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Q4 and Full FISCAL YEAR 2009 EARNINGS CONFERENCE CALL

September 30, 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 fourth quarter and full-year which ended July 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 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 two hours after the call's conclusion until 7:00 p.m. Eastern Time on October 5, 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 206-4149.

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 we welcome your participation in our call today.

Before we begin, I would like to introduce Steve Neil, our Chief Financial and Administrative Officer, who will join me as we review our prepared remarks. Andrew Burke, our Senior Vice President of Marketing, will join us for the Q&A session.

In the face of a very challenging economic environment, Diamond reported record sales and earnings, while continuing to make significant investments in our future. As we begin the call today, let me share some of the highlights for the year:

- We completed the purchase of Pop Secret from General Mills and quickly integrated the brand into our supply chain, giving us a much larger footprint in the snack aisle.

- We continued to improve the distribution and shelf position of both Diamond culinary nuts and our snack products in traditional grocery. In the second half of the year we gained significant new distribution in the mass merchandise and club channels for Emerald and Pop Secret.

- Full-year sales exceeded $570 million. Retail sales, where we have focused much of our effort over the last few years, grew 26% and now make up over 80% of our business. In fact, it is worth noting that during fiscal 2009, while we added $95 million in retail sales growth, we also elected to eliminate $55 million in lower-margin non-retail sales. We will continue to monitor and right-size our non-retail business as we deem appropriate in the future.

- Full-year EPS grew from 91 cents last year, to a record $1.47 per share this year, an increase of 62%. Our earnings growth reflects a higher proportion of retail sales in our mix, incremental margins as we increase the scale of our snack portfolio, and production efficiencies coupled with normalizing input costs.

- We also made significant progress in improving the strength of our balance sheet. In order to finance the Pop Secret acquisition, we assumed roughly $200 million in debt last fall. The capability of our business to generate strong cash flow coupled with tight working capital management, enabled us to pay down over $100 million of this debt within nine months.

- Finally, we accomplished all of this while substantially increasing the investment in our brands. We doubled our spending on research and development, and increased advertising by 40% as we integrated Pop Secret and supported our expanded snack portfolio with a national television campaign. Late in the year, we began construction of an integrated roasting and packaging line at our Fishers, Indiana plant. This project will help enhance the quality and cost efficiency of our products and enable Emerald’s expansion into new segments within the snack nut category.

Now I’ll have Steve cover some of the highlights from the quarter.

Steve Neil:

Thanks Michael and good afternoon everyone. Please note that our earnings press release and 10-K were both filed today.

The fourth quarter, which concluded in July, was another very good quarter for Diamond Foods.

- Retail sales grew 17% as we more than doubled our snack sales;

- Operating margins improved 450 basis points to 7.5%;

- We supported our brands with a 125% increase in advertising, and a significant increase in promotional activity;

- And we earned 25 cents per share, 56% more than we earned during the same period last year.

The strong retail sales growth we achieved in the fourth quarter came despite a 27% decline in Diamond culinary nut sales as we elected to pass on more favorable input costs to our retail partners and consumers, and we rationalized some non-strategic SKUs.

Our snack brands had an exceptional quarter. Sales were nearly $55 million, reflecting how we have continued to successfully execute across a wide range of objectives, including:

- Converting existing shelf space of Emerald SKUs from lower velocity items, to core, higher velocity items;

- Continuing to roll out innovative new products;

- And supporting our brands with effective advertising and promotions that excite our retail partners and attract new consumers to the category.

For the year, snack sales grew over 100% reflecting the acquisition of Pop Secret and strong growth from Emerald new product introductions, distribution gains and more effective merchandising. Culinary sales grew 1% for the year, retaining market share, but unfavorably impacted by price deflation and our decision to rationalize non-strategic SKUs in the value channel.

Gross margin expansion in the fourth quarter and for the year was a result of a more profitable mix of retail sales (including Pop Secret in this year’s results), continuing strength of our retail nut business, more normalized input costs and manufacturing efficiencies.

- At retail, declining input costs are largely being offset by higher promotional spending to spur greater unit velocity and deliver better consumer value.

- The manufacturing efficiencies in Q4 were due primarily to higher recovery from our shelling operations. Normally the crop is not completely shelled until after the fiscal year, essentially following the normal demand cycle. However, we were successful in marketing our remaining uncommitted inventory which allowed us to shell the crop out early and reduce our secondary processing.

