

DIAMOND FOODS, INC.
Fiscal 2007 Fourth Quarter and Full-Year Earnings Release Conference Call Q&A
September 20, 2007
3:30 pm CT

Operator: Your first question comes from the line of Heather Jones.

Heather Jones: Good evening. Congratulations on the quarter.

Michael Mendes: Hello, Heather. Thank you.

Heather Jones: I had a few questions, was one on the walnut harvest. Just wondering, was there were growing issues or weather, etc. – or why is it projected to be down 8%?

Michael Mendes: So it was a bit surprising. I think most people, given the historical production trends with walnuts, had expected this crop to be much larger. But early in the growing year we could see that the set was staggered; the nut set had started developing at different times during the year versus one consistent time period and also that there just weren't as many nuts in the set.

So most people have attributed to there was not enough winter chilling hours where the temperature trees need to go into a dormant period. Now while it was cold, the combination of cold with humidity tends to influence the trees. And some people project that might what'd been that impacted it.

The one thing that we would note though is that the bearing acres do continue to increase. And yield per acre on the new varieties is much larger than the average production of the current trees bearing. And so long term we do feel very confident that the supply will be there to support the markets but this year it will be a bit short. At least that's what the current objective estimate reads.

Heather Jones: Okay. Thank you. As far as your sales projections for snack going into '08, have you all secured any permanent placements or I should say incremental permanent placement at Costco or with Wal-Mart?

Gary Ford: As I mentioned in the call, Heather – this is Gary Ford – we did have a major feature program with Costco's Passport program in July. That was our Emerald smoked almonds. Since then some regions have elected to keep the item in permanent distribution.

And others have indicated they're going to use it on an in-and-out basis. And we also have some permanent distribution on FruitNola and Spicy Southwest Mix in some of the regions.

Heather Jones: In some of Costco's regions?

Gary Ford: Yes.

Heather Jones: And what about Walmart? Not Sam's Club, but the Walmart stores?

Gary Ford: Well as you're aware, we have had four canister items in Walmart. We just recently gained another hundred stores. So we're now at 750 stores. We're very pleased with product movement. Our items are moving and growing faster than the category there, so we remain confident that we'll continue to increase our distribution and number of stores within that important chain.

Seth Halio: Yes, Heather, I would add the other thing we gained in Walmart was checkout or front end, some product at the front end of Walmart. And that was towards the very end of '07. So I think it's two items, and I don't have the exact number of stores on hand.

Michael Mendes: One final thing is that we do have a small footprint in distribution with our produce snack offering. That's now under the Emerald Harmony lifestyle

brand in a limited number of distribution channels. We just converted that product line over to this new brand positioning and we added some new products that we think are very interesting. We're hoping that if that performs well that that's another opportunity for us also going forward.

Heather Jones: Okay. And as far as your long term sales growth projections for that segment – 40% to 50% in '08 and going to \$200 to \$250 million by 2011 – those numbers would imply a significant slowdown at some point. And I was just wondering is that just being conservative towards the very tail end of that period? Or do you expect a slowdown beginning in fiscal '09?

Michael Mendes: I think it does reflect the balance between growth and our earnings expansion. We also have some significant earnings improvements that we're projecting for those future periods. And so I think that there may be some conservatism. But I think it's also recognizing that some channels may not be as profitable as some of our other channels. But we feel that it's very obtainable.

Heather Jones: Okay. And then my final question to you is – well it's a two part question. What is the pre-tax non-cash option expense for '08?

Seth Halio: Pre-tax? About \$6.8 million or so would be the midpoint of the range. The range is after-tax of \$25 to \$27 million – I think that's about \$6.8 million at the midpoint.

Heather Jones: And when you're projecting EBITDA growth of, I think you said 30% through 2011 on average, is there some point where that is EBITDA by your definition so pre-stock option expense?

Seth Halio: Correct. So the expense is added back to arrive at the EBITDA.

