

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Cyanotech Corporation (CYAN)



**BRENT BAILEY** is President and Chief Executive Officer of Cyanotech Corporation, and a Director of the company, since January 2011. Mr. Bailey most recently was President of Unlocking Potential, LLC, a leadership development and strategic planning consulting firm. Previously, as President and Chief Operating Officer of Pharmavite LLC, a \$500-million subsidiary of Otsuka Pharmaceutical Company, he and his team drove the Nature Made brand to the number-one position in mass market nutritional supplements, and built Pharmavite into an industry leader. Prior to that, Mr. Bailey was Executive Vice President of Marketing for Del Monte Foods, and Senior Vice President and General Manager-Household Division of The Dial Corporation. Earlier, he held marketing leadership positions with Van de Kamp's Frozen Foods and Frito-Lay. Mr. Bailey is a graduate of Claremont McKenna College in economics and has an MBA from the UCLA Anderson School of Management.

### SECTOR — HEALTH SERVICES

**TWST: Can you begin with a brief introduction to the company, including some highlights from your history and an overview of your current operations?**

**Mr. Bailey:** Cyanotech was founded back in the early 1980s by Gerry Cysewski. Gerry is still with us, and he is now our Chief Science Officer. He picked Kona because he felt that it was the best coastal area in the United States to grow microalgae. We now have a 90-acre farm in that location that was carved out of lava. The company has grown and evolved from that startup operation into what is now approaching a \$28 million business.

**TWST: In your most recent quarter, the March quarter, your sales were up 15% over last year. To what you attribute that increase?**

**Mr. Bailey:** Most of that growth was in our consumer products business and the branded area in particular, and was driven by efforts we've been making on the mainland to increase our distribution and our presence there. We started selling consumer products about 10 years ago, primarily focused in Hawaii, and that business has done extremely well, and we're now moving to the domestic mainland. We're focused primarily on the natural products channel and are doing extremely well building distribution. Our market share is approximately 50% in that channel. We believe, based on what we have seen in Hawaii and what we're seeing in the mainland, that we have significant upside potential on the consumer side of the business.

**TWST: Can you talk a little bit more about your distribution network? Who are your distributors, and where are they located?**

**Mr. Bailey:** We use distributors in the natural products channel on the mainland. We also have some brokers there. In Hawaii, we basically do everything direct to the retailers. We sell in all channels in Hawaii, natural products as well as the mass channels; we're in Wal-Mart and Kmart and Target and Costco, major grocery and drug chains as well as the natural products retailers there.

We also have distributors in the international market. The bulk ingredients business has been the cornerstone of the company, and the consumer products business is now growing and has almost reached the same size. However, the bulk ingredients piece of the business is almost exclusively international now. We made the decision to build our domestic branded consumer products business ourselves; we've effectively exited the bulk business in the United States. We've kept a few strategic customers we feel are committed to building the Astaxanthin and Spirulina markets.

At one point, we were selling in 62 countries. We now feel that we were probably too broad and shallow in that respect, and we're really focusing more on fewer markets and attempting to go narrow and deep. Asia, Central and South America, and Europe are areas that we're focusing on at this point. Although we're becoming more of a consumer products company, we expect to remain in the bulk business in the international markets, where we simply don't have the resources, the expertise or the cultural knowledge to build those markets ourselves. So both businesses, bulk side and consumer, we expect to grow long term, but we will do it a little differently than we have historically.

**TWST: Tell us a bit more about your products. In which categories do you expect to see the best growth?**

**Mr. Bailey:** We were largely a one-product company with Spirulina for about the first 15, 20 years, and then we developed Astaxanthin as well, and believe that there is huge potential in both areas. Spirulina is basically nutrition in its most concentrated form, and the benefits related to that are immunity, energy and replenishing nutrients, so those three areas have huge potential, in my opinion, for just about anybody.

The same is true of Astaxanthin; it's the strongest natural antioxidant that's yet been discovered. It's a powerful anti-inflammatory and helps with healthy aging. So both of those two categories have got huge upside growth potential, but very limited mainstream awareness either in the United States or globally. About two years ago there was a four-minute segment on "The Dr. Oz Show" titled "The Best Supplement You've Never Heard of that You Should Be Taking." As soon as that hit, the Astaxanthin business took off. We were about a \$17 million company, and we grew to \$24 million over the next year. The majority of that growth was a function of the publicity related to that one four-minute segment. We took advantage of it in terms of building our business, but that was really the first mainstream publicity related to that product category, and things took off from that point. We believe that Spirulina has similar upside potential, and yet is largely unknown to the mainstream audience.