SG&A expense as a percentage of sales for the year was 10.7% compared to 8.2% last year. The increase reflects the impact from the Pop Secret acquisition and costs associated with supporting our growing retail business. We anticipate the percentage will decline in fiscal 2010 since we will not incur Pop Secret transition costs, and in 2009 we adjusted our trademark intangibles which caused current year expense to be higher than what we anticipate going forward.

Q4 advertising expense was $7.7 million, up $4.3 million from last year. This primarily reflects activity in support of our snack product lines. For the year we invested $8.3 million more than last year, which is consistent with the high end of the guidance we communicated earlier in the fiscal year.

As a result, operating margin grew 450 basis points to 7.5% during the quarter, and finished the year at 8.0%, up 350 basis points.

Interest expense continued to track in the same range as during Q3, so that we finished with $6.3 million for the year, at the low end of our initial guidance. This reflected lower borrowing rates, and our ability to use free cash flow to pay down debt. Our year-end leverage ratio was less than 1.8x, so we will continue to benefit from a low 150 basis point credit spread over LIBOR during Q1 of fiscal 2010.

Our effective tax rate was 38.6% (GAAP) for the year, which reflected some discrete tax expense items recorded in the quarter. We anticipate the effective tax rate in fiscal 2010 to be similar to the 2009 rate.

As a result of our favorable sales mix and cost efficiencies, EPS was $0.25 in the quarter, compared to $0.16 in the fourth quarter last year, and as Michael noted, full-year EPS was $1.47, up 62% over last year.

On July 24 we paid a four and one-half cent per share dividend, for a total payment of $0.18 per share for the year.

Briefly looking at cash flow, we generated $45.4 million in free cash flow in 2009, reflecting $53.4 million in cash flow from operations and $8 million in CAPEX. In 2010 we anticipate CAPEX will be $8-10 million.

Given our strong finish in 2009 and the scale benefits we expect as snacks grow to $220-230 million, we are increasing fiscal year 2010 EPS guidance to a range of $1.70 to $1.80 per share, from the previous range of $1.55 to $1.70. This represents growth of between 16 and 22 percent above fiscal 2009's $1.47.

Finally, I want to address two other topics.

- Today we filed a $250 million universal shelf registration statement on Form S-3 with the S.E.C. While we have no specific plans or needs to offer securities under the shelf registration at this point, the filing gives us the ability to move quickly to access capital if necessary. By filing now with our recurring annual filings, we condense certain accounting and legal services and save the Company some money.

- Second, I wanted to comment on our performance against the long-term financial targets that we first established in fiscal 2006.

Back then, we said that we expected to achieve the following by fiscal 2011:

- Top line growth of 8% to 10% per year;
- Snack sales growth of 40% per year;
- Gross margin of 20% and operating margin of 10%;
- And EPS growth of more than 15% per year.

Through fiscal 2009, we have significantly outpaced our snack and EPS growth targets, we are already realizing greater than 20% gross margins, and our compounded annual top line growth rate is only slightly below our target. So roughly midway through this initial long-term period we are certainly meeting our target expectations.

We thought it appropriate to update these targets now given our performance against them and since we've had about a year of experience in the microwave popcorn category from which to better understand the opportunities we have with Pop Secret.

I am going to turn the call over to Michael to cover our new long term targets.

Michael Mendes:

As we look to establish the credibility and confidence that is only achieved by consistently delivering strong, stable financial performance, Diamond has done so while continuing to make substantial investments in our future. Our strategy is to:

- Drive profitable, sustainable growth as we leverage our premium brand portfolio;
- Focus on categories where we can achieve scale at the retail shelf and deliver exceptional value to retailers and consumers, alike, and;
- Introduce innovative new products and packaging, while stimulating consumer interest with effective marketing that will provide the foundation for dynamic organic growth.

As we look to the future, we believe we can deliver significant growth, which when effectively leveraging our resources, can help produce exceptional earnings and cash flow. Over the next five years, we believe this business is capable of generating $1 billion in total sales, snack sales of over $500 million and earnings of $3.50 per share. In order to meet these targets, we will seek to drive strong organic growth while exploring acquisition opportunities that can enable or accelerate our ability to deliver and sustain long-term shareholder value.

At this time we will conclude our formal comments and open the call for questions.

[Q&A]

Bob Philipps:

Thank you, operator.

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

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