed in the period in which they are incurred.

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Apio has been the target of a union organizing campaign which has included three unsuccessful attempts to unionize Apio's Guadalupe, California processing plant. The campaign has involved a union and over 100 former and current employees of Pacific Harvest, Inc. and Rancho Harvest, Inc. (collectively "Pacific Harvest"), Apio's labor contractors at its Guadalupe, California processing facility, bringing legal actions before various state and federal agencies, the California Superior Court, and initiating over 100 individual arbitrations against Apio and Pacific Harvest.

The legal actions consisted of three main types of claims: (1) Unfair Labor Practice claims ("ULPs") before the National Labor Relations Board ("NLRB"), (2) discrimination/wrongful termination claims before state and federal agencies and in individual arbitrations, and (3) wage and hour claims as part of two Private Attorney General Act ("PAGA") cases in state court and in over 100 individual arbitrations.

The ULP claims were settled in fiscal year 2017 for \$310,000. Apio was responsible for half of this settlement, or \$155,000. On May 5, 2017, the parties to the remaining actions executed a Settlement Agreement concerning the discrimination/wrongful termination claims and the wage and hour claims which covers all non-exempt employees of Pacific Harvest working at Apio's Guadalupe, California processing facility from September 2011 through the settlement date. Under the Settlement Agreement, the plaintiffs were paid \$6.0 million in three installments: \$2.4 million of which was paid in July 2017, \$1.8 million of which was paid in November 2017 and \$1.8 million of which was paid in July 2018, representing the final payment due under the settlement agreement. The Company and Pacific Harvest have each agreed to pay one half of the settlement payments. The Company paid the entire first two installments of \$4.2 million and will be reimbursed by Pacific Harvest for its \$2.1 million portion. As of November 25, 2018, the outstanding balance of the receivable was \$1.9 million of which \$900,000 and \$1.0 million is included in Prepaid and other current assets and Other assets, respectively, in the accompanying Consolidated Balance Sheets. This receivable will continue to be repaid through monthly payments until fully paid, which the Company expects to occur by December 2020. The Company's recourse against non-payment by Pacific Harvest is its security interest in assets owned by Pacific Harvest. The receivable is reviewed quarterly for collectability. At November 25, 2018, the Company has concluded that the receivable is not impaired and therefore is not subject to an impairment loss. At November 25, 2018, the carrying amount of \$1.9 million is reflective of its fair value.

As of November 25, 2018 and May 27, 2018, the Company had accrued \$0 and \$1.0 million, respectively, related to these actions, which are included in Other accrued liabilities in the accompanying Consolidated Balance Sheets.

Recent Accounting Guidance

Recently Adopted Pronouncements

Income Taxes

In February 2018, the FASB issued ASU 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* that permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act enacted in December 2017. The standard is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. The Company adopted ASU 2018-02 on August 27, 2018. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements and related disclosures.

Stock Compensation

In May 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-09, Compensation—Stock Compensation (Topic 718): *Scope of Modification Accounting*, which provides guidance about which changes to the terms or conditions of a stock-based payment award require an entity to apply modification accounting in Topic 718. This pronouncement is effective for annual reporting periods beginning after December 15, 2017. The Company adopted ASU 2017-09 on May 28, 2018. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements and related disclosures.

Restricted Cash

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): *Restricted Cash* ("ASU 2016-18"). ASU 2016-18 requires that entities include restricted cash and restricted cash equivalents with cash and cash equivalents in the beginning-of-period and end-of-period total amounts shown on the Statement of Cash Flows. The amendments in ASU 2016-18 are effective for fiscal years beginning after December 15, 2017, including interim reporting periods within those fiscal years. The Company adopted ASU 2016-18 on May 28, 2018. As a result of this retrospective adoption, the beginning-of-period and end-of-period total cash and cash equivalents in the Statement of Cash Flows have been adjusted to include restricted cash of \$325,000 for all periods presented.

Intra-Entity Transfers

In November 2016, the FASB issued ASU 2016-16, *Intra-Entity Transfers of Assets Other Than Inventory*. ASU 2016-16 requires companies to account for the income tax effects of intercompany transfers of assets other than inventory (e.g., intangible assets) when the transfer occurs. This pronouncement is effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. Effective May 28, 2018, the Company adopted the ASU, without any impact to the presentation of its financial statements and disclosures.

Statement of Cash Flows

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): *Classification of Certain Cash Receipts and Cash Payments* (a consensus of the Emerging Issues Task Force). ASU 2016-15 clarifies guidance on the classification of certain cash receipts and payments in the statement of cash flows to reduce diversity in practice. Among other things, debt prepayment or debt extinguishment costs will be presented as cash outflows for financing activities on the statement of cash flow. Effective May 28, 2018, the Company adopted the ASU, without any impact to the presentation of its financial statements and disclosures.

Revenue Recognition

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, which creates FASB ASC Topic 606, *Revenue from Contracts with Customers* (“Topic 606”) and supersedes ASC Topic 605, *Revenue Recognition*. The guidance replaces industry-specific guidance and establishes a single five-step model to identify and recognize revenue. The core principle of the guidance is that an entity should recognize revenue upon transfer of control of promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. Additionally, the guidance requires the entity to disclose further quantitative and qualitative information regarding the nature and amount of revenues arising from contracts with customers, as well as other information about the significant judgments and estimates used in recognizing revenues from contracts with customers.

The Company adopted Topic 606 on May 28, 2018 using the modified retrospective method. The adoption of this Topic 606 did not have a material impact upon the timing and measurement of revenue recognition. Additionally, the Company concluded that its historical methodology for estimation and recognition of variable consideration, i.e., rebates and other cash-based customer incentives remains consistent with the requirements of Topic 606. Revenues from the Company’s Natural Foods segment are mostly generated from the sales of finished goods. Revenues from the Company’s Biomaterials segment are mostly generated from its supply and contract manufacturing arrangements. Such sales predominantly contain a single performance obligation and revenue is recognized at a point-in-time, when control of the product transfers from the Company to the customer.

In the notes to the consolidated financial statements, the Company has expanded its revenue recognition disclosures. Additionally, it has implemented changes to accounting policies and procedures, business processes, and controls in order to comply with the revenue recognition and disclosure requirements of Topic 606.

Recently Issued Pronouncements to be Adopted

Disclosure simplification

In August 2018, the U.S. Securities and Exchange Commission (“SEC”) adopted the final rule under SEC Release No. 33-10532, *Disclosure Update and Simplification*, amending certain disclosure requirements that were redundant, duplicative, overlapping, outdated or superseded. In addition, the amendments expanded the disclosure requirements relating to the analysis of stockholders’ equity for interim financial statements. Under the amendments, an analysis of changes in each caption of stockholders’ equity presented in the balance sheet must be provided in a note or separate statement. The analysis should present a reconciliation of the beginning balance to the ending balance of each period for which a statement of income is required to be filed. This final rule is effective on November 5, 2018. Although this rule was effective on November 5, 2018, the SEC has provided for an extended transition period to implement the expanded shareholders’ equity disclosure requirements, which will be effective for the Company during the third quarter of fiscal 2019. The Company continues to evaluate the impact the application of this rule will have on its future financial statements and disclosures.

Cloud Computing Arrangements

In August 2018, the FASB issued ASU 2018-15, *Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract* (ASU 2018-15), which requires that requires a customer in a cloud computing arrangement that is a service contract to follow the internal-use software guidance in Accounting Standards Codification 350-40 to determine which implementation costs to defer and recognize as an asset. The Accounting Standards Update generally aligns the guidance on recognizing implementation costs incurred in a cloud computing arrangement that is a service contract with that for implementation costs incurred to develop or obtain internal-use software, including hosting arrangements that include an internal-use software license. ASU 2018-15 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application is permitted. The Company is currently assessing the future impact of this update on its consolidated financial statements and related disclosures.

Hedging

In August 2017, the FASB issued ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities* (ASU 2017-12), which amends the presentation and disclosure requirements and changes how companies assess effectiveness. The amendments are intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting, and increase transparency as to the scope and results of hedging programs. ASU 2017-12 is effective for annual periods beginning after December 15, 2018, including interim periods within those periods. Early application is permitted. The Company is currently assessing the future impact of this update on its consolidated financial statements and related disclosures.

Financial Instruments – Credit Losses

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (ASU 2016-13), which requires the measurement of all expected credit losses for financial assets including trade receivables held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The adoption of ASU 2016-13 is not expected to have a material impact on the Company's consolidated financial statements and related disclosures.

