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Diamond Foods, Inc.

When the phone rang in September 2011, Mark Roberts wasn't thinking about walnuts. But walnuts were what his caller wanted to discuss—that and a company called Diamond Foods, a San Francisco-based purveyor of nuts and other snack foods.¹

The caller wouldn't say who he was, and he insisted that this would be the only time he and Roberts would speak. He said that Diamond had sent a large payment to each of its contract walnut growers accompanied by a letter. The letter said the growers were receiving momentum payments toward their 2011 harvests. The caller didn't know what a momentum payment was, and he wouldn't hand over the letter. But he did know this: some farmers were angry at Diamond, believing that it had been underpaying them for their walnuts for several years. It had signed them to multiyear contracts, promising cooperation. Now, the farmers believed, it was squeezing them.

Roberts, founder of Off Wall Street Consulting Group, an investment research company in Cambridge, Mass., didn't usually base his reports on anonymous tips, especially ones involving companies that were in the middle of acquisitions, like Diamond. Just a few months before, Diamond had announced plans to purchase the Pringles potato-crisp brand from Procter & Gamble for \$2.35 billion. The deal hadn't closed, and that made Roberts wary. Acquisitions were messy; they clouded financial reports. You never knew exactly what the resulting company would look like or whether promised efficiencies would arise. A clear view of accounting mattered a lot to Roberts, who made short-sale and stock-purchase recommendations to hedge funds and other large investors. He wouldn't publish a recommendation unless he could nail down his views with robust analysis.

Roberts cherished his credibility. In the 21 years since he'd started Off Wall Street, he'd earned a reputation as one of the more prescient stock analysts around, thanks to such recommendations as his 2001 short call on Enron, the Texas energy-services company that collapsed in a massive accounting fraud. His firm didn't make a lot of recommendations in a year—typically only 20 to 25—so Roberts had to be confident when it did. That caution paid off: Off Wall Street had been right 80% percent of the time. Roberts didn't want that to change—he didn't want to squander his firm's reputation or waste his time on a fool's errand.

But the Diamond tipster had provided so much detail that Roberts felt compelled to investigate. He hadn't heard of a momentum payment, either. That piqued his curiosity. Why, he wondered, would a public company need to invent a new financial term?

Before he could do anything else, he had to get a copy of that letter.

Professor Suraj Srinivasan and Research Associate Tim Gray prepared this case with assistance from Research Associate Jordan Smith. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Diamond in the Rough

For most of its life, Diamond Foods wasn't a company. It was a cooperative. California walnut farmers had created it in 1912. They had figured that, by banding together, they would have more leverage in negotiating with buyers and greater heft in marketing their nuts. They based the name of their brand on the most precious of stones, and that was no accident. They adhered to a strict quality standard—nuts that weren't plump or pretty enough couldn't be marketed under the name. Within a few years, they also started a nationwide advertising campaign—the first of its kind for a nut. By the 1950s, they'd opened a headquarters office in Stockton, Calif., about two hours east of San Francisco.²

California walnuts were high quality, bigger and meatier than those from elsewhere. They were first cultivated in the late 1700s by Franciscan missionaries. Commercial growing began about a century later. The state's walnut farms came to be centered in the northern section of the Central Valley, a 400-mile-long swath of verdant farmland wedged between California's coastal mountains and the Sierra Nevada range. In 2012, the valley accounted for "99 percent of the commercial U.S. supply and three-quarters of world trade," according to the California Walnut Association.³ That same year, California had about 4,500 walnut growers. Their annual harvest stretched from late August through late November.

For decades, consumers could find Diamond's nuts in the baking sections at groceries in canisters marked with a red diamond-shaped logo. The nuts were sold as a cooking ingredient—a compliment to cookies, brownies, salads and stuffing.

By the 1990s, consumer tastes had begun to change, and U.S. walnut demand was slackening, even as supply increased. Walnuts hadn't yet gotten a boost as a heart-healthy food—research showing the benefits of their omega-3 fatty acids wouldn't become popular until the next decade—yet farmers had planted more trees, and harvests had grown. Diamond was selling some of its surplus abroad but not enough to prevent falling prices. The cooperative had to find new customers and shed its old-fashioned ways.

A Suit Enters a Blue-Jean Business

The CEO chosen to lead the push into new markets was Michael J. Mendes. Only 33 years old when he became boss, Mendes boasted the kind of self-made résumé that a businessperson might brag about. His parents had immigrated to the United States from the Azores, a Portuguese archipelago in the middle of the Atlantic Ocean. He'd grown up in Oakdale, Calif., a farming town not far from Stockton. He'd earned his bachelor's at California Polytechnic State University-San Luis Obispo and his master's in business at the University of California Los Angeles.⁴ After college, Mendes did a stint with Dole Foods and then joined Diamond in 1991 as vice president of sales and marketing. He made his ambitions plain from the start: in a boots-and-blue-jeans business, he showed up for work every day in a suit.

Within six years, he was CEO, and he put his marketing savvy to work to try to revive the cooperative's flagging fortunes. He expanded the culinary line, adding other nut varieties and pushing the company into the leading position in that segment of the market.

