

## **Q1 FISCAL YEAR 2009** **EARNINGS CONFERENCE CALL**

December 3, 2008, 1:30 PM PT

Chairperson: Bob Philipps, VP Treasury & Investor  
Relations

### **Bob Philipps:**

Thank you, operator, and good afternoon everyone. Welcome to the Diamond Foods investor conference call and webcast to review the financial results of our fiscal 2009 first quarter which ended October 31.

Before we get started, let's cover a few housekeeping items.

- First, a printed copy of our prepared remarks will be available on our website [diamondfoods.com](http://diamondfoods.com) under the section titled "Investor Relations" followed by "Earnings Releases" within 1 hour after the call's conclusion.
- Second, we've arranged for a taped replay of this call to be available via telephone beginning about three hours after the call's conclusion through midnight Eastern

Time on December 8, 2008. The dial-in number to access the replay is 1-888-203-1112 from the U.S./Canada or 719-457-0820 elsewhere, and the conference ID is 5429-012.

In addition, this call is being webcast live, and a replay will be available on the website.

- Third, we want to remind you that during the course of today's call we will make forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995, including projections of our results. Since actual results may differ materially from these projections, we encourage you to learn more about the risks and uncertainties that affect our business by reviewing our SEC filings under the heading "Risk Factors."

Note that our forward-looking statements are based on factors that are subject to change, and therefore these statements speak only as of the date they are given. We do not undertake to update forward-looking statements.

Now I'd like to turn the call over to Michael Mendes, President and Chief Executive Officer of Diamond Foods.

## **Michael Mendes:**

Thanks Bob. Good afternoon everyone, and thank you for joining us.

On our call today will be Gary Ford, our Chief Operating Officer, and Steve Neil, our Chief Financial and Administrative Officer.

Diamond was founded in 1912 and has endured a number of difficult economic cycles over this period. During the last decade, we have more than tripled the size of our company, and have prospered by staying focused on two underlying principles:

- Delivering compelling quality, service and value to consumers and our trade partners;
- And, maintaining a disciplined focus on executing against our strategy, while demonstrating an exceptional ability to adapt to a rapidly changing environment.

By investing in our brands and continuing to increase our value proposition to our customers, we will strengthen the foundation of our business in order to deliver sustainable

earnings growth. Based on our strong start to fiscal 2009, we are confident we can achieve this goal despite facing a difficult economic environment.

Let me take a few moments to address some of the highlights of the quarter.

North American retail sales, the focus of our growth efforts, increased 23 percent for the quarter over last year and represented 77 percent of our sales mix. As the walnut harvest was delayed by a week, in-shell and ingredient sales were lower than projected, further increasing the shift towards higher margin retail sales.

In addition, our cost efficiency initiatives and the continued leveraging of our infrastructure resulted in a significant increase in margins. Our gross margin was 21 percent for the quarter, and our operating margin was 11 percent. Non-GAAP EPS grew 29 percent to \$0.67 per share.

But the numbers only tell part of the story:

- Our strategy to broaden the distribution of core Emerald items in grocery is progressing, and translating into meaningful velocity gains. This

bodes well for the brand's ability to grow profitably in the future and drive category expansion.

- We acquired Pop Secret from General Mills on September 15. Consistent with our intent to re-energize the microwave popcorn category, we launched a series of Pop Secret television commercials only 40 days following the acquisition. We have already aired over 400 television ads nationally during October and November alone.
- We continue to be committed to supporting our brands with marketing, product and packaging innovation. Coupled with our unparalleled quality, service, and supply chain management, we are making significant strides in bolstering our position as a trusted supplier to our trade partners. This can be illustrated, in part, by the performance of the Diamond brand, which grew sales three times faster than the category, securing a 100 basis point share gain over the last 12 week period.
- Finally, it is worth noting that much of the capital raised during our 2005 IPO was initially allocated to projects that added capacity to support the growth of our retail snack business. Beginning last year, we've started to shift a larger portion of our capital

investment towards efficiency projects designed to lower our unit costs in the future.

