

DIAMOND FOODS, INC.  
**FISCAL Q2 2007 EARNINGS CONFERENCE CALL**

March 8, 2007, 1:30 PM PT

**Q&A TRANSCRIPT**

- M. Mendes            At this time we'd like to open the call to any questions.
- Operator             Thank you, sir. Ladies and gentlemen, at this time we will begin the question and answer session. If you have a question, please press the star followed by one on your pushbutton phone. If you'd like to decline from the polling process, press the star followed by two. If you are using a speaker phone equipment, you will need to lift your handset before pressing the numbers.
- Our first question is from Diane Geissler with Merrill Lynch. Please go ahead.
- D. Geissler           Hi, good afternoon.
- Management        Hi, Diane.
- D. Geissler           A question for you... obviously there was a lot of new product development in the quarter and associated activities around that. Can you quantify for us what kind of impact that had in dollar terms, slotting or give us some kind of idea about the direction on that?
- M. Mendes           Directionally in terms of slotting, Diane, we talked in the past about the fact that for the full fiscal year we're going to be slotting in the neighborhood of 7 new products. Obviously some of the products we began the slotting process last year. Some of them we may not get fully slotted by the end of this fiscal year, but in the neighborhood of about 7 of them will be slotted this year and that would be the 3 peanut products, the new smoked almond product and the 3 trail mix products.
- As we've talked about before, to slot a single SKU nationally runs between \$1.0 and \$2.0 million, so I think you're looking on that level of scale for the year.
- In terms of the quarter, most of the slotting we incurred this year would be incremental trail mix, incremental smoked almond and then some of the new peanut products but really there's more to come as the year plays out.
- D. Geissler           Okay, so \$1 to \$2 million on the 7 new products knowing that you achieved slotting on some of the products last year. Should we think about that kind of evenly through the four quarters or not? Because my impression with the Emerald Bowl that there was a lot of activity for the second quarter, and really in the third quarter, and those would be the 2 periods that would be most affected by the new product development.
- S. Halio               Certainly the third quarter and even into the fourth quarter, Diane, but again a lot

of it depends on when the retailer actually gets it up on the shelf for resets on so on and at that point is when we incur the slotting.

D. Geissler I guess the other question I had was I missed some of Gary's comments about the mass merchandiser channel. Maybe if you could repeat that and any details on what's transpiring in mass, what your plans are over the remainder of the year and then as you head into your new fiscal year or later this summer.

G. Ford We didn't spend a lot of time on that, Diane, but I will give you a little more color on that front. We had announced in our last call that we were planning a special Super Bowl promotion in one of the major mass merchandisers so we did conduct that promotion. That was an in-and-out 5-week promotion in one of the major merchandisers, we have distribution in about 600 of their stores out of some 2,000 stores.

The other mass merchandiser we're in pretty much full distribution with between 3 to 7 snack items depending on the size of the store. We feel quite positive about our performance in that channel and that's an area where we're going to be working hard to build out more distribution this year.

D. Geissler I know your ACV [distribution] in grocery ... obviously it's pretty phenomenal. How is it grocery versus drug? I think you tend to put those 2 together when you talk about your percentage of revenue from each of the major channels. Could you talk a bit about your exposure in grocery versus drugs.

M Mendes Obviously grocery was our phase one target in our roll out and drug was part of a phase two so we're more advanced in food. I would say that generally as a rule food has a much lower percentage of private label snack mix than drug so I would say the scale of that opportunity, the number of facings dedicated to branded snacks is a little bit lower in the drug channel so I would say on a steady state basis even when that channel's fully distributed for us it will probably not have as many facings, as many items as food will.

Obviously they're called drug stores for a reason. I mean the primary purpose for being is not to market food products. That's something that they also do but that's one thing that they're growing in more and more. We think it's an interesting category. It's one that we're working hard to develop but it is not as well developed for us as the food category is.

D. Geissler Do you feel like where you are today you're in line with what your expectations were, do you think you're a little bit ahead. How would you characterize your standing right now.

G. Ford With food and drug or just all categories?

D. Geissler I'm specifically trying to break apart grocery and drug to get an idea. I think based on your comments and our discussions over the last 5 or 6 quarters you're obviously very well developed in grocery but historically that was where you were the strongest because of your culinary line. I'm trying to get a feeling for a new channel that you've gone into like drugs that has actually a little more

development work done behind it versus say mass which is sort of the phase 3. I'm trying to get a feeling for where you think you are in terms of the development of that channel versus your original expectations.

M. Mendes      Very good. I think probably pulling back a little bit, if you look at prior to our entry into the snack category, we were quite intensively marketing our products in grocery, in clubs and in the mass merchandise channels or one of the major mass merchandisers in particular, and we virtually were selling no products into drug. I think drug has a little lower barrier to entry but it's an area that we've not had as much historical company experience in knowing how to maximize the performance in that channel. I think that can speak to the opportunity for us.

I would say though that when you look at overall categories of food, mass merchandiser, club and drug, that drug probably has a more intensified focus on private label than the other 3 channels, so I think that frames that opportunity.

One good thing about drug, though, is that it's pretty much a warehouse delivery system model so our supply chain is very well situated to leverage that. The one thing is we generally have historically not sold culinary nuts through the drug channel. One thing that's interesting though is our snack entry has provided an entree for us to now try to also market culinary nuts. I hope that gives you a little more background.

D. Geissler      Are you at where you thought you'd be, you know, looking back even to pre-IPO or around the IPO. I mean is this where you thought you'd be in terms of some of these channel developments?

