

## **Q4 and FULL FISCAL YEAR 2010 EARNINGS CONFERENCE CALL**

October 5, 2010, 1:30 PM PT

### **Bob Philipps:**

Thank you, operator, and good afternoon everyone. Welcome to the Diamond Foods investor conference call and webcast to review our fiscal 2010 fourth quarter and full year financial results for the period 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](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

two hours after the call's conclusion until 4:30 p.m. Pacific Time on October 12, 2010. The toll-free dial-in number to access the replay is (888) 203-1112; otherwise, use (719) 457-0820. The pass code is 377-4568.

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.

- Fourth, since we incurred deal-related costs this year associated with the Kettle Foods acquisition and integration, we will focus our prepared remarks on non-GAAP results. A reconciliation to GAAP can be found in the press release.

Finally, since this call is the first one in which we'll discuss fiscal 2011 at length, we'll cover many of the assumptions that support our financial guidance, along with giving you a deeper understanding of our key priorities for the year.

Now I'd like to turn the call over to Michael Mendes, our Chairman, President and Chief Executive Officer.

**Michael Mendes:**

Thanks Bob. Good afternoon everyone.

Joining me on the call today will be Steve Neil, our Chief Financial and Administrative Officer, and

Linda Segre, our Senior Vice President of Corporate Strategy.

Today, we are pleased to report that we had a very strong finish to our fiscal year. For the fourth quarter, sales were up 55% and earnings up 79% as compared to the same period last year. For the full year, Diamond total sales increased 19% and earnings were up 52%.

Organic growth in our snack portfolio and the acquisition of Kettle contributed to the largest portion of our growth. The Kettle transaction was immediately accretive to earnings despite the increased share count and higher debt load. As a result, fully diluted EPS grew 36% for the quarter and 32% for the full year.

For the 4<sup>th</sup> quarter, retail sales comprised 95% of total net sales, the highest in the company's history. The shift in our sales mix reflects the strength of our retail brands, and the decision to sell a higher portion of non retail inventory earlier in the year. We also succeeded in reducing our tax burden to 28% (as

compared to the 35% we had projected at the end of the third quarter) which contributed \$0.03 in EPS for the quarter.

Looking ahead, we are confident in our plan for fiscal 2011. We are projecting net sales of \$910 million to \$940 million and snack sales of \$540 million to \$560 million. We are raising full-year EPS guidance to a range of \$2.38 to \$2.48 per share, an increase of 25% to 30% versus last year.

All of our brands are gaining share in their respective categories, with Emerald and Kettle each posting strong year-over-year sales growth and all time record market shares. We achieved significant new distribution gains at mass, drug and grocery for all of our brands, which should begin to add to gross sales in the first half of fiscal 2011. We plan to support this new distribution with a strong promotional program to drive product trial, and we will incur slotting expenses, which are net of sales and are recognized as a current period expense. While these programs will impact earnings in the first half of the year, our strategy is to support new distribution with the appropriate level of investment

in order to achieve a sustainable growth trajectory over the long run.

We are extremely pleased with the seamless integration of the Kettle business, and how our new combined entity is positioned to grow and serve the market in the future. Linda will now review our progress with Kettle, as well as touch on several key new product initiatives for our snack and culinary portfolio scheduled for 2011.

**Linda Segre:**

Thank you, Michael.

As we noted on our Q3 conference call, we integrated the Diamond and Kettle sales and marketing organizations in the U.S. as part of the first phase of our integration. We are now beginning to see the benefits of leveraging retailer and distributor relationships across our entire brand portfolio. Our sales team has begun cross selling our brands in new channels and new geographies. For example, the scale of distribution in our integrated snack portfolio accelerated Emerald's

entry into Canada, and we've begun to market the combination of Emerald and Kettle in the C-store and UDS channels.

We've also made excellent progress in expediting a number of exciting new product and promotion ideas, such as Tias!, which were launched in the natural channel. It's interesting to note that the corn and tortilla chip category is about 45% larger than the potato chip category in the natural channel. Our Reduced Fat potato chips have done well in test markets, and we anticipate expanding distribution in the back half of the fiscal year. In addition, we have recently announced an integrated Super Bowl promotion across all three of our snack brands, which will start in the second quarter.

In the mass and food channel, we've made significant penetration gains with single-serve Kettle items in the deli sections. These items are a great trial vehicle to help increase household penetration of Kettle throughout the U.S.

With our anticipated growth in Kettle, we're now looking ahead to make sure that we have adequate

capacity in place to support the brand's growth in future years. New capacity will be added in a phased approach: in August, we announced an \$8.4 million capacity expansion in the Salem, Oregon plant that should be completed by the spring of 2011. This expansion adds 25% capacity to the Salem facility. In addition, we are working on a major capacity expansion to support our growth opportunities in Midwestern and Eastern markets. This plant will be located east of the Rockies, and we are in discussions to finalize the location.