At this time, I would like to turn the call over to Gary, who will provide some additional insight on the operating highlights for the quarter.

**Gary Ford:**

Thanks, Michael.

Our path to sustainable earnings growth has three key elements:

- Growing our value added branded segment to improve the product mix and continue to rationalize low margin business;
- Maintaining a disciplined focus on the channels in which we compete in order to leverage our existing infrastructure;
- And, investing in capital projects that improve the cost efficiency of our business.

Let me start with a review of our snack business.

Our snack portfolio grew 96 percent during the quarter, which reflected the mid quarter acquisition of Pop Secret and over 20 percent growth from Emerald.

- In grocery, Emerald's ACV distribution improved 200 basis points to 88 percent, and we continue to gain market share as additional shelf space is allocated to core items.

In the mass merchandise channel, Breakfast on the Go has been expanded from two SKUs to three, and all three will be in nearly 3,000 stores early in the calendar year.

In the club channel, Cocoa Roast Almonds is now a regular item in about 150 stores, and will be in an additional 350 stores starting in February. Two of our newest items, Gourmet Snack Mix and one hundred calorie pack Cocoa Roast Almonds, have begun shipping this month to a regional club store customer. This is the first time Emerald has made inroads with this customer, and our one hundred calorie pack snack nuts, in particular, target a segment of the category that is currently underserved. Finally, Sea Salt & Pepper Cashews and the

Gourmet Snack Mix are being tested in a number of other club stores around the country.

- Pop Secret is off to a good start for the 45 days we owned the brand this quarter. Grocery sales for October grew 7 percent and market share held steady at 24 percent.

Note that we are in the very early stages of Pop Secret's integration into our snack business, so there is a lot of work to be done. A key part of our integration plan was to take over sales and marketing responsibility day one, while relying on General Mills for transitional services in other areas including order-to-cash and supply chain services. By working closely with customers to better understand their Pop Secret business and replenishment needs, we believe this will facilitate a smoother transition of supply chain responsibilities when we complete the cutover in our third fiscal quarter.

- Now, let's move to culinary nuts. Our reputation for delivering service and quality is a key selling point for retailers looking to manage risk and assure reliability. As a result, culinary sales grew 23% and outpaced the category, with walnut sales growing by more than 14% vs. last year in grocery.



Now, let me switch gears and talk about what we're doing to improve operating efficiency.

In last year's first quarter we outsourced some of our rigid form club packaging as we began to develop the business. Later in the year we brought this capability in-house, and we're now seeing the full benefit in lower unit costs this year as our club sales continue to grow.

Looking ahead, we are working on a number of similar efficiency projects that will lower unit costs, while we continue to leverage fixed costs as sales scale up.

- When our Stockton, CA plant was constructed in the late 1950's it was designed to handle nut varieties which are no longer popular today. In fact, the three most popular varieties of walnuts today weren't even in existence back then. We are initiating a material handling project that will optimize the processing of these new varieties. This multi-year project will result in higher yields and throughput (both of which drive down unit costs) as well as produce better quality.
- In our Fishers, IN plant we are preparing to invest in new roasting and packaging equipment to support our

snack business and reduce transit times (and costs) to the east coast.

- Finally, we are continuing to reduce fixed costs by rationalizing some of our remote handling facilities.

Now, I'll turn it over to Steve.

**Steve Neil:**

Thanks, Gary and good afternoon everyone. Please note that both the press release and 10-Q were filed today.

Let me start with a few comments about the quarter.

- The 21 percent gross margin in the quarter reflects our continuing product mix shift to higher margin retail sales, as well as the actions we took last year to tightly manage our production costs to help cover higher input costs. Since the walnut crop and the timing of Thanksgiving were a bit later this year than last, sales of lower margin in-shell and ingredient business will shift into the balance of the year, reducing overall margins a bit.

