

Solazyme Positions Itself In The Challenged Market For Clean-Label Foods

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Disclosure: The author is long SZYM. (More...)The author wrote this article themselves, and it expresses their own opinions. The author is not receiving compensation for it (other than from Seeking Alpha). The author has no business relationship with any company whose stock is mentioned in this article.

Summary

- Solazyme enters 2015 with two food ingredients and two oils for the food markets.
- The food industry is beginning to feel the pressure to simplify its ingredient labels.
- The company offers a solution to the hydrocolloid industry for a clean label solution.

As the year progresses, food ingredients have begun to play a much larger role for renewable oils and specialty products producer **Solazyme (NASDAQ:SZYM)**. In my last article [found here](#), I wrote about how Solazyme gained a favorable ruling that helped fortify its first-to-market advantage when it comes to its proprietary whole algal ingredients. The company now enters the year with a strong portfolio of unique food ingredients and high-performance algae oils that have all received de facto U.S. regulatory approval through the company's receipt of FDA GRAS No Questions letters. This has been accomplished after more than a half decade of research and development.

(click to enlarge)



(Source: [AlgaVia](#))

Attesting to this momentum is Solazyme's growing client backlog in this business segment. The company states that its ingredients are now found in 65 active application projects with leading food manufacturers. This doubles the project backlog from where the company stood just 6 months ago, and the range of these projects spans across 30 product categories. When it comes to the company's food oils, it is also expected that several active projects will convert to begin selling product on the shelves [later in the year](#).

Helping to propel this adoption momentum at a seemingly accelerated rate are the unique characteristics of the company's whole algal ingredients. Pertaining to whole algal flour, the ingredient helps to reduce overall fat, saturated fat, cholesterol, and calorie count, while also maintaining an enhanced texture, emulsification, water binding, and flavor delivery. The product is also vegan, natural, non-allergenic, gluten-free, non-GMO, kosher, and halal. All of these are attributes bode well, and place Solazyme squarely in the middle of multiple converging consumer trends.

Products For A Clean Label

Yet, when it comes to manufacturers, there remains an additional incentive to consider the new ingredients. Now, many years underway, the food industry has been challenged by a need to develop cleaner food ingredient labels. This is a trend which has been gaining momentum across the board, and most recently, scored a victory when both Hershey (NYSE:[HSY](#)) and Nestle ([OTCPK:NSRGY](#)) [announced their commitment to clean labels](#) within days of each other. As two of the largest manufacturers who inevitably set the tone for a new industry standard, the actions will remove all artificial colors and flavors from their confectionery products by the end of 2015.

But what is a clean label? For some companies, the trend means a move towards more natural and wholesome ingredients, while creating shorter and simpler ingredient listings. According to [FoodNavigator.com](#), there is no defined definition of what clean label actually means. Yet, as a concept, the article states the following:

"As for a working definition, [Tom Vierhile] says that the primary implication of 'clean label' is transparency - in terms of wholesomeness of ingredients, a lack of artificial ingredients, and often a lack of common allergens."

The challenge remains great for a food industry which originally moved towards artificial substitutes with open arms. In the slow retreat back, it now faces complex challenges that can be as complicated as poor naming standards. For example, by originally designing complex names for some ingredients, confusion has led to unfriendly consumer labels which leave consumers into believing a particular ingredient isn't naturally derived, when in fact, it is. This is one such problem that is facing the market for hydrocolloids, as seen in the video [found here](#).

It is also in this niche market where Solazyme hopes to make an impact as a solution provider. Attesting to this idea is Solazyme's Commercial & Innovation VP, Charles Bowman, who will be presenting on the topic at the Food Hydrocolloids 2015 conference in April. With over 20 years' work experience with hydrocolloids at CPKelco and Cargill, the experienced representative will speak on behalf of Solazyme on the topic of "Clean Labels - Healthy Options with Texture." In particular, the company will be armed with a natural ingredient that meets several properties while simply being referred to on an ingredient label as "whole algal flour."