Leases

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* ("ASU 2016-02"), which requires companies to generally recognize on the balance sheet operating and financing lease liabilities and corresponding right-of-use-assets. ASU 2016-02 also requires improved disclosures to help users of financial statements better understand the amount, timing and uncertainty of cash flows arising from leases. In July 2018, the FASB issued ASU 2018-11—*Leases (Topic 842) – Targeted Improvements*. This ASU provides transition relief on comparative reporting to the previously-issued ASU 2016-02 and related guidance. The Company will adopt ASU 2016-02 beginning in the first quarter of fiscal year 2020 on a modified retrospective basis.

The Company is currently in the process of evaluating the impact that ASU 2016-02 will have upon its consolidated financial statements and related disclosures. The Company's assessment efforts to date have included:

- Reviewing the provisions of ASU 2016-02;
- Gathering information to evaluate its lease population and portfolio;
- Evaluating the nature of its real and personal property and other arrangements that may meet the definition of a lease; and
- Systems' readiness evaluations.

As a result of these efforts, the Company currently anticipates that the adoption of ASU 2016-02 will have a significant impact on its long-term assets and liabilities, as, at a minimum, virtually all of its leases designated as operating leases are expected to be reported on the consolidated balance sheets. The pattern of recognition for operating leases within the consolidated statements of comprehensive income is not anticipated to significantly change. The adoption is not expected to have an impact on the Company's ability to meet its loan covenants as the impact from the adoption of ASU 2016-02 was taken into consideration when determining its loan covenants.

2. Acquisition of *O*

On March 1, 2017, the Company purchased substantially all of the assets of *O* for \$2.5 million in cash plus contingent consideration of up to \$7.5 million over fiscal years 2018 through 2020 based upon *O* achieving certain EBITDA targets. All accounting for this acquisition is final.

The potential earn out payment of up to \$7.5 million is based on *O*'s cumulative EBITDA over the Company's fiscal years 2018 through 2020. At the end of each fiscal year, beginning in fiscal year 2018, the former owners of *O* will earn the equivalent of the EBITDA achieved by *O* for that fiscal year in an amount not to exceed \$4.6 million over the three year period. The former owners can also earn an additional \$2.9 million on a dollar for dollar basis for exceeding \$6.0 million of cumulative EBITDA over the three year period. Each quarter the Company performs, with the assistance of a third party appraiser, an analysis of *O*'s projected EBITDA over the earnout period. Based on this analysis, the Company records a contingent consideration liability, included in Other non-current liabilities. As of November 25, 2018 and May 27, 2018, the contingent consideration liability was \$3.1 million and \$4.0 million, respectively, representing the present value of the expected earn out payments. The \$900,000 reduction in the contingent consideration liability was recorded as a reduction to SG&A during the three and six months ended November 25, 2018 in the accompanying Consolidated Statements of Comprehensive Income.

3. Investment in Non-public Company

On February 15, 2011, Apio entered into a share purchase agreement (the "Windset Purchase Agreement") with Windset. Pursuant to the Windset Purchase Agreement, Apio purchased from Windset 150,000 Senior A preferred shares for \$15 million and 201 common shares for \$201. On July 15, 2014, Apio increased its investment in Windset by purchasing from the Newell Capital Corporation an additional 68 common shares and 51,211 junior preferred shares of Windset for \$11 million. After this purchase, the Company's common shares represent a 26.9% ownership interest in Windset. The Senior A preferred shares yield a cash dividend of 7.5% annually. The dividend is payable within 90 days of each anniversary of the execution of the Windset Purchase Agreement. The non-voting junior preferred stock does not yield a dividend unless declared by the Board of Directors of Windset and no such dividend has been declared.

The Shareholders' Agreement between Apio and Windset, as amended on March 15, 2017, includes a put and call option (the "Put and Call Option"), which can be exercised on or after March 31, 2022, whereby Apio can exercise the put to sell its common, Senior A preferred shares, and junior preferred shares to Windset, or Windset can exercise the call to purchase those shares from Apio, in either case, at a price equal to 26.9% of the fair market value of Windset's common shares, plus the liquidation value of the preferred shares of \$20.1 million (\$15 million for the Senior A preferred shares and \$5.1 million for the junior preferred shares). Under the terms of the arrangement with Windset, the Company is entitled to designate one of five members on the Board of Directors of Windset.

On October 29, 2014, Apio further increased its investment in Windset by purchasing 70,000 shares of Senior B preferred shares for \$7 million. The Senior B preferred shares pay an annual dividend of 7.5% on the amount outstanding at each anniversary date of the Windset Purchase Agreement. The Senior B preferred shares purchased by Apio have a put feature whereby Apio can sell back to Windset the \$7 million at any time after October 29, 2017.

At any time, Windset has the right to call the Senior B preferred shares owned by Apio. Windset's partial call provision is restricted such that a partial call cannot result in Apio holding less than 10% of Windset's common shares outstanding.

The investment in Windset does not qualify for equity method accounting as the investment does not meet the criteria of in-substance common stock due to returns through the annual dividend on the non-voting senior preferred shares that are not available to the common stockholders. As the put and call options require all of the various shares to be put or called in equal proportions, the Company has deemed that the investment, in substance, should be treated as a single security for purposes of accounting.

The fair value of the Company's investment in Windset was determined utilizing the Windset Purchase Agreement's put/call calculation for value and a discounted cash flow model based on projections developed by Windset, and considers the put and call conversion options. These features impact the duration of the cash flows utilized to derive the estimated fair values of the investment. These two discounted cash flow models' estimate for fair value are then weighted. Assumptions included in these discounted cash flow models will be evaluated quarterly based on Windset's actual and projected operating results to determine the change in fair value.

During each of the three months ended November 25, 2018 and November 26, 2017, the Company recorded \$412,500 in dividend income. During each of the six months ended November 25, 2018 and November 26, 2017, the Company recorded \$825,000 in dividend income. The increase in the fair market value of the Company’s investment in Windset for the three month periods ended November 25, 2018 and November 26, 2017 was \$600,000 and \$1.3 million, respectively. The increase in the fair market value of the Company’s investment in Windset for the six month periods ended November 25, 2018 and November 26, 2017 was \$1.6 million and \$2.2 million, respectively, and is included in Other income in the accompanying Consolidated Statements of Comprehensive Income.

4. Stock-Based Compensation

The Company’s stock-based awards include stock option grants and restricted stock units (“RSUs”). The Company records compensation expense for stock-based awards issued to employees and directors in exchange for services provided based on the estimated fair value of the awards on their grant dates and is recognized over the required service periods, generally the vesting period.

The following table summarizes the stock-based compensation for stock options and RSUs (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | November 25, 2018 | November 26, 2017 | November 25, 2018 | November 26, 2017 |
| Options | \$ 223 | \$ 354 | \$ 444 | \$ 678 |
| RSUs | 715 | 762 | 1,222 | 1,388 |
| Total stock-based compensation | \$ 938 | \$ 1,116 | \$ 1,666 | \$ 2,066 |

The following table summarizes the stock-based compensation by income statement line item (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | November 25, 2018 | November 26, 2017 | November 25, 2018 | November 26, 2017 |
| Cost of sales | \$ 117 | \$ 137 | \$ 218 | \$ 261 |
| Research and development | 30 | 23 | 55 | 42 |
| Selling, general and administrative | 791 | 956 | 1,393 | 1,763 |
| Total stock-based compensation | \$ 938 | \$ 1,116 | \$ 1,666 | \$ 2,066 |

The estimated fair value for stock options, which determines the Company’s calculation of stock-based compensation expense, is based on the Black-Scholes option pricing model. RSUs are valued at the closing market price of the Company’s common stock on the grant date. The Company uses the straight-line method to recognize the fair value of stock-based compensation arrangements.

As of November 25, 2018, there was \$5.9 million of total unrecognized compensation expense related to unvested equity compensation awards granted under the Landec incentive stock plans. Total expense is expected to be recognized over the weighted-average period of 1.9 years for stock options and 2.2 years for RSUs.

5. Diluted Net Income Per Share

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

| | Three Months Ended | | Six Months Ended | |
|---|----------------------|----------------------|----------------------|----------------------|
| | November 25, 2018 | November 26, 2017 | November 25, 2018 | November 26, 2017 |
| Numerator: | | | | |
| Net (loss) income applicable to Common Stockholders | \$ (584) | \$ 487 | \$ (395) | \$ 2,633 |
| Denominator: | | | | |
| Weighted average shares for basic net income per share | 27,764 | 27,518 | 27,751 | 27,512 |
| Effect of dilutive securities: | | | | |
| Stock options and restricted stock units | — | 357 | — | 354 |
| Weighted average shares for diluted net income per share | 27,764 | 27,875 | 27,751 | 27,866 |
| Diluted net (loss) income per share | \$ (0.02) | \$ 0.02 | \$ (0.01) | \$ 0.10 |

Due to the Company's net loss for the three and six months ended November 25, 2018, the net loss per share includes only weighted average shares outstanding and thus excludes 1.5 million and 1.4 million, respectively, of outstanding options and RSUs as such impacts would be antidilutive for these periods.