- SG&A expense was 8.1 percent of sales compared to 8.2 percent for full-year fiscal 2008, and last year's Q1 of 6.2 percent. This quarter's number includes the amortization of intangibles and incremental staffing and expenses associated with the Pop Secret acquisition.
- The advertising expense increase in the quarter reflects the first flight of Pop Secret advertising and continuing investment in the Diamond and Emerald brands.
- Interest expense was \$1.5 million due primarily to borrowings supporting the purchase of Pop Secret. At October 31 our debt outstanding was \$206 million with a weighted average interest rate just over 5 percent.
- There were two non-recurring items recorded in Other Income & Expense that had about a 3 cents per share adverse impact on EPS.
  - As part of the Pop Secret acquisition, we paid off our senior long-term notes and incurred a \$2.6 million prepayment penalty which represented the present value of all future interest expense that would have been paid on the notes if we had held them to maturity.
  - Partially offsetting this was a \$1.7 million gain on the sale of emission reduction credits that were primarily

earned as a result of the closure of our cogeneration power facility in 2005.

- We booked an effective tax rate of 37.5% in the quarter. We continue to expect a full year effective tax rate of between 37 and 38 percent, as discrete items per GAAP can only be recorded in the quarter they are realized.
- As a result of our favorable sales mix and aggressive production cost control, profits beat the high end of our guidance. EPS for the quarter of \$0.64, or \$0.67 on a non-GAAP basis, compared to \$0.52 last year.
- And finally, we paid a four and one-half cent per share dividend on October 29.

Now, let me shift gears and review our financial expectations for full-year fiscal 2009, which are consistent with what we communicated last quarter.

- We expect full-year non-GAAP EPS to range from \$1.20 to \$1.27. GAAP EPS would be impacted by 3 cents in net non-recurring charges from the debt prepayment penalty and the sale of ERC credits previously mentioned.

- We expect net sales to be between \$585 million and \$615 million, driven by North American retail sales growth of between 27% and 31%. Included in this growth is an assumption that snack sales will be between \$175 million and \$185 million.
- Gross margins for the year should improve 150 to 200 basis points as a result of efficiency initiatives that we are driving in the manufacturing and supply chain areas, the rightsizing of our low margin business, and, of course, the addition of Pop Secret.
- Advertising expenses will range from \$26 million to \$29 million, reflecting the investments we plan to make in Pop Secret as well as continued heavy support of the Emerald and Diamond brands, and cross promotional activities.
- Interest expenses, which of course are influenced by the finance markets, are likely to run between \$9 million and \$10 million, reflecting higher levels of debt incurred from financing Pop Secret.
- CAPEX will be between \$10 million and \$13 million in fiscal 2009 as we invest in information technology improvements, equipment associated with manufacturing efficiency, new products and capacity.

For the second quarter of fiscal 2009, we expect the top line to be between \$140 million and \$155 million compared to last year's \$133.8 million. EPS looks to be between \$0.24 and \$0.29 compared to \$0.17 in last year's quarter. This means that 1<sup>st</sup>-half Fiscal 2009 EPS growth should be fairly close to what we expect for the full fiscal year.

At this time, we'd like to open the call for questions.

**[Q&A]**

**Michael Mendes:**

Thank you, operator.

Before we conclude our call today, we wanted to remind you of a few upcoming events.

On the investor relations front, we are attending the Merrill Lynch Small Cap Conference in Boston on December 10<sup>th</sup>, and we have an analyst day scheduled for January 27 at the NASDAQ market site in New York.

This month, we are sponsoring the Emerald Bowl on Saturday, December 27 in San Francisco. The College Bowl game will feature teams from the ACC and Pac 10 Conferences and will be aired nationally on ESPN. We will also sponsor the Emerald Midnight Run on Dec 31 in New York City. We invite you to join us in Central Park for this annual event to ring in the New Year as a part of our healthy lifestyle run series.

For more information about upcoming investor and promotional events, please encourage you to visit the Diamond Foods website.

Thank you for joining us, and this will conclude our call.