M. Mendes      I would say that overall in aggregate in some places we're further than we thought we'd be. In some places maybe it's a little slower but I think in aggregate we're about where we had hoped we'd be and we're particularly pleased with the reception and the turns on the brand. And that brand premium of the product, we're quite pleased particularly when you look at the tree nut subset of the snack nut category.

The nuts that cost consumers the most are the categories that we're performing the strongest in and that bodes well for the perception of our products as a premium brand.

D. Geissler      Thanks for your comments. I'll turn it over to whoever is next.

M. Mendes      Thank you, Diane.

Operator      Our next question comes from Kenneth Zaslow with BMO Capital Markets. Please go ahead with your question.

K. Zaslow      Hi, guys.

Management      Hi, Ken.

K. Zaslow      Just a couple quick questions. One is on the snacks in the Super Bowl. Was

there any incremental sales in the quarter that may not recur or is there something ... I mean, is this the new runrate for how we should look at your snack nut sales?

M. Mendes        We did have a special promotion in the mass merch channel which gave us an in-and-out program for the Super Bowl. But generally what we're hoping we'll see is that there's going to be a surge because we had quite a bit of critical mass around some promotional activity around the Super Bowl, particularly with Bud Bowl tie-in.

We're hoping we've established a revised baseline for the business and you'll see some of that strength carrying into Q3.

K. Zaslow        Great. I know you're somewhat hesitant to talk about it, but if there's a way you could give us some sort of view on what new channels or new customers have you increased the penetration in terms of SKUs. Has that changed at all throughout the quarter or have you seen anything evolving in that sense?

M. Mendes        Maybe I'll have Gary talk about an alternate channel, some work we've just done there. Gary...

G. Ford            Hi, Ken. As we've talked several times, the C-store channel is a place that we did not have a lot of experience when we entered the snack business and is a little bit of a complicated distribution system. We continue to make progress there. It is an imported channel and we just picked up Valero, which is a C-store chain, for our Bold [peanut] items and a couple other items in one thousand of their stores (which is the entire chain). We continue to make progress as we get better at understanding that distribution model as well as getting the right products for that C-store channel.

K. Zaslow        Great. Seth, is there a way you can give us some sort of view or quantify the cost savings, how it's going to come through, what degree will these cost savings actually be?

S. Halio            You're referring to the integrated line between processing and packaging?

K. Zaslow        And I think you also said something about another project that was starting to ...

S. Halio            Yeah, the dry roaster, in Fishers [Indiana]. The line Gary spoke of, this is the first of several lines we plan to do. We have an internal goal over the next few years to have a large percentage, 60%, of all our packaged items go through this kind of process. Let me back up for a second.

The way the process works is for the snack nuts, it goes from processing, glazing to packing, in a can, in a package without human touching or human intervention so your labor costs are down. But more importantly, and I'll ask Gary maybe to touch on this as well, it improves the quality which is really where we think Emerald is nicely positioned for growth.

Really what this new line does is dramatically improve the quality and maybe,

Gary, you can touch on that a little.

G. Ford Yes, and by that it's just less material handling, going directly into packaging versus going into a toter bin and then being moved with a forklift, etc. We just went directly to packaging so the quality component is primarily a reduction in breakage which is something we're focusing on to take quality to the next level.

K. Zaslow Great. Thank you very much.

Management Thanks, Ken.

Operator Our next question comes from Heather Jones with BB&T Capital Markets. Please go ahead.

Management Hi, Heather.

B. Hundley Hey guys, it's Brett [Hundley]. How are you?

Management Hi, Brett.

B. Hundley Seth, I apologize. I missed some of your gross margin comments and why that fell slightly year-over-year. Can you please just reiterate the reasoning behind that?

S. Halio Sure. There were really 2 components to it, the first in terms of snacks. In terms of snacks as we've been saying, with the introduction of the new products we have begun to incur slotting costs putting the product on the shelf, as well as large promotional activities we had in the quarter to continue to drive growth for snacks. And the final component related to snack is we've continually been putting capacity ahead of the sales growth to be able to meet the sales growth and that had a little bit of an impact on our gross margin this quarter as well.

The second component is some of our incremental growth in the culinary product line was in lower margin channels than it was last year.

B. Hundley Alright, thank you. I appreciate it. Then the SG&A as a percentage of sales kind of creeping up a little bit. Again, does that just go back to some of that displaced advertising from Q1?

S. Halio That would be a component of it as well as again similar to slotting and promotional, we've been investing in staffing for the sales and marketing team here. You've started to see some of that around fourth quarter last year and then continued into the second quarter this year. Our dollar spending in the second quarter for SG&A is about flat versus the first quarter.

B. Hundley Alright. Thank you. Then, Michael, you did mention your 3 new products only contributed slightly to the top line in the quarter. Do you have any idea of what you can give us contribution-wise as far as dollars go?

M. Mendes Really, we just began shipping those products. It is an innovative process that

we use for these products so there was some structural preparation for the rollout of those items. We will really see the distribution build on those 3 items taking place in the next 2 months. Then we'll start ramping up that distribution so we think a lot of the benefit from that work is in front of us.

B. Hundley            Thanks, guys, that's all I had.

Management        Thank you.

Operator            At this time I'd like to turn the call back to management for any closing remarks they may have.

M. Mendes           Thank you, everyone, for joining us on the call this quarter. Goodbye.

Operator            Ladies and gentlemen, this does conclude the Diamond Foods fiscal second quarter 2007 conference call. You may now disconnect. Thank you for using ACT Teleconferencing.

[END OF CALL]