



INITIATION OF COVERAGE

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LANDEC CORPORATION (NASDAQGS: LNDC)

Landec Corporation (www.landec.com) designs, develops, manufactures and sells temperature-activated and other specialty polymer products for food, agriculture and licensed partner applications.

Current Price (04/01/09)	\$5.68	Market Cap (issued)	\$152 million
18 mos. Target Price	\$12.00	Shares O/S (issued)	26.8 million
Investment Opinion	BUY	Avg. Volume (3 mos.)	164,000
LTD/Capital	0%	52-Week Price Low/High	\$3.87-\$9.94
Dividend	Nil	P/B	1.1X
FY Year Ends	May 30	P/S	0.60X
P/E '08A	11.4X	P/ Free C/F	11.4X
P/E '09E	17.8X	EV/EBITDA	5.6X
P/E '10E	14.2X	Cash/Share (11/30/08)	\$2.28

Quarterly Earnings Per Share				Last 12 Mos. Price Chart	
	<u>FY 2008A</u>	<u>FY 2009E</u>	<u>FY 2010E</u>		
Q1 (Aug.)	\$0.11A	\$0.10A	\$0.09E		
Q2 (Nov.)	0.12A	0.06A	0.09E		
Q3 (Feb.)	0.15A	0.07E	0.11E		
Q4 (May)	0.13A	0.09E	0.11E		
	\$0.50A	\$0.32E	\$0.40E		

Source: BigCharts.com

We are initiating coverage on Landec Corporation (NasdaqGS: LNDC) with a BUY rating and an 18-month price target of \$12.00 for LNDC shares for the following reasons:

- Patented technology creates a “moat around its castle” – growth will accelerate as polymer technology further penetrates consumer, pharmaceutical, and agricultural industries.
- Over the next 24 months expect new licensing agreements.
- Price target of \$12.00 for LNDC shares is achievable without any new licensing agreements. Current business historical valuation justifies target on P/B, P/S, and EV/EBITDA.
- Cash equates to 40% of market capitalization.

THE TECHNOLOGY

Temperature Activated Polymer: these 3 words are the thesis that sets Landec apart from the rest of the world. The company's origin dates back to 1986 (IPO '96) and it is here that the genesis of a unique concept evolved. This firm prides itself on its scientific prowess and ability to initiate a physical change, not a permanent change in a polymer. LNDC has patented all applications of its technology and currently applies this expertise in the food marketplace, and licenses it to other industries outside of consumables. The Company's temperature-activated polymer products are based on its proprietary Intelimer polymers which differ from other polymers in that they can be customized to abruptly change their physical characteristics when heated or cooled through a pre-set temperature switch.

STRATEGIC ACQUISITION: APIO FOOD BUSINESS

Apio was acquired in 1999 and allowed the company to have instant distribution and recognition. This franchise permitted the first meaningful application BreatheWay, a patented Intelimer coated membrane. BreatheWay is a patch applied to a package of fruits and vegetables that is sold in a ready-to-eat format. Its current roster of clients is impressive- Costco, Walmart/Sams, Stop & Shop, Albertsons, just to name a few. Why do these customers and many other retailers purchase this product at a premium to what other food distributors' offer? The answer lies in the embedded attributes of the patch. Fruits and vegetables ripen on a rather rapid basis as this a natural organic process. What LNDC brings to the table through the scientific engineering of the patch is controlling the flow of oxygen into the package and the exit of carbon dioxide. This significantly enhances the shelf life, results in better taste, smell and appearance of the product, reduces shrinkage for the retailer, and, most importantly eliminates the need for ice. Here is the beauty of the technology. Fruits and vegetables can be shipped from one end of the earth to the other. We know that time is the enemy of shipping since the ripening process accelerates as our food is plucked. Being hauled on a freighter encapsulated in ice adds to the cost of shipping. Apio eliminates the need for ice and therefore there is less cost associated with transportation. Rushing the order also becomes a diminished concern. The concept and the marketability of its process have been accepted. Landec has between a 25-40% share in the tray and bag (customized) market and it is growing. We estimate the total market that the company competes in to be under \$500 million, and LNDC'S revenues equaling \$165 million (estimated for FY '09). Its 2 competitors are Taylor and Mann. Taylor's focus is on the club stores and competes on price, and its sales are approximately \$100 million. Mann's concentration is on retail and prides itself on relationships & good distribution while its top line is \$80-\$100 million (revenues estimates for both companies are just for the value added portion of their businesses). Another \$100 million is composed of regional players catering to customers within 100 miles of their respective regions. LNDC does not compete on price, yet continues to grow. Overall industry growth over the past 5 years has ranged from 10%-20%, though this year the sub-sector will decline at least 10% due to consumer retrenchment.

