DIAMOND FOODS, INC.
First Quarter Fiscal 2009 Earnings Conference Call
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Q&A

Operator: Thank you sir. I'd like to remind everyone in order to ask a question you may do so by pressing star, one on your touchtone phone. We'll pause for just a moment to compile the Q&A roster.

And we'll go ahead and take our first question from Heather Jones with BB&T Capital Markets.

Brett Hundley: Hey guys. This is actually Brett Hundley. I hope you're all doing well.

Michael Mendes: Hope you are too.

Brett Hundley: Thank you. My first question - just looking at your culinary segment here and it did very well. It was very strong relative to our estimate and year-over-year and I was wondering if, Michael, you wouldn't mind putting a little color to that for me.

Michael Mendes: I think that there are some macro trends that are favorable for us right now in that culinary segment. As people are looking for more in-home meal preparation, our culinary line is very well positioned to capitalize on that trend. Also, we have a very well developed brand and very strong merchandising which we've been working on improving. And I think that those are some of the trends that have helped support the business. But we are pleased with our performance in the quarter there.

Brett Hundley: Okay. And then as far as the walnut harvest coming in rather large, what do you anticipate for pricing at the retail level? Do you see that maybe coming down along with the walnut crop?

Michael Mendes: As far as the walnut crop, the harvest is just winding up now. The actual state [of California] final numbers get reported in January. So at that time we'd have knowledge of the full crop size.

So it's a little preliminary to make that estimate now since in January we'll also have better knowledge of other tree nut crops that compete in the macroeconomic environment with walnuts. That being said, I think that generally with tree nuts we're seeing probably in the back half of the year some price reductions reflecting the overall larger supply.

I would say that the nature of the culinary and snack nut business, culinary in particular, is that the biggest demand and the biggest sales take place in the fall. Most of that product needs to be positioned in the supply chain in July and August in order to service that business. So you wouldn't see any impact of any commodity price adjustments probably until the second half of our fiscal year.

Brett Hundley: Okay. That's helpful. And then my last question here - just two parts if you wouldn't mind. The first part is that watching Pop Secret, as well as your new products initially, is it too early to tell kind of what these items will do to your long-term sales growth goals as far as moving that range?

And then secondly are you guys still comfortable with your accretion guidance for Pop Secret? Thank you.

Michael Mendes: I'll take the second part first. As far as our comfort on our single-digit accretion guidance, we're very early into the integration. But I would say that there is nothing that has happened to this date that we feel has materially affected our thinking from when we gave that guidance.

But we are going to be converting the - taking full control and completing the integration in February of next year. So there are a lot of components that we need to take on ourselves and General Mills is still in a transition services agreement for us.

So again, I think it's a bit early to state with great confidence where we're going to end up with integration. But at this point in time we're very pleased with the work we've done to date. As far as the overall range, it's a bit early.

We've been very focused on the integration. We do know that if we want to grow in the microwave popcorn category we're going to need to bring innovation in terms of product and packaging. And so the first thing we did was start to invest in new product research and also investing money on consumer research to have a better understanding of consumers' needs and desires.

So we're still in the learning phase and we feel optimistic that we can bring some things to the category there. But it's, again, pretty early in the game for us to speak with a lot of detail at this point in time. But we'll try to give more color on that in our future calls.

Operator: We'll take our next question from Diane Geissler with Merrill Lynch.

Diane Geissler: Good afternoon.

Michael Mendes: Hi Diane.

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Steve Neil: Good afternoon.

Diane Geissler: Just wanted to ask - you obviously exceeded your target that you had set in late September for the quarter, but reiterating the guidance for the full year. If you could just help me understand is there something in particular you're looking at that says, okay we should remain cautious?

Is it just you've only owned Pop Secret for six weeks? Or I guess - when did you get it? Mid-September so it would be longer than that. But is it just that you haven't owned Pop Secret long enough or you're concerned about trade down in the retail channel that would keep you from moving your target range up at this time?

Michael Mendes: I think when you look at the first quarter, Diane, and some of the comments we made earlier, one thing that we did benefit from was having a higher proportion of our sales be represented by our retail sales because in part the walnut crop was later and also Thanksgiving was a bit later this year.

