LUCILLE FARMS INC
Form 10-Q
February 15, 2005

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended:
December 31, 2004
Commission File Number 1-12506

LUCILLE FARMS, INC.
(Exact Name of Registrant as Specified in its charter)

Delaware	13-2963923
(State or other Jurisdiction of Incorporation)	(I.R.S. Employer Identification number)
150 River Road, P.O. Box 517 Montville, New Jersey	07045
(Address of Principal Executive Offices)	(zip code)

(Registrant's Telephone Number, Including Area Code) (973)334-6030

Former name, former address and former fiscal year, if changed since last report. N/A

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
YES [X] NO [ ]

The number of shares of Registrant's common stock, par value $.001 per share, outstanding as of February 14, 2005 was 3,353,937.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LUCILLE FARMS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
ASSETS

	DECEMBER 31, 2004 (UNAUDITED)	MARCH 31, 2004
CURRENT ASSETS:		
Cash and cash equivalents	$ 156,000	$ 611,000
Accounts receivable, net of allowances of $201,000 at December 31, 2004 and $170,000 at March 31, 2004	5,589,000	4,618,000
Inventories	3,119,000	3,234,000
Prepaid expenses and other current assets	746,000	684,000
Total current assets	9,610,000	9,147,000
PROPERTY, PLANT AND EQUIPMENT, NET	9,144,000	9,579,000
OTHER ASSETS:		
Deferred costs, net	667,000	215,000
Other	22,000	19,000
Total other assets	689,000	234,000
TOTAL ASSETS	$19,443,000	$18,960,000

See accompanying notes to consolidated financial statements

2

LUCILLE FARMS,INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
LIABILITIES AND STOCKHOLDER'S EQUITY

	DECEMBER 31, 2004	MARCH 31, 2004

	(UNAUDITED)	
CURRENT LIABILITIES:		
Revolving credit loan	--	$ 4,281,000
Accounts payable	2,274,000	3,970,000
Current portion of long-term debt	681,000	711,000
Accrued expenses	505,000	568,000
Total Current Liabilities	3,460,000	9,530,000
LONG-TERM LIABILITIES:		
Revolving credit loan	5,090,000	--
Long-term debt	6,808,000	6,423,000
Long-term accounts payable	1,500,000	--
	13,398,000	6,423,000
TOTAL LIABILITIES	16,858,000	15,953,000
STOCKHOLDERS' EQUITY:		
Preferred Stock $0.001 par value 250,000 shares authorized:		
216 shares Series A convertible issued and outstanding at March 31, 2004	--	1,000
583 shares Series B convertible issued and outstanding	1,000	1,000
Common stock, $ 0.001 par value, 25,000,000 shares authorized, 3,570,675 shares issued, 3,353,937 outstanding at December 31, 2004 and 3,354,675 shares issued and 3,137,937 outstanding at March 31, 2004	4,000	3,000
Additional paid in capital	8,548,000	8,548,000
Accumulated deficit	(5,656,000)	(5,234,000
	2,897,000	3,319,000
Less cost of 216,738 shares of treasury stock	(312,000)	(312,000
Total Stockholders' Equity	2,585,000	3,007,000
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 19,443,000	$ 18,960,000

============ ============

See accompanying notes to consolidated financial statements

LUCILLE FARMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	THREE MONTHS ENDED DECEMBER 31	
	2004	2003
SALES	$ 11,628,000	$ 10,850,000
COST OF SALES	11,473,000	10,493,000
GROSS PROFIT	155,000	357,000
OTHER EXPENSE:		
SELLING	335,000	239,000
GENERAL AND ADMINISTRATIVE	180,000	230,000
INTEREST EXPENSE	237,000	205,000
TOTAL OTHER EXPENSE	752,000	674,000
NET LOSS	$ (597,000)	$ (317,000)
LOSS PER SHARE		
BASIC:	$(.18)	$(.10)
DILUTED:	$(.18)	$(.10)
WEIGHTED AVERAGE SHARES OUTSTANDING USED TO COMPUTE NET INCOME PER SHARE		
BASIC:	3,353,937	3,137,937
DILUTED:	3,353,937	3,137,937