Heather Jones: Okay. All right. Thank you very much.

Michael Mendes: Thank you.

Operator: Your next question comes from the line of Kenneth Zaslow.

Kenneth Zaslow: Good afternoon everyone.

Michael Mendes: Hello, Ken.

Kenneth Zaslow: A couple quick questions. In terms of your assumptions for the snack nut resets, what are you looking for or is there some sort of built-in expectation for what you're going to get in the reset? Or would you consider the reset to be incremental to your outlook?

Michael Mendes: Help me with what he said. I'm sorry, Ken.

Kenneth Zaslow: No. You usually get like in the February, March, April period a lot of the stores...don't they usually reset and you get new distribution there?

Michael Mendes: You know, the resets really are chain by chain in terms of when they do it. So there may be some more in the spring but they do it in different times of the year depending on the chain. So I think it's something we'd see throughout the year.

Kenneth Zaslow: So there wouldn't be anything that would be unusual in the spring at all that would kind of bump up the number or that you already have included in your numbers?

Michael Mendes: Well I would say that the spring would be, more of the retailers than less are doing resets in spring, particularly some of the mass merchandiser customers. So given that we achieved some of our distribution expansion objectives, it would be surprising if it actually happened during that period.

Kenneth Zaslow: So can you give us a little bit more clarity of what you would expect during this reset system, reset timing? Is there another step up in your sales growth in – I guess during that period? I guess that's what you're saying? Just trying to figure that out.

Seth Halio: Ken, as you know in the past we haven't given quarterly guidance.

Kenneth Zaslow: But...

Seth Halio: And we have started to dip our toe into that this – for the first time now when we gave Q1. But I think our snack sales are going to be lumpy and fluctuate quarter to quarter – it's a new and growing product line. And it's hard for us to give you specific numbers as we sit here today.

Kenneth Zaslow: Okay.

Seth Halio: On what's going to happen in six or eight months.

Kenneth Zaslow: In terms of just quarterly, given that the snack business seems to be projected pretty strongly, would that be able to – historically you have had some quarters where you've had losses in the EPS. Would that be able to be overcome? So would there be any quarter that you would still have losses? Or is it typical distribution similar to what we've seen in the history? Or are you not going to have any losses?

Seth Halio: Well I think when you look at the guidance we gave for Q1 versus the whole year – versus the last since we've gone public – it's probably proportionately a little lower versus the whole year than the prior years. So I think that would infer that the earnings stream – while still pretty heavy in the first six months – it has leveled out more than it has in the past.

Kenneth Zaslow: All right. And then the last question I have is, in terms of promotional activity throughout the year, I think it was the quarter before last that you had a culinary walnut promotion. And then after that you had a, this quarter you had the summer. I was wondering do we have any other promotions going throughout the year? And how is that going to work throughout the year? So we could just hopefully gauge the lumpiness of it.

Andrew Burke: Hi, Ken, it's Andrew. As you know from my comments we talked about retail activation. And so we are looking to more level-out our spend throughout the year for promotion. And I think you'll see us driving business throughout the year.

And as you can see from our IRI results where seven out of the last nine months were growing over 30%, we are starting to see that. And I think that'll continue as we get to be a bigger business. And things will kind of start taking on more of an even plane.

Kenneth Zaslow: Great. I appreciate it.

Seth Halio: Thanks, Ken.

Michael Mendes: Thanks, Ken.

Operator: Your next question comes from the line of Chris Routhe.

Chris Routhe: Hi. Good afternoon.

Seth Halio: Hello, Chris.

Chris Routhe: I have a few questions for you. First of all, the 4% growth in culinary during the quarter was a bit better than our expectations. And so I'm just trying to get a handle on as we look into fiscal '08, should we expect the majority of

the growth, the volume growth in culinary to continue to be heavily concentrated in club? Or maybe over time throughout the year to be spread out more evenly across channels?

