

Q2 FISCAL YEAR 2011  
EARNINGS CONFERENCE CALL

March 8, 2011, 1:30 PM PT

Chairperson: Linda Segre, SVP Corporate Strategy

**Linda Segre:**

Thank you, [operator], and good afternoon everyone. Welcome to the Diamond Foods investor conference call and webcast to review the financial results of our second quarter fiscal 2011 which ended January 31st.

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

- 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.

- 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 7:30 p.m. Eastern Time on March 15, 2011. Please refer to our press release for the dial-in numbers. In addition, this call is being webcast live, and a replay will be available on the website.
- 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, please review our risk factors in our SEC filings.

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

- Since we incurred integration-related costs this quarter associated with the Kettle Foods

acquisition, we will focus our prepared remarks on non-GAAP results. A reconciliation to GAAP can be found in the press release.

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

**Michael Mendes:**

Thanks, Linda. Good afternoon everyone and thank you for joining us. Before we begin today, I would like to introduce Steve Neil, our Chief Financial and Administrative Officer, and Lloyd Johnson, our Chief Sales Officer, who will join me as we review our prepared remarks. Andrew Burke, our Chief Marketing Officer, will also be available for our Q&A session.

We had record level revenue and earnings in the second quarter and are confident that we will achieve

our targets for the fiscal year. As a result of the addition of Kettle and double digit organic growth in our snack portfolio, snack revenue grew 133% and drove a 63% increase in retail sales. Earnings per share increased 90% over last year to 91 cents, which is the top end of our guidance range. Cash flow was particularly attractive for the period, with EBITDA of \$46 million allowing us to continue to reduce leverage against the business.

Based on this performance and our outlook for the balance of the fiscal year, we are raising our full year net sales guidance. For the year, we are now projecting net sales growth of nearly 40%, led by snack sales growth of more than 70%. We are also raising full-year EPS to \$2.45 to \$2.51 per share, despite increasing our advertising budget to capitalize on new snack distribution.

We are well positioned to achieve our revenue growth targets for the second half of the year. We have had a major breakthrough due to our investment in Pop Secret, and as a result, will

significantly increase our distribution in the Mass and Club channels. Emerald hit an all time high market share for the most recent period, and we had a successful launch into the breakfast aisle. Given the positive trajectory of this new offering, we have elected to increase and accelerate our planned investment in slotting and consumer support. Kettle continues to grow, as we expand distribution and increase the breadth of our offering in the US and the UK. As the Kettle brand continues to outpace the category, we see great opportunities for developing our international snack markets in the future. While today, Diamond does not have the scale to afford the infrastructure required to rapidly develop many of our international markets, Kettle has delivered sales growth in Europe of nearly 30% this year.

Lloyd will now provide more detail on our performance for the quarter, and our plans for the second half of the year.

**Lloyd Johnson:**

Thank you, Michael.

Let me provide a few highlights from the past quarter and discuss some opportunities moving forward.

Our non-snack retail sales were strong in the quarter. The Diamond culinary brand maintains a 28% share of the category in grocery and delivered 7% revenue growth for the quarter, which is a good indicator of the strength of the brand across all channels.

Our snack portfolio continued to perform well this quarter. This was despite lapping last year's strong promotional period behind the introduction of Emerald Dry Roasted peanuts. During the key Super Bowl time frame, the Emerald brand was up over 18%, setting a new share record at 11.6%, an increase of 150 basis points over the same period a year ago. What's most impressive is that we significantly outperformed the category by a factor of 7 times. For the most recent twelve week period,

Emerald's tree nut performance continued to post very solid results, led by our cashew offerings, which were up almost 21%.

In the food, drug and mass channels, Emerald made very good progress on our distribution initiatives. Our total distribution grew by about 10%, which represents an 800 basis points improvement from prior year. Between our key drive period results and our expanded distribution, Emerald revenues continued to grow at a double-digit pace in the quarter.

The response to Breakfast on the go! from retailers has been extremely positive. Within 4 weeks of launching, the product is already scanning in 59% of U.S. grocery stores. In preparation for the start of our consumer support campaign, we continue to focus on expanding distribution and securing key promotions with our retail partners. Our marketing support plan in the back half of our fiscal year will be the largest program we have ever executed behind a new item launch. We will create three new

television commercials, a new print campaign and a range of digital assets. Our media plan will kick off in April with our sponsorship of Major League Baseball's opening day telecast on ESPN, as well as sponsoring local team's opening day telecasts in our major markets. We will coordinate our in-store promotions to coincide with the timing of this investment, as we introduce our Emerald brand to the 'convenient breakfast' consumer.

Pop Secret also performed well this quarter, with the biggest news being the recent expanded distribution in the mass and club channels. Pop Secret just began shipping into an additional 1900 stores in the mass channel. This equates to roughly 7600 incremental points of distribution. Pop Secret also gained new distribution in the club channel with our Better For You 100 calorie item. In U.S. all outlets during the 12 week period ending February 19th, Pop Secret gained 130 basis points of market share. In addition, in US Grocery, Pop Secret now has three of the top five and six of the top ten selling SKUs in the category.

In US grocery, Kettle's growth continued to outpace the potato chip category by a factor of 2 times in the most recent 12-week period, as well as outpacing category growth in the natural channel, where it is the largest brand across all salty snacks. We continue to make good progress in increasing distribution of Kettle in the U.S. market. We recently gained expanded space for a broader set of items in 1000 stores of a large mass merchant and gained authorization for our all natural flavored tortilla item, Kettle Brand TIAS! in several grocery, mass and club outlets. Since taking over ownership of the brand, we've been approaching mainstream aisle distribution in a careful and disciplined fashion having added a small, but meaningful number of retailers that have transitioned the brand to mainstream grocery.