See accompanying notes to consolidated financial statements

LUCILLE FARMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	NINE MONTHS ENDED DECEMBER 31 2004	2003
SALES	$ 36,344,000	$ 30,199,000
COST OF SALES	34,548,000	28,277,000
GROSS PROFIT	1,796,000	1,922,000
OTHER EXPENSE:		
SELLING	775,000	644,000
GENERAL AND ADMINISTRATIVE	728,000	684,000
INTEREST EXPENSE	714,000	570,000
TOTAL OTHER EXPENSE	2,217,000	1,898,000
INCOME (LOSS) BEFORE INCOME TAXES	(421,000)	24,000
PROVISION FOR INCOME TAXES	1,000	1,000
NET INCOME (LOSS)	$ (422,000)	$ 23,000
EARNINGS (LOSS) PER SHARE BASIC:	$(.13)	$.01
DILUTED:	$(.13)	$.01
WEIGHTED AVERAGE SHARES OUTSTANDING USED TO COMPUTE NET INCOME (LOSS) PER SHARE BASIC:	3,277,748	3,138,862

DILUTED:	3,277,748	3,138,862

See accompanying notes to consolidated financial statements

LUCILLE FARMS, INC. AND SUBSIDIARES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	NINE MONTHS ENDED DECEMBER 31 2004	2003
Cash flows from operating activities:		
NET INCOME (LOSS)	$ (422,000)	$ 23,000
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	717,000	702,000
Provision for doubtful accounts	31,000	25,000
(Increase) decrease in assets:		
Accounts receivable	(1,002,000)	(567,000)
Inventories	115,000	(512,000)
Prepaid expenses and other current assets	(62,000)	(32,000)
Other assets	(21,000)	106,000
Increase (decrease) in liabilities:		
Accounts payable	(196,000)	714,000
Accrued expenses	(63,000)	(149,000)
Net cash provided by (used in) operating activities	(903,000)	310,000
CASH FLOW FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(282,000)	(301,000)
CASH FLOW FROM FINANCING ACTIVITIES:		
Proceeds from revolving credit loan-net	809,000	686,000
Principal payments on long-term debt and notes	355,000	(695,000)
Loan financing fees	(434,000)	--
Net cash provided by (used in)		

financing activities	730,000	(9,000)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(455,000)	--
CASH AND CASH EQUIVALENTS-BEGINNING	611,000	4,000
CASH AND CASH EQUIVALENTS-ENDING	$ 156,000	$ 4,000
NON-CASH FINANCING ACTIVITIES:		
Conversion of 216 Series A Convertible Preferred Stock into 216,000 Shares of Common Stock	$ 1,000	$ --
Refinancing of Revolving Credit Loans and Long Term Debt	$ 7,281,000	$ --

See accompanying notes to consolidated financial statements

LUCILLE FARMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. The Consolidated Balance Sheet as of December 31, 2004, the Consolidated Statement of Operations for the three and nine month periods ended December 31, 2004 and 2003 have been prepared by the Company without audit. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the financial position of Lucille Farms, Inc. and subsidiaries as of December 31, 2004, the results of its operations for the three and nine months ended December 31, 2004 and 2003 and its cash flows for the nine months ended December 31, 2004 and 2003.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these financial statements be read in conjunction with the year-end financial statements and notes thereto for the fiscal year ended March 31, 2004 included in the Company's Annual Report on Form 10-K as filed with the SEC.

The accounting policies followed by the Company are set forth in the notes to the Company's consolidated financial statements as set forth in its Annual Report on Form 10-K as filed with the SEC.

Recent Accounting Pronouncements

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities" (VIE's), an interpretation of Accounting Research Bulletin No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. In December 2003, the FASB issued FIN 46R (revised December 2003), which delays the effective date of the application of FIN 46 to non-special purpose VIE's acquired or created before February 1, 2003, to the interim period ended December 31, 2004, and provides additional technical clarifications to implementation issues. Management does not anticipate the adoption of this interpretation will have a material impact on the consolidated financial statements.

In December 2004, the FASB issued Statement 123 (revised 2004), "Share-Based Payment" ("FAS 123R") that will require compensation costs related to share-based payment transactions to be recognized in the financial statements. FAS 123R is effective for public entities that do not file as small business issuers as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. Management anticipates that the adoption of this statement may impact the consolidated statements if future grants of options to employees are incurred.