So, as a result, our ingredient and international sales in the quarter were lower than we would have projected because the crop was lower. So the profitability of the quarter was higher, and ingredient and international sales will shift to the last three quarters of the year.

So that's one part of it. The second component of it is that obviously there's a lot of volatility around input costs and as well as consumers' pricing orientation and the channels which will excel. And I think in context of that our guidance captures the puts and the takes that we see at this point being one quarter into the fiscal year.

And when you look at that we're guiding 32 percent to 40 percent earnings growth for the year, which is quite strong versus a lot of food companies in the United States, we think that it's prudent to hold pat here being less than a third of a way through the fiscal year.

Diane Geissler: Okay. Well, you know Wall Street. It's never enough, right? Anyway, can we just talk a little bit about the consumer? This is obviously something we've heard with a lot of the companies that have reported in this cycle about trade down.

Obviously snack nuts are a little more discretionary then some other items that you can find in the grocery store. What have you heard from retailers and what have you experienced at the shelf?

It sounds like you're continuing to get pretty good distribution of new products, whether it's the mass or club or even within grocery but can you talk about that a little bit, what you've seen this fall? And then I guess - why don't you talk about that and then I'll ask a follow up?

Michael Mendes: Broadly, in the last three years where we saw commodity price acceleration in tree nuts, one way that we addressed this with our retail partners is we shifted more of our promotional spending towards smaller pack size items, recipe-ready, single serve items and we did not promote as intensely in the large frame items.

Moving forward what we are seeing now and what we are projecting forward is to pass on a little more value in those large size packs. Some of that will flow just into by pack size. Some of that will flow more into the channels as well that carry those large sizes.

So I think that that's where you'll see a more of a value being passed through to consumers as well as perhaps a little more of an increase in the frequency and the depth of our promotions.

Diane Geissler: Okay. And then I guess just the comment on the expectation that we might see some deflation in pricing at retail because of lower commodity prices in the back half of the year.

I mean that deflation is a little scary. It actually sounds good for you because one of the impediments for your product has always been the high price point. Do you see that as, if you can maintain your margin and pass that on to the end consumer wouldn't you expect that there would be incremental volume off that relationship? In other words it's an event you actually welcome because tree nut prices have just been so high.

Michael Mendes: That's the very discussion we had yesterday, myself and some of the leadership team. And I think that the thing we've noticed is that there are definite price points particularly in promotions where you can get multiple items at a certain price point that really trigger significant volume increases.

And I do think that we may be moving into a period that we may be able to achieve that and provide a better value for consumers versus other choice that they have. And so I definitely think that's part of the opportunity. And what we need to do is try to be very strategic and clever to make sure that we identify and understand those price points and those value opportunities and we try to work with our retail partners to provide those opportunities to the consumers versus just sort of bluntly spreading weakening pricing over a bunch of weeks of the year.

So I think that it does provide an opportunity for us and I think that we will see some volume increase in particular as a result of that.

Diane Geissler: Okay. And just maybe to clarify your comment from before because based on our read of the IRI data, we haven't seen that shift out of snack nuts.

Maybe the volume is down a little bit but pricing is up significantly because of this factor on the raw input costs but the dollar sales seems to have been holding steady. Is that your experience?

Michael Mendes: Yeah.

Diane Geissler: The category itself seems to be holding in there and then of course you are either - I think the last period you showed us a slight decline. But for the last 13 four-week periods, the majority of them you've shown you've outpaced the category. Is that your experience?

Michael Mendes: Yes. And I think the thing that we're encouraged about is the non-scan channels, which are more of the value channels.

We're actually seeing stronger performance then in grocery. So if grocery represents maybe a third of all snack nut consumption goes at grocery channel, I think in the value channels you're actually seeing an even stronger velocity because of their positioning in type of environment.

So I would say that the health benefit trends of health nuts and also the convenience is a very good environmental benefit of these products relative to what consumers have to choose from and I think that we do very much benefit from the fact that in the last few years, more and more consumers really are understanding of the healthful benefits of the dietary fats you can get from nut products and as a good source of protein.