Michael Mendes: Let me take the first half of that and maybe Gary might add some color. We did talk about the fact that because of some commodity pricing issues – the latest walnuts that we did advance in pricing during the back-half of the year.

So I think you will see in traditional retail some growth that'll be more price related than normal. Generally most of our growth is volume but we'll see a little growth related to price on food. I think that you will still see us continue to gain business in the club and mass merch channel relative to the opportunity. Those are very big channels.

And I think the one thing about the club channel is they continue to be very successful and being a venue for food service customers. And I think we've been a good partner for that front. So we're pursuing those opportunities. I don't know if Gary has any color to add on that.

Gary Ford: Yes, I agree with that. I think we'll probably see a little more growth in the mass merch and club channels. But we're pretty optimistic that our recent price increases that we've taken in culinary are sticking, and we're confident that we'll get that leverage at traditional grocery as well.

Michael Mendes: One final thing is that this year we will be in the Bake Center in Wal-Mart with our Diamond brand of product. We didn't have that last year. And so that'll generate some incremental sales growth that we didn't have last year.

Chris Routhe: Okay. That makes sense. And then in terms of the investment savings, it looks like you have some investment savings this year from lower slotting fees in snack as that sort of ramp up slows down.

I was just wondering if you identified maybe a top priority from your perspective or a list of priorities, a list of targets? Has that investment savings – it's maybe shifted into other areas of the business? Have you tried to balance your growth so far?

Seth Halio: Well I guess when you say investments, you're referring to promotional activities or advertising or...

Chris Routhe: Well I'm speaking in terms of specifically the slotting fees for snack. Those are going to be lower in '08 versus '07. Isn't that true?

Seth Halio: Well we haven't historically given out our actual slotting. What I can tell you is, for sure, they're a lower percent of the snack sales. And we're definitely getting some benefit of leveraging.

Some of how the slotting will play out during the year as the year progresses will depend on new product introductions and the timing of when retailers put specific products on the shelves. We did make a lot of distribution gains in 2007 with the new trail mix and peanut products. But not all the retailers had it on the shelf by the end of the year so some of it did carry into 2008.

Chris Routhe: Okay.

Seth Halio: But we are going to get the leveraging benefit. And all of our expectations are built into our guidance.

Chris Routhe: Okay. Okay. That makes sense. Well I just have one final question. I'm just wondering what the reception has been like for the new bold products and bold flavored products. I think you introduced them early in the fourth quarter. And as you sit today, do you have sort of an indication on what the reception has been since they've been on the shelf for nearly a full quarter?

Andrew Burke: Yes, Chris. It's Andrew. The reception has been very good. It's starting to ramp up now. And as we start looking down at the customer level we're seeing good trends and hearing very positive reaction from retailers. We're very hopeful as we kind of move forward and that thing starts to rollout and scale up.

Chris Routh: Okay. Very good. Thank you.

Seth Halio: Operator?

Operator: Your next question comes from the line of Alton Stump.

Management: Hi, Alton.

Alton Stump: Hi. Thank you. Good afternoon.

Alton Stump: Just have two quick questions, so first off, on the snack business, could you talk a bit more about your summer promotions with Coke this year – what you took away from that and sort of looking forward, if you think there might be some major alignments like that going forward?

Andrew Burke: Yes, Alton. The Coke promotion has gone very well. We've basically over the summer put up around 4,000 displays. And as you know from our IRI results, our Emerald brand is up 37% over the last 12 weeks especially in the food class.

For us Coke is kind of an evolution that started with Anheuser-Busch. We started the Bud Bowl promotion with them around the Super Bowl. And then that led to us going out and getting the Coke promotion.

And then as I mentioned in my remarks, we're also teaming up on culinary with a couple of brands to kind of really push recipes around the holiday

period. So for us that's the whole charge of retail activation which is continuing to partner, create these snack solutions in store and really give the retailer as well as the consumer something to get excited about.