He also saw promise in a place where Diamond hadn't much competed—snacks. The sector was estimated to be three times as large as culinary nuts. But it was also mature and dominated by a single big player, the Planter's division of Kraft Foods. Planter's had a market share of about 40%,

and Kraft appeared to have gotten complacent.⁵ The iconic emblem of the product line, Mr. Peanut, had existed for nearly a century. Still sporting a monocle and a top hat, he'd gone stale.

Mendes saw a chance to appeal to younger consumers. They weren't committed to any particular brand or to nuts at all. And they liked to snack on the go, as they hustled to work or scurried to class. To lure them to Diamond, Mendes led the creation of the Emerald line of nuts and nut-and-dried-fruit mixes. The Emerald offerings came in a slim green canister that fit easily into an automobile cup holder, backpack pocket or purse. Diamond introduced the line with a cheeky ad campaign that played off its E.N. initials. TV spots featured "Envious Nomads," "Enterprising Norwegians" and "Exercising Newscasters." The ad campaign would culminate in 2005 with a 30-second spot during the Super Bowl.

Emerald took off, helping to boost Diamond's revenue. For fiscal 2004, the cooperative reported net sales of \$360 million, a 14% jump over the prior year.

Cracking a New Nut

Mendes's ambitions weren't limited to raising nut sales. He wanted to move from the farm to the financial district. He began lobbying his farmer-members to support the conversion of Diamond from a grower-controlled cooperative into a publicly traded company.

His persuasion worked. In 2005, more than 80% of the members voted for the conversion, and Diamond became a public company. As part of the transaction, the members could choose to receive either stock in the new company or cash. Thus Diamond Foods issued about 6.7 million shares of stock to the former members as part of an initial public offering. Members also received cash payments to compensate them for working capital tied up in the cooperative. The combination of the stock and the cash meant that farmers collected about \$120 million in the conversion. As stockholders, they would also be entitled to stock dividends. The new Diamond also sold stock to the public, raising about \$150 million. It used some of the proceeds to pay off debt and kept some to develop new products and acquire equipment.⁶

The conversion changed the governance of the enterprise. Diamond went from having a board of farmer-members to having one where the former cooperative was represented by only three of the nine seats. (See **Exhibit 1** for biographies of the board members in 2011.) The farmers also became suppliers to a company, rather than members of a cooperative. They were offered contracts enabling them to continue to sell their walnuts to Diamond. A contract could last three, five or 10 years—the farmer could choose—and 95% of growers opted for one.⁷ Under the contracts, Diamond would buy their entire crop. The company then had the right, after each year's harvest, to set the price it would pay for the nuts, based on spot prices, quality and other factors. The farmers received no price guarantees. Payments came in installments, and the final one wouldn't arrive until after the harvest. Thus for, say, the 2010 harvest, which would've stretched from August through November of 2010, the first payment would be in November 2010, but the bulk of the payments would be made between March 2011 and August 2011. Diamond was also free to source walnuts abroad, as it was already doing with hazelnuts, pecans and pine nuts.

The following year, Diamond made an announcement that augured expansion beyond the groves of California's Central Valley. That May, the company said it was paying \$18 million for assets of Harmony Foods. As part of the deal, it acquired a plant in Fishers, Indiana, which produced trail mixes, dried fruits and other sweet snacks. Just a few months later, Diamond issued its annual financial report—its first full-year statement as a public company. It reported net sales of \$477 million

and cost of sales of \$412 million for fiscal 2006. Its gross margin percentage was 14.3, and its diluted earnings per share were \$0.47.⁸ (See **Exhibit 2a** for Diamond's income statements, **Exhibit 2b** for balance sheets and **Exhibit 2c** for cash flow statements.)

Not all farmers were pleased with the new direction. In 2007, a group of 42 of them formed a coalition called the Growers Committee for a Fair Price from Diamond and complained that the company had underpaid farmers by more than \$20 million for the 2005 harvest and nearly \$30 million for the 2006 harvest.⁹ Diamond responded by pointing out that the two years had yielded record harvests and that it had paid the highest price per acre of walnuts in the country's history. It also noted that the complainers were a tiny minority of its walnut growers. When the company released its financial report for fiscal 2007, net sales continued to climb, reaching \$523 million. Cost of sales rose to \$444 million, while gross margin percentage hit 15 and earnings per share, \$0.53.

Growth through Acquisitions

The next year brought another acquisition—and a declaration that that Diamond was expanding into the broader and potentially more profitable snack market. In August 2008, the company purchased the Pop Secret brand from General Mills for \$190 million in cash. Pop Secret was the second largest brand of microwave popcorn, behind ConAgra's Orville Redenbacher, and it had a 25 percent share in U.S. groceries.¹⁰ Mendes said the acquisition would "significantly broaden our presence in the snack aisle."¹¹ A larger footprint in the snack aisle brought opportunities for cross promotions and also gave Diamond greater leverage in dealing with grocery buyers, as the same buyer would typically handle both popcorn and nuts. What's more, Diamond's introduction of Emerald had given the company and its CEO reputations as innovators in terms of marketing. Several analysts speculated in their briefs analyzing the acquisition that Diamond would be able to revive a brand that had been neglected by General Mills because it didn't dovetail with the company's other offerings.