The part of Apio discussed above goes under the banner of Apio Value Added. As previously noted we expect revenues of \$165 million and gross margins of 11.4% for FY'09. Margins will be negatively impacted by declining consumer spending coupled with increased raw material costs for produce and packaging. We expect a significant improvement in gross margins to 16% for the next fiscal year (see Annual Income Statement). The second part of the food business is Apio Trading. Landec is a wholesaler of food for this operation buying produce from around the world with a primary focus of selling to Asia. Revenues for FY '09 will approach \$64 million yielding a consistent commission of 5-6%. This business is inherently low risk, predictably profitable, and will net \$2 million this fiscal year. This business came along with the Apio acquisition in 1999. Some day management may leverage its Intelimer technology to the trading business. The third leg of Apio is the smallest, yet holds the potential for breakout growth. Apio Packaging revenues for FY '09 will be \$3.6 million. Landec is closely engaged with Chiquita (CQB-NYSE- \$6.63) in trials and test markets to rollout Intelimer coated membranes for its bananas. All this is earmarked to convenience stores, coffee chains, mini marts, fast food restaurants, and retail grocery chains. Package size can range from 4 to 90 bananas depending on the targeted end market. We envision an aggressive rollout within next 24 months however the current economic state of the consumer can impact timing. Chiquita is also a major supplier of bananas to Starbucks who has recently rolled out its new venture "Vivanno" banana smoothie program throughout the United States. McDonald's is also conducting regional market tests for banana products, including banana smoothies which uses Chiquita

bananas delivered in Landec's BreatheWay packaging. Another new target for the patch is the \$1 billion avocado market. Chiquita is selling avocados packaged in its Breatheway technology to food service customers. Chiquita also has developed a retail store application for Avocados that is currently in trial. The ensuing years holds large rewards for the company if just some of these initiatives manifest themselves. The risk to a rollout, however, is the current economic environment and the impact it is having on Chiquita. CQB is focusing on debt reduction; nonetheless, this concern, we believe, has negatively impacted the stock of Landec.

To get a flavor for the potential market of Apio Packaging, let's run some numbers. Chiquita sells to 200,000 outlets in North America and a similar amount in Europe. If we focus on just the N. American market and multiple by 365 days and the profit it earns on one 20lb. box of bananas and tax effect it at a 40% rate we arrive at accretion of \$0.14/share just for this market. Clearly, penetration in all 200,000 outlets is aggressive, however, the assumption of selling just one 20 lb. box/establishment is conservative.

Table 1: Chiquita

Chiquita Potential for Landec

N. Amer. Outlets:	200,000 units
European Outlets:	200,000 units
LNDC receives:	\$0.085/20 lb. box
N. Amer:	200,000 X \$0.085 X 365 days=\$6.2 million
	\$6.2million X 40% tax rate = \$3.7 million (net income)
	\$3.7 million/27million shares= \$0.14/share accretion

