

LANDEC CORP \CA\
Form 10-Q
October 05, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Fiscal Quarter Ended August 26, 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:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock	The NASDAQ Global Select Stock 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 X 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 X 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	<u>X</u>
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 September 21, 2018, there were 27,749,280 shares of Common Stock outstanding.

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LANDEC CORPORATION

FORM 10-Q

For the Fiscal Quarter Ended August 26, 2018

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Table of Contents**LANDEC CORPORATION****CONSOLIDATED BALANCE SHEETS****(In thousands except par value)**

	August 26, 2018 (unaudited)	May 27, 2018
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,359	\$ 2,899
Accounts receivable, less allowance for doubtful accounts	48,660	53,877
Inventories	29,986	31,819
Prepaid expenses and other current assets	8,312	7,958
Other current assets, discontinued operations	—	510
Total Current Assets	88,317	97,063
Investment in non-public company, fair value	67,500	66,500
Property and equipment, net	165,875	159,624
Goodwill	54,510	54,510
Trademarks/tradenames, net	16,028	16,028
Customer relationships, net	5,576	5,814
Other assets	5,095	5,164
Total Assets	\$ 402,901	\$ 404,703
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 27,027	\$ 34,668
Accrued compensation	4,953	9,978
Other accrued liabilities	8,845	8,706
Deferred revenue	2,062	2,625
Line of credit	39,000	27,000
Current portion of long-term debt	4,940	4,940
Other current liabilities, discontinued operations	—	458
Total Current Liabilities	86,827	88,375
Long-term debt, net	36,125	37,360
Capital lease obligation, less current portion	3,615	3,641
Deferred taxes, net	17,394	17,485
Other non-current liabilities	5,559	5,280
Total Liabilities	149,520	152,141
Stockholders' Equity:		
	28	28

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Common stock, \$0.001 par value; 50,000 shares authorized; 27,749 and 27,702 shares issued and outstanding at August 26, 2018 and May 27, 2018, respectively

Additional paid-in capital	142,805	142,087
Retained earnings	109,489	109,299
Accumulated other comprehensive income	1,059	1,148
Total Stockholders' Equity	253,381	252,562
Total Liabilities and Stockholders' Equity	\$ 402,901	\$ 404,703

See accompanying notes to the consolidated financial statements.

Table of Contents**LANDEC CORPORATION****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)****(In thousands, except per share amounts)**

	Three Months Ended	
	August	August
	26, 2018	27, 2017
Product sales	\$124,668	\$115,781
Cost of product sales	108,331	96,979
Gross profit	16,337	18,802
Operating costs and expenses:		
Research and development	2,833	2,719
Selling, general and administrative	13,951	13,358
Total operating costs and expenses	16,784	16,077
Operating (loss) income	(447)	2,725
Dividend income	413	413
Interest income	46	31
Interest expense	(758)	(404)
Other income	1,000	900
Net income from continuing operations before taxes	254	3,665
Income tax expense	(64)	(1,310)
Net income from continuing operations	\$190	\$2,355
Discontinued operations:		
Loss from discontinued operations	\$—	\$(203)
Income tax benefit	—	60
Loss from discontinued operations, net of tax	—	(143)
Consolidated net income	190	2,212
Non-controlling interest expense	—	(66)
Net income applicable to common stockholders	\$190	\$2,146
Basic net income (loss) per share:		
Income from continuing operations	\$0.01	\$0.09
Loss from discontinued operations	—	(0.01)
Total basic net income per share	\$0.01	\$0.08

Diluted net income per share:		
Income from continuing operations	\$0.01	\$0.08
Loss from discontinued operations	—	—
Total diluted net income per share	\$0.01	\$0.08
Shares used in per share computation:		
Basic	27,738	27,506
Diluted	28,020	27,858
Other comprehensive loss, net of tax:		
Net unrealized losses on interest rate swap contracts (net of tax effect of \$27 and \$57)	\$(89)	\$(103)
Other comprehensive loss, net of tax	(89)	(103)
Total comprehensive income	\$101	\$2,043

See accompanying notes to the consolidated financial statements.