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We've done well in the natural products channel in Hawaii. We've done well in the mainstream channels in Hawaii. We're doing well domestically in the natural products channel, and over time we'll get into the mainstream market as well and build awareness of the products that we're selling. The bottom line is we believe that both Spirulina and Astaxanthin have huge upside potential. To try to quantify that potential, we're currently selling \$1.47 net sales per capita in the state of Hawaii of the two products combined. If we can duplicate that on the mainland, the potential is enormous. We've seen no indication that we can't realize that potential long term.

Now as far as the markets go, we started as primarily a bulk ingredient manufacturer. We still have limited resources, and so we want to get as much out of those lava ponds as possible. Since we get much higher revenue and margins per kilo that we produce in the consumer markets, we are in the process of migrating our business and our focus domestically to the consumer side of the business.

**TWST: What do you find are the most effective strategies to reach your potential customers?**

**Mr. Bailey:** Nutritional supplements are kind of an interesting consumer product category in that consumers are very skeptical of classical marketing approaches, typical advertising and those kinds of things. There's been so much snake oil in this industry over the years that consumers are skeptical, and justifiably so, in many respects. We believe that public relations is a much more effective approach to build awareness and drive emerging categories. We work with credible third

parties who have credentials in various areas to advocate the products, but we feel that consumers are more open to listening to someone with academic or medical credentials.

In addition, when you've got Spirulina and Astaxanthin with such low awareness, obviously we're looking for other ways to build the business in addition to public relations. In the state of Hawaii we've built a very successful business, and we've done it largely through local marketing efforts. We are heavily involved in marathons, triathlons and local running events, as well as in radio with local disc jockeys. Those approaches are things that we believe we can translate to the mainland as well, and in fact we're doing a test right now in a market on the West Coast to evaluate how that translates and whether we can duplicate what we've done in Hawaii on the mainland.

Another key piece of building a consumer products business is to have new products and product improvements. News is really critical; we want to have something new at least every six months, and so we are putting a process in place to develop new products and product improvements so that we'll have things lined up in a queue, and we've got something new coming out every six months or so. We've also brought in several people who have consumer-packaged goods marketing experience and digital marketing experience, so we're building our organization in that respect. The company is still relatively small; we have less than 100 employees, and many of them have been with us from nearly the beginning. As we move from a bulk ingredient supplier to a consumer products company, we will need to add different skills and talents.

**TWST: What's the competitive landscape like for you, and what do you think are some of your advantages?**

**Mr. Bailey:** There are really only a handful of companies worldwide who have been able to successfully produce on a consistent basis commercial quantities of high-quality microalgae for human consumption. There are many companies who are interested in it, and many who have tried to do it, but only been a handful that have been successful over an extended period. So from that standpoint, we have a significant barrier to entry. This is not easy to do, and it's not just science. There's a fair amount of art to it as well. The fact that we've been doing it for such a long time gives us a very significant advantage. As far as we know, we are the only company that has been able to meet those criteria on both Spirulina and Astaxanthin.

Another advantage is that most of the companies we compete against in the retail landscape are broadline brands — Nature's Bounty, Nature Made, NOW Foods — who have hundreds of SKUs across multiple categories. The advantage that that brings us is this is the only thing we do, and so for those folks Astaxanthin and Spirulina is a line extension; for us it's our primary focus. Most retailers are more interested in buying from a supplier who is totally focused on growing those segments and can help them realize the potential that these products have. That's exactly what we've done in Hawaii, and we've built a very significant business there and done it in both the natural products channel and mass market.

**TWST: Could partnering with a larger retailer who has more SKUs, but doesn't have your products, make sense for you?**

**Mr. Bailey:** Anytime I'm dealing with a retailer, I want to partner with them to the degree possible. Our focus is always working together with our retail partners to build the category for our mutual benefit. So yes, that's an approach that we would definitely take and are in fact taking in terms of the natural products retailers that we're working with.

**TWST: Do you think the investment community has a good understanding of your story and value proposition? Secondly, what is something that you would like the investment community to better understand about you?**

**Mr. Bailey:** The investment community does not have a good understanding of our business, largely because we've been very low-profile. Our primary focus up to this point has been building our business. As I mentioned, we've grown from \$17 million to \$28 million in the last two years.