Potential for Europe is similar

TECHNOLOGY LICENSING REVENUE

Revenues for this division are projected to be \$6.5 million for FY '09 and will be composed of royalty payments. This can be another win for the firm as Landec has aligned its intellect this time with Monsanto (MON- NYSE- \$81.88). The gem it supplies is to Monsanto's agricultural division and is called Intellicoat. Basically LNDC encapsulates the seed that Monsanto offers to its farmers. The technology is in the shell that is surrounding the seed. It allows the farmer to do early planting for corn, cotton, soybean, canola, and vegetables. Monsanto has over a 30% market share in corn, soybeans & cotton and is a major player in canola & vegetable seeds. The farmer can then better plan his seeding and not be concerned about the cold injuring the seed. The seed will not emerge until a certain temperature is attained and during the interim is protected against moisture- it can lay inert for weeks. Landec's seed coatings also acts as a carrier of fungicides and insecticides which can be dispensed at the appropriate time based on time or soil temperature. Landec has a five year agreement with Monsanto equating to \$17.5 million, or \$3.5 million/annum and incrementally receives full reimbursement of \$1.3 million/annum that it expends on R&D. The end game could result in the joint venture being acquired by Monsanto and then LNDC becoming the exclusive supplier of the seed treatment. The first meaningful field trials commence in Spring '09. The economics in a simplified manner are as follows: Seeds cost the farmer approximately \$50/acre. The incremental cost for Intellicoat is under \$5/acre and the increase in yield (productivity) approaches \$15/acre. We calculate that if Monsanto exercises its option in 2011 and purchases Intellicoat, Landec's net income (it would become supplier of seed treatment) would rise incrementally from \$0.04- \$0.20/share based on usage. \$0.04/share equates to Monsanto applying coating to 20% of its seeds while \$0.20/share assumes 100% application. These assumptions are based on Monsanto's current 30- 35% market share range for corn, canola, cotton, and soybean.

Technology licensing revenues do not end with Monsanto. The company is actively pursuing other ventures. Air Products is paying \$2.5 million over 3 years to LNDC. What they receive in return is thermo-control of their personal care products. Previous ingredients of this company could not effectively penetrate the skin. With Landec's technology Air Products' ingredients are able to penetrate quicker and more effectively. Another licensing agreement is with Nitta Corporation where it provides its technology for electronic applications working with adhesives. Royalty payments approximate \$200,000/annum. The road does not end here as LNDC has other licensing agreements. The plan is to continue to grow its licensing business and the applications appear unlimited.

MANAGEMENT

All directors and executive officers of Landec own approximately 12% of the outstanding shares. The architect and key strategist of the company is Gary T. Steele, President, CEO & Chairman. He has been with the company since 1991 and has in excess of 25 years of experience in the biotechnology, instrumentation and material science fields. From 1985-1991 he was CEO of Molecular Devices Corp., a bioanalytical instrumentation company. From 1981- 1985 Gary was V.P., Product Development and Business Development at Genentech. He has also worked with McKinsey and Co. and Shell oil Company.

FINANCIALS, VALUATION AND CONCLUSION

As of November 2008 the company had no debt and cash per share of \$2.28. The stock is selling at \$5.68/share and if we net out the cash we are paying \$3.40 to own this security. We are estimating EPS of \$0.32 for this fiscal year equating to an adjusted P/E of 10.6X. This is very reasonable for a company that has meaningful growth initiatives in place. We do expect a meaningful reduction in margins this fiscal year given that consumable pre-cut packages that Landec arranges for its customer base has been impacted by a softening in discretionary purchases. Despite the pressure from weakening demand LNDC is garnering market share. The latest Nielsen data for this industry sector reveals that Landec unit volume was off 7% vs. a 12% drop for the industry. We do expect a return to the organic growth characteristics (FY '10) that had been evident until this year.

The company has been a consistent generator of free cash flow over the past several years averaging anywhere from \$0.25-\$0.50/annum and we expect this to continue into the foreseeable future. Our estimate for FY '09 is for free C/F from operations approaching \$0.25/share. On an EV/EBITDA basis the company is selling at a modest 5.6X. We believe the stock of Landec has discounted a softening environment as the stock is off a peak of \$14 over the past 52 weeks. We do not have a crystal ball and cannot predict the severity and longevity of the economic contraction that we are currently encountering. We do know that once the current lethargic environment lifts Landec will regain characteristics of a growth stock. LNDC valuation prices the stock as a typical consumer company that has modest growth prospects, and clearly this is not the case as the company is consistently leveraging its patented technologies onto numerous paths. We do not need all to succeed to have meaningful growth. Even one or two successes can launch the company and its valuation into a new paragon. By FY '10 EPS should rebound to \$0.40/share without any contribution from new products. During FY '11 (2H calendar '10) some contribution from new revenue sources is possible. At that juncture we can be looking at incremental annualized EPS of \$0.25. Based on just average historical valuation bands for LNDC we establish a price target of \$12.