Stock Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations in accounting for stock options and rewards. Accordingly, no compensation costs for stock options are included in operating results since all awards were made at exercise prices at or above their fair value on the dates of grants.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation- Transition and Disclosure", amending FASB Statement No. 123, "Accounting for Stock Based Compensation." This statement amends SFAS No. 123 to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on operating results of an entity's accounting policy decisions with respect to stock-based employee compensation. SFAS No. 148 also amends APB Opinion 128, "Interim Financial Reporting" to require disclosure about those effects in interim financial information.

In April 2004, ten-year options to purchase 5,000 shares of the Company's common stock were granted to six directors of the Company at an exercise price of $3.00 per share. Such options vest immediately. Fair value was determined on the date of grant using the Black-Scholes option pricing model using an expected dividend yield of 0; a risk free interest rate of 4.4%, expected stock volatility of 116%, and an expected option life of ten years.

The following table illustrates the effect on results of operations if the Company had applied the fair value recognition provisions of SFAS No. 123 for the six-month periods ended September 30, 2004 and 2003 (unaudited).

	3-Mos ended December 31,		9-Mos. ended December 31,	
	2004	2003	2004	2003
Net (loss) Income as reported	$(597,000)	$(317,000)	$(422,000)	$ 23,00
Deduct: Total stock-based				

Employee Compensation determined under fair value method for stock options, net of tax	--	--	42,000	-
Pro forma income (loss) applicable to common stockholders	$(597,000)	$ 317,000	$(464,000)	$ 23,00
Basic income (loss) per share, as reported	$ (0.18)	$ (.10)	$ (.13)	$ 0.0
Basic income (loss) per share, pro forma	$ (0.18)	$ (.10)	$ (.13)	$ 0.0
Diluted income (loss) per share, as reported	$ (0.18)	$ (.10)	$ (.14)	$ 0.0
Diluted income (loss) per share, pro forma	$ (0.18)	$ (.10)	$ (.14)	$ 0.0

2. The results of operations for the three and nine months ended December 31, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year.

3. Inventories are summarized as follows:

	December 31, 2004	March 31, 2004
Finished goods	$2,354,000	$2,164,000
Raw Materials	179,000	691,000
Supplies and Packaging	586,000	379,000
	$3,119,000	$3,234,000

8

4. On December 2, 2004, the Company obtained an $11 million borrowing facility from LaSalle Business Credit, LLC, consisting of:

   a. a $7,000,000 revolving loan with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate (5.25% at December 31, 2004) to be repaid on December 1, 2009. At December 31, 2004 the outstanding balance due on the revolving loan is $5,090,000,

   b. a $2,000,000, five year, "term loan A," with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate, payable interest only for the first two years with equal monthly installments of principal of $23,810 (based on a 7 year amortization schedule) commencing on December 1, 2006 and continuing thereafter on the first day of each succeeding calendar month with any unpaid principal balance due on December 1, 2009. The proceeds of term loan A were used to repay outstanding loans,

c. a $1,000,000, two year "term loan B," with interest payable at 1.5% over the LaSalle Bank prime lending rate, payable in equal monthly installments of principal of $41,667 commencing January 1, 2005. The proceeds of term loan B will be used for working capital, and

d. capital equipment loans aggregating $1,000,000, with interest at 1.25% over the LaSalle prime lending rate, the proceeds of which will be used to purchase equipment as part of the Company's capital expansion plan. Each capital expenditure loan will be repaid in equal monthly installments in an amount sufficient to repay such loan in full by the end of the sixtieth month following the date of the loan advance. There was no balance due on the capital equipment loans at December 31, 2004.

The borrowing facility is collateralized by all of the Company's assets with additional collateral in the form of an assignment of the proceeds of a life insurance policy insuring the life of the CEO of the Company in an amount of $1,000,000.

At December 31, 2004, the Company was in default of various covenants related to its debt with LaSalle Business Credit, LLC. The Company has received waivers for the existing defaults and amended such covenants going forward.

5. Earnings per Share

Basic earnings per share is computed by dividing net earnings available to common shareholders by the weighted average common shares outstanding for the period. Diluted earnings per share is computed by dividing net earnings available to common shareholders by the weighted average common shares outstanding adjusted for the dilutive effect of options granted under the Company's stock option plans, outstanding warrants, and convertible preferred stock.