The deal brought Diamond into direct competition with some of the biggest companies in world, including PepsiCo, via its Frito-Lay division. Frito-Lay dominated the snack sector, controlling nearly half of the market and selling such well-known brands as Lay's, Doritos and Cracker Jack. In 2008, Frito-Lay also introduced a line of nuts and nut snacks called TrueNorth. The other major players in the industry—ConAgra, General Mills, Kraft Foods—each had a share of about 5%, compared with Diamond's share of 2%.¹²

In an interview with *Investors Business Daily*, Mendes explained the thinking behind the acquisition and his company's move into the broader snack market.¹³ Like nuts, popcorn was a mature snack category with stable sales, but Diamond aimed to revive the category, as it had done with nuts, by introducing new flavors, more appealing packaging and grabbier advertising, Mendes said. "We believe we can be additive to the microwave popcorn category in a similar way we were to the snack nut category," he said. On top of this, popcorn complemented Diamond's nut offerings, providing potential efficiencies. Popcorn was typically sold in the same section of grocery stores as snack nuts, and the same retail buyer would usually handle both types of products. Both products also had long shelf lives and didn't require refrigeration. "There's a big opportunity to regrow the [popcorn] category with some marketing dollars and product improvement," an analyst told *Investors Business Daily*.¹⁴

Even with the Pop Secret acquisition, Diamond was still small, but its moves were beginning to win more attention from investors. Throughout much of 2009, its share price climbed. The stock began the year at about \$20 a share, just a few dollars above the offering price, and closed it at about

\$35 a share. Its trailing price-earnings (P/E) ratio for the year reached 21, compared with an average of 18.6 for the S&P 500.

Earnings were rising, too. In fiscal 2008, net sales grew to \$532 million, while cost of sales reached \$443 million, giving Diamond a gross profit percentage of 16.6. In fiscal 2009, net sales kept climbing, to \$571 million, but cost of sales fell to \$435 million. Diamond's gross profit percentage swelled to 23.7. The financial reports also indicated that the acquisitions had remade Diamond's product mix. In fiscal 2008, culinary nuts still accounted for the bulk of the company's revenue. But by the following year, snack sales surged—if they continued their trajectory, they'd soon match, even outstrip, culinary sales.

In February 2010, Diamond made a move that pushed snacks to the forefront of its business. It announced that it was buying Kettle Foods, a potato chip maker, from Lion Capital for \$615 million in cash. The purchase included two Kettle Foods plants in the United States and one in the United Kingdom. As with Pop Secret, Kettle Foods stood to make Diamond an even more formidable competitor in snacks. The deal, which was to close at the end of the following month, would double the size of Diamond's snack business. Also like the Pop Secret acquisition, it offered opportunities for cross promotions and further bulked up Diamond's muscle in the snack aisle. And the burlier Diamond became, the more it could demand good positioning for its products on store shelves. Potato chips also offered a new sort of distributional efficiency to Diamond: they were bulky but light, which meant that they complimented heavy, but less bulky, nuts. A truck carrying nut snacks to a supermarket might have plenty of room left for lightweight chips.

Diamond said it would fund the purchase with a combination of cash reserves, debt and new equity. It soon did a stock offering that raised \$181 million. It also took on two large new loans—\$200 million revolving-credit agreement and a \$400 million term credit agreement. It said that it would draw on \$170 million of the revolving loan and the entire term loan to help pay for Kettle and pay off existing debt. The loans came with covenants requiring that Diamond maintain a maximum consolidated leverage ratio of not more than 4.75 to 1. The covenants required that that ratio decline annually to reach 3.25 to 1 by the end of April 2014, and they mandated a minimum fixed-charge coverage ratio of 1.1 to 1 through October 2012. (See **Exhibit 3** for Diamond's debt covenants.)

When Diamond released its fiscal 2010 earnings a few months later, it looked like a different company. Snack sales—now \$321 million—outweighed culinary sales of \$218 million. “For 2010, our snack sales grew 70 percent,” Mendes said.¹⁵ He projected that they would rise to \$540 million in fiscal 2011—or “25 times larger than when we went public in 2005.” (See **Exhibit 4** for Diamond segment sales information.) Mendes added a cautionary note, saying that developments in the walnut industry might affect the coming year's earnings. “The 2010 California tree nut crop is projected to be the largest in history but will be harvested much later than normal,” he said. That could change the timing of the company's revenue, pushing sales later in the year, he said.

All the while, Diamond's stock price kept climbing. By the end of 2010, it had reached about \$55 a share from the IPO offer price of \$17.50. Diamond's P/E rose to 42, when the average P/E of the S&P 500 was to 15.5. (See **Exhibit 5** for Diamond stock-price performance since its IPO.)

Not all investors were swayed by Diamond's move into snacks. The company's stock price wasn't the only thing rising: short-seller interest was increasing, too. It began to tick up in the second half of calendar 2009 and remained elevated. (See **Exhibit 6** for the quarterly percentage of short interest in Diamond.) The “shorts” might have noticed that Diamond's snack business was unproven and that the company's accounting for it was opaque. Diamond didn't break out the profitability of its various segments, only their total sales. What's more, as a snack company, Diamond was a Lilliputian among

leviathans: it paled next to outfits like Frito-Lay and Kraft. A new entrant like Diamond would probably have to take share from these incumbents, and they might use their financial heft to fight back. The short sellers might have noticed, too, that Diamond's acquisitions had brought a growing slug of debt to its balance sheet. The company would have to produce enough cash to service that debt in good times and bad. Much of the debt carried floating interest rates. If market rates rose, Diamond could find its cash flows squeezed.

