

## **Q2 FISCAL YEAR 2009** **EARNINGS CONFERENCE CALL**

March 11, 2009, 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 second quarter which ended January 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 March 16, 2009. The toll-free dial-in number

to access the replay is 1-888-203-1112; otherwise, use 719-457-0820. The conference ID is 9395-904.

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, our President and Chief Executive Officer.

## **Michael Mendes:**

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

On our call today will be Steve Neil, our Chief Financial and Administrative Officer, and Andrew Burke, our Senior Vice President of Marketing. Gary Ford, our Chief Operating Officer will join us for the Q&A session.

During the last few quarters, the deteriorating global economy has resulted in many companies reporting constricting margins and a pessimistic view as to when conditions may improve. Diamond Foods has not only weathered these conditions, but has prospered. Our focused business model and ability to rapidly adapt to change have enabled us to post year-over-year EPS growth for 6 quarters in a row.

This quarter was another example of our ability to deliver strong financial results.

- North American retail sales grew 27%, led by the performance of Emerald and Pop Secret. These trends are continuing as we begin the 3<sup>rd</sup> quarter, as Emerald set a new market share record of 8% in February.

- For the fifth quarter in a row, gross margins grew over the prior year as our mix of retail sales improved to nearly 90%. In fact, our gross margins increased even though we spent significantly more on promotions in order to deliver greater value to consumers.
- In the 2<sup>nd</sup> quarter, we earned \$0.37 per share, 118% above the EPS of \$0.17 for the same period last year. Earnings were \$0.03 above the top end of our guidance range, which we had just raised by \$0.05 at our analyst meeting in late January.

During the current economic environment, we are increasing our investment in our brands as we look to sustain and expand our market share. Andrew will now provide some more detail on our efforts to enhance brand value in order to stimulate sales and distribution growth.

## **Andrew Burke:**

Thanks Michael.

As Michael highlighted, our retail brands are well positioned to grow.

- Diamond culinary nuts are benefiting from consumer trends to prepare more meals at home, and the brand resonates strongly with retailers and consumers, especially in today's economy.
- Emerald offers consumers nutritious, innovative snacks that are a convenient source of dietary protein.
- Pop Secret has also benefited from recent consumer trends favoring in-home entertainment, and the category has begun to grow as the two national brands have stepped up investment.

We have worked hard improving the distribution of our core Emerald items in grocery over the last year. While Emerald's brand-level distribution has remained steady at just under 90%, its higher velocity items have gained shelf space and are driving sales growth. For example, Emerald's almond sales have increased 32% over the last 12 weeks in U.S. grocery, while our whole cashew

business is up 49%. This resulted in Emerald driving double-digit growth while the category declined.

In the mass merchandiser channel, Emerald's 100-calorie pack items began shipping nationally in December and continue to perform well. We anticipate an expansion of additional items by the end of this summer. In club, Cocoa Roast Almonds started selling in 150 stores last quarter and will be expanding to 550 nationwide this spring.

In December, we began shipping two new Emerald Dry Roasted Peanut items to select retailers in the northeast. Initial sales are encouraging, and we will continue to expand the rollout to new markets in a disciplined manner so we can properly support this program. This is an important initiative for us since these items target a segment of the market, peanuts, which represents about 30% of the dollars and 50% of the volume in the snack nut category. We believe our product quality and 16-ounce clear P.E.T. package offer an attractive value for both the retailer and consumer.

We remain committed to investing in our brands. It is important to demonstrate the unique value and role our brands can play in consumer's everyday lives.

- This spring Diamond culinary nuts will run a recipe contest asking consumers to submit their favorite recipes. The grand prize is a trip to Napa's Culinary Institute of America, and the winner gets his or her recipe printed on millions of bags of culinary walnuts. This is our first spring promotion in years, and comes on top of new distribution resulting from being named the category manager at one of the top three grocery chains in the U.S.
- This month we launched print and out-of-home creative in support of our Emerald Cocoa Roast Almonds. Our proprietary dry roast process delivers a rich satisfying flavor without adding any calories. Consumer and customer response to this item has been strong and we look forward to the results of this added investment.
- On the retail activation front (where we bring our brands to life in-store), we will be partnering with both Miller and Corona to develop in-market programs around NASCAR and the Cinco-de-Mayo holiday. These are two great brands, which we can align Emerald with to provide meaningful snack solutions that our retail partners are seeking.
- In April, we will debut our next generation Emerald "natural energy" creative campaign. It is a series of

three television commercials that will run during the NCAA March Madness final four and championship games. The campaign is called “flashback” and depicts the bad things that can happen when you don’t eat Emerald nuts at 3pm.

- Finally, we continue to develop our positioning and our creative idea for Pop Secret. We have been conducting category research with popcorn consumers and are finalizing our creative concepts. We expect to have a national campaign ready by summer.

Now, I’ll turn it over to Steve.

**Steve Neil:**

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

- Overall, net revenues grew 13%, with retail sales up 27% and non-retail sales down 36%. This reflects commodity price deflation and our continuing strategy to reduce the mix of low margin SKUs.
- Gross margin was 22.6% for the quarter, an improvement of 580 basis points over last year. Gross margin benefited from the inclusion of Pop Secret in



this year's results, continuing strength of our retail nut business, lower input cost and manufacturing efficiencies. At retail, declining input costs are largely being offset by higher promotional spending designed to spur greater unit velocity and consumer value.