9

At December 31, 2004 and 2003, 1,166,666 and 799,333 potential common shares, respectively, issuable upon conversion of preferred stock and exercise of warrants are excluded from the determination of diluted earnings per share as the related contingencies have not been met. The dilutive effect of the 496,667 and 120,000 potential common shares at December 31, 2004 and 2003, respectively, are outlined in the following schedule:

	Three-Months Ended December 31, 2004	Three Months Ended December 31, 2003	Nine E Decemb
Numerator:			
Net income (loss)- basic	$ (597,000)	$ (317,000)	$ (

Net Income (loss)-diluted	$ (597,000)	$ (317,000)	$ (
Denominator			
Denominator for basic earnings per share Weighted avg. shares	3,353,937	3,137,937	3,
Effect of dilutive securities Stock options	--	--	
Denominator for diluted earnings per share	3,353,937	3,137,937	3,
Earnings (loss) per share			
Basic:	$ (.18)	$ (.10)	$
Diluted:	$ (.18)	$ (.10)	$

6. Long Term Accounts Payable

In connection with the Company's borrowing facility with LaSalle Business Credit, LLC, St. Albans Cooperative Creamery, Inc., the Company's milk supplier, agreed to subordinate to LaSalle a $1,500,000 outstanding trade account payable due from the Company to St. Albans, on which trade account payable the Company is paying interest at the Bank North short-term repo rate. Pursuant to the terms of the subordination, St. Albans may receive, so long as no default exists with respect to the LaSalle borrowing facility (a) regularly scheduled payments of interest and principal, on a current basis, up to a maximum of $75,000 in any fiscal year of the Company (the "Basic Payment"), and (b) commencing with the Company's fiscal year ended March 31, 2006, a prepayment in an amount equal to 10% of the Company's Excess Cash Flow (as defined in the LaSalle lending documents) for the fiscal year, minus the amount of the Basic Payment made to St. Albans during the fiscal year, and (c) if LaSalle elects to defer all or a portion of its right to be paid 25% of the Company's Excess Cash Flow for any fiscal year (the "Deferred Amount"), St. Albans may receive an additional payment not to exceed the Deferred Amount, provided, however that the payments contemplated by clauses (b) and (c) may only be paid to St. Albans as long as and to the extent that at the time of and at all times during the thirty (30) day period immediately preceding such payments and after giving effect to such payments, the Company has Excess Availability (as defined in the LaSalle lending documents) of at least $300,000. Also, St. Albans may receive, toward the payment of such trade account payable, fifty percent (50%) of the amount of new equity capital raised by the Company in excess of six million dollars ($6,000,000).

7. Deferred Costs

The Company incurred approximately $434,000 in costs in December 2004 associated with the LaSalle Business Credit LLC borrowing facility that is being amortized over the life of the loan (5 years).

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

General

The Company's low moisture mozzarella cheese, which accounts for more than a majority of the Company's sales, is a commodity item. The Company prices this product competitively with others in the industry, which pricing is based on the Chicago Mercantile Exchange Block Cheddar Market (CME Block Market). The price the Company pays for fluid milk and condensed skim milk solids, a significant component of cost of goods sold, is not determined until the month after its cheese has been sold. The price of milk is based upon the raw milk components and a weighted average of a number of market components. While the Company generally can anticipate a change in the price of milk because of changes in the CME Block Market, it cannot anticipate the full extent thereof. Therefore, if the CME Block Market price to which our selling price is referenced changes at a different rate than the price of milk our margins are affected accordingly. By virtue of the pricing structure in the industry the Company cannot readily pass along to its customers the changes in the cost of milk. As a consequence thereof, the Company's gross profit margin for its products is subject to fluctuation, which fluctuation, however slight, can have a significant effect on profitability.

10

The Company is unable to predict any future increase or decrease in prices in the CME Block Market as such market is subject to fluctuation based on factors and commodity markets outside of the control of the Company. Although the cost of fluid milk does tend to move correspondingly with the CME Block Market, the extent of such movement and the timing thereof is not predictable. As a result of these factors, the Company is unable to predict pricing trends.