For the three and six months ended November 26, 2017, the computation of the diluted net income per share excludes the impact of options to purchase 1.3 million and 1.4 million shares, respectively, of Common Stock as such impacts would be antidilutive for those periods.

6. Income Taxes

On December 22, 2017, the U.S. Government enacted the reconciled tax reform bill, commonly known as the Tax Cuts and Jobs Act of 2017 (the "TCJA"). The TCJA makes broad changes to the U.S. tax code including, but not limited to, reducing the Company's federal statutory tax rate from 35%, to an average rate of 29.4% for the fiscal year ended May 27, 2018, and then 21% for the three and six months ended November 25, 2018 and thereafter; requiring companies to pay a one-time transition tax on certain unrepatriated earnings of foreign subsidiaries; generally eliminating U.S. federal income taxes on dividends from foreign subsidiaries; requiring a current inclusion in U.S. federal taxable income of certain earnings of controlled foreign corporations' creating a global intangibles low-taxed income inclusion and the base erosion anti-abuse tax, a new minimum tax. The TCJA also enhances and extends through 2026 the option to claim accelerated depreciation deductions on qualified property, however, the domestic manufacturing deduction, from which the Company has historically benefitted, has been eliminated.

In March 2018, FASB issued Accounting Standards Update No. 2018-05, Income Taxes Topic (740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118, ("ASU 2018-05") to address the application of GAAP in situations when a registrant does not have the necessary information available, prepared or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Act. The Company's accounting for the Tax Act was incomplete as of May 27, 2018. As of November 25, 2018, the Company's analysis for the Transition Tax and the re-measurement of deferred taxes due to the Tax Rate Reduction was considered to be complete and the Company does not expect its analysis to substantially change from its current result. The impact resulting from the completion of this analysis resulted in additional tax expense of \$347,000 for the three and six months ended November 25, 2018. Ongoing guidance and accounting interpretation for the Tax Act are expected over the coming months and years and the Company will consider any changes in the accounting of the TCJA in the period in which such additional guidance is issued.

The provision for income taxes for the six months ended November 25, 2018 and November 26, 2017 was \$342,000 and \$1.5 million, respectively. The effective tax rate for the six months ended November 25, 2018 and November 26, 2017 was 25% and 35%, respectively. The effective tax rate for the six months ended November 25, 2018 was higher than the statutory federal income tax rate of 21% primarily due to the impact of state taxes and stock-based compensation, partially offset by the generation of federal & state R&D Credits.

As of November 25, 2018 and May 27, 2018, the Company had unrecognized tax benefits of approximately \$582,000 and \$479,000, respectively. Included in the balance of unrecognized tax benefits as of November 25, 2018 and May 27, 2018 was approximately \$507,000 and \$372,000, respectively, of tax benefits that, if recognized, would result in an adjustment to the Company's effective tax rate. The Company does not expect its unrecognized tax benefits to change significantly within the next twelve months.

The Company has elected to classify interest and penalties related to uncertain tax positions as a component of its provision for income taxes. The Company has accrued an insignificant amount of interest and penalties relating to the income tax on the unrecognized tax benefits as of November 25, 2018 and May 27, 2018.

Due to tax attribute carryforwards, the Company is subject to examination for tax years 2015 forward for U.S. tax purposes. The Company is also subject to examination in various state jurisdictions for tax years 2012 forward, none of which were individually material.

The Company's estimated annual effective tax rate may be subject to further uncertainty due to the recent changes in U.S. tax rates and tax laws.

7. Debt

Long-term debt, net consists of the following (in thousands):

| | November 25, 2018 | May 27, 2018 |
|--|-------------------|------------------|
| Term loan with JPMorgan Chase Bank (“JPMorgan”), BMO Harris Bank N.A. (“BMO”), and City National Bank; due in quarterly principal and interest payments of \$1,250 beginning December 1, 2016 through September 23, 2021 with the remainder due on maturity, with interest based on the Company’s leverage ratio at a per annum rate of the Eurodollar rate plus a spread of between 1.25% and 2.25% | \$ 40,000 | \$ 42,500 |
| Total principal amount of long-term debt | 40,000 | 42,500 |
| Less: unamortized debt issuance costs | (171) | (200) |
| Total long-term debt, net of unamortized debt issuance costs | 39,829 | 42,300 |
| Less: current portion of long-term debt, net | (4,940) | (4,940) |
| Long-term debt, net | <u>\$ 34,889</u> | <u>\$ 37,360</u> |

On September 23, 2016, the Company entered into a Credit Agreement with JPMorgan, BMO, and City National Bank, as lenders (collectively, the “Lenders”), and JPMorgan as administrative agent, pursuant to which the Lenders provided the Company with a \$100.0 million revolving line of credit (the “Revolver”) and a \$50.0 million term loan facility (the “Term Loan”), guaranteed by each of the Company’s direct and indirect subsidiaries and secured by substantially all of the Company’s assets, with the exception of the Company’s investment in Windset.

Both the Revolver and the Term Loan mature in five years (on September 23, 2021), with the Term Loan providing for quarterly principal payments of \$1.25 million commencing December 1, 2016, with the remainder due at maturity.

Interest on both the Revolver and the Term Loan is based on either the prime rate or Eurodollar rate, at the Company’s discretion, plus a spread based on the Company’s leverage ratio (generally defined as the ratio of the Company’s total indebtedness on such date to the Company’s consolidated EBITDA for the period of four consecutive fiscal quarters ended on or most recently prior to such date). The spread is at a per annum rate of (i) between 0.25% and 1.25% if the prime rate is elected or (ii) between 1.25% and 2.25% if the Eurodollar rate is elected.

The Credit Agreement provides the Company the right to increase the Revolver commitments and/or the Term Loan commitments by obtaining additional commitments either from one or more of the Lenders or another lending institution at an amount of up to \$75.0 million.

The Credit Agreement contains customary financial covenants and events of default under which the obligation could be accelerated and/or the interest rate increased. The Company was in compliance with all financial covenants as of November 25, 2018.

On November 1, 2016, the Company entered into an interest rate swap contract (the “2016 Swap”) with BMO at a notional amount of \$50 million. The 2016 Swap has the effect of changing the Company’s Term Loan obligation from a variable interest rate to a fixed 30-day LIBOR rate of 1.22%. For further discussion regarding the Company’s use of derivative instruments, see the Financial Instruments section of Note 1 – Organization, Basis of Presentation, and Summary of Significant Accounting Policies.

On June 25, 2018, the Company entered into an interest rate swap contract (the “2018 Swap”) with BMO at a notional amount of \$30.0 million. The 2018 Swap has the effect of converting the first \$30.0 million of the total outstanding amount of the Company’s 30-day LIBOR borrowings from a variable interest rate to a fixed 30-day LIBOR rate of 2.74%.

In connection with the Credit Agreement, the Company incurred lender and third-party debt issuance costs of \$897,000, of which \$598,000 and \$299,000 was allocated to the Revolver and Term Loan, respectively.

As of November 25, 2018, \$42.0 million was outstanding on the Revolver, at an interest rate of 4.30% under the Eurodollar option.

8. Stockholders' Equity

During the three months ended November 25, 2018, the Company granted options to purchase 45,000 shares of common stock and awarded 19,000 RSUs. During the six months ended November 25, 2018, the Company granted options to purchase 175,000 shares of common stock and awarded 254,000 RSUs.

As of November 25, 2018, the Company has reserved 2.7 million shares of Common Stock for future issuance under its current and former equity plans.

On July 14, 2010, the Company announced that the Board of Directors of the Company had approved the establishment of a stock repurchase plan authorizing the repurchase of up to \$10 million of the Company's common stock. The Company may repurchase its common stock from time to time in open market purchases or in privately negotiated transactions. The timing and actual number of shares repurchased is at the discretion of management of the Company and will depend on a variety of factors, including stock price, corporate and regulatory requirements, market conditions, the relative attractiveness of other capital deployment opportunities and other corporate priorities. The stock repurchase program does not obligate Landec to acquire any amount of its common stock and the program may be modified, suspended or terminated at any time at the Company's discretion without prior notice. During the six months ended November 25, 2018, the Company did not repurchase any of its outstanding common stock.