And so we're able to play in a much larger threshold of product choices then we might have historically. So we definitely like the product range that we're in and we feel good about this ability to hold a good mindshare and product share with the consumer.

Diane Geissler: Okay. All right. Well, thank you for your comments.

Michael Mendes: Thanks Diane.

Operator: The next question comes from Mark Argento with Craig-Hallum Capital.

Mark Argento: Hi. Good afternoon. I know with the dollar strengthening here over the last few months in particular could you talk a little bit about how you seen that impact your business in terms of buying trends?

Michael Mendes: I'm going to answer that a little more broadly and then I'm going to have Gary talk about this on the back end.

As far as our sourcing, a major portion of our raw material sourcing is from parts of the United States.

On the go-to-market side we do have an international business, which we have been strategically rationalizing over the last few years in that we felt there was an opportunity to reduce our business risk by moving away from customers in some of our international markets who really were quite price-sensitive on the commodity front. That's boded quite well for us in this current environment and so we're pleased with that. Let me have Gary talk a little more about the input costs and the impact of the currency.

Gary Ford: Yes. We are definitely looking at some positive things from our input costs going forward in pretty much all commodities.

From an international sales standpoint we were a little soft early because of the late crop. We're now starting to see that pick up and from a price standpoint if we were record prices, record high prices last year, some of that has and with kind of the normalizing for lack of a better word of

some of the products we sell internationally, that's kind of had an offset to the strengthening dollar.

Mark Argento: That was helpful. I'll switch gears here quickly. In terms of overall unit growth on the culinary side, what kind of unit growth are you experiencing?

I know you're experiencing 20 percent plus top line growth there but what kind of unit growth are you experiencing there?

Michael Mendes: We don't generally disclose that for competitive purposes but obviously with the price per ounce on a number of these tree crops being higher, there's been a bit of a trade-off on the volume.

I would say on the net it's been a favorable transaction but I do think that as we promote these products a bit more aggressively this coming year we will see a drive upwards in volume and that coupled with greater availability.

I think one of the issues has been we've had a limited supply of tree nuts, of certain tree nuts at the back half of each year in the last three years. And I think that lack of availability did impact some, pursuing some sales opportunities. The nice thing about a more abundant supply environment I think is going to allow us to just get after opportunities that we were somewhat supply constrained to pursue. And so I think that we do have a significant opportunity to increase volume this coming year.

Mark Argento: What are you seeing from retailers? I mean we've talked to some retailers and some other food companies and clearly retailers are really pushing the manufacturers to bring down price or to get more aggressive on promotion - you know, get the turns up on the shelves. Are you seeing that same type of behavior within the grocery aisle business?

Michael Mendes: Our mindset with our retailers is really a partnership orientation and our approach has been to hand and glove work with them to determine how we can bring greater value to the consumers.

So we feel very aligned with the desire to try to bring value to the consumers particularly in this economic environment to work with our retail partners. We've been quite aggressive in trying to find ways to drive volume for us and them with the way we've been preparing our promotional program for this coming year.

On the consumer support side it's another way we support our retail partners that support our brand is to stimulate the consumers to buy the product. We are significantly increasing our advertising this year as compared to last year not only on Diamond and Emerald but also on Pop Secret compared to what was spent to get that brand in the last two or three years.

So I think when you look at the whole host of input investments we are turning up the volume in a way that brings more value for the consumers but also stimulates interest which generally is very closely aligned with our retail partners. So our thought process is their challenge is valid and that as good partners we need to work with them together to try to bring that consumer value because we will all get rewarded with greater sales velocity in the future.

Mark Argento: That's helpful. And then this last question - I know the legacy being that of a co-op you have the relationship with the growers on the walnut side and you're obligated to take the product.

Can you explain a little bit just from a high level how you actually price the product in terms of what you're paying the growers relative to how that works itself through your P&L, meaning if you

take all the product up front you get to sell it through and then go back and then set the price? Can you just walk through how that works at a high level?

Michael Mendes: Yes. We have got a fantastic relationship with our walnut grower partners and there's a lot of ways that we provide them value. The price for the raw materials is one part of it.