Kettle U.K. had strong sales leading into the important winter holiday season. The brand grew 15% in the 12 week period ended February 19<sup>th</sup>, which is more than twice as fast as the category.

Growth is coming from strong sales of Kettle Ridge Crisps and the new multi-pack format items as well as continued growth in impulse channel sales.

Looking forward across our portfolio, we continue to focus on increasing the breadth and depth of our distribution. For Kettle and Emerald, we have significant opportunity across most retail channels. While Pop Secret and Diamond are more fully distributed, we still have opportunities to expand in selective channels and markets.

This Spring, we will be launching our March basketball tournament retail promotion, which will include both the Emerald and Kettle brands. This promotion is an integrated campaign including digital, print and in store activation. Last year, we leveraged the Emerald Underdog bracket promotion to drive significant display activity resulting in strong sales and share during this period.

Now I'll turn it over to Steve to talk about our financial and operational results.

## **Steve Neil:**

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

The second quarter was another very good quarter for Diamond Foods. Today I want to focus on a few highlights in the quarter and then comment on our guidance.

Michael and Lloyd have commented on our strong retail sales which grew 63% in the quarter. I wanted to briefly comment on our non-retail sales.

Our international non-retail sales were down slightly in the first half of the fiscal year compared to the first half last year. We expect second half sales to approximate the first half this year, which is a significant increase over the second half last year. At the same time, our North American ingredient and foodservice sales in the first half are significantly lower than last year due principally to

the USDA school lunch program not being offered this year. We expect second half ingredient and food service sales to modestly exceed last year's comparable period sales.

The reason for this additional color is to highlight that the timing and magnitude of our non-retail sales will vary year-to-year and are impacted by different factors than our retail business. Similarly, the raw material inventory balances maintained to service these sales will also vary from year-to-year.

Gross margin in the quarter was 27.5%, 550 basis points above Q2 last year and 230 basis points above the first quarter. Significantly stronger retail sales drove the year-to-year comparison and more favorable product mix drove the quarter-to-quarter improvement.

We are experiencing increases in some of our input costs and are effectively managing these through hedging and long positions as well as executing operational efficiencies within our supply chain and manufacturing operations. We have also taken a culinary price increase to be effective in the third quarter to offset cost increases for certain tree nuts.

I commented last quarter that advertising expense is going to vary from period to period depending on the specific activities we are running. In Q2 last year for example, our advertising expense included producing four new commercials, and sponsoring a bowl game which we chose not to repeat, and thus we did not incur these costs in Q2 this year. As a result, our second quarter advertising expense was lower this year than last. However, for the year we are increasing our guidance on advertising expense in order to increase consumer support for our successful Breakfast on the go! launch and our expanded Pop Secret distribution. We expect this year's Q3 advertising expense to be around \$5 million greater than Q3 last year and second half advertising investment to be up almost 50% compared to last year's second half.

Now let me comment on our integration of the Kettle operations – which remains on plan. As we discussed at the end of last year, we completed significant components of the integration starting with our US sales and marketing activities immediately after closing and have been operating as an integrated go-to-market team this entire fiscal year. We expect integration activities to

be substantially completed on schedule by the end of the fiscal year.

We remain focused on cash flow generation. In the three full quarters we have owned Kettle, our EBITDA is \$109 million. For the six months ended January 31<sup>st</sup>, cash flow from operations was \$35 million, up \$24 million over the same period last year, driven by EBITDA growth. In Q2 we reduced our net debt by \$21.6 million and our net leverage ratio was 3.9 at quarter end. We expect to exit fiscal 2011 with a net leverage ratio between 3.5 and 3.8 and anticipate a net leverage ratio below 3.0 by the end of fiscal 2012.

While we remain focused on cash generation, since the acquisition of Kettle we have announced three significant capital programs focused on meeting the market demand for Kettle chips. Our Salem facility expansion is on schedule to go live in May and will add 12% of additional U.S. capacity, our Beloit expansion has received local permits and is on track to add another 50% to U.S. capacity this time next year, and our packaging line and multi-pack capacity expansion in Norwich, England is scheduled for completion in the Fall, in advance of the important holiday selling season. Each of

these projects have a quick payback and position us to take advantage of market growth opportunities.

Additionally, we are adding capacity in our nut glazing operations but otherwise have adequate Emerald and Pop Secret capacity to meet the growth initiatives for these product lines.

Now I'd like to comment on the Q3 and full year guidance we provided in the release and earlier on the call.

- We expect Q3 sales to range from \$210 million to \$220 million.
- We anticipate Q3 EPS of \$0.45 to \$0.50 per share, compared to \$0.30 last year. Note that for Q3 last year there were approximately 2.7 million fewer shares outstanding and we plan on spending around \$5 million more on advertising in Q3 this year, so this EPS growth represents a meaningful improvement in earnings over last year.

For the full year,

- Our gross margin guidance range of 200 to 300 basis points above 2010 remains unchanged.
- We have widened our operating margin expectations to 11.0% to 12.0% excluding integration costs from our previous guidance of 11.5% to 12.0%, to accommodate our anticipated sales mix and increased advertising investment.
- We expect our tax rate for the year will likely be in the lower half of our guidance range of 32% to 34% reflecting the current year impact of anticipated discrete items and tax planning initiatives.
- Overall we are increasing our EPS guidance to \$2.45 to \$2.51 per share from \$2.43 to \$2.49 per share while increasing advertising guidance by \$2 million to \$3 million. This represents growth of 53% to 57% in net income.
- We are raising our EBITDA guidance to \$138 million to \$143 million from \$135 million to \$140 million previously.

- Our FY2011 capital expenditure guidance remains unchanged at \$35 to \$40 million.

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

**[Q&A]**

**Linda Segre:**

Thank you, [Operator].

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

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