If the Kettle acquisition decisively turned Diamond from nut merchant to snack foods company, then its announcement in April 2011 of its plans to acquire Pringles made clear that the company aimed to compete head to head with the likes of Frito-Lay. Pringles was an iconic snack brand, known for its uniquely shaped potato crisps. Their saddle shape, called a hyperbolic paraboloid by mathematicians, was created partly to facilitate packaging. It enabled the crisps to be stacked one atop another in tubular canisters.¹⁶ The shape became so identified with the crisps that a velodrome built in London for the 2012 Olympics with a roofline of the same shape would be nicknamed "the Pringle."¹⁷

The Pringles acquisition was like a chipmunk trying to munch a walnut in one big bite. Everything about it was large, from the price tag—\$2.35 billion—to the amount of debt that Diamond would assume from Procter & Gamble—\$850 million. Diamond said that the deal would triple the size of its snack business.¹⁸

The deal wasn't just hefty. It was also knotty. Rather than buying Pringles outright, Diamond agreed to acquire it through a Reverse Morris Trust, which provided tax benefits for P&G's shareholders. P&G would split off Pringles into a new entity, which would then merge with Diamond. P&G's shareholders could choose whether they wanted to participate. Those who did would exchange their P&G shares for Diamond shares. Diamond predicted that it would incur one-time merger-related costs of \$100 million over the two years following the transaction. Its shareholders would be left with 43 percent of the resulting company. (See **Exhibit 7** for Pringles deal pricing and **Exhibit 8** for Pringles financials.)

In a news release announcing the deal, Mendes said: "Pringles is an iconic, billion dollar snack brand with significant global manufacturing and supply chain infrastructure. Our plan is to build upon the brand equity Pringles has established in over 140 countries. This strategic combination will create an independent, global leader in the snack industry..."¹⁹

Stock analysts echoed Mendes's enthusiasm, recommending that investors buy the stock and highlighting its potential to contribute to Diamond's continued growth. One analyst's report called attention to the Diamond management team's "proven ability to create and grow brands with imaginative marketing and product innovation."²⁰ Another argued that integrating Pringles into Diamond's snack lineup would make the company's earnings more stable and that that stability would appeal to even more investors. That report also pointed out that Diamond was more focused on snacks than was Procter & Gamble, a multinational with dozens of brands in multiple consumer categories. "This greater focus could bring with it higher sales growth in the years to come," the report said.²¹ A few analysts suggested that Procter & Gamble had let Pringles languish, failing to invest enough money in refreshing the brand's marketing and product innovation. Pringles had a few flavors—all of them could have fit into a single grocery bag—but nothing to rival the dozens of options offered by Frito-Lay. Diamond wouldn't become a giant multinational with one acquisition, but it could use Pringles as a platform to introduce all sorts of savory snacks.

Investors appeared to cheer the transaction. Over the weeks that followed, Diamond's stock climbed, and it mostly continued climbing throughout the summer. That September, Diamond

reported record earnings for the 2011 fiscal year. Net sales swelled to \$966 million, including snack sales of \$553 million.²² Cost of sales grew to \$715 million, giving the company a gross margin percentage of 26. Earnings were \$50 million, or \$2.22 a share, and included \$16.8 million worth of integration and acquisition costs related to the Kettle and Pringles deals. “We’re particularly pleased that we could achieve such strong performance while effectively managing the Pringles integration,” Mendes said.²³

The Pringle’s deal caught the attention of a popular stock commentator—Jim Cramer, host of CNBC’s *Mad Money*. On Sept. 16, 2011, Cramer featured Diamond on his show, interviewing Mendes on the air.²⁴ Cramer urged his viewers to buy “high quality, best-of-breed companies,” like Diamond. He called Diamond’s acquisition of Pringle’s “brilliant” and applauded the company for building its brand by investing in advertising. “Diamond may have a whole new leg of growth ahead of it thanks to this Pringle’s buy,” he said. “This major brand may have been lost in the crowd at P&G. It’s now getting the full attention it needs.”²⁵

Investors seemed just as enthusiastic as Cramer. That September, Diamond’s stock hit its high up to that point—\$92.47 a share. The market, in effect, was applauding for Mendes’s deals and counting on further growth.

Gumshoeing in the Groves

Within a few weeks of Diamond’s fiscal 2011 earnings announcement, Mark Roberts, of Off Wall Street, had sent an investigator to California to learn more about the momentum payments that his anonymous caller had reported. At his offices in Cambridge, just a few blocks from the buskers and bustle of Harvard Square, he and his analysts were also examining the economics of the walnut industry. They learned that demand for U.S. walnuts was growing abroad, particularly in China and Turkey. In 2006, fewer than 25 million pounds of walnuts had been shipped to China. By 2010, shipments had grown more than fourfold. Similarly, Turkey’s shipments had grown from a negligible amount in 2006 to more than 50 million pounds in 2010.²⁶