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

	Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive Income	Total Stockholders' Equity
	Shares	Amount	Capital	Earnings		
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")	39	—	—	—	—	—
Taxes paid by Company for employee stock plans	—	—	(10)	—	—	(10)
Stock-based compensation	—	—	728	—	—	728
Net income	—	—	—	190	—	190
Other comprehensive loss, net of tax	—	—	—	—	(89)	(89)
Balance at August 26, 2018	27,749	\$ 28	\$ 142,805	\$ 109,489	\$ 1,059	\$ 253,381

See accompanying notes to the consolidated financial statements.

Table of Contents**LANDEC CORPORATION****Consolidated Statements of Cash Flows****(Unaudited)****(In thousands)**

	Three Months Ended	
	August 26, 2018	August 27, 2017
Cash flows from operating activities:		
Consolidated net income	\$ 190	\$ 2,212
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,145	2,954
Stock-based compensation expense	728	950
Deferred taxes	(63)	1,150
Change in investment in non-public company, fair value	(1,000)	(900)
Net gain on disposal of property and equipment	(3)	(2)
Changes in current assets and current liabilities:		
Accounts receivable, net	5,735	(768)
Inventories	1,833	(2,849)
Prepaid expenses and other current assets	(363)	(841)
Accounts payable	(2,544)	4,664
Accrued compensation	(5,269)	(2,825)
Other accrued liabilities	386	(269)
Deferred revenue	(589)	(26)
Net cash provided by operating activities	2,186	3,450
Cash flows from investing activities:		
Purchases of property and equipment	(14,440)	(5,727)
Issuance of note receivable	—	(1,185)
Proceeds from sales of fixed assets	3	43
Net cash used in investing activities	(14,437)	(6,869)
Cash flows from financing activities:		
Proceeds from sale of common stock	—	1
Taxes paid by Company for employee stock plans	(10)	(43)
Payments on long-term debt	(1,271)	(1,271)
Proceeds from lines of credit	12,000	10,500
Payments on lines of credit	—	(3,000)
Other, net	—	14
Net cash provided by financing activities	10,719	6,201

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Net (decrease) increase in cash, cash equivalents and restricted cash ⁽¹⁾	(1,532)	2,782
Cash, cash equivalents and restricted cash, beginning of period ⁽¹⁾	3,216	5,734
Cash, cash equivalents and restricted cash, end of period ⁽¹⁾	\$1,684	\$8,516

Supplemental disclosure of non-cash investing and financing activities:

Purchases of property and equipment on trade vendor credit	\$3,118	\$799
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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 ⁽¹⁾ 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.

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LANDEC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

I. 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. Through its O Olive Oil and Vinegar (“O”) division, which the Company acquired on *March 1, 2017*, the Company sells premier California specialty olive oils and wine vinegars under the O brand to natural food, conventional grocery and mass retail stores, primarily in the United States and Canada.

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 *August 26, 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*.

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 *three months ended August 27, 2017*.

The results of operations for the *three months ended August 26, 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 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 *three months ended August 27, 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.

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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):

	August 26, 2018	May 27, 2018	August 27, 2017	May 28, 2017
Cash and cash equivalents	\$1,359	\$2,899	\$8,264	\$5,998
Restricted cash	325	325	325	325
Cash, discontinued operations	—	(8)	(73)	(589)
Cash, cash equivalents and restricted cash	\$1,684	\$3,216	\$8,516	\$5,734

Restricted Cash

The Company was required to maintain \$325,000 of restricted cash as of both *August 26, 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):

	August 26, 2018	May 27, 2018
Raw materials	\$13,891	\$15,286
Work in progress	3,146	3,672
Finished goods	12,949	12,861
Total	\$29,986	\$31,819

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.