To leverage our scale in operations and back office activities, all of our operations and supply chain teams coordinate across common suppliers and share best practices and experience in such areas as logistics, procurement, operations and food safety. In the finance area, we have seen significant benefits from combining several activities such as cash and risk management. In IT, we are migrating Kettle U.S. onto Diamond's enterprise system so that we can serve customers as a single, unified company with one order-to-cash system for all of our brands.

I'd also like to talk about our Kettle U.K. business. Despite a challenging promotional environment in the spring and summer, the brand is now seeing renewed growth as reflected in the 18.3% growth rate reported in scanned channels in the most recent 4-week period. The brand's growth is coming from a variety of sources. The new Ridge Crisp line, launched in test market in February, has been accepted into all major grocers in the U.K. Multipacks comprise over 50% of the U.K. potato chip market, but Kettle is significantly under-represented in this format, so we are adding capacity to grow in this segment. We're also seeing strong growth in the impulse channel with both single serve and sharing pack sizes.

Now, I want to spend a few moments talking about some of our other important distribution gains and new product initiatives scheduled for 2011.

### Culinary

- In culinary, the quality and innovation of Diamond continues to sustain the brand's equity and relevance in the category. While Diamond has a

market share almost 10 times greater than the number two brand, we gained 100 basis points of market share in the most recent 4-week period. Increasingly, retailers recognize the value the Diamond brand provides them through a premium, high-quality and differentiated product offering as well as national supply chain capability and category-leading marketing support.

## Snack

- In snack, as we've reported, Emerald gained new distribution in the mass and drug channels over the summer, which should provide the brand with a strong start to fiscal 2011.
- In grocery, where Emerald is more established, there still remains significant opportunity for organic growth. We have increased our footprint to an average of 8 items per store, yet only 3 items have more than 65 percent ACV distribution. In addition to expanding our shelf presence, we see significant opportunities to drive growth through innovation.

- One example of our innovation is Breakfast on the Go. We introduced this item in the mass channel and are launching more broadly across U.S. grocery later in the fiscal year. Our grocery offering has three unique mixes of nuts, granola and dried fruits that are specially formulated to appeal to today's busy consumers. They utilize our proprietary glazing and roasting technologies, and enable us to penetrate an entirely new day part and category. The \$2.2 billion convenience breakfast category is more than 40% larger than the snack nut category in measured channels where Emerald currently competes.

This initiative demonstrates the evolution of the Emerald brand life cycle. Emerald's vibrant, relevant positioning as a natural source of energy enables us to extend the brand outside of snack nuts and appeal to new consumers and new occasions. Leveraging the brand's equity into a new product platform and category helps us increase our return on investment.

- For Pop Secret, we should see the full-year benefit of expanded distribution in the mass merchandise channel we gained in the fourth quarter and increased this quarter. In addition, several new products are slated for release in the second half of the fiscal year.

As we've done with Emerald in snack nuts, we are working on ways to energize and attract new consumers to the microwave popcorn category. One example, Pop Secret Magic Colors, is specifically designed for kids, but appeals to their parents who are looking for a better-for-you snack option.

- Across our snack portfolio, we recognize and are positioned to capitalize on healthier lifestyle trends. We have a discipline around delivering great taste and texture in a broad assortment of Better for You snacks, supported by continuing investment in vehicles that enable consumers to lead healthy, active lifestyles. More than two thirds of our snack new item launches over the past two years have been Better for You items. From 100-calorie portion control packs to Baked

Kettle chips to Cocoa Roasted Almonds with no added calories, our Better for You portfolio is expanding and will continue to be a focus in the near term. In January, we will kick off a national campaign raising awareness of our new offerings as well as our investments in sponsoring events like our national road racing series, spanning the country from the Los Angeles Marathon to the New York City Marathon.

Now, I'll turn it over to Steve to cover the financials.

**Steve Neil:**

Thanks, Linda. Please note that our earnings press release and 10-K were both filed earlier today.

I'll begin by running through some of the highlights.

- Total sales grew 55% for the quarter as a result of an 81% increase in retail sales, which, in turn, were driven by a 129% increase in snack sales. Pop Secret saw modest growth, so snacks

benefited from both Emerald and the addition of Kettle in this year's numbers. We implemented some changes in our snack promotional strategy by increasing frequency and reducing depth, along with running more joint promotions involving our brands. While changes make it difficult to compare results year-over-year, we will continue to work on optimizing the impact of our promotional spending to drive brand profitability.

- Let me get into a bit of detail on our non-retail products. You will note that like Q3, our Q4 non-retail sales declined as we elected to sell the vast majority of the product in the first half, yet for the year sales increased 4% on slightly greater volume. For fiscal 2010, we sold 80% of our non-retail sales in the first half of the year compared to approximately 60% in 2009. While we would continue to expect the majority of non-retail shipments to occur in the first half of the year, we anticipate year-to-year variability as we look to optimize the profitability of these sales. For 2011 we expect year-on-year non-retail sales to decline modestly as we focus on our higher margin retail products.