Three months ended December 31, 2004 compared to the three months ended December 31, 2003

Sales for the three months ended December 31, 2004 increased to $11,628,000 from $10,850,000 for the comparable period in 2003, an increase of $778,000 or (7.2%). Approximately $1,394,168.11 or (155.25%) was due to an increase in the average selling price per pound of cheese from $1.54 for the three month period ended December 31, 2003 to $1.76 for the three month period ended December 31, 2004. This increase was offset by a decrease in the number of pounds sold from approximately 6,853,000 pounds in 2003 to 6,521,000 pounds in 2004, a decrease of 332,000 pounds or (4.8%). Sales for whey amounted to $410,000 in 2004 compared to $354,000 for the same period last year, an increase of $56,000 or (15.8%). The increase in the average selling price per pound of cheese was the result of a higher CME block cheddar price during the quarter, an average price of $1.61 compared to last year's average of $1.46.

Cost of sales and gross profit margin for the three month period ended December 31, 2004 were $11,473,000 (or 98.7% of sales) and $155,000 (or 1.3% of sales) respectively, compared to a cost of sales and gross profit margin of $10,493,000 (or 96.7% of sales) and $357,000 (or 3.3% of sales) respectively, for the comparable period in 2003. The increase in the cost of sales and corresponding decrease in gross profit margin for 2004, as a percentage of sales, were the result of the selling price per pound of cheese dropping dramatically while the price of milk remained high, thus putting pressure on our gross margins. Cost of sales was also affected by higher natural gas costs, payroll expenses and parts and supplies expense.

Selling, general and administrative expenses for the three month period ended December 31, 2004 amounted to $515,000 (or 4.4% of sales) compared to $470,000 (or 4.3% of sales) for the comparable period in 2003. Higher promotional expenses, commission costs, advertising expenses, bank charges and franchise taxes accounted for most of the increase in expenses.

Interest expense for the three month period ended December 31, 2004 amounted to $237,000 compared to $205,000 for the same period last year, an increase of $32,000. Higher balances and the increases in the prime rate thus raising our rate charged on our revolver and term loans were partially offset by the refinancing of our new revolver loan with the interest rate charge of 1% over the prime rate compared to the previous charge of 3% over prime.

The provision for income tax for the period takes advantage of the tax benefits of operating loss carry forwards being offset by the effect of changes in the valuation allowance. Such amounts are re-evaluated each period based on the results of the operations.

The Company's net loss was $597,000 for the three months ended December 31, 2004, compared to net income of $317,000 for the comparable period in 2003. The primary factors contributing to these changes are discussed above.

11

Nine months ended December 31, 2004 compared to nine months ended December 31, 2003

Sales for the Nine months ended December 31, 2004 increased to $36,344,000 from $30,199,000 for the comparable period in 2003, an increase of $6,145,000 (or 20.4%). Approximately $6,980,000 (or 113.6%) was due to an increase in the average selling price per pound of cheese from $1.49 last year to $1.85 this year. This increase was partially offset by a decrease in the number of pounds sold from 20,061,000 pounds in 2003 to 19,390,000 in 2004, a decrease of 671,000 pounds (or 3.3%) year to year. Sales for whey amounted to $1,365,000 in 2004 compared to $1,032,000 for the same period last year, an increase of $333,000 (or 32.3%).

Cost of sales and gross profit margin for the nine months ended December 31, 2004 were $34,548,000 (or 95.1% of sales) and $1,796,000 (or 4.9% of sales) compared to a cost of sales and gross profit margin of $28,277,000 (or 93.6% of sales) and $1,922,000 (or 6.4% of sales), respectively, for the comparable period in 2003. The increase in the cost of sales and decrease in gross profit margins can be attributed to higher milk costs, labor costs, higher natural gas costs, repairs and maintenance expenses and equipment parts and supplies.

Selling, general and administrative expenses for the nine months ended December 31, 2004 amounted to $1,503,000 (or 4.1% of sales) compared to $1,328,000 (or 4.3% of sales) for the comparable period in 2003. Higher commission expenses, trade show and advertising expenses, promotional allowances and bank charges accounted for the increase year over year.