9. Business Segment Reporting

Prior to May 2018, the Company managed its business operations through three strategic reportable business segments: Packaged Fresh Vegetables, Food Export, and Biomaterials. These segments were based upon the information reported to the Chief Executive Officer, who is the chief operating decision maker ("CODM"). However, in May 2018, the Company discontinued its Food Export business segment. As a result, the Company met the requirements of ASC 205-20 and ASC 360 to report the results of the Food Export business segment as discontinued operations. The operating results for the Food Export business segment, for the three and six months ended November 26, 2017, have been reclassified to discontinued operations and are no longer reported as a separate segment.

Beginning in fiscal year 2019, the Company realigned the management of its business and now has three strategic reportable business segments: the Natural Foods segment, the Biomaterials segment, and the Other segment. Our Natural Foods business is comprised of our historical Packaged Fresh Vegetables and BreatheWay® activities, our *O* olive oils and wine vinegars business and our new Now Planting refrigerated soups business. Our Natural Foods segment includes activities to market and pack specialty packaged whole and fresh-cut fruit and vegetables, the majority of which incorporate the BreatheWay specialty packaging for the retail grocery, club store and food services industry and are sold under the Eat Smart® and GreenLine® brands. The Natural Foods segment also includes sales of BreatheWay packaging to partners for fruit and vegetable products, sales of olive oils and wine vinegars under our *O* brand and sales of soups under our Now Planting brand. The Biomaterials segment sells products utilizing hyaluronan, a naturally occurring polysaccharide that is widely distributed in the extracellular matrix of connective tissues in both animals and humans, and non-HA products for medical use primarily in the Ophthalmic, Orthopedic and other markets. The Other segment includes corporate general and administrative expenses, non-Natural Foods and non-Biomaterials interest income and income tax expenses. All of the assets of the Company are located within the United States of America.

The Company's international sales by geography are based on the billing address of the customer and were as follows (in millions):

| | Three Months Ended | | Six Months Ended | |
|---------------------|----------------------|----------------------|----------------------|----------------------|
| | November 25, 2018 | November 26, 2017 | November 25, 2018 | November 26, 2017 |
| Canada | \$ 20.3 | \$ 17.3 | \$ 40.2 | \$ 35.6 |
| Belgium | \$ 0.5 | \$ 0.5 | \$ 2.5 | \$ 2.7 |
| Ireland | \$ 1.2 | \$ 0.8 | \$ 2.3 | \$ 1.6 |
| Denmark | \$ — | \$ 0.5 | \$ 0.2 | \$ 0.7 |
| Switzerland | \$ 0.5 | \$ — | \$ 0.6 | \$ — |
| Mexico | \$ 0.1 | \$ 0.2 | \$ 0.1 | \$ 0.3 |
| All Other Countries | \$ 0.6 | \$ 1.1 | \$ 1.1 | \$ 1.2 |

Operations by business segment consisted of the following (in thousands):

| | Natural Foods | Biomaterials | Other | Total |
|--|---------------|--------------|------------|------------|
| Three Months Ended November 25, 2018 | | | | |
| Net sales | \$ 109,466 | \$ 15,446 | \$ — | \$ 124,912 |
| International sales | \$ 20,367 | \$ 2,842 | \$ — | \$ 23,209 |
| Gross profit | \$ 10,915 | \$ 5,678 | \$ — | \$ 16,593 |
| Net (loss) income from continuing operations | \$ (418) | \$ 1,298 | \$ (1,464) | \$ (584) |
| Depreciation and amortization | \$ 2,196 | \$ 978 | \$ 139 | \$ 3,313 |
| Dividend income | \$ 412 | \$ — | \$ — | \$ 412 |
| Interest income | \$ 30 | \$ — | \$ 3 | \$ 33 |
| Interest expense, net ⁽¹⁾ | \$ 276 | \$ — | \$ 470 | \$ 746 |
| Income tax (benefit) expense | \$ (50) | \$ 432 | \$ (105) | \$ 277 |
| Six Months Ended November 25, 2018 | | | | |
| Net sales | \$ 221,517 | \$ 28,063 | \$ — | \$ 249,580 |
| International sales | \$ 40,480 | \$ 6,558 | \$ — | \$ 47,038 |
| Gross profit | \$ 24,285 | \$ 8,645 | \$ — | \$ 32,930 |
| Net income (loss) from continuing operations | \$ 1,349 | \$ 751 | \$ (2,495) | \$ (395) |
| Depreciation and amortization | \$ 4,236 | \$ 1,954 | \$ 268 | \$ 6,458 |
| Dividend income | \$ 825 | \$ — | \$ — | \$ 825 |
| Interest income | \$ 61 | \$ — | \$ 18 | \$ 79 |
| Interest expense, net ⁽¹⁾ | \$ 863 | \$ — | \$ 641 | \$ 1,504 |
| Income tax expense (benefit) | \$ 612 | \$ 250 | \$ (520) | \$ 342 |
| Three Months Ended November 26, 2017 | | | | |
| Net sales | \$ 108,348 | \$ 14,113 | \$ — | \$ 122,461 |
| International sales | \$ 17,749 | \$ 2,675 | \$ — | \$ 20,424 |
| Gross profit | \$ 9,704 | \$ 5,217 | \$ — | \$ 14,921 |
| Net (loss) income from continuing operations | \$ (435) | \$ 1,260 | \$ (411) | \$ 414 |
| Depreciation and amortization | \$ 1,958 | \$ 910 | \$ 112 | \$ 2,980 |
| Dividend income | \$ 412 | \$ — | \$ — | \$ 412 |
| Interest income | \$ 18 | \$ — | \$ 24 | \$ 42 |
| Interest expense, net | \$ — | \$ — | \$ 480 | \$ 480 |
| Income tax (benefit) expense | \$ (95) | \$ 374 | \$ (114) | \$ 165 |
| Six Months Ended November 26, 2017 | | | | |
| Net sales | \$ 211,965 | \$ 26,277 | \$ — | \$ 238,242 |
| International sales | \$ 35,923 | \$ 6,174 | \$ — | \$ 42,097 |
| Gross profit | \$ 24,984 | \$ 8,739 | \$ — | \$ 33,723 |
| Net income (loss) from continuing operations | \$ 3,166 | \$ 1,105 | \$ (1,502) | \$ 2,769 |
| Depreciation and amortization | \$ 3,930 | \$ 1,775 | \$ 229 | \$ 5,934 |
| Dividend income | \$ 825 | \$ — | \$ — | \$ 825 |
| Interest income | \$ 28 | \$ — | \$ 45 | \$ 73 |
| Interest expense, net | \$ — | \$ — | \$ 884 | \$ 884 |
| Income tax expense | \$ 1,002 | \$ 347 | \$ 126 | \$ 1,475 |

- (1) Beginning in first quarter of fiscal 2019, the Company began allocating interest expense to its reportable segments in information provided to its CODM to enhance visibility into how financing activities impact the discrete financial results.

During the six months ended November 25, 2018 and November 26, 2017, sales to the Company's top five customers accounted for 45% and 49% of sales, respectively. The Company's top two customers, Costco Wholesale Corporation and Wal-Mart Stores, Inc., from the Natural Foods segment, each accounted for 17%, respectively, of revenues for the six months ended November 25, 2018, and 19% and 18%, respectively, for the six months ended November 26, 2017.

10. Discontinued Operations

During the fourth quarter of fiscal year 2018, the Company discontinued its Food Export business segment. As a result, the Company met the requirements of ASC 205-20, to report the results of the Food Export business segment as a discontinued operation and to classify the Food Export segment as a group of assets and liabilities held for abandonment. The operating results for the Food Export business segment have therefore been reclassified as a discontinued operation.