- SG&A expense totaled \$15.9 million, about level with the amount spent in the first quarter. This puts us at \$31.7 million halfway through the fiscal year.

There are two primary factors that should cause spending to run at a lower level during the next two quarters:

- The first is that the transition services agreement we had with General Mills ended in February, one month ahead of schedule. We are now fully responsible for all aspects of the Pop Secret business, including supply chain, ordering, invoicing and collections.
  - The second is that broker commissions are a variable expense tied to net sales, and typically decline in the second half of the year due to the seasonality of our business.
- Year-to-date advertising expense of \$12.1 million is slightly ahead of where we were through two quarters

last year. Full-year advertising guidance remains \$26 million to \$29 million (compared to \$20.5 million spent last year), and we expect to see more spending in the 2<sup>nd</sup>-half.

- As a result, operating margins grew 450 basis points to 7.9 percent in the quarter.
- Interest expense was \$2.2 million, benefiting both from attractive rates and lower borrowings. We finished the quarter with \$135 million in debt; \$71 million lower than at the end of Q1. The resulting leverage ratio of 1.9 was a dramatic improvement from the 3.2 ratio we posted in Q1. It also means we'll benefit from a lower credit spread on our borrowings during the 3<sup>rd</sup> fiscal quarter. Our cash flows, like our sales, are subject to seasonality, and our focus remains on optimizing our leverage position.

As a result of our favorable sales mix and cost efficiencies, EPS was \$0.37, beating the high end of our guidance by \$0.03. Included in the quarter was a small discrete tax expense item which benefited EPS by about a penny.

Finally, while many companies have reduced or eliminated their dividend, we have sustained our four

and one-half cent per share dividend which was paid on January 29.

Today, we are raising fiscal year 2009 non-GAAP EPS by \$0.02 per share to a range of \$1.27 to \$1.34. This represents between 40 and 47 percent growth over last year's \$0.91. GAAP EPS will be \$0.03 lower due to net non-recurring charges recorded in our first quarter.

On the CAPEX front, we had initially guided to between \$10 million and \$13 million anticipating capital needs at Pop Secret which are not required this fiscal year. This will lower our CAPEX to \$6 million to \$8 million, which is more typical of our past spending. One project we have initiated this year, however, is to install an integrated roasting and packaging line in our Fishers, Indiana plant to support our new peanut items and drive further supply chain efficiencies.

For the third quarter of fiscal 2009, we expect EPS of between \$0.11 and \$0.14 compared to \$0.07 in last year's quarter.

Now I'll turn it back to Michael.

**Michael Mendes:**

Based on the strong performance of our business, we have raised full-year earnings guidance twice so far this year: \$0.05 in January and \$0.02 today. Diamond's earnings growth has been fueled by our retail expansion, greater scale in our snack business, input cost normalization and efficiency projects which have helped streamline our operational cost structure.

- We have adjusted our full year sales guidance to \$535 to \$565 million primarily due to a sales reduction in our bulk walnut business where we generally don't realize a significant brand premium. This is one of the reasons we have been downsizing this business since the IPO.
- This fall, California produced a record walnut crop, and the carry-out inventory will exceed the largest in history. In light of this environment, we have determined we can best maximize the crop value by shifting a portion of our sales from the 4<sup>th</sup> quarter to the 1<sup>st</sup> quarter of next year (as has been our historical practice).
- We expect that our retail sales will grow 18 to 22% for the year. The modest reduction in our growth rate reflects increased promotional spending, enabling us to

pass on a portion of the favorable input costs to consumers in order to sustain and expand market share.

In closing, let me address our longer term outlook.

Normally, we provide earnings guidance at the beginning of our fiscal year. However, we recognize that we are in an unprecedented period of economic volatility, and that for many of you, it is more difficult than ever to assess investment prospects over the next 12-18 months.

Accordingly, today we will share our current outlook for fiscal 2010 earnings, and provide more specifics during our 4<sup>th</sup> quarter earnings call.

Through fiscal 2008, we experienced a 2-3 year period of margin compression as input costs rose to historical highs, and more rapidly than we could pass these cost increases on at retail. Now that markets are normalizing, we are confident that we can sustain an appropriate brand premium while delivering even greater value to our customers.

We can further leverage our cost structure as we maintain a disciplined focus on the growth of our product portfolio. We believe that with the current economy, interest rates should remain low. This, when coupled with our ability to generate cash, will help us reduce interest expense as we rapidly pay down our debt.

As a result, we currently project fiscal 2010 earnings in the range of \$1.55 to \$1.70 per share, approximately 25% above our current fiscal 2009 guidance.

One final comment. In early 2006, we established 5-year financial targets that implied a dramatic transformation in the profitability of our business. These targets included improving gross margins from 10% to 20% by 2011, and improving operating margins from 3% to 10%. Due to the progress we've made in building our retail franchise, we are now on track to exceed our gross margin target this fiscal year (which is 2 years earlier than planned), and to approach our operating margin target next year (which would be one year earlier than planned).

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 that we will be sponsoring the “Emerald Across the Bay 12K” in San Francisco on March 15th. The run across the Golden Gate Bridge was recognized by Runners World as the best bridge run in the United States. We welcome you to join us for this event, and you can find additional information by visiting our website.

Thank you for joining us. This will conclude our call.

# # #