

Cyanotech Corporation (NASDAQ:CYAN)

Q3 2018 Earnings Broadcast

February 9, 2018; 5:00pm ET

**Executives:**

Mawae Morton – Chief Executive Officer

Jolé Deal – Chief Financial Officer

**Investor broadcast**

**Mawae Morton**

Aloha from Kona, Hawaii. Thank you all for joining us today. We're pleased to report Cyanotech's third quarter fiscal year 2018 earnings results. I am Mawae Morton, Chief Executive Officer for Cyanotech and Nutrex. At this stage I'd like to introduce our Chief Financial Officer, Jolé Deal, who will make a Safe Harbor statement and review our financial results for the third quarter. We will respond to several questions after Jolé shares the Q3 financial results.

**Jolé Deal**

Let me start by saying our discussion today may include forward-looking statements which are current as of today's date. We do not undertake any obligation to update forward-looking statements either as a result of new information, future events or otherwise. Our actual results may differ materially from what is described in these forward-looking statements. Some of the factors that may cause results to differ are listed in our publicly filed documents. For additional information, we encourage you to review our 10-Q and 10-K filings with the Securities and Exchange Commission.

**Mawae Morton**

Thank you, Jolé. Before Jolé discusses the details of the quarter, I would like to point out that the third quarter was an improvement over the quarter a year ago. Gross profit margin increased by 8.7% and we reported net income of \$1,107,000 compared to a loss of \$349,000 a year ago.

## **Jolé Deal**

Okay, now I'll go through the results for the third quarter. Total revenues for the quarter increased 20% compared to the prior year period. Revenues from our Nutrex packaged products increased 23%, reflecting growth in our strategic channels. These sales included orders with Amazon.com to support a January promotion that was new for us this year. On a year-to-date basis, total revenues are up 5% compared to the prior year period.

Revenues from our bulk products for the third quarter increased 5% compared to the same period last year, and are down 23% on a year-to-date basis due to lower spirulina supply.

Gross margin for the third quarter was 46.3%, which is an 8.7 percentage point increase from Q3 of last year. This was driven by a favorable mix toward higher margin customers and products, along with lower product costs from increased astaxanthin production levels this year.

Our operating expenses for the quarter increased 3% compared to last year.

Net income for the third quarter was \$1.1 million compared to a loss of \$349,000 in the prior year period. We recognized a tax benefit of \$127,000 this quarter representing an effective tax rate of -13%, compared to a tax expense of \$27,000 in Q3 of last year. The current period benefit is the result of the release of the valuation allowance related specifically to our Alternative Minimum Tax carryforward, which we now expect to be fully refundable under the new tax act.

Also under the tax act, our corporate income tax will drop from 34% to the blended rate of 30.79% in this current fiscal year, which ends on March 31, and then to 21% beginning in our fiscal 2019. As you may be aware from prior filings, we have an \$11.7 million net operating loss carryforward which makes up the majority of our net deferred tax asset, and this net deferred tax asset is fully reserved via a valuation allowance. Because of the tax rate reduction, we re-measured and wrote down our net deferred tax asset by \$1.2 million with a corresponding reduction of the valuation allowance. As a result, this had no impact on our income statement. The tax adjustments made in the third quarter are provisional and may require additional adjustment to our deferred tax assets and liabilities, but are expected to be offset against the valuation allowance.

## **Mawae Morton**

First, I also want to thank everyone who sent in questions and I'll respond to those now.

The first question is how has the new tax bill impacted our company? The only impact so far has been in the form of the accounting adjustment Jole just talked about. After we use our full net operating loss carryforward, the lower tax rate will mean lower cash taxes for us. We don't have any foreign subsidiaries, so many elements of the tax bill don't impact us at all.

The second question refers to a Seattle newspaper advertisement and the questions were: Is there a more focused emphasis on market awareness and growth? Was this ad in other mainland newspapers? Which ones? Will there be other media ads and how costly will this be? This ad was created to support our regional Costco efforts. Newspaper advertising in Hawaii has produced proven positive results in building awareness and driving trial here on the islands, so as we transition our focus to the mainland, we are using these proven marketing tactics to help increase awareness and drive trial. This ad was also strategically planned around "New Year, New You" as it was published on January 7th. This time of year is an opportunity for us to advertise to consumers who are looking to get healthy after the holidays and they tend to seek out supplements to support their "get healthy" resolution for the new year. Regarding the question about other mainland newspapers, the answer is no, not yet. We plan to only use newspaper advertising on a strategic basis to drive awareness and trial in these newer Costco regions.

Another question we received was related to the water restrictions we discussed last time? So, in response, we can share with you that on January 9<sup>th</sup> the County of Hawaii Department of Water Supply significantly reduced water restriction to a voluntary 10% conservation measure. This will not affect production at the Company. The reduced restriction is because all but 2 of 13 the deep well pumps are now running. During the tightest water restrictions 5 of the 13 deep-well pumps were not running.

Another question. It was on recent communications, which have highlighted new cultivation techniques and farm management practices targeting improved consistency of production. Has the company increased astaxanthin production levels

over prior years? If yes, are additional production increases anticipated? Finally, assuming there have been production increases, how has this been achieved – via better practices, expanded production area, or modified practices, such as closed system production? In response, I can share that year-to-date astaxanthin is 14% higher than the prior year period on the same footprint of production land. This improvement was from a bit of production practices. We continue to produce in open systems here. I would also say that we are an aquaculture/agriculture enterprise, so there will be some natural volatility both during and between years.

The next question is: Could you please update prior disclosure relating to store penetration at Costco? We are still in 5 of the 8 Costco regions, so that's 264 stores. Our sales to Costco year-to-date quarter 3 are up 18.4% compared to the same prior year period and our focus is on building awareness and sales within these regions before we expand further.

The next question is, Could you please update prior disclosure relating to efforts to capture first-mover market share in China? The Company's BioAstin Natural Astaxanthin continues to be the only astaxanthin product in China with a "Blue Hat" registration, which allows for health claims to be made. Sales of BioAstin to China continue and we are exploring opportunities to increase sales in China.

The next question is, Why has inventory been building faster than sales – particularly given disclosure concerning recent inability to fulfill spirulina orders due to lack of supply? Our inventory growth, which is a \$1.7 million increase vs. March 2017, is primarily due to the 14% increase astaxanthin production I mentioned earlier. Sales continue to grow, but at a slower pace than this inventory growth. This growth leveled off in the most recent quarter, with Q3 inventory levels for astaxanthin slightly below Q2.

The next question is for 2018, the expansion plans with Costco. Do you plan to open 20 more stores or 100, or? We do not have any approved expansion plans at the current time. Our focus is on building sales in our existing regions that are situated in the western US before expanding into the remaining Costco regions in Midwest and the East Coast.

There are two more questions here. Do you plan to reduce inventories significantly this year and by how much? Inventory management is something that we continue to monitor carefully in order to balance stock for expansion, and safety stock levels.

The final question is, What is the plan this year to reduce debt? How much? Debt is being paid based on normal amortization, which is just under \$500,000 per year. We have a \$2.5 million loan that matures in September 2022 and a \$5.5 million loan that matures in August 2032. These two loans make up the majority of our outstanding debt. We don't have plans at this time to accelerate payments on our loans.

So that concludes the questions that we have. We want to thank you for joining the call today and for submitting questions and participating. Aloha.