The carrying amounts of the major classes of assets and liabilities of the Food Export business segment included in assets and liabilities of discontinued operations are as follows (in thousands):

| | Period Ended | |
|--|-------------------|---------------|
| | November 25, 2018 | May 27, 2018 |
| Current and other assets, discontinued operations: | | |
| Cash and cash equivalents | \$ — | \$ (8) |
| Accounts receivable | — | 518 |
| Inventory | — | — |
| Other assets | — | — |
| Total assets, discontinued operations | <u>\$ —</u> | <u>\$ 510</u> |
| Other current liabilities, discontinued operations: | | |
| Accounts payable | \$ — | \$ 230 |
| Accrued expenses and other current liabilities | — | 228 |
| Total other current liabilities, discontinued operations | <u>\$ —</u> | <u>\$ 458</u> |

After the Food Export business segment was discontinued, the operations associated with this business qualified for reporting as discontinued operations. Accordingly, the operating results, net of tax, from discontinued operations are presented separately in the Company's Consolidated Statements of Comprehensive Income and the notes to the consolidated financial statements have been adjusted to exclude the food export business segment for the three and six months ended November 26, 2017. Components of amounts reflected in income (loss) from discontinued operations, net of tax are as follows (in thousands) for the three and six months ended:

| | Three Months | Six Months Ended |
|--|-------------------------|-------------------|
| | Ended November 26, 2017 | November 26, 2017 |
| Revenues | \$ 13,996 | \$ 21,572 |
| Cost of sales | (13,165) | (20,257) |
| Selling, general and administrative | (690) | (1,377) |
| Other | — | — |
| Income (loss) from discontinued operations, before taxes | 141 | (62) |
| Income tax (expense) benefit | (42) | 18 |
| Income (loss) from discontinued operations, net of tax | <u>\$ 99</u> | <u>\$ (44)</u> |

11. Subsequent event*Yucatan Acquisition*

On December 1, 2018, Apio entered into a capital contribution and partnership interest and stock purchase agreement (the "Purchase Agreement") by and among Yucatan Foods, L.P., a Delaware limited partnership ("Yucatan"), Camden Fruit Corporation, a California corporation and the General Partner of Yucatan ("Camden"), the equityholders of Camden and Yucatan, the Company, in its capacity as guarantor, and Ardeshir Haerizadeh, as a representative of the equityholders. Pursuant to the Purchase Agreement, the Company acquired, on December 1, 2018 (the "Closing"), all of the issued and outstanding limited partnership interests of Yucatan and all of the issued and outstanding capital stock of Camden (the "Acquisition") for initial consideration of \$60.0 million in cash and \$20.0 million in Landec common stock ("Stock Consideration"). The Stock Consideration has 3-and-4-year lock-up provisions (such that 50% of the Stock Consideration is released from lock-up on the 3 year anniversary of the Closing and the balance on the 4 year anniversary).

Given the timing of the completion of the acquisition, the Company is currently in the process of valuing the assets acquired and liabilities assumed in the acquisition. As a result, the Company is unable to provide the amount to be recorded as of the acquisition date for the major classes of assets acquired and liabilities assumed. The Company will provide these disclosures in its Quarterly Report on Form 10-Q for the third quarter ending February 24, 2019.

Fourth Amendment to the Credit Agreement

On November 30, 2018, Landec and certain of its subsidiaries entered into the Fourth Amendment and Joinder to Credit Agreement and Other Loan Documents (the “Amended Credit Agreement”) with JPMorgan, BMO and City National Bank, as lenders, which amended the Credit Agreement by and among Landec, certain of its subsidiaries, and the Lenders. The Amended Credit Agreement increased the capacity of the credit facility available under the Credit Agreement by \$55,000,000 to (i) a \$105,000,000 revolving line of credit (the “Amended Revolver”) and (ii) a \$100,000,000 term loan facility (the “Amended Term Loan”) from its preexisting credit facility comprised of (i) a \$100,000,000 Revolver and (ii) a \$50,000,000 Term Loan.

The Amended Credit Agreement continues to be guaranteed by certain of Landec's direct and indirect subsidiaries and secured by substantially all of Landec's and such direct and indirect subsidiaries' personal property assets (with the exception of Apio's equity interest in Windset Holdings 2010 Ltd.). Both the Amended Revolver and the Amended Term Loan continue to mature on September 23, 2021, with the Amended Term Loan requiring increased quarterly payments of \$2,500,000 and with the remainder continuing to be due at maturity. Interest on both the Amended Revolver and the Amended Term Loan continues to be based upon the Company's “Total Leverage Ratio”, now at a per annum rate of either (i) the prime rate plus a spread of between 0.25% and 2.25% or (ii) the Eurodollar rate plus a spread of between 1.25% and 3.25%, but also now allowing for a Total Leverage Ratio of up to 4.50 to 1.00. The Amended Credit Agreement also contains an “accordion” feature that provides Landec the right to increase the Amended Revolver commitments and/or the Amended Term Loan commitments by obtaining additional commitments either from one or more of the Lenders or another lending institution in an amount of up to \$10,000,000.

Landec entered into the Amended Credit Agreement primarily to fund its acquisition of Yucatan and its related entities on December 1, 2018, to pay certain fees and expenses incurred in connection with the consummation of the Amended Credit Agreement, and for other general corporate purposes.

The Amended Credit Agreement continues to contain customary events of default under which the obligation could be accelerated and/or the interest rate increased.

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 27, 2018.

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 Form 10-Q and those mentioned in Landec’s Annual Report on Form 10-K for the fiscal year ended May 27, 2018. 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 and use of estimates from those disclosed in the Company’s Form 10-K for the fiscal year ended May 27, 2018 with the exception of the adoption of Topic 606 which is discussed further in Note 1 – Organization, Basis of Presentation, and Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements. For a discussion of our critical accounting policies and use of estimates, refer to Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Use of Estimates in Part II, Item 7 of the Company’s Annual Report on Form 10-K for the fiscal year ended May 27, 2018.

Recently Issued Accounting Pronouncements

The Company is subject to several recently issued accounting pronouncements. Note 1 – Organization, Basis of Presentation, and Summary of Significant Accounting Policies – Recently Adopted Accounting Pronouncements of the Notes to the Consolidated Financial Statements which is contained in Part I, Item 1 of this Quarterly Report on Form 10-Q, describes these new accounting pronouncements and is incorporated herein by reference.

The Company

Landec Corporation and its subsidiaries (“Landec” or the “Company”) design, develop, manufacture and sell differentiated health and wellness products for food and biomaterials markets. There continues to be a dramatic shift in consumer behavior to healthier eating habits and preventive wellness to improve quality of life. In our Natural Foods segment, which includes the Apio, Inc. (“Apio”) Eat Smart[®] brand of packaged fresh produce products and salads, the O Olive Oil & Vinegar[®] (“O”) business (which sells premium California sourced specialty olive oils and wine vinegar products) and the newly created Now Planting[®] brand (which markets and sells plant-based refrigerated soups since its launch in October 2018), we are committed to offering healthy, fresh produce products conveniently packaged to consumers. In our Lifecore Biomedical, Inc. (“Lifecore”) biomaterials business, we commercialize products that enable people to stay more active as they grow older.

Landec’s Natural Foods and Biomaterials businesses utilize polymer chemistry technology, a key differentiating factor. Both businesses focus on business-to-business selling such as selling directly to retail grocery store chains and club stores for Natural Foods and directly to partners in the medical device and pharmaceutical markets, with a concentration in ophthalmology for Biomaterials.

Landec has three reportable business segments – Natural Foods and Biomaterials, each of which is described below, and an Other segment. Financial information concerning each of these segments is summarized in Note 9 – Business Segment Reporting.

The Natural Foods business is comprised of the Eat Smart brand (formerly in Packaged Fresh Vegetables), which combines our proprietary BreatheWay[®] food packaging technology with the capabilities of a large national food supplier and value-added produce processor and the GreenLine[®] brand to foodservice operators, as well as under private labels. Within the Eat Smart brand, produce is processed by trimming, washing, sorting, blending, and packaging into bags and trays that in most cases incorporate Landec’s BreatheWay membrane technology. The BreatheWay membrane increases shelf-life and reduces shrink (waste) for retailers and helps to ensure that consumers receive fresh produce by the time the product makes its way through the distribution chain. Apio also generates revenue from the sale and/or use of its BreatheWay technology by partners such as Windset Holding 2010 Ltd., a Canadian corporation (“Windset”), for packaging of greenhouse grown cucumbers and peppers.

The Natural Foods business also includes sales of olive oils and wine vinegars under our *O* brand and sales of soups under our Now Planting brand.

Lifecore operates our Biomaterials business and is involved in the development and manufacture of pharmaceutical-grade sodium hyaluronate (“HA”) products and providing contract development and aseptic manufacturing services. Sodium hyaluronate is a naturally occurring polysaccharide that is widely distributed in the extracellular matrix in animals and humans. Based upon Lifecore’s expertise working with highly viscous HA, the Company specializes in fermentation and aseptic formulation, filling, and packaging services, as a contract development and manufacturing organization (“CDMO”), for difficult to handle (viscous) medicines filled in finished dose vials and syringes.

Landec was incorporated in California on October 31, 1986 and reincorporated as a Delaware corporation on November 6, 2008. Our common stock is listed on The NASDAQ Global Select Market under the symbol “LNDC”. The Company’s principal executive offices are located at 5201 Great America Parkway, Suite 232, Santa Clara, California 95054, and the telephone number is (650) 306-1650.

Description of Core Business

Landec operates its business in three reportable business segments: Natural Foods, Biomaterials, and Other.