One thing about many of our large walnut growers is that our ability to provide them outstanding service at the time of harvest is critical in their ability to provide an optimal quality product.

And if they can provide optimal quality product they can significantly impact their return per pound. And that's been a big part of our focus here in the early fall. Generally we have some visibility on our retail value of walnuts and some things we're doing in the fall early on.

But the back half of the year is very difficult to predict at this time of year. And some of the things that we have to factor in are the contracts that we may book for the year and if there's any risk of those contracts being executed. I think that one of the issues in a large supply year is there may be some risk of compliance with some of the customers in the more commodity-based part of the business.

Fortunately we've reduced our reliance on that. That's still volatility. And then there's an estimated value of the raw material. We tend to try to set this price in March. We'll need to project forward what that value is going to be of that unsold product.

So how much product we have sold at that time we're setting the price makes it easier; if there's less of that product is sold at that time that makes that job a little bit more difficult. So there's science and there's a bit of art to it and the key is from our vantage point is to maximize value - our ability to maximize value, optimize our ability to increase that total return.

And so we do feel that we're doing some things to optimize value that maybe our competitors can't. And one big part of that is cost efficiency and cost management. And the final thing is that with a little larger supply we can perhaps have some more efficiency in our overhead utilization and so we're working through a lot of those components. And so there's a lot to it and that's some of the broad strokes.

Steven Neil: And I would say Mark, just from a pure GAAP cost perspective we have to estimate what that cost is here in the first two quarters when we finalize it in the third quarter.

So we do our best estimate to project out to the year and obviously when you get into March it becomes solidified.

Mark Argento: If we're seeing a larger crop, one would assume that means pricing comes down a little bit. Is that how you go about estimating what your cost of goods are in the first two quarters?

Michael Mendes: You know, that could be one component but if that's what you had used in the previous three years you would have been wrong.

Mark Argento: I guess maybe a different question for you guys is your estimate flat, up or down that you've been using over the last couple of quarters or in your estimates as you say in Q1 and your reporting?

Steven Neil: Again we have to take a look at the whole macro environment so you can't really draw a conclusion Mark.

A couple of years ago was a record crop and the costs went up so it's pretty dynamic. You can't focus on just one thing and we need to put all the components together in all the markets. So I think Michael was probably right, it's a little bit more of an art perhaps then a science.

But usually we end up being reasonably close so you don't see huge swings as we affirm the estimates up. So I don't know if we can get any more specific than that.

Mark Argento: No I guess I'm just trying to understand the dynamic given the fact that you bring all your crop in and then you have to parse it out, you don't really know what the price is. I guess I'm just trying to understand where, if prices are actually coming down on the input side, has that already been reflected in your Q1 numbers? That's really the genesis of my question.

Michael Mendes: I would say that the margin gap will hold but the actual top line component could have some variability on that.

Mark Argento: Good. I appreciate it. Thanks guys.

Michael Mendes: Thanks, Mark.

Operator: We'll take our next question from Ken Zaslow with BMO Capital Markets.

Kenneth Zaslow: Hey everybody.

Michael Mendes: Hi Ken.

Kenneth Zaslow: Just one point of clarification - did you say to Diane's question that you have less sales therefore you have higher profit? Is that why in the first quarter and therefore you're going to have more sales in the back half of the year, therefore you're going to have lower profits?

Michael Mendes: That the international ingredient sales that there were less in the first quarter correct, and there'll be therefore more shifted into the back three quarters and that the margin on that business is lower than our retail business, that's correct.

Kenneth Zaslow: But the actual dollars that you bring in - because maybe I'm just misunderstanding. The question was because you had a better quarter in the first quarter but your guidance for the back three quarters is kind of a little bit lower.

Your full year is the same so but you had a better quarter because you had lower sales and higher profits but going back you're going to have less sales and higher profits?

Steven Neil: No. Let me say it a bit differently Ken. In the first quarter our retail sales as a percentage of total sales were higher because the later walnut crop meaning less in-shell and less ingredient were in the first quarter than we would have estimated.