Exports had to rise because, while Americans were eating more walnuts, they weren’t consuming enough to counterbalance increased production. California’s total production had grown for much of prior decade, reaching 500,000 short tons in 2010. Prices per ton had bounced up and down, with the increased demand and increased production pulling in different directions at different times. According to the U.S. Department of Agriculture, the price per ton of in-shell walnuts started the decade at about \$1,100 and more than doubled by 2007, hitting \$2,290 per ton. It sank the following year, dropping to \$1,280 per ton, and then grew anew in 2009 and 2010, reaching \$2,110.²⁷

Before long, Roberts’s investigator had persuaded a farmer to provide a copy of Diamond’s letter to its walnut growers, which confirmed that the company had made the momentum payments on Sept. 2. The investigator interviewed farmers about the history and timing of their payments from Diamond. He learned that some of them felt like they were being shortchanged. They told him that, each year, the price that the company typically paid for walnuts was 10 cents to 15 cents a pound less than the market price. Fiscal 2011, which had ended on July 31, had been far worse, the farmers said. Diamond had paid only \$1 a pound when the market price was \$1.45 a pound. But then, in early September, that momentum payment arrived. It equaled about 35 cents a pound and would raise the total payment for the 2010 harvest to about \$1.35 a pound—except Diamond insisted that it didn’t apply to the 2010 harvest. The company said it was a loyalty bonus that shouldn’t be counted toward the 2011 harvest.

That all sounded odd to Roberts. He reasoned that the momentum payment might be a way for Diamond to shift costs into the next year and thus increase 2011 earnings. At 35 cents a pound, the payment would've amounted to about \$97 million worth of costs, and he figured that Diamond could have sold at least half of those nuts, or about \$50 million worth, in fiscal 2011.

Roberts Reports his Findings

On Sept. 25, 2011, Roberts alerted his clients—most of them hedge fund managers and large institutional investors seeking stocks that they might sell short—to his conclusions. He published a report criticizing Diamond's handling of the momentum payment and highlighting the potential impact on earnings.

"[W]e question whether Diamond included this 'momentum payment' in its cost of goods sold for its FY 2011, which ended on July 31," his report said.²⁸ The report pointed out that the payment roughly coincided with an SEC filing in which Diamond had said that the integration costs for the Pringles acquisition would be \$50 million more than originally estimated—\$150 million, instead of \$100 million. "If we are correct in our assessment of these 'momentum' payments," the company conceivably might even be forced to restate its FY 2011 financial statements," the report added.

Roberts also alleged that deteriorating relations with farmers were hurting Diamond's walnut business. The company was alienating its growers by annually paying them 10 cents to 15 cents a pound less than the market price, his report said. If farmers chose not to renew their contracts, it might be Diamond that would end up being squeezed. "Diamond has enjoyed a very dominant position in the walnut business. That dominance appears to be coming to a close." Diamond was losing market share in walnuts and would likely lose more, the report said. (See **Exhibit 9** for Off Wall Street's estimates of Diamond's share of the walnut market and **Exhibit 10** for Off Wall Street's estimates of discounts taken by Diamond in paying farmers.)

Roberts believed that the changing dynamics of the walnut business, including more competition from buyers domestically and from demand abroad, might have motivated Mendes's move into the broader snack business. To fund the necessary acquisitions, Diamond had to have a strong stock price and the ability to borrow money relatively cheaply. The momentum payment might have been a way to make the company look more profitable, and less risky, than it really was. Had half of the payment been included in Diamond's fiscal 2011 income statement, it would've more than halved earnings. In effect, Roberts was accusing Diamond of accounting fraud.

Off Wall Street's report also said that Diamond's growth was an illusion, a product of its acquisitions, not efficient operations or smart marketing of new products. Diamond had reported a compound annual growth rate (CAGR) for revenue of 15% from fiscal 2006 to 2011. Off Wall Street argued that the real rate was closer to 3.5%. The reason was simple: Pop Secret and Kettle Foods were not the growing businesses that Diamond had portrayed them to be. They were, at best, mature and maybe declining. In some years, their sales had even fallen, the report said. (See **Exhibit 11** for sales of Pop Secret and Kettle Foods before their acquisition by Diamond.) Pringles would be more of the same, the report said. It, too, was a slow grower. It was a niche brand in a business dominated by Frito-Lay. It would contribute little to Diamond's future growth.

Not everyone bought the analysis. Some stock analysts supported the company's arguments that its accounting was proper and that its business was solid and growing. One called the dispute a "he said/she said," adding, "Management insists that this momentum payment is viewed and treated

internally as a payment related to this year's crop, not last year's, and that attestations to the contrary are simply misinformed."²⁹

Another analyst pointed out that the Diamond (DMND) routinely paid its growers in installments, and the only difference this time was the payment's name. "While DMND appears to give its payments different names from year to year—maybe it would be advisable to keep a consistent name to avoid confusion over the nature of the payments—the payment itself is not unusual," the analyst's report said.³⁰ That same analyst also took issue with Roberts' argument that Diamond's moves away from walnuts had been forced by deteriorating relations with farmers and a loss of its near-monopoly on their nuts. Diamond was diversifying into snacks because that was a better business, the report argued. In trying to buy Pringles, it wasn't scrambling to compensate for lost walnut sales and soured relations with growers, the report said. It was smartly leaving a low-margin business behind.