Natural Foods

The Natural Foods business is comprised of Apio’s packaged fresh vegetables business sold primarily under the Eat Smart brand, *O* branded olive oils and wine vinegars and Now Planting branded refrigerated plant-based soups.

Packaged Fresh Vegetables

Based in Guadalupe, California, Apio’s primary business is fresh-cut and whole vegetable products primarily packaged in proprietary BreatheWay packaging. The packaged fresh vegetables business markets a variety of fresh-cut and whole vegetables to the top retail grocery chains, club stores, and food service operators. During the fiscal year ended May 27, 2018, Apio shipped approximately 28 million cartons of produce to its customers throughout North America, primarily in the United States.

There are four major distinguishing characteristics of Apio that provide competitive advantages in the packaged fresh vegetables market:

Packaged Vegetables Supplier: Apio has structured its business as a marketer and seller of branded and private label blended, fresh-cut and whole vegetable products. It is focused on selling products primarily under its Eat Smart brand, with some sales under its GreenLine brand and private label brands. As retail grocery chains, club stores and food service operators consolidate, Apio is well positioned as a single source of a broad range of products.

Nationwide Processing and Distribution: Apio has strategically invested in its Packaged Fresh Vegetables business. Apio’s largest processing plant is in Guadalupe, CA, and is automated with state-of-the-art vegetable processing equipment in one of the lowest cost, growing regions in California, the Santa Maria Valley. With the acquisition of GreenLine in 2012, Apio added three East Coast processing facilities and five East Coast distribution centers for nationwide delivery of all of its packaged vegetable products in order to meet the next-day delivery needs of customers.

Expanded Product Line Using Technology and Unique Blends: Apio is introducing new packaged vegetable products each year, and many of these products use our BreatheWay packaging technology to extend shelf-life. These new product offerings range from various sizes of fresh-cut bagged products, to vegetable trays, to whole produce, to vegetable salads and to snack packs. During the last twelve months, Apio introduced fifteen new unique products.

Products Currently in Approximately 68% of North American Retail Grocery Stores: Apio has products in approximately 68% of all North American retail grocery stores. This gives Apio the opportunity to sell new products to existing customers and to increase distribution of its approximately 120 unique products within those customers.

Most vegetable products packaged in the Company's BreatheWay packaging have a shelf-life of approximately 17 days. In addition to packaging innovation, the Company has developed innovative blends and combinations of vegetables that are sold in flexible film bags or rigid trays. The Company has launched a family of salad kits that are comprised of "superfood" mixtures of vegetables with healthy toppings and dressings. The first salad kit to launch under the Eat Smart brand was Sweet Kale Salad, which now has significant distribution throughout club and retail stores in North America. Additionally, we have launched under the Eat Smart brand several other superfood salad kits including Chopped and Crumble, Southwest Salad, and Asian Sesame and more recently a new line of single-serve salads under our new Salad Shake-Ups!™ brand. The Company's expertise includes accessing leading culinary experts and nutritionists nationally to help in the new product development process. We believe that the Company's new products are "on trend" and strong market acceptance supports this belief. Recent statistics show that more than two-thirds of adults are considered to be overweight or obese and more than one-third of adults are considered to be obese. More and more consumers are beginning to make better food choices in their schools, homes, and in restaurants and that is where the superfood products can fit into consumers' daily healthy food choices.

The Company also periodically licenses its BreatheWay packaging technology to partners for packaging fruits and vegetables, and Windset for packaging peppers and cucumbers that are grown hydroponically in greenhouses. These packaging license relationships generate revenues either from product sales or royalties once commercialized. The Company is engaged in the testing and development of other BreatheWay products. Landec manufactures its BreatheWay packaging through selected qualified contract manufacturers.

Windset

The Company believes that hydroponically-grown produce using Windset's know-how and growing practices will result in higher yields with competitive growing costs that will provide dependable year-round supply to Windset's customers. In addition, the produce grown in Windset's greenhouses uses significantly less water than field grown crops and has a very high safety profile as no soil is used in the growing process. Windset owns and operates greenhouses in British Columbia, Canada and California. In addition to growing produce in its own greenhouses, Windset has numerous marketing arrangements with other greenhouse growers and utilizes buy/sell arrangements to meet fluctuation in demand from their customers.

On March 15, 2017, the Company and Windset agreed to extend their relationship through March 31, 2022.

See Note 3 – Investment in Non-public Company of the Notes to Consolidated Financial Statements for a discussion about the Company's 26.9% minority ownership interest in Windset.

O Olive Oils & Vinegars (O)

The Company acquired *O* on March 1, 2017. *O*, founded in 1995, is based in Petaluma, California, and is the premier producer of California specialty olive oils and wine vinegars. Its products are sold in over 4,000 natural food, conventional grocery and mass retail stores, primarily in the United States and Canada.

Now Planting Soups

The Company created the Now Planting brand to offer pure-plant meal solutions for the fresh, refrigerated sections of retail and club stores. The Company has been developing new lines of products to be launched under its new Now Planting brand with the first line being refrigerated soups which the Company began shipping in October 2018.

Biomaterials

Lifecore uses its fermentation process and aseptic formulation and filling expertise to be a leader in the development of HA-based products for multiple applications and to take advantage of non-HA device and drug opportunities which leverage its expertise in manufacturing and aseptic syringe filling capabilities. Elements of Lifecore's strategy include the following:

- (1) **Establish strategic relationships with market leaders:** Lifecore will continue to develop applications for products with partners who have strong marketing, sales, and distribution capabilities to end-user markets. Through its strong reputation and history of providing pharmaceutical grade HA and products, Lifecore has been able to establish long-term relationships with the market leading ophthalmic surgical companies, and leverages those partnerships to attract new relationships in other medical markets.

- (2) **Expand medical applications for HA:** Due to the growing knowledge of the unique characteristics of HA, and the role it plays in normal physiology, Lifecore continues to identify and pursue opportunities for the use of HA in other medical applications, such as wound care, aesthetic surgery, drug delivery, next generation orthopedics and device coatings and through sales to academic and corporate research customers. Further applications may involve expanding process development activity and/or additional licensing of technology.
- (3) **Utilize manufacturing infrastructure to pursue contract aseptic filling and fermentation opportunities:** Lifecore has made strategic capital investments in its CDMO business focusing on extending its aseptic filling capacity and capabilities. It is investing in this segment to meet increasing partner demand and attract new contract filling opportunities outside of HA markets. Lifecore is using its manufacturing capabilities to provide contract manufacturing and development services to its partners in the area of sterile pre-filled syringes and vials, as well as, fermentation and purification requirements.
- (4) **Maintain flexibility in product development and supply relationships:** Lifecore’s vertically integrated development and manufacturing capabilities allow it to establish a variety of contractual relationships with global corporate partners. Lifecore’s role in these relationships extends from supplying HA raw materials to providing technology transfer and development services to manufacturing aseptically filled, finished sterile products, and assuming full supply chain responsibilities.

Other

Included in the Other segment is Corporate.

Results of Operations

Revenues (in thousands):

| | Three Months Ended | | | Six Months Ended | | |
|-----------------------|----------------------|----------------------|--------|----------------------|----------------------|--------|
| | November 25, 2018 | November 26, 2017 | Change | November 25, 2018 | November 26, 2017 | Change |
| Natural Foods | \$ 109,466 | \$ 108,348 | 1% | \$ 221,517 | \$ 211,965 | 5% |
| Biomaterials | 15,446 | 14,113 | 9% | 28,063 | 26,277 | 7% |
| Total Revenues | <u>\$ 124,912</u> | <u>\$ 122,461</u> | 2% | <u>\$ 249,580</u> | <u>\$ 238,242</u> | 5% |

Natural Foods

Natural Foods revenues consist of revenues generated from the sale of specialty packaged fresh-cut and whole processed vegetable products that are washed and packaged in the Company’s proprietary packaging and sold under the Eat Smart and GreenLine brands and various private labels. In addition, the Natural Foods reportable business segment includes the revenues generated from the sale of BreatheWay packaging to license partners and from the sales of olive oils and vinegars by O.

The increase in Natural Foods revenues for the three and six months ended November 25, 2018 compared to the same periods last year was primarily due to a 6% and 9%, respectively, unit volume sales increase, principally resulting from increased demand from existing customers. These volume increases were partially offset by an unfavorable mix shift to a higher percentage of sales coming from our lower-priced core vegetable products versus our higher-priced salad products compared to the same periods last year.

Biomaterials (Lifecore)

Lifecore generates revenue from the development and manufacture of pharmaceutical-grade sodium hyaluronate (“HA”) products and providing contract development and aseptic manufacturing services to customers. Lifecore generates revenues from three integrated activities: (1) Aseptically filled syringes and vials, which represented approximately 46% of Lifecore’s revenues in fiscal year 2018, (2) Fermentation products, which represented approximately 32% of Lifecore’s revenues in fiscal year 2018, and (3) development activities, which represented approximately 22% of Lifecore’s revenues in fiscal year 2018.