Michael Mendes: We've been measuring how the brand performs when we give it an opportunity to get promotional activity beyond just sitting on the shelf. And one of the metrics that we look at is when we have an off-shelf display, a feature ad and a small price reduction, what kind of lift do we get?

With the Diamond brand when we run those three components, we'll see a 300% lift which is very good. With the Emerald brand we see an over 800% lift which can just show you how well this brand can do when consumers can see the product is visible and we work with our retail partners to promote the product.

So tying in with other meal occasions that are relevant to our product or the snack we think is just very additive and something we're going to continue to work on.

Alton Stump: Okay. Thank you. And then just one other question, obviously one of your key platforms has been to target younger consumers with your products and with the graphics and the flavors. Are you seeing much competition at this point within that category? Or are you essentially dominating? I know you mentioned something earlier about that, but just want to get some more details there.

Andrew Burke: We are not seeing much competition within the snack nut category. Again, we look at ourselves as being part of a \$30 billion snack category which encompasses things like chips and popcorn and those type of things. They have always traditionally done well against that younger end consumer – 25 to 40 year old consumer.

And we have had success there in snack nuts. And we're going to continue to kind of push and continue to run promotions so that we can kind of really drive against that demographic. The other thing that we know from our research is that – or we conducted research with a company called NPD – and we know that we index more than 61 times the leading national brand against that 25 to 35 year old target. And customers and retailers are very excited about that because we're bringing new people into the snack nut category.

Alton Stump: Okay. Great. Thanks guys.

Management: Thank you.

Operator: Your next question comes from the line Robert Simmons.

Seth Halio: Hi.

Robert Simmons: Hey guys. I was wondering about your advertising plans for next year. You'd said \$20 to \$22 million, right?

Seth Halio: \$20 to \$22 million – that's correct.

Robert Simmons: And are you planning on running the Super Bowl ad? Have you made any kind of decision on that?

Seth Halio: On the Super Bowl ad?

Robert Simmons: Yes.

Seth Halio: You broke up there a little bit.

Andrew Burke: We are not going to run a Super Bowl ad this year. As you know, we've had great success with the Super Bowl in past years. The fact that the Emerald brand is only three years old and it already has an 84% brand awareness.

We really utilized the Super Bowl to be that broad vehicle to kind of get the word out about Emerald Nuts as a brand. This year we used the Super Bowl as a way to get out the word about our natural energy campaign and kicking that off.

And now we feel like, as we move forward and scale up as a snack business that we want to extend our promotions throughout the year. We will still do big promotions around the Super Bowl. We will team up again with Anheuser-Busch. We will have great retail promotions and really drive our business during the Super Bowl. But we're just not going to run a Super Bowl ad.

Robert Simmons: Okay. Got you. Thanks.

Seth Halio: Thank you.

Operator: As a reminder if you would like to ask a question, press star 1 on your telephone keypad.

Your next question comes from the line of Diane Geissler.

Seth Halio: Hi, Diane.

Diane Geissler: Hi. Good afternoon. Congrats on your quarter.

Michael Mendes: Thanks.

Diane Geissler: Just a question for you on the – you gave us the gross margin per pound. And I backed in to sort of the total tonnage number of around 212. Is that packed pounds for full 2007? Is that about right?

Seth Halio: You said 2007, right?

Diane Geissler: Yes.

Seth Halio: Yes. That's about right.

Diane Geissler: Okay. So what suggests to me...

Seth Halio: Diane, that's for all product lines.

Diane Geissler: Sure.

Seth Halio: Right, including snack and so forth.

Diane Geissler: Okay. And that suggests to me about a 16% volume increase in the fourth quarter. Does that seem right?

Seth Halio: Year over year?

Diane Geissler: Yes.

Seth Halio: I don't have that right with me. Let me look at it and get back to you on that.

Diane Geissler: Sure. And I guess just kind of coming out at it from the tonnage perspective again – obviously you indicated the crop – the walnut crop expected to be down and some of your cost going up there. Can you give us a range for kind of what your total per pound price in fiscal 2007 was on walnuts? I think it

before you provided it in some of your investor presentations like 75 cents to 85 cents a pound. Does that sound about right?