The complaining farmers, for their part, might not have liked being paid less than the market's spot price, the analyst said, but their complaints ignored a critical fact: Diamond had agreed to buy all of their production before the harvests even began. "[C]ontracted growers benefit from having a guaranteed buyer, which at times can lead to price disparities, especially in years when many export buyers are purchasing directly from uncontracted growers," the analyst's report said. "A group of dissatisfied growers actually sued the company in 2008, alleging below-market-rate prices, but the lawsuit was dismissed in 2010."³¹

Now, investors would have to decide for themselves what was happening at Diamond. Was it a growth company as many investors seemed to believe and was Diamond's shift into snacks a promising move out of a low-margin business and into a higher-margin one? Was its snack business going to turbocharge its profitability, as Mendes's public statements suggested? What was the evidence of that?

Or was Roberts right? Was Diamond's move into snacks really a diversion intended to mask the deterioration of the company's core business? And what was the purpose of the momentum payment—was it a loyalty bonus as the company argued, or was it a way to shift costs and boost profits as Roberts alleged? How might its treatment affect Diamond's profitability?

Exhibit 1 Excerpt of Biographies of Members of the Board of Directors of Diamond Foods.

“John J. Gilbert has served as Chairman Emeritus since January 2010. He served as the Chairman of our Board from July 2005 to January 2010 and was Chairman of the Board of our predecessor company, Diamond Walnut Growers, from 1996 to July 2005. Since 1983, Mr. Gilbert has been the owner and President of Gilbert Orchards and Rio Oso Groves, Inc., each of which is a family corporation focusing on walnuts. Mr. Gilbert was selected as a director nominee because of his in-depth experience in agribusiness, his long-term perspective on Diamond as a result of his service on the Board of Diamond Walnut Growers, his knowledge and expertise in the tree-nut industry and his close ties with our international customers, particularly in Japan and Korea.

“Steven M. Neil has served as our Executive Vice President, Chief Financial and Administrative Officer since March 2008. In addition, Mr. Neil has served on our Board since July 2005. Prior to joining Diamond Foods, Mr. Neil was Executive Vice President and Chief Financial Officer of The Cooper Companies, Inc., a company that manufactures specialty healthcare products, from April 2007 until March 2008. From January 2005 to April 2007, Mr. Neil was Vice President and Chief Financial Officer of The Cooper Companies. From July 2003 to January 2005, Mr. Neil served as Executive Vice President, Chief Financial Officer and Secretary of Ocular Sciences, Inc., a contact lens company. Mr. Neil holds a B.A. from the University of California, Santa Barbara, and an M.B.A. from the Anderson School of Management at the University of California, Los Angeles.

“Robert J. Zollars has served as Chairman and Chief Executive Officer of Vocera Communications, Inc., a company providing instant wireless communications solutions, since June 2007. From May 2006 to June 2007, Mr. Zollars was President and Chief Executive Officer of Wound Care Solutions, LLC, a holding company that operates chronic wound care centers in partnership with hospitals in the U.S. Mr. Zollars was selected as a director nominee as a result of his experience in serving as the chief executive of public companies and running businesses from \$100 million to over \$5 billion in revenue, and his expertise in general management, corporate strategy, and mergers and acquisitions.

“Edward A. Blechschmidt was Chief Executive Officer of Novartis Corp. from December 2006 until its sale to the Birla Group on May 2007. Mr. Blechschmidt was Chairman, Chief Executive Officer and President of Gentiva Health Services, Inc., a leading provider of specialty pharmaceutical and home health care services, from March 2000 to June 2002. Mr. Blechschmidt serves as a director of Healthsouth Corp., Lionbridge Technologies, Inc., and Columbia Laboratories, Inc. Mr. Blechschmidt was selected as a director nominee given his extensive background in executive management, mergers and acquisitions, and his financial and accounting expertise, including as Audit Committee Chairman for other public companies.

“Joseph P. Silveira served as a member of Board of Directors of our predecessor company, Diamond Walnut Growers, from June 2002 to July 2005. Mr. Silveira also served on the Board of Valley Fig Growers from 1992 to 2004, an agricultural cooperative, and while on that Board, he also served on the Board of Directors of Sun Diamond, a master cooperative organization that included Diamond Walnut Growers. Mr. Silveira brings considerable expertise in agribusiness to Diamond Foods, including strategic insight in commodity markets and large-scale production of agricultural products, his long-term perspective on Diamond as a result of his service on the Board of Diamond Walnut Growers and Sun Diamond, and his valuable contacts in the tree-nut industry.

“Laurence M. Baer has served as the President of the San Francisco Giants Baseball Club, a major league baseball team, since October 2008. Prior to becoming President, Mr. Baer was Executive Vice President of the San Francisco Giants Baseball Club since 1992 and was its Chief Operating Officer since 1996. Mr. Baer holds a B.A. from the University of California, Berkeley, and an M.B.A. from Harvard Business School. Mr. Baer brings to Diamond a background in marketing, media and general management and lends his expertise to our strategic focus on building our consumer brands, including the use of advertising and consumer promotions.