The increase in Lifecore’s revenues for the three months ended November 25, 2018 compared to the same period last year was due to a \$1.7 million increase in development services revenue from existing customers and a \$537,000 increase in aseptic filling revenues mainly due to existing customers increasing their aseptic business with Lifecore. These increases were partially offset by a \$1.0 million decrease in fermentation revenues as a result of the timing of shipments within the fiscal year compared to last fiscal year.

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The increase in Lifecore's revenues for the six months ended November 25, 2018 compared to the same period last year was due to a \$3.2 million increase in development services revenue primarily from existing customers. This increase was partially offset by a \$724,000 decrease in aseptic filling revenues and a \$670,000 decrease in fermentation revenues both as a result of the timing of shipments within the fiscal year compared to last fiscal year.

Gross Profit (in thousands):

| | Three Months Ended | | | Six Months Ended | | |
|---------------------------|----------------------|----------------------|--------|----------------------|----------------------|--------|
| | November 25, 2018 | November 26, 2017 | Change | November 25, 2018 | November 26, 2017 | Change |
| Natural Foods | \$ 10,915 | \$ 9,704 | 12% | \$ 24,285 | \$ 24,984 | (3%) |
| Biomaterials | 5,678 | 5,217 | 9% | 8,645 | 8,739 | (1%) |
| Total Gross Profit | <u>\$ 16,593</u> | <u>\$ 14,921</u> | 11% | <u>\$ 32,930</u> | <u>\$ 33,723</u> | (2%) |

General

There are numerous factors that can influence gross profit 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. The Company includes in cost of sales all of the following costs: raw materials (including produce, seeds, packaging, syringes and fermentation and purification supplies), direct labor, overhead (including indirect labor, depreciation, and facility-related costs) and shipping and shipping-related costs. The following are the primary reasons for the changes in gross profit for the three and six months ended November 25, 2018 compared to the same period last year as outlined in the table above

Natural Foods

The increase in gross profit for the Natural Foods business for the three months ended November 25, 2018 compared to the same period last year was primarily due to a decrease in sourcing costs resulting from improved raw product sourcing primarily in our core vegetable product line, partially offset by startup manufacturing costs in the Now Planting product line and lower revenues in the sale of BreatheWay membranes.

The decrease in gross profit for the Natural Foods business for the six months ended November 25, 2018 compared to the same period last year was primarily due to an increase in start-up manufacturing costs in our Now Planting Soup product line and lower sales of BreatheWay membranes. These decreases were partially offset by gross profit on higher sales.

Biomaterials (Lifecore)

The increase in Lifecore's gross profit for the three months ended November 25, 2018 compared to the same period last year was due to increased development services and aseptic revenues.

The decrease in Lifecore's gross profit for the six months ended November 25, 2018 compared to the same period last years was due to an unfavorable product mix shift and the timing of production and shipments within fiscal year 2019.

Operating Expenses (in thousands):

| | Three Months Ended | | | Six Months Ended | | |
|----------------------------------|----------------------|----------------------|--------|----------------------|----------------------|--------|
| | November 25, 2018 | November 26, 2017 | Change | November 25, 2018 | November 26, 2017 | Change |
| Research and Development: | | | | | | |
| Natural Foods | \$ 1,175 | \$ 1,488 | (21%) | \$ 2,532 | \$ 2,505 | 1% |
| Biomaterials | 1,225 | 1,334 | (8%) | 2,430 | 2,702 | (10%) |
| Other | 133 | 550 | (76%) | 404 | 884 | (54%) |
| Total R&D | <u>\$ 2,533</u> | <u>\$ 3,372</u> | (25%) | <u>\$ 5,366</u> | <u>\$ 6,091</u> | (12%) |

| | Three Months Ended | | | Six Months Ended | | |
|---|----------------------|----------------------|--------|----------------------|----------------------|--------|
| | November 25, 2018 | November 26, 2017 | Change | November 25, 2018 | November 26, 2017 | Change |
| Selling, General and Administrative: | | | | | | |
| Natural Foods | \$ 9,558 | \$ 8,158 | 17% | \$ 18,615 | \$ 16,692 | 12% |
| Biomaterials | 1,647 | 1,428 | 15% | 3,245 | 2,943 | 10% |
| Other | 3,461 | 2,658 | 30% | 6,757 | 5,967 | 13% |
| Total SG&A | <u>\$ 14,666</u> | <u>\$ 12,244</u> | 20% | <u>\$ 28,617</u> | <u>\$ 25,602</u> | 12% |

Research and Development

Landec's Research and Development ("R&D") consisted primarily of product development and commercialization initiatives. R&D efforts in our Natural Foods business are primarily focused on innovating our current product lines such as salads and soups. In addition, R&D efforts focus on the Company's proprietary BreatheWay membranes used for packaging produce, with a focus on extending the shelf-life of sensitive vegetables and fruit. In the Lifecore business, the R&D efforts are focused on new products and applications for HA-based and non-HA biomaterials. For Other, the R&D efforts are primarily focused on supporting the development and commercialization of new products and new technologies in the Company's new natural food business.

The decrease in R&D expenses for the three and six months ended November 25, 2018 compared to the same periods last year was primarily due to a decrease in R&D expenses in our Other segment as a result of a decrease in product development activities for our new ventures.

Selling, General and Administrative

Selling, general and administrative ("SG&A") 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 SG&A expenses for the three and six months ended November 25, 2018 compared to the same periods last year was due to an increase in our Natural Foods and Corporate segments primarily as a result of increased professional fees related to various cost-out projects and merger and acquisition costs.

Other (in thousands):

| | Three Months Ended | | | Six Months Ended | | |
|---------------------------|----------------------|----------------------|--------|----------------------|----------------------|--------|
| | November 25, 2018 | November 26, 2017 | Change | November 25, 2018 | November 26, 2017 | Change |
| Dividend Income | \$ 412 | \$ 412 | 0% | \$ 825 | \$ 825 | 0% |
| Interest Income | \$ 33 | \$ 42 | (21%) | \$ 79 | \$ 73 | 8% |
| Interest Expense | \$ (746) | \$ (480) | 55% | \$ (1,504) | \$ (884) | 70% |
| Other Income | \$ 600 | \$ 1,300 | (54%) | \$ 1,600 | \$ 2,200 | (27%) |
| Income Tax Expense | \$ (277) | \$ (165) | 68% | \$ (342) | \$ (1,475) | (77%) |

Dividend Income

Dividend income is derived from the dividends accrued on the Company's \$22 million senior preferred stock investment in Windset which yields a cash dividend of 7.5% annually. There was no change in dividend income for the three and six months ended November 25, 2018 compared to the same period last year.

Interest Income

The decrease in interest income for the three months ended November 25, 2018 compared to the same period last year was not significant.

The increase in interest income for the six months ended November 25, 2018, compared to the same period last year was not significant.

Interest Expense

The increase in interest expense for the three and six months ended November 25, 2018 compared to the same periods last year was primarily due to the Company's line of credit balance increasing from \$10.0 million as of November 26, 2017 to \$42.0 million as of November 25, 2018.

Other Income

The decrease in other income for the three months ended November 25, 2018 was a result of the change in the fair value of the Company's investment in Windset which increased \$600,000 for the three months ended November 25, 2018 compared to an increase of \$1.3 million for the three months ended November 26, 2017.

The decrease in other income for the six months ended November 25, 2018 was a result of the change in the fair value of the Company's investment in Windset which increased \$1.6 million for the six months ended November 25, 2018 compared to an increase of \$2.2 million for the six months ended November 26, 2017.

Income Taxes

The increase in the income tax expense during the three months ended November 25, 2018 compared to the same period last year was primarily due to a \$347,000 charge related to the completion of the Company's transition tax analysis pursuant to the TCJA, which was slightly offset by a pre-tax loss of \$307,000.

The decrease in the income tax expense during the six months ended November 25, 2018 compared to the same period last year was primarily due to a 101% decrease in pre-tax income as well as a decrease in the effective tax rate.

Liquidity and Capital Resources

As of November 25, 2018, the Company had cash and cash equivalents of \$1.5 million, a net decrease of \$1.4 million from \$2.9 million as of May 27, 2018.