Interest expense (net) for the nine months ended December 31, 2004 amounted to $714,000 compared to $570,000 for the nine months ended December 31, 2003, an increase of $144,000. The Company refinanced its revolving line of credit with LaSalle Bank and raised its line to $7,000,000 from $5,000,000. The interest rate on the new loan is prime rate plus one percent compared to prime rate plus three percent. In addition, the Company also secured two term loans to restructure some of the Company's existing debt to provide for a longer payment period and provide additional working capital.

The provision for income tax for the nine-month periods ended December 31, 2004 and December 31, 2003 of $1,000 reflect minimum state taxes. Charges for federal income taxes were offset by changes in the valuation allowances for the nine months ended December 31, 2004 and December 31, 2003. Such amounts are re-evaluated each quarter based on the results of operations.

The Company's net loss of $422,000 for the nine months ended December 31, 2004 represents a decrease of $445,000 from the net income of $23,000 for the comparable period in 2003. The primary factors contributing to these changes are discussed above.

Liquidity and Capital Resources

On December 2, 2004, the Company obtained an $11 million borrowing facility from LaSalle Business Credit, LLC, consisting of (a) a $7,000,000 revolving loan, with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate, to be repaid on December 1, 2009, (b) a $2,000,000, five year, "term loan A," with interest payable at 1/4 of 1% over the LaSalle Bank prime lending rate, payable interest only for the first two years with monthly principal payments of $23,810 (based on a 7 year amortization schedule) beginning in year 3 and continuing thereafter until December 1, 2009 when the unpaid principal balance becomes due, the proceeds of which were used to repay outstanding loans, (c) a $1,000,000, two year "term loan B," with interest payable at 1.5% over the LaSalle Bank prime lending rate, payable in equal monthly installments of principal of $41,667 commencing January 1, 2005, the proceeds of which are to be used for working capital, and (d) capital equipment loans aggregating $1,000,000, with interest at 1.25% over the LaSalle Bank prime lending rate, the proceeds of which are to be used to purchase equipment as part of the Company's capital expansion plan.

12

The revolving loan substantially reduced the interest rate the Company paid on its then existing revolving loan, increased the Company's borrowing limit by $2,000,000 to provide for growth, and increased the amount of cash the Company receives on its accounts receivable and inventory; Term Loan A restructured some of the Company's then existing debt at a lower interest rate, and provided for a longer payment period; Term Loan B provided the Company with additional working capital; and the capital equipment line enhances the Company's goal to further reduce operating expenses through automation and the installation of more productive equipment.

At December 31, 2004, the Company was in default of certain covenants under its borrowing facility, for the test period ended December 31, 2004, relating to (a) the maintenance of a Tangible Net Worth of not less than 90% of its Tangible Net Worth at September 30, 2004, and (b) the maintenance of a Fixed Charge Coverage Ratio of not less than 1.00 x 1.00. On February 14, 2005, LaSalle and the Company entered into a First Amendment and Waiver to its Loan and Security Agreement which, among other things, waived the foregoing defaults, amended such covenants on a going forward basis, and suspended the capital expenditure loans unless and until (x) on or before February 15, 2006, LaSalle Business Credit, LLC shall have received the Company's internally-prepared quarterly financial statements for the fiscal quarter ended December 31, 2005, and (b) the Company shall have maintained a ratio of its FC Numerator to Fixed Charges of not less than 1.20 to 1.00 with respect to the twelve (12) month period then ended.

At December 31, 2004, the Company had working capital of $6,150,000 compared to negative working capital of ($383,000) at March 31, 2004. The Company's revolving bank line of credit is available for the Company's working capital requirements.

At December 31, 2004, $5,090,000 was outstanding under the revolving credit line.

On February 8, 1999, a $4,950,000 bank loan agreement was signed. The loan is collateralized by the Company's plant and equipment and guaranteed by the USDA. Provisions of the loan are as follows:

A $3,960,000 commercial term note with interest fixed at 9.75 percent having an amortization period of 20 years with maturity in February 2019.

A $990,000 commercial term note with interest fixed at 10.75 percent having an amortization period of 20 years with maturity in February 2019.

On August 26, 2004, the Company entered into a new term loan with St. Albans Cooperative Creamery for $1,000,000 with interest payable at 1% above the prime rate. The loan is repayable in two consecutive annual installments of $500,000 with the next installment due on May 1, 2005. The loan is collateralized by the Company's plant and equipment and is used for working capital. This loan is the result of St. Albans Cooperative Creamery paying off the term loan owed to CoBank by Lucille Farms, Inc.