BALANCE SHEET

(\$ in 000's)

	11/30/2008	5/25/2008
<u>ASSETS</u>		
Current Assets:		
Cash	\$ 61,227	\$ 59,039
A/R, net	16,140	19,871
Inventories	7,665	7,329
A/R, net	1,086	501
Deferred Taxes	2,180	2,180
Other C/A	1,521	1,746
Total Current Assets	\$ 89,819	\$ 90,666
Property & Equip, net	22,083	21,306
Intangible assets	35,589	35,582
Other assets	3,435	3,035
Total Assets	<u>\$ 150,926</u>	<u>\$ 150,589</u>
<u>Liabilites & S/H Equity</u>		
Current Liabilities:		
A/P	\$ 16,563	\$ 19,264
Inc. tax payable	252	
Accrued comp	906	2,197
Other accrued liab.	2,187	2,930
Deferred rev.	2,167	3,613
Total Current Liabilities	\$ 22,075	\$ 28,004
Deferred revenue	4,000	5,000
Deferred taxes	2,502	1,569
Minority interest	1,531	1,550
Shareholders' Equity		
Common stock	\$ 114,955	\$ 112,974
Retained earnings	5,829	1,492
Total S/H equity	<u>\$ 120,818</u>	<u>\$ 114,466</u>
Total Liab. & S/H equity	<u>\$ 150,926</u>	<u>\$ 150,589</u>

QUARTERLY INCOME STATEMENT

		<u>3 Mos. Ended</u>		
		<u>11/30/2008</u>	<u>11/25/2007</u>	
<i>(\$ in 000's, except per share data)</i>				
Revenues				% Change
	Product Sales	55,267	56,274	-1.8%
	Service Revs.	998	909	9.8%
	License Fees	1,550	1,550	0.0%
	Royalty	223	228	-2.2%
Total revenues		\$ 58,038	\$ 58,961	-1.6%
Cost of revenues				
	Cost of Product Sales	49,644	49,348	0.6%
	Cost of Service Revs.	837	756	10.7%
Total cost revenues		50,481	50,104	0.8%
Gross Profit		\$ 7,557	\$ 8,857	-14.7%
	Gross Margin	13%	15%	
Operating costs:				
	R&D	867	788	10.0%
	SG&A	4,449	4,239	5.0%
Total Oper. Costs:		5,316	5,027	5.7%
Operating Income		\$ 2,241	\$ 3,830	-41.5%
Interest Income		455	607	-25.0%
Interest Expense		(3)	(5)	-40.0%
Other Expense		(132)	(109)	21.1%
Pretax Income		2,561	4,323	-40.8%
Taxes		(1,063)	(1,198)	-11.3%
Net Income		\$ 1,498	\$ 3,125	-52.1%
EPS		\$ 0.06	\$ 0.12	-51.7%
Shares O/S		26,814	27,020	-0.8%

ANNUAL INCOME STATEMENT

(\$ in 000's, except per share data)

	FY '08A	FY '09E	FY '10E
Revenues			
Prod. Sales	227,550	227,700	245,000
Serv. Revs.	3,640	3,800	5,000
License fees	6,231	6,500	7,000
Royalty and R&D	1,106	1,100	1,200
Total revenues	\$ 238,527	\$ 239,100	\$ 258,200
Cost of Revenues			
Cost of P. S.	197,288	203,625	213,400
Cost of serv.	3,011	3,135	3,500
Total cost of revs.	200,299	206,760	216,900
Gross Profit	\$ 38,228	\$ 32,340	\$ 41,300
Gross margin	16%	14%	16%
Operating costs			
R & D	3,251	3,300	4,000
SG&A	19,801	19,500	20,000
Total oper. costs	23,052	22,800	24,000
Operating income	\$ 15,176	\$ 9,540	\$ 17,300
Interest income	2,219	1,000	1,020
Interest expense	(22)	(10)	(20)
Other expense	(477)	(400)	(500)
Pretax income	16,896	10,130	17,800
Taxes	3,354	1,520	7,120
Net Income	\$ 13,542	\$ 8,610	\$ 10,680
EPS(f/d)	\$ 0.50	\$ 0.32	\$ 0.40
Shares O/S	26,935	26,900	27,000

APIO & TECHNOLOGY LICENSING FINANCIALS

(\$ in 000's)