However retail sales were up in the quarter. 77 percent of the sales in this quarter were retail sales. If you look last year it was - retail was only 70 percent. So higher margin retail sales were greater in the first quarter and then contrary in the balance of the year the ingredient and in-shell sales will be greater then what we had previously predicted. Does that make sense now?

Kenneth Zaslow: I'll ask you offline because I don't think you bring margins down to the EPS line. You bring dollars. I'll ask you offline. I'm not fully understanding that.

Steven Neil: Dollars, that's correct. But the margin could be different on the two channels, two different mixes of business.

Kenneth Zaslow: I understand that. I totally agree with that. It just seems to me that your dollars are still going to be less then what you would have expected and it doesn't matter about the margin.

But I'll take it offline. The next question I had was if I look at your sales growth for the snack nuts, you said I think it was up 20 percent plus? How did that break out between pricing and volume? And particularly on the volume side, did you get more distribution? What was the benefit of the volume on those snack nut sales?

Michael Mendes: We did build out distribution on our core items. That's one thing we've talked about on previous calls that we're trying to build that distribution of core Emerald items and we had a nice increase in terms of our facings and us mapping versus the prior year quarter.

We had more distribution in those higher moving, higher velocity areas and then we also had the benefit of new distribution of items like Cocoa Roast Almonds and Sea Salt & Pepper in grocery as well as some new distribution of Breakfast on the Go in the mass merchant channel. I think those were some of the elements that were driving that.

Kenneth Zaslow: Great. So the volume and pricing was relatively balanced?

Michael Mendes: I would say a little more price then volume perhaps but relatively balanced.

Kenneth Zaslow: But still getting volume growth.

Michael Mendes: Yes. I would say that maybe the mix Ken, just to kind of get your mind around it, is that tree nuts was up as part of the mix so really it was more possible a mix issue.

As part of our movement went away we have less volume against some of our less strategic peanut SKUs and we had more dollar volume against more strategic tree nut SKUs at our core items. And that's why the price is higher. It's not that just price increased or anything like that.

Kenneth Zaslow: Okay. If you take us through the utilization rates from last year to this year to how you see it, can you tell us how that's going to progress?

I think you have enough capacity to build out I believe like 50 percent of it. Is there some sort of progression to which you'll be building out your capacity, if you could update us on that?

Michael Mendes: I'm going to have Gary talk about it. I think in the script Gary did mention about a capital project that we have planned for our Indianapolis facility, which is going to reduce costs and increase capacity.

As far as our base snack operation in Stockton, we still do have capacity there particularly for the club segment for the large frame items since we put the new PET line in. But let me have Gary talk a little about the broader capacity.

Gary Ford: Yeah. Ken, as we're in a high growth mode here we would definitely want to not be constrained with capacity. So we're going to invest a little bit in front of that and part of that is we're going to do it not just in invest in capacity but we're also, it's an investment in cost reductions.

As we mentioned in the Fishers, Indiana plant we're going to be installing a state of the art oven with packaging capabilities and we'll be doing that over the next several quarters and that's not just going to add capacity as we look forward as to what we're going to need but its also going to reduce our costs drastically, particularly from a miles-driven standpoint of both commodities coming in as we get peanuts and pecans and from the southeast, southwest, the US, running to California then running it back to the east coast is quite expensive.

So in addition to adding needed capacity that's going to create a significant cost reduction for us as well. So we're already in the engineering design stages of that project and we're not going to

put an exact date as to when we're going to complete it yet because we're still in the design stages but we'll have it online before we need the capacity

Kenneth Zaslow: Okay. So are you starting to fill up the capacity that you - are you almost up to the point where you're going to need to get that extra capacity?

Michael Mendes: I think the question will be what's our product mix this coming year? I think as we grow into the more premium tree nut items as we have up to this date the volume, the pound volume is lower.

But we are a bit underdeveloped in the peanut subset of the snack nut category. If we can make gains in that segment that would be more in line with our overall market share in tree nuts, that would go through capacity quite quickly.

And so we do have a vision for that and I think we are comfortably ahead of ourselves but we're trying to be prudent.