On May 16, 2002, the Company entered into an agreement with St. Albans Cooperative Creamery, Inc. ("St. Albans"), the Company's primary supplier of raw materials, pursuant to which St. Albans (i) converted $1,000,000 of accounts payable owed by the Company to St. Albans into 333,333 shares of common stock, (ii) converted $3,500,000 of accounts payable owed by the Company to St. Albans into (A) preferred stock convertible into 583,333 shares of common stock, which preferred stock (1) automatically converts into such number of shares of common stock if the common stock is $8.00 or higher for 30 consecutive trading days, and (2) may be redeemed by the Company for $3,500,000, and (B) a 10-year warrant to purchase 583,333 shares of common stock (subject to adjustment under certain circumstances to a maximum of 1,416,667 shares of common stock) at $.01 per share, which warrant (1) may not be exercised for a period of three-years, (2) terminates if, during such three-year period, the Company's common stock is $8.00 or higher for 30 consecutive trading days, and, (3) in the event the Company's common stock is not $8.00 or higher for 30 consecutive trading days during such three-year period, may only be exercised on the same basis percentage wise as the preferred shares are converted, (iii) converted an additional $1,000,000 of accounts payable owed by the Company to St. Albans into a convertible promissory note due on April 14, 2005, which note is convertible into common stock at $6.00 per share at any time by St. Albans and, at the option of the Company, automatically shall be converted into common stock at $6.00 per share if the common stock is $8.00 or higher for a period of 30 consecutive trading days, and (iv) provided the Company with a pricing structure for milk and milk by-products, for a minimum of one-year and a maximum of four-years (subject to renegotiation at the expiration of the applicable period), designed to produce profitability for the Company. The applicable period for the milk and milk by-products pricing structure expired in May 2003. Thereafter, St. Albans maintained the pricing structure through June 30, 2003. Commencing July 2, 2003, and again as of September 1, 2003, the pricing structure was modified to progressively decrease the benefits accruing to the Company in light of the profitability of the Company.

For the nine month period ended December 31, 2004, cash used by operating activities was $1,337,000. A loss from operations of $422,000 decreased cash along with an increase in accounts receivable prepaid expenses, and other assets and a decrease in accounts payable and accrued expenses. A decrease in inventory provided cash.

Net cash used in investing activities was $282,000 for the period ended December 31, 2004, which represented the purchase of property, plant and equipment.

Net cash provided by financing activities was $1,164,000 for the period ended December 31, 2004 as a result of the new financing obtained by the Company.

Safe Harbor Statement

This Quarterly Report on Form 10-Q (and any other reports issued by the Company from time to time) contains certain forward-looking statements made in reliance upon the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are based on current expectations that involve numerous risks and uncertainties. Actual results could differ materially from those anticipated in such forward-looking statements as a result of various known and unknown factors including, without limitation, future economic, competitive, regulatory, and market conditions, future business decisions, the uncertainties inherent in the pricing of cheese on the Chicago Mercantile Exchange upon which the Company's prices are based, changes in consumer tastes, fluctuations in milk prices, and those factors discussed above under Management's Discussion and Analysis of Financial Condition and Results of Operations. Words such as "believes," "anticipates," "expects," "intends," "may," and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. The Company undertakes no obligation to revise any of these forward-looking statements.

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

In September 2004, the Company began to hedge the risks of the prices in the cheese and milk markets to ensure profitability. The Company has undertaken a program to sell cheese under long-term contracts and to hedge the transaction through the purchase of milk futures. Increases and decreases in the price of milk in the market (resulting in potential losses or profits on the sale of cheese) would generally be offset by corresponding losses and gains on the related hedging instruments, resulting in negligible net exposure for such transactions. To date, the majority of our expense for milk is not hedged.

In designing a specific hedging program approach, the Company considers several factors including offsetting exposures, significance of exposures, costs associated with entering into a particular hedge instrument and potential effectiveness of the hedge. Our hedging program reduces, but does not entirely eliminate, the impact of milk price movements. Due primarily to our limited use of the hedging program to date, the impact of the hedging program on milk expense fluctuations has not been material to our consolidated financial statements.