Michael Mendes: We don't really talk about our commodity prices for competitive reasons. But I can talk to you generally about directionally of the tree nut suite if that helps you.

Diane Geissler: That would be very helpful.

Michael Mendes: Again, I think when you look at last year, almonds ... when you look at the underpinnings of the economic drivers, it's helpful because you can apply it going forward.

Last year we had total tree nut production between almonds, walnuts and pecans in North America and the U.S. of about 2 billion pounds. This year, based on the estimates that I gave earlier in the call, those three tree nuts would have a total of approximately about 2.3 billion pounds.

Last year a very favorable exchange rate situation in Europe made higher priced tree nuts from the U.S. still a very good value. So it was a very good situation last year that even production was quite strong -- they weren't short crops by and large -- that prices were quite strong in all the tree nuts.

This coming year, with both the pecan crop and the almond crop being quite a bit stronger, I think that the total tree nut cost between the three tree nuts will probably some relief compared to last year. It's just a little too early to really say because one thing that affects the pecan crop, for example -- the pecan crop gets harvested in the back end of October -- is weather and the hurricane season has not ended. And so a hurricane can come through and dramatically reduce the size of that crop. But I would say, with what we know now, I think it'll be in the direction which I stated earlier.

Diane Geissler: All right. And then I guess the other question I had was you've given guidance here for your snack sales sort of a little higher than what I was thinking and really kind of an indication I think you gave on your last earnings call.

And I guess is it some of the successes that you've had this summer have given you more confidence that you'll be able to post that kind of revenue growth? Is there one thing in particular or maybe a couple things in particular that have given you that confidence?

Michael Mendes: I think that ... probably I'd take it on two fronts. One is I think that we are really gaining credibility with our retail customers sort of have our, say, our first level of penetration. And I think that they're learning that we can be a very valuable partner in helping them grow the snack nut category.

But more importantly we're seeing some very good velocity in our measured channels and our data share from IRI continues to show some very good directional movement. We just actually got – IRI just reported this morning, and again, we see that for the last 12-week period, our market share is now up to 5.2%, which is 130 basis points versus the same period last year.

So I think the quality of our distribution, the velocity of our core items, the progress we're making in channels we're trying to penetrate, I think that they're all boding very well for us. And also we're very excited about some of the new product initiatives we have. We've got a lot of ways in which we can be successful – a lot of very, we think, exciting items that consumers will find appealing – that can help enable us to achieve our growth objectives.

Diane Geissler: Okay. And I guess then on kind of one area that we haven't really touched on – the ingredient side. I know that you've had a lot of planned sort of volume reductions that you kind of right sized that business focusing on margins and overall returns.

When do you see kind of, when would you see that stabilizing... where you get the business rate like it should be? Would that be in fiscal '08? Or is there still some sort of streamlining that you'll do kind of in the out first?

Michael Mendes: I think you'll still see some streamlining. But what you will probably see replacing some of that reduction slowly over time is a growth in food service and our value added snack products. In particular we've got a very unique facility in Fishers, Indiana that has the capability to do some things for our food service customers that we can do profitably. Maybe not as profitable as our retail business but it's a nice part of business.

It allows us to more effectively leverage that asset and service that business. And also we have some of our traditional ingredient customers who are looking for products that require more value added processing or who are customers that are willing to pay a premium value for a Diamond brand who really value the quality and the security and the business stability of our business.

And we will be looking to protect that. I think that what you will find are customers who are very price sensitive – to the point that they would trade off quality – that we will continue to rationalize away from that type of customer set. So I think that our customer base will somewhat self-select on that exercise.

So we like the business we have now. What I would say, every customer is a good customer, but they can elect whether they want to have more of a long-term orientation in terms of a business process.