FY 5/09E (\$000)	Apio Value Added	Apio Packaging	Apio Trading	Total Apio	Tech. Licen	Corp. Exp.	Total
Net Sales	165,000	3,600	64,000	\$ 232,600	6,500		\$ 239,100
Gross Profit	18,840	3,000	4,000	\$ 25,840	6,500		\$ 32,340
Oper. Inc.							\$ 9,540
Net Inc.				\$ 12,850	5,000	(7,400)	\$ 8,610
Dep & Am.				\$ 3,000	200		\$ 3,200
Cap. Ex.				\$ 4,000	180		\$ 4,180
FY 5/08A (\$000)							
Net Sales	167,817	3,317	60,414	\$ 231,608	6,919		\$ 238,527
Gross Profit	24,615	3,245	3,449	\$ 31,309	6,919		\$ 38,228
Oper. Inc.							\$ 15,176
Net Inc.				\$ 16,250	4,919	(7,627)	\$ 13,542
Dep. & Am.				\$ 2,990	214		\$ 3,204
Cap. Ex.				\$ 4,051	189		\$ 4,240
FY 5/07A (\$ 000)							
Net Sales	154,744	1,730	49,706	\$ 206,180	4,319		\$ 210,498
Gross Profit	23,426	1,639	3,187	\$ 28,252	4,134		\$ 32,386
Oper. Inc.							\$ 13,435
Net Inc.				\$ 14,677	3,500	(7,777)	\$ 10,400
Dep & Am.				\$ 2,684	576		\$ 3,260
Cap.Ex.				\$ 6,277	505		\$ 6,782

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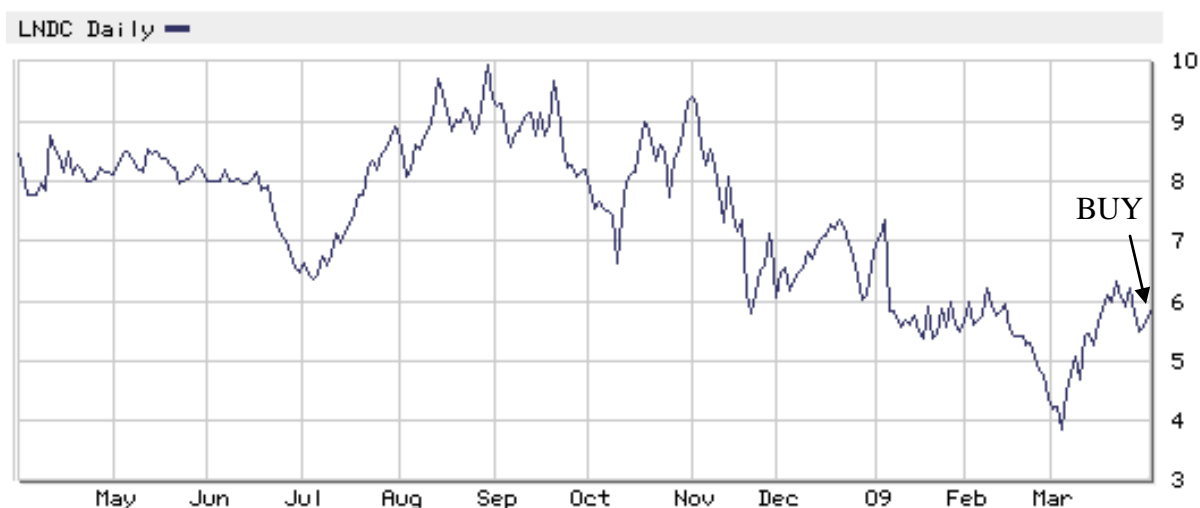
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PRICE CHART



4/2/09 – Initiating Coverage: share price (04/01/09): \$5.68; rating: BUY; 18-month price target: \$12.00.

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ABOUT THE ANALYST: Morris Ajzenman is a CFA with 30 years experience specializing in small capitalization companies. His career includes co-managing \$4 billion in assets for Lazard Asset Management, \$2 billion at Mitchell Hutchins (division of Paine Webber), as well as managing long/short portfolios at 2 other firms. Morris' approach is designed to identify companies that are expected to remain profitable, particularly during recessions. Morris focuses on companies that: generate free cash flow; sell at low multiples of C/F; have little debt; have appropriate levels of cash; have conservative accounting practices (e.g. where companies do not delegate liabilities to only footnotes); have a “moat around its castle”; have a catalyst or strategic action by management to unlock value; and, stocks selling at historic low valuations.