The Company is subject to interest rate exposure on variable rate debt. The amount of that debt at balance sheet date of December 31, 2004 and March 31, 2004 amounted to $8,090,000, and $5,781,000, respectively. Since the interest rate on debt is based upon the prime rate plus 1% or 1 1/2%, the cost of this debt will increase or decrease accordingly with changes in the prime rate.

The Company has exposure to the commodity price for cheese, dry whey and fluid milk. We have addressed these exposures in the general paragraph of Management's

Discussion and Analysis, Item 2 above.

ITEM 4. CONTROLS AND PROCEDURES

Within 90 days prior to the date of filing this Form 10-Q, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Securities Exchange Act of 1934 Rule 13a-14. Based upon the evaluation, the Company's CEO and CFO concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's periodic SEC filings.

The Company does not expect that its disclosure controls and procedures will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

Subsequent to the date of the Company's evaluation, there have been no significant changes in the Company's internal controls or in other factors that could affect internal controls.

PART II - OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

On June 12, 2001, the Company sold $540,000 of Series A Redeemable Convertible Preferred Stock to an accredited investor in exchange for roll drying equipment. The shares were sold pursuant to Section 4(2) of the Securities Act and Rule 506 of Regulation D promulgated thereunder. On July 7, 2004, these shares were converted to 216,000 shares of Lucille Farms common stock per the preferred stock agreement.

Item 5. Other Information

At December 31, 2004, the Company was in default of certain covenants under its borrowing facility, for the test period ended December 31, 2004, relating to (a) the maintenance of a Tangible Net Worth of not less than 90% of its Tangible Net Worth at September 30, 2004, and (b) the maintenance of a Fixed Charge Coverage Ratio of not less than 1.00 x 1.00. On February 14, 2005, LaSalle and the Company entered into a First Amendment and Waiver to its Loan and Security Agreement which, among other things, waived the foregoing defaults, amended such covenants on a going forward basis, and suspended the capital expenditure loans unless and until (x) on or before February 15, 2006, LaSalle Business Credit, LLC shall have received the Company's internally-prepared quarterly financial statements for the fiscal quarter ended December 31, 2005, and (b) the Company shall have maintained a ratio of its FC Numerator to Fixed Charges of not less than 1.20 to 1.00 with respect to the twelve (12) month period then ended.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.1 Loan and Security Agreement, dated as of December 2, 2004, among LaSalle Business Credit, LLC, Lucille Farms, Inc., and Lucille Farms of Vermont, Inc.

10.2 First Amendment and Waiver to Loan and Security Agreement, dated February 14, 2005, by and among LaSalle Business Credit, LLC, Lucille Farms, Inc. and Lucille Farms of Vermont, Inc.

31.1 Certification of Periodic Report pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005.

31.2 Certification of Periodic Report pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005.

32.1 Certification of Periodic Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005

32.2 Certification of Periodic Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005.

(b) Reports on Form 8-K

Current Report on Form 8-K, filed November 15, 2004, relating to the results of operations for the period ended June 30, 2004.

Current Report on Form 8-K, filed December 6, 2004, relating to the new $11 million borrowing facility from LaSalle Business Credit, LLC.

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

Date: February 14, 2005 Lucille Farms, Inc.

(Registrant)

By: /s/ Jay Rosengarten

Jay Rosengarten,
Chief Executive Officer

By: /s/ Albert Moussab

Albert Moussab,
Chief Financial Officer
(chief financial and accounting officer)

EXHIBIT INDEX

Exhibit Number	Description of Exhibit
10.1*	Loan and Security Agreement, dated as of December 2, 2004, among LaSalle Business Credit, LLC, Lucille Farms, Inc., and Lucille Farms of Vermont, Inc.
10.2*	First Amendment and Waiver to Loan and Security Agreement, dated February 14, 2005, by and among LaSalle Business Credit, LLC, Lucille Farms, Inc. and Lucille Farms of Vermont, Inc.
31.1*	Certification of Periodic Report pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005.
31.2*	Certification of Periodic Report pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005.
32.1*	Certification of Periodic Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005.
32.2*	Certification of Periodic Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated February 14, 2005.

* Filed herewith