- We continue to improve our profitability as we benefit from our product mix, scale and efficiency. Full year operating margins grew 150 basis points to a record 9.5%, which is more than double our operating margin just two years ago.
- Looking at gross margins, Q4 gross margin of 24.8% was a nice improvement over last year's 20.0% on a comparable basis. You will recall that in Q4 last year we had a \$10.2 million favorable commodity price and yield accounting adjustment related to prior quarters that added 890 basis points to the Q4 fiscal 2009 gross margin. In the current quarter there was no adjustment made to prior period commodity costs. Since commodity costs are finalized at our fiscal year end, our year-to-date margins are comparable and reflect any and all adjustments made during the year. Gross margin was 23.7% for the full year, reflecting manufacturing efficiencies and a favorable product mix with the Kettle acquisition, offset by slotting, higher promotional spending and commodity cost increases.

- 2010 SG&A expense was \$63.8 million, or 9.4% of net sales compared to last year's 10.7%. Note that last year's number included some costs associated with the Pop Secret transaction.
- For the year, our advertising expense of \$33 million was \$4 million, or 14.5%, above the prior year as we continue to aggressively support our brands.
- For the year, we generated \$85 million in EBITDA compared to \$61 million during the prior year, and we anticipate \$135-\$140 million in 2011, so we continue our strong focus on cash generation from operations.
- Interest expense in the quarter of \$6.1 million reflected our first full quarter with debt related to the Kettle financing, along with the benefit of a low rate environment. Our average borrowing rate for the quarter was 4.7% (pre-tax).
- The effective tax rate for Q4 was 28.3%, and was 32.3% for the year. Q4 EPS was benefitted by 3 cents due to more favorable manufacturing tax

credit generation in the U.S. than we had anticipated (Section 199 credit), as well as the favorable impact on deferred taxes from the 1% lower tax rate announced in the U.K. in July. Looking forward into 2011, we anticipate our effective tax rate to be in the 34-36% range, down significantly from just last year when it was 38.7%.

- So overall we reported non-GAAP EPS of \$0.34 in the quarter, with \$0.03 generated by the lower effective tax rate for the year. On a full year basis, non-GAAP earnings were \$36.8 million, a 52% increase over 2009.
- We finished the year with a strong balance sheet: DSOs were at 35 days and Payables were at 65 days. Debt was essentially level with what we reported in Q3 as a result of some opportunistic commodity acquisitions we made in Q4.

Turning to our expectations for 2011, since we've already covered our revenue guidance, I'll focus on the cost side.

In fiscal 2011, we expect our base commodities (nuts, potatoes and corn) to comprise approximately 45% of our cost of goods, compared to 75% when we went public five years ago. This reduction in relative “commodity density” directly impacts our margin structure, and is a key reason why our gross margins have improved 1,320 basis points since the IPO.

However, the base commodities in most branded food companies average in the 35% to 40% range. As a result, while we’ve made great progress, we see more opportunity for improvement. Since our mix is moving toward more value-added products that have lower commodity density (and inherently higher gross margins), we anticipate margin improvement will be one of the key drivers to achieving our 5-year EPS target of >\$4.00.

It is important to note that although commodities account for a large portion of our cost structure, we have the ability to hedge and otherwise manage these input costs quite effectively, and if necessary, pass on price increases due to the strong brand equity we have earned in the marketplace.

As a result, when we look across the basket of input costs, including commodities and other packaging and ingredient materials, we think that cost inflation during fiscal 2011 will be very manageable, and not nearly as severe as many of the other food companies who are exposed to grain-based price inflation. Our expectations are that gross margins in 2011 will exceed those in 2010 by 250 to 300 basis points.

We anticipate advertising expense in the range of \$38 million to \$43 million and an operating margin of 11.5% to 12.0%, excluding integration costs.

Overall we are raising our full year EPS guidance to \$2.38 to \$2.48 per share, up from \$2.35 to \$2.45, which implies net income growth of between 45% and 50% over 2010.

Now let me comment on our earnings expectations for the first half of 2011. In the past we have typically earned about 70% of our full year net income in the first half of the fiscal year with about 2/3 of first half earnings falling in the first quarter.

With Kettle being a less seasonal business, we expect first half earnings in 2011 to be 60% to 65% of our full year net income, ranging from \$32 million to \$34 million, an increase of 40% to 50% over last year. This represents EPS of \$1.45 to \$1.55 per share compared to \$1.36 last year on 5.4 million fewer shares outstanding. Additionally, with a late tree nut crop this year, reduced bulk in-shell business transacted in the fall, and increased snack advertising in our first quarter, we expect approximately 40% of first half earnings to fall in Q1 resulting in EPS of between \$0.58 to \$0.62 per share.

We believe fiscal 2011 capital expenditures will be in the range of \$30 to \$35 million, primarily reflecting our investments in expanding snack capacity.

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

**[Q&A]**

**Bob Philipps:**

Thank you, operator.

Before we conclude, let me mention that we plan to participate in the BB&T investor conference during November. For a complete list and schedule of investor events, please see our website.

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

# # #