“Michael J. Mendes has served as our Chairman, President and Chief Executive Officer since January 2010 and served as our President and Chief Executive Officer since 1997. Mr. Mendes served as our Vice President of International Sales and Marketing prior to being appointed as our Chief Executive Officer. He began his career in international marketing at the Dole Food Company. Mr. Mendes currently serves on the Board of Grocery

Manufacturers Association and is currently on the Advisory Board of the Wine Group, a wine company. Mr. Mendes received an M.B.A. from the Anderson School of Management at the University of California, Los Angeles. Mr. Mendes serves on our Board as a result of his in-depth knowledge of Diamond Foods' products and strategies and his extensive international experience. As Chief Executive Officer, he has led Diamond through rapid growth and transformation into a consumer packaged goods company.

“Robert M. Lea served as a member of the Board of Directors of our predecessor company, Diamond Walnut Growers, from 1993 to July 2005. Since November 2004, Mr. Lea has practiced law as a solo practitioner with the Law Offices of Robert Lea, which he founded. Mr. Lea holds a B.A. from the University of California, Davis and a J.D. from the University of California, Berkeley, School of Law (Boalt Hall). Mr. Lea brings to Diamond Foods extensive legal experience handling complex civil cases, business experience generally, a long-term perspective on Diamond as a result of his service on the Board of Diamond Walnut Growers, and his insights on the walnut industry, tree-nut commodity markets and general economic conditions affecting Diamond.

“Dennis Mussell is the retired former President and Chief Executive Officer of Chicken of the Sea International, a packaged seafood company, after serving from August 1997 until January 2005. Prior to holding this position, Mr. Mussell served in various senior capacities with Van Camp Seafood Company, Inc., the predecessor corporation to Chicken of the Sea International, including most recently Chief Operating Officer. Mr. Mussell has extensive work experience in the packaged food industry and brings to Diamond Foods his knowledge and understanding of food manufacturing and the retail environment. Mr. Mussell holds a B.S. from Southwest Missouri State University.

“Glen C. Warren, Jr. has served as President, Chief Financial Officer and a director of Antero Resources LLC, a natural gas exploration and production company, since June 2002. Prior to joining Antero Resources LLC, Mr. Warren served as a Managing Director of Concert Energy Advisors, an investment banking advisory firm to energy companies, from November 2001 to June 2002. Mr. Warren holds a B.A. from the University of Mississippi, a J.D. from the University of Mississippi School of Law and an M.B.A. from the Anderson School of Management at the University of California, Los Angeles. Mr. Warren has wide-ranging experience and expertise in mergers and acquisitions, finance, and investment banking, which assist us in assessing strategic transactions to support our growth plans.”

Audit Committee: The members of the Audit Committee were Mr. Silveira, Mr. Mussell, and Mr. Blechschmidt, with Mr. Blechschmidt serving as committee chairman.

Compensation Committee: The members of the Compensation Committee were Mr. Baer, Mr. Warren and Mr. Zollars, with Mr. Zollars serving as committee chairman.

Nominating and Governance Committee: The members of the Nominating and Governance Committee were Mr. Mussell, Mr. Warren and Mr. Zollars, with Mr. Warren serving as committee chairman.

All Directors have served since 2005 with the exception of Edward A. Blechschmidt, who was appointed in 2008.

Source: Excerpt from Company Proxy Statement (SEC Form DEF 14A), Filed November 26, 2010.

Exhibit 2a Diamond Foods Inc. Income Statement

Year End July 31st	2006	2007	2008	2009	2010	2011
Revenue	477.2	522.6	531.5	570.9	680.2	965.9
Cost of Goods Sold	411.8	443.9	443.5	435.3	519.2	714.8
Gross Profit	65.4	78.7	88.0	135.6	161.0	251.1
Selling, General & Administrative Expenses	38.0	42.6	43.6	61.0	64.3	97.0
Advertising	18.0	20.4	20.5	28.8	33.0	44.4
Other Operating Expenses, Total	56.1	63.0	64.1	89.8	97.3	141.4
Operating Income	9.3	15.7	23.9	45.8	63.7	109.7
Interest Expense	(0.3)	(1.3)	(1.0)	(6.3)	(10.2)	(23.8)
Net Interest Expense	(0.3)	(1.3)	(1.0)	(6.3)	(10.2)	(23.8)
Other Non-Operating Income/(Expense)	(0.3)	(0.2)	-	(0.9)	(1.8)	-
EBT Excluding Unusual Items	8.7	14.2	22.9	38.6	51.7	85.9
Restructuring Charges	(1.0)	-	-	-	-	-
Merger and Related Restructuring Charges	-	-	-	-	(11.5)	(16.8)
Legal Settlements	(1.4)	-	-	-	-	-
Other Unusual Items	-	(3.0)	-	-	-	-
EBT Including Unusual Items	6.3	11.2	22.9	38.6	40.2	69.1
Income Tax Expense	(1.0)	2.8	8.1	14.9	14.0	18.9
Earnings from Continuing Operations	7.3	8.4	14.8	23.7	26.2	50.2
Net Income to Company	7.3	8.4	14.8	23.7	26.2	50.2
Net Income	7.3	8.4	14.8	23.7	26.2	50.2
Per Share Items	\$0.47	\$0.53	\$0.92	\$1.45	\$1.4	\$2.33
Basic EPS	\$0.47	\$0.53	\$0.91	\$1.42	\$1.36	\$2.22
Diluted EPS	15.7	15.8	16.3	16.7	19.3	22.2
Weighted Average Diluted Shares Out	\$0.12	\$0.12	\$0.18	\$0.18	\$0.18	\$0.18
Dividends per Share	19.2%	22.6%	19.6%	12.5%	13.2%	7.9%
Payout Ratio %	\$0.47	\$0.53	\$0.92	\$1.45	\$1.4	\$2.33

USD in millions except per share data.