If they're strictly looking to buy on price and compromise quality, that's not going to be a right kind of partner for us long-term. So I think that a lot of

that you have to decide. I would expect this coming year that we will right size that business a bit more.

Diane Geissler: Do you envision – is it just it's going from one channel into another? Or do you envision a period where you're actually handling less tonnage as you rationalize away from the ingredient?

Michael Mendes: I think that's still hard to say at this stage of the game. I think that, like I said, that I think the food service channel, we've grown business and I – the customers would not prefer, would prefer that I wouldn't disclose what we're doing with them.

But we've done some things with a few ingredient customers that are profitable for us, that uses our core walnut items and that is very profitable for them because they don't need to do things in their facility that otherwise they might have to use a much less reputable business partner to provide those ingredients.

I think that our performance is going to dictate the direction of that. And so I would say it's still, we're still proving out how well we're going to grow that part of the business. But we will not pursue that business if it's not profitable.

Diane Geissler: Okay. And then I guess just a final question on the first quarter. The details you've given us – first of all, thank you for giving us some idea about kind of how this thing's going to flow. But I guess my question is really – you're giving us the EPS range below last year. I know there was a seasonal timing shift there. Is that all we should read in to the...

Seth Halio: Well I think part of it – Diane, this is Seth. I think part of it is, as we said, our advertising is going to be up about \$1 million year on year which is about 4 cents...

Diane Geissler: Right.

Seth Halio: ...in EPS there. And then some of it is mix. And because we're coming out of '07 with very low inventory...

Diane Geissler: Right.

Seth Halio: ...particularly our non-retail business is going to be impacted as some of our contracts from last year will be using crop from the new harvest which will be at a higher cost than last year. So it kind of impacts the shift between quarters.

And they're also going to – there also will be some channel mix which may lower our margin as well. But I would say as we get into Q2 proportionally we should be closer to '07.

Diane Geissler: Okay. And the advertising at \$20 to \$22 million – is that just a reflection of you're not going to do the Super Bowl anymore? And it's going to be more advertising and promo demonstration which doesn't fall into advertising?

Michael Mendes: Yes. That's pretty consistent with the level we were at last year. And I think we had shared that we were going to – that was what our thoughts were at one of the earlier calls. The one good bit of news I think you don't really see in the numbers is our customers that have a high-low model they generally have a promotional program that we work with them on.

And so a customer who does have high-low model, they might – we'll see something like 20% of the sales price in promotional dollars. So as we're looking to increase our snack business pretty significantly – 50% plus this coming year – that would result in those customers and us, working with those customers to spend quite a significant increase in our promotional support.

So I feel that with the increased promotional support – the fact that we'll be running our advertising campaign – and when you exclude that Super Bowl commercial – the media and some of the activity around that and spread those dollars against media buying throughout the year, I think we're going to have a program that's going to really help us build the depth and the breadth of the brand.

So we feel it's a very good campaign. And we're excited about it.

Diane Geissler: Yes. I know. I completely support the no Super Bowl ad.

Michael Mendes: Well I have one thing I will say, Diane, is I think you have to have the right view of every moment in the life of a brand. And I think...

Diane Geissler: I totally agree. I think it was great for your launch and sort of what it did for you in getting your name in front of everybody. But a more approach – where you spread your ad dollars more evenly through the year – I think makes sense for where you are.

Michael Mendes: I agree.

Diane Geissler: That's all I had. Thank you very much.

Michael Mendes: Thank you, Diane.

Operator: At this time, we have reached our allotted time for questions. I would now like to turn the call back over to Michael Mendes for the conclusion of the call.

Michael Mendes: Thank you, Operator. Thanks everyone for joining us. I appreciate your time today. We will be attending a CAGNY lunch in New York on October 3, so we hope to see some of you at that meeting. Thank you.

Operator: This concludes the Diamond Foods Fourth Quarter and Full Fiscal Year 2007 Earnings conference call. You may now disconnect.

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