The Complex Market Of Hydrocolloids

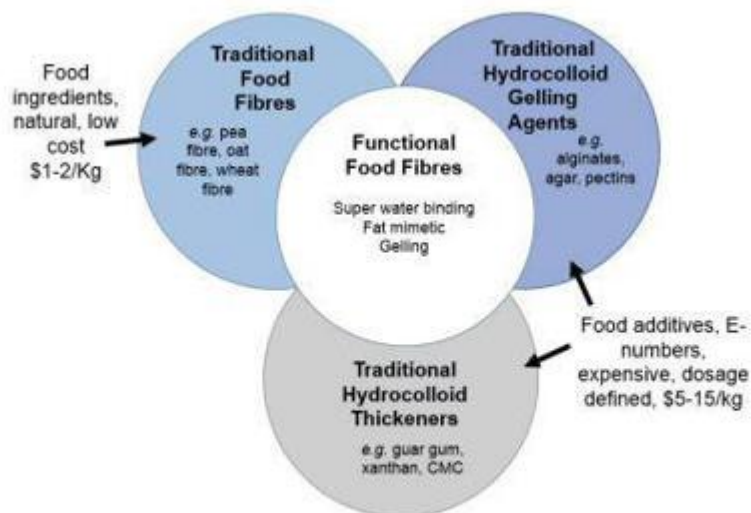
A hydrocolloid is a suspension of particles in water, where the molecules bind to water and to one another, thereby slowing the flow of liquid and solidifying into a gel. They populate a

wide spectrum of applications, including frozen meals, sauce & dressings, processed meat, dairy products, beverages, confectionery foods, etc. It is here where whole algal flour's water-binding properties can come into play.

According to the research report [found here](#), the market for hydrocolloids is expected to grow to \$7.91 billion in 2019. The leading players in the industry include CP Kelco, Cargill, DuPont (NYSE:DD), and DSM (OTCQX:RDSMY). What makes the market for hydrocolloids so promising is the changing landscape in which it operates.

According to the American Oil Chemists' Society in an article [found here](#), hydrocolloids are now being used more for their nutritional functionality, in addition to their texture properties. This is especially the case as hydrocolloids are now being used to replace the lost functional and textural properties of food as a result of reducing sugar, fat, and salt in product formulations.

(click to enlarge)



The emergence of functional food fibers showing the overlap in functionality between hydrocolloid gelling agents and thickeners and traditional food fibers.

(Source: [AOCS](#))

Yet, in the same effort, many of the traditional categorizations of the ingredients are beginning to merge. By shortening the list of ingredients and improving the overall healthiness of a product, the industry is looking for "functional food fibers" which serve multiple roles, including their use as a hydrocolloid or a thickening agent. With a rising need, the race is now on to innovate and develop methodologies which can allow for the production of cheaper functional fibers that replace the need for several ingredients with a single ingredient with multiple uses.

It is in this realm that Solazyme helps to fill the growing need. The following excerpt was taken from the [company's petition](#) to qualify whole algal flour as an organic ingredient. Speaking upon the need and function of the product, the company wrote the following:

"Many companies use a combination of starch, gums, hydrocolloids, and fiber to try and achieve lower fat or more indulgent products. Whole Algal Flour can achieve this in one

multi-component food ingredient, and create better mouthfeel without increasing viscosity. Unhealthy fats can be reduced by the use of this whole food alternative.

There are no other solutions that match the functional and nutritional benefits of Whole Algal Flour in one ingredient. To achieve the same results as Whole Algal Flour, organic producers would have to use more non-synthetic or synthetic ingredients in their products. Whole Algal Flour also has the benefit of reducing the fat content in organic products without compromising taste or texture.

As I noted in boldfaced statement above, Solazyme asserts that there is currently no other ingredient which can meet the functional and nutritional role that whole algal flour currently looks to fulfill in a single ingredient. As such, the company finds itself already in a position of the converging trend capable of meeting these multiple functionalities with a single ingredient. Once again, Solazyme finds itself opportunistically positioned with a unique proprietary ingredient capable of influencing a well-established industry. Looking forward, whole algal ingredients are likely to gain additional traction as the company markets the product lines, as innovative solutions that help address many of the challenges now facing the market as a whole.

A Look At The Company Now

Solazyme now trades with a market capitalization of \$223 million, based on the closing price of \$2.80 as of March 27. As of December 31, the company carried total assets of \$312.6 million. Of this amount, cash and short-term investments make up approximately \$207.3 million. Included in a 50-50 joint venture with Bunge Ltd. (NYSE:[BG](#)) is Solazyme's largest manufacturing facility. As of December 2014, the joint venture (whose revenue is not consolidated with Solazyme's financials) had total assets of \$166.1 million. For the year, the joint venture saw a net loss of \$46.2 million. With the proportional loss flowing back to the company, Solazyme saw, in all, a net loss of \$162.1 million.

The company expects to continue incur losses as it begins to ramp up production at its new plants in Brazil and the United States. Some of these losses are the result of depreciation and other non-cash related expenses. As such, investors would do well in evaluating the company's cash on hand and cash flow going forward. Solazyme is currently in the process of ramping its production facilities, and is conducting this on an S-curve production ramp. This means that the most heavy losses are expected in the beginning of the ramp, and will ease in an accelerated fashion once the company begins production in large volumes at improved economies of scale. Such a push for larger volume production is anticipated in the second half of 2015.