Cash Flow from Operating Activities

The Company generated \$4.8 million of net cash from operating activities during the six months ended November 25, 2018, compared to \$6.3 million of net cash generated from operating activities for the six months ended November 26, 2017. The primary sources of net cash from operating activities during the six months ended November 25, 2018 were from \$8.1 million of depreciation/amortization and stock based compensation expense. These sources of cash were offset by (1) a \$1.6 million increase in fair value of the Windset investment; (2) a \$900,000 decrease in the fair value of the *O* earn-out liability; (3) a net decrease of \$653,000 in working capital. These increases were partially offset by a net loss of \$395,000.

The primary factors which decreased working capital during the first six months of fiscal year 2019 were (1) a \$3.3 million decrease in accrued compensation due to fiscal year 2018 earned bonuses being paid during the first quarter of fiscal year 2019, (2) a \$1.4 million decrease in accounts payable due to the timing of vendor payments, and (3) a \$958,000 decrease in deferred revenue due to the timing of billings at Lifecore. These decreases in working capital were partially offset by (1) a \$1.6 million increase in other accrued liabilities in the current period versus the prior year period, and (2) a \$2.3 million increase in prepaid expenses and other current assets primarily related to the timing of growing advances for raw products at Apio.

Cash Flow from Investing Activities

Net cash used in investing activities for the six months ended November 25, 2018 was \$18.4 million compared to \$11.5 million for the same period last year. The primary uses of cash in investing activities during the six months of fiscal year 2019 were for the purchase of \$18.6 million of equipment, primarily to support the growth of the Natural Foods and Lifecore businesses, slightly offset by \$195,000 of proceeds from the collections of a note receivable.

Cash Flow from Financing Activities

Net cash provided by financing activities for the six months ended November 25, 2018 was \$12.2 million compared to \$4.1 million for the same period last year. The net cash provided by financing activities during the first six months of fiscal year 2019 was due to \$15.0 million of borrowing under the Company's line of credit. These borrowings were partially offset by \$2.5 million of payments on the Company's long-term debt.

Capital Expenditures

During the six months ended November 25, 2018, Landec purchased equipment to support the growth of the Natural Foods and Lifecore businesses. These expenditures represented the majority of the \$18.6 million of capital expenditures in the period.

Debt

On September 23, 2016, the Company entered into a Credit Agreement with JPMorgan Chase Bank (“JPMorgan”), BMO Harris Bank N.A. and City National Bank, as lenders (collectively, the “Lenders”), and JPMorgan as administrative agent, pursuant to which the Lenders provided the Company with a \$100 million revolving line of credit (the “Revolver”) and a \$50 million term loan facility (the “Term Loan”), guaranteed by each of the Company’s direct and indirect subsidiaries and secured by substantially all of the Company’s assets, with the exception of the Company’s investment in Windset.

Both the Revolver and the Term Loan mature in five years (on September 23, 2021), with the Term Loan providing for quarterly principal payments of \$1.25 million commencing December 1, 2016, with the remainder due at maturity.

See Note 7 – Debt and Note 11 - Subsequent Events of the Notes to Consolidated Financial Statements for further discussion of the Company’s debt arrangements.

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

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

There have been no material changes to the Company's market risk during the first six months of fiscal year 2019.

Item 4. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

Management evaluated, with participation of the Chief Executive Officer and the Chief Financial Officer, the effectiveness of the Company’s disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. The disclosure controls and procedures are intended to ensure that information required to be disclosed in reports filed under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission and (2) accumulated and communicated to the Company’s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based on this evaluation, although the Company has initiated its remediation plan to address the material weakness over financial reporting as identified in the Company’s Annual Report on Form 10-K for the fiscal year ended May 27, 2018, the Chief Executive Officer and Chief Financial Officer have concluded that the Company’s disclosure controls and procedures were not effective as of November 25, 2018.

Changes in Internal Control over Financial Reporting

There were no changes in internal controls over financial reporting during the fiscal quarter ended November 25, 2018 that have materially affected, or are reasonably likely to materially affect, internal controls over financial reporting.

As discussed in greater detail under Item 9A, Controls and Procedures, in our Annual Report on Form 10-K for the fiscal year ended May 27, 2018, we initiated a remediation plan to address the material weakness in our internal control over financial reporting identified as of the fiscal year then-ended. Our efforts to improve our internal controls are ongoing.

For a more comprehensive discussion of the material weakness in internal control over financial reporting identified by management as of May 27, 2018, and the remedial measures undertaken to address this material weakness, investors are encouraged to review Item 9A, Controls and Procedures, in our Annual Report on Form 10-K for the fiscal year ended May 27, 2018.

PART II. OTHER INFORMATION

Item 1. Legal Contingencies

In the ordinary course of business, the Company is involved in various legal proceedings and claims.

The Company makes a provision for a liability relating to legal matters when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least each fiscal quarter and adjusted to reflect the impacts of negotiations, estimate settlements, legal rulings, advice of legal counsel and other information and events pertaining to a particular matter. Legal fees are expensed in the period in which they are incurred.

Apio has been the target of a union organizing campaign which has included three unsuccessful attempts to unionize Apio's Guadalupe, California processing plant. The campaign has involved a union and over 100 former and current employees of Pacific Harvest, Inc. and Rancho Harvest, Inc. (collectively "Pacific Harvest"), Apio's labor contractors at its Guadalupe, California processing facility, bringing legal actions before various state and federal agencies, the California Superior Court, and initiating over 100 individual arbitrations against Apio and Pacific Harvest.

The legal actions consisted of three main types of claims: (1) Unfair Labor Practice claims ("ULPs") before the National Labor Relations Board ("NLRB"), (2) discrimination/wrongful termination claims before state and federal agencies and in individual arbitrations, and (3) wage and hour claims as part of two Private Attorney General Act ("PAGA") cases in state court and in over 100 individual arbitrations.

The ULP claims were settled in fiscal year 2017 for \$310,000. Apio was responsible for half of this settlement, or \$155,000. On May 5, 2017, the parties to the remaining actions executed a Settlement Agreement concerning the discrimination/wrongful termination claims and the wage and hour claims which covers all non-exempt employees of Pacific Harvest working at Apio's Guadalupe, California processing facility from September 2011 through the settlement date. Under the Settlement Agreement, the plaintiffs were paid \$6.0 million in three installments: \$2.4 million of which was paid in July 2017, \$1.8 million of which was paid in November 2017 and \$1.8 million of which was paid in July 2018, representing the final payment due under the settlement agreement. The Company and Pacific Harvest have each agreed to pay one half of the settlement payments. The Company paid the entire first two installments of \$4.2 million and will be reimbursed by Pacific Harvest for its \$2.1 million portion. As of November 25, 2018, the outstanding balance of the receivable was \$1.9 million of which \$900,000 and \$1.0 million is included in Prepaid and other current assets and Other assets, respectively, in the accompanying Consolidated Balance Sheets. This receivable will continue to be repaid through monthly payments until fully paid, which the Company expects to occur by December 2020. The Company's recourse against non-payment by Pacific Harvest is its security interest in assets owned by Pacific Harvest.

As of November 25, 2018 and May 27, 2018, the Company had accrued \$0 and \$1.0 million, respectively, related to these actions, which is included in Other accrued liabilities in the accompanying Consolidated Balance Sheets.

Item 1A. Risk Factors

Our estimated annual effective tax rate may be subject to further uncertainty due to the recent changes in U.S. tax rates and tax laws. Other than this item, there have been no significant changes to the Company's risk factors which are included and described in the Form 10-K for the fiscal year ended May 27, 2018 filed with the Securities and Exchange Commission on August 10, 2018.

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

There were no unregistered sales of equity securities or shares repurchased by the Company during the fiscal quarter ended on November 25, 2018.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable

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. |
| 101.INS** | XBRL Instance |
| 101.SCH** | XBRL Taxonomy Extension Schema |
| 101.CAL** | XBRL Taxonomy Extension Calculation |
| 101.DEF** | XBRL Taxonomy Extension Definition |
| 101.LAB** | XBRL Taxonomy Extension Labels |
| 101.PRE** | XBRL Taxonomy Extension Presentation |
| + | Filed herewith. |

** XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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 of Finance and Administration and Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: January 4, 2019

CERTIFICATION

I, Molly A. Hemmeter, 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: January 4, 2019

/s/ Molly A. Hemmeter
Molly A. Hemmeter
Chief Executive Officer and President

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: January 4, 2019

/s/ Gregory S. Skinner

Gregory S. Skinner

Vice President of Finance and Administration and
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 November 25, 2018 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Molly A. Hemmeter, 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: January 4, 2019

/s/ Molly A. Hemmeter
Molly A. Hemmeter
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 November 25, 2018 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: January 4, 2019

/s/ Gregory S. Skinner
Gregory S. Skinner
*Vice President of Finance and Administration 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.