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Related Party Transactions

The Company sells products to and earns license fees from Windset Holdings 2010 Ltd. (“Windset”). During the *three* months ended *August 26, 2018* and *August 27, 2017*, the Company recognized revenues of *\$134,000* and *\$104,000*, respectively. These amounts have been included in product sales in the accompanying Consolidated Statements of Comprehensive Income. The related receivable balances of *\$114,000* and *\$334,000* are included in accounts receivable in the accompanying Consolidated Balance Sheets as of *August 26, 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* months ended *August 26, 2018* and *August 27, 2017*, the Company recognized cost of product sales of *\$6,000* and *\$0*, respectively, in the accompanying Consolidated Statements of Comprehensive 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 *\$248,000* were recorded as prepaid expenses and other current assets, and other assets, respectively, as of *August 26, 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 *\$125,000* was recorded as current portion of long-term debt, and long-term debt, net, respectively, as of *August 26, 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 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	(89)
Amounts reclassified from OCI	—
Accumulated OCI, net, as of August 26, 2018	\$1,059

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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 *August 26, 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 *August 26, 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.

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As of *August 26, 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.

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 *three* months ended *August 26, 2018* was due to the Company's 26.9% minority interest in the change in the fair market value of Windset during the period. 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 August 26, 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
August 26,
2018

10% increase in revenue growth rates	\$ 10,100
10% increase in expense growth rates	\$ (9,400)
10% increase in income tax rates	\$ (500)
10% increase in discount rates	\$ (4,300)

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 August 26, 2018			Fair Value at May 27, 2018		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Assets:						
Interest rate swap contract	\$—	\$1,466	\$—	\$—	\$1,529	\$—
Investment in non-public company	—	—	67,500	—	—	66,500
Total assets	\$—	\$1,466	\$67,500	\$—	\$1,529	\$66,500
Liabilities:						
Interest rate swap contract	\$—	\$54	\$—	\$—	\$—	\$—
Contingent consideration liability	—	—	4,000	—	—	4,000
Total liabilities	\$—	\$54	\$4,000	\$—	\$—	\$4,000

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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.

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. Shipping and other transportation costs charged to customers are recorded in both revenue and cost of goods sold. 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	
	August	August
Natural Foods:	26, 2018	27, 2017
Salads	\$49,080	\$42,048
Core vegetables	61,750	58,075
Other	1,221	3,494
Total	\$112,051	\$103,617

	Three Months Ended	
	August	August
Biomaterials:	26, 2018	27, 2017
Aseptic	\$5,766	\$7,026
Fermentation	3,070	2,791
Development services	3,781	2,347
Total	\$12,617	\$12,164

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 in the accompanying Consolidated Statements of Comprehensive Income.

Legal Contingencies

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

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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, of which \$800,000 and \$1.3 million is included in Prepaid and other current assets and Other assets, respectively, in the accompanying Consolidated Balance Sheets. This receivable will 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 August 26, 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.

Recent Accounting Guidance

Recently Adopted Pronouncements

Restricted Cash

In November 2016, the Financial Accounting Standards Board (“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.

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.

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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.

The timing of revenue recognition for these types of sales remains virtually unchanged under Topic 606. In the notes to the consolidated financial statements, the Company has expanded its revenue recognition disclosures. The Company has elected the practical expedient that allows an election to account for the cost of shipping and handling that is performed after control of a good has been transferred to the customer as a fulfillment cost. 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

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.

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 is currently evaluating the impact that the adoption of this guidance will have on its consolidated financial statements.

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.

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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 its 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 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 both *August 26, 2018* and *May 27, 2018*, the contingent consideration liability was \$4.0 million, representing the present value of the expected earn out payments.

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.

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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 on or after *February 15, 2017*, Windset has the right to call any or all of the outstanding common shares, but at such time must also call the same proportion of Senior A preferred shares, Senior B preferred shares, and junior 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 *August 26, 2018* and *August 27, 2017*, the Company recorded \$412,500 in dividend income. The increase in the fair market value of the Company's investment in Windset for the *three* month periods ended *August 26, 2018* and *August 27, 2017* was \$1.0 million and \$900,000, 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 AugustAugust 26, 27, 2018 2017	
Options	\$ 221	\$ 324
RSUs	507	626
Total stock-based compensation		