The company's food ingredients business always been an important business segment for Solazyme. Yet, today there exists a bit of a disconnect for investors who strongly associate the company with commodity crude oil, given its former emphasis as a biofuel and renewable chemical play. As noted in the chart below, Solazyme has often traded alongside the direction of crude oil prices. This is despite the fact that the majority of its revenue is currently derived from consumer discretionary goods like branded cosmetics. Additionally, investors appear to dismiss the fact that the company's refocused efforts will emphasize higher-margin consumer staples such as food ingredients and intermediates used in personal care products.



Mar 28 2015, 5:27PM EDT. Powered by **YCHARTS**

What appears to be largely underappreciated altogether by the investment community is the company's competitive strength of target market flexibility. Unlike most companies, Solazyme maintains the ability to use the ideal feedstock of a region and pair it with the optimal target market at a given point in time and pricing environment. This is the reason why Solazyme can offer from the same equipment of a manufacturing facility today a lower-margin oil used for biofuel, and begin marketing a higher-margin tailored oil used in foods or cosmetics within a few days.

Such an advantage enables the company to adapt to changing market situations, such as what is currently underway with the decline in commodity crude oil. In light of falling prices, Solazyme has begun to advance the market development of its higher-margin products sooner, and delayed the volumetric production of its lower-margin commodity oil replacements. Both actions extend the period of time in which Solazyme is in a mode of higher-cost production. Nevertheless, they also place the company in a more favorable cash flow environment as these markets are realized.

As such, Solazyme is now placing a higher emphasis on its high-margin product lines. This includes the company's oilfield services division, with its increasing sales of Encapso targeted drilling lubricant. It also includes the company's AlgaVia line, with high anticipation for the new food oils expected to come to market this year. Additionally, Solazyme's cosmetics brand of Algenist continues to be the backbone of the company's existing revenue until it is able to push greater volumes of product out of its new manufacturing plants.

Final Thoughts

One of the most difficult problems facing Solazyme today from a valuation standpoint is an investment community that understands how to properly evaluate the company on the basis of its technology. Despite having invested more than half a billion dollars over the past dozen years, Solazyme now trades at a valuation near to its cash on hand.

In a [recent interview](#), CEO Jonathan Wolfson described a problem that exists within the industrial biotechnology industry as a whole. He states the following:

"If you look at the Internet, mobile applications, or even computer hardware, there are investor communities that built up over time in each of these areas, and an investor community that built up around medical biotechnology. The space that I'm in doesn't really have that core, investor community yet. It doesn't have that model of how businesses are valued the same way either. That timeline and scale-up, for us, is different."

Inherently in this statement is the acknowledgement that the market does not understand the current worth of the company's long-term valuation. Instead, Solazyme's near-term lack of overall profitability and dwindling cash on hand stands more as alarming signs for investors now than a rational perspective of what the company is able to achieve. Rather than understanding that Algenist can already be profitable on third-party manufacturing alone, investors stand fixated on the heavy capital spending needed to ramp the company's largest production facilities.

This sentiment stands in stark contrast to management's own perception of its technology, according to its [Q3 2014 conference call](#), where Wolfson said the following:

"Over almost 12 years at Solazyme, we believe that we built a company and a technology that will produce numerous disruptive products that are better for the planet and will ultimately deliver a multi-billion-dollar profitable commercial entity."

As such investors should dwell upon these risks when they consider this company as an investment. Solazyme trades with an investment community that appears unwilling to currently evaluate the company on the basis of its long-term capability. The company carries the cash on hand needed to develop another plant the size of its largest facility in Brazil, but it must also endure the high-cost production ramp of the present due to increasing volumes at its first facilities. Of course, this also means that the company is currently enduring a heavy loss. Nevertheless, Solazyme's product lines continue to be strengthened in their unique value propositions.

Increasingly, the company's products also find themselves squarely in a position of strength when it comes to marketing potential. When it comes to food ingredients, Solazyme has developed products which fall in line with existing consumer trends. Whole algal ingredients appear to offer a unique solution in the move towards cleaner labels.

This is impressive, considering the long duration of time that is often needed to develop a single new food ingredient. It requires the time, the money, the regulatory approvals, the relationships, and the manufacturing capability needed to implement and scale up the idea. Solazyme now stands armed with two whole algal ingredients and two highly differentiated food oils ready to hit the markets this year.