Kenneth Zaslow: My last question. The macroeconomic environment and all that's going on, that doesn't change how you look at the future in terms of getting to your long-term numbers. I'm assuming that's a softball question that just is a simple yes, right?

Michael Mendes: You know, Ken and ultimately I think that we need to be a student of this environment and ask ourselves how can a company like ourselves position ourselves to be successful two and three years out?

We are very committed to that long-term sustainable profit growth and that means that in a year like this, we're going to be evaluating all sorts of ways that this weakened economic environment

can give us a chance to maybe create value in our assets that can be generated into earnings in future years and we will execute against that and that's reflected in our guidance.

Kenneth Zaslow: I'm talking about beyond this year.

Michael Mendes: I'm just saying that this year and I think more of a question for you should be, what are you doing this year to get the returns next year?

Well you'd better be investing this year and we are investing and we are not going to compromise that earnings-generating engine by shorting our investments against our brands or our new distribution and our new products.

And we are significantly increasing for example our investment in new product development right now. And those are the things we're going to need to do, versus me just saying yeah; we're going to hit the number. I think a better answer is and here's what we're doing now in order to be a better company next year and two years from now. And we're very committed to that.

Kenneth Zaslow: Okay. So there is no reason to believe that your long-term outlook should change?

Michael Mendes: No.

Kenneth Zaslow: Okay. Great. Thank you.

Michael Mendes: Okay. Thanks Ken.

Operator: Next to Sarah Lester with Sidoti & Company.

Sarah Lester: Good afternoon.

Michael Mendes: Hi Sarah.

Sarah Lester: I have a question about SG&A expense. I guess some of those are costs from the Pop Secret acquisition. Will any of that go away once the integration is complete? And if so, is there any way you can quantify how much?

Steven Neil: Yes and no. You are right; most of the cost increases is associated with Pop Secret and let me give you a little bit more color on that.

We did staff-up ahead of the acquisition so that we would be in a position to start the integration from day one. So there's a little bit of a spending ahead of what you would say the revenue was for the quarter.

Once we get into the business we have the normal sales expense, broker expense, etc. so that's why you're seeing the dollars going up a bit. There is some cost that will go away. We have a transition services agreement as we've mentioned with General Mills so we are building our infrastructure i.e. spending the SG&A today as well as incurring some transition services expenses with General Mills.

As we convert in our third fiscal quarter the transition expenses with General Mills goes away and we just have our infrastructure. It's not a gigantic number by any means but certainly is, there's multiple spending today that would be reduced a little bit as we get into the end of the third fiscal quarter.

Michael Mendes: There are some elements Sarah such as brokerage, where for the Pop Secret business most of the business resides in grocery, which is a full brokerage environment.

And our average Diamond Foods business on average has a lower brokerage percentage then on average the Pop Secret business will have going forward. So that would be an example of where as a percentage of sales SG&A would be higher.

Take R&D - I would say that our R&D spend as a percentage of sales given the size of the Pop Secret business will be higher then proportionately our base business. But then hopefully we'll pick up some efficiencies go forward. I think that that's very important this year that we integrate this business in a very effective manner.

Our feeling is that a long integration costs more than a short integration and you don't get any better output so we will be working hard to do it right the first time. And again, in total we reflect that in our guidance but you will see that higher SG&A as a percentage reflect some of those elements.

Sarah Lester: Okay. And then I'm not sure - I might have missed this. Did you break out how much of sales from Pop Secret this quarter?

Steven Neil: No we didn't. Pop Secret, because of the cross-promotional activities, is basically joined by the hip with Emerald. So we're just going to report the snack performance.

We did indicate that the overall Emerald products were up over 20 percent in the quarter so you can kind of back into it but just because it gets so muddied as we cross promote it just doesn't make good sense to do that. So we're not going to break it out.

Michael Mendes: And we did and will continue to share lead indicators such as market share, which will hopefully be helpful.

Steven Neil: Right.

Sarah Lester: Okay. That's all. Thank you.

Steven Neil: Thanks Sarah.

Operator: That is all the time we have for questions today. At this time I'd like to turn things back to Mr. Michael Mendes for any additional or closing comments.

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