I think our story is actually pretty simple. As I mentioned previously, there are only a handful of companies worldwide who've been able to consistently produce commercial quantities of high-quality microalgae for human consumption, and we believe that we are the only ones doing it in both Spirulina and Astaxanthin.

We also sell products that you can feel the difference when you take them. Most vitamins and supplements you take on faith based on clinical studies, but you don't necessarily feel anything. The first year I worked for Cyanotech and started taking the products, I was commuting to Kona, Hawaii, from Pinehurst, North Carolina, every two weeks. That was a 17-hour trip each way on several different planes. I did not get a single cold during that period.

In addition, we have extremely high repeat rates. Typical repeat consumption rates for a successful consumer product are about 40%. Our repeat rates are a lot higher than that. So we know that if we get awareness and trial, people will continue to buy the product. We've demonstrated that we can sell effectively in Hawaii, built the business and get high repeat rates. Now the challenge is repeating that success on the mainland. We've started with the natural products channel. Our market shares there on the mainland are currently 50% both for Spirulina and Astaxanthin. They're both small categories at this point, largely because nobody's really driven them. We expect to do that, and we believe that we can as we have done in Hawaii.

To summarize, there are a handful of companies doing what we do: we're the only one who does it in both Astaxanthin and Spirulina. We make products where you can actually feel the difference, which is different than many nutritional supplements. We currently generate \$1.47 per capita net sales in Hawaii, have higher repeat rates than most successful new products, which makes our marketing investment more productive, and have achieved very high market shares as we've expanded to the mainland. The upside potential of this business is significant.

**TWST: What are most significant risks on the horizon, and what are your risk-management strategies?**

**Mr. Bailey:** I would say the biggest challenge right now is satisfying the existing demand for our products. We're focusing on doing that by doing two things. One is converting from primarily a bulk manufacturer to a consumer products manufacturer, where we will use significantly less raw material to generate significantly higher revenue

and profits. We are also looking at additional capacity expansion. We've increased the number of our Astaxanthin producing ponds by about 33% over the last 12 to 18 months. We're currently evaluating additional capacity expansion beyond that. The next big challenge is to build the awareness of both Astaxanthin and Spirulina to realize our full potential. We're doing that by translating our marketing approach from Hawaii to the mainland, and we'll continue to drive things with public relations as I mentioned before.

**TWST: You've already talked about your strategic goals. Is there anything else you want to mention about where you want to see the company in five to seven years?**

**Mr. Bailey:** Basically what we're attempting to do is make significant progress toward our potential over that period of time. I don't believe that we can realize all of the potential that we've demonstrated in Hawaii on the mainland in the next five years, but I think we can make significant progress towards that potential. That is our primary focus at this point.

**TWST: In summary, what do you think are the most compelling reasons for an investor to take a closer look at you, particularly right now at this stage in your growth and development?**

**Mr. Bailey:** I think there are a couple of things. One is that we are vertically integrated in the very difficult-to-produce microalgae business, and I think that gives us a very significant advantage. In addition to what we've talked about already, we're in the process of building our own extraction facility, which will put us in control of the raw material all the way through to the consumer, and that will be completed within the next 12 to 18 months. It will also significantly reduce our costs and our lead times in getting product to customers and consumers.

I would say that the other key thing is the demonstrated ability to consistently produce commercial quantities of high-quality microalgae is absolutely essential in this area, and there are very few of us who've been able to do that. We've also demonstrated an ability to build a successful consumer products business in the state of Hawaii, but we're doing the same thing on the mainland, and we're having similar success today in the natural products channel. We are confident that we can translate that success into the mass market. So if you look at that story and you combine it with the very low awareness of the two products that we make and the categories that they're in and our demonstrated potential to drive that revenue, we think that we've got huge upside potential, and the realization of that potential is simply a matter of time.

**TWST: Thank you. (MES)**

**BRENT BAILEY**  
**President & CEO**  
**Cyanotech Corporation**  
**73-4460 Queen Kaahamanu Highway**  
**Suite 102**  
**Kailua-Kona, HI 96740**  
**(808) 326-1353**  
**(800) 395-1353 — TOLL FREE**  
**(808) 329-4533 — FAX**  
**www.cyanotech.com**