Source: Capital IQ.

Exhibit 2b Diamond Foods Inc. Balance Sheet

Year End July 31st	2006	2007	2008	2009	2010	2011
Assets						
Current assets						
Cash and cash equivalents	35.6	33.8	74.3	24.8	5.6	3.1
Accounts Receivable	49.5	50.7	46.3	33.5	65.6	98.2
Inventories	99.2	90.6	88.5	85.0	143.4	145.6
Deferred income taxes	4.2	2.4	4.3	3.6	5.8	13.1
Prepaid expenses	4.6	4.8	7.4	13.1	10.5	13.2
Other current assets	4.9	1.9	-	-	9.2	2.8
Total current assets	198.0	184.1	220.7	160.0	240.1	276.0
Non-current assets						
Property, plant and equipment						
Gross property, plant and equipment	111.1	117.8	122.1	143.6	220.4	247.6
Accumulated depreciation	(76.8)	(83.9)	(87.5)	(92.4)	(102.6)	(120.2)
Net property, plant and equipment	34.3	33.9	34.6	51.1	117.8	127.4
Long-term investments	2.2	1.8	-	1.5	-	-
Goodwill	5.1	5.4	5.4	76.1	396.8	407.6
Intangible assets	3.9	3.7	3.5	97.9	449.0	450.9
Deferred tax assets, LT	4.8	4.9	5.8	6.2	13.6	3.9
Other long-term assets	4.8	2.5	3.2	2.1	8.5	22.6
Total non-current assets	55.0	52.2	52.5	235.0	985.7	1,012.4
Total assets	253.0	236.4	273.3	394.9	1,225.9	1,288.4
Liabilities and stockholders' equity						
Current liabilities						
Accounts payable	102.3	72.3	78.8	61.4	78.5	81.4
Accrued expenses	8.0	11.3	20.4	32.2	47.9	53.9
Short-term borrowings	-	-	-	-	-	-
Current portion of LT debt	-	-	-	15.0	40.0	41.7
Current income taxes payable	-	-	-	-	1.5	8.7
Total current liabilities	110.3	83.6	99.3	108.6	167.9	185.8
Non-current liabilities						
Long-term debt	20.0	20.3	20.2	100.1	516.1	490.0
Deferred taxes liabilities	-	-	-	1.2	144.8	131.9
Other long-term liabilities	11.9	7.1	7.6	11.6	17.2	26.0
Total liabilities	142.2	111.1	127.0	221.6	845.9	833.6
Stockholders' equity						
Common stock	0.0	0.0	0.0	0.0	0.0	0.0
Additional paid-in capital	94.0	101.1	112.6	122.8	307.0	318.1
Retained earnings	16.9	23.4	35.3	56.1	78.8	125.1
Treasury stock	-	(1.4)	(3.2)	(4.3)	(5.1)	(6.9)
Comprehensive income and other	0	2.2	1.6	(1.3)	(0.9)	18.5
Total stockholders' equity	110.8	125.3	146.2	173.3	379.9	454.8
Total liabilities and stockholders' equity	253.0	236.4	273.3	394.9	1,225.9	1,288.4

USD in millions except per share data.

Source: Capital IQ.

Exhibit 2c Diamond Foods Inc. (DMND) Statement of Cash Flows

Year End July 31st	2006	2007	2008	2009	2010	2011
Net Income	7.3	8.4	14.8	23.7	26.2	50.2
Depreciation & Amortization	5.5	7.3	6.2	9.6	13.3	21.6
Amortization of Goodwill and Intangibles	0.1	0.2	0.2	1.8	3.9	7.9
Total Depreciation & Amortization	5.5	7.6	6.4	11.4	17.2	29.5
(Gain) Loss from Sale of Assets	-	(1.2)	-	-	-	-
Stock-Based Compensation	4.0	5.9	6.9	3.9	3.2	7.0
Tax Benefit from Stock Options	0	0	(0.6)	(1.1)	(0.4)	(2.3)
Other Operating Activities	(1.1)	0.8	(3.0)	(1.9)	8.2	(6.5)
Change in Accounts Receivable	(4.8)	(1.0)	4.4	12.8	(2.9)	(32.7)
Change in Inventories	17.3	8.1	2.1	10.3	(45.9)	(2.2)
Change in Accounts Payable	(4.4)	(26.7)	15.9	(6.6)	(5.5)	17.6
Change in Other Net Operating Assets	10.2	2.0	0.2	0.9	(1.7)	5.0
Cash from Operations	34.0	3.8	47.1	53.4	(1.6)	65.7
Capital Expenditures	(8.4)	(6.8)	(6.6)	(8.0)	(11.8)	(27.7)
Sale of property, plant, and equipment	0.0	2.9	0.0	0.1	-	-
Cash Acquisitions	(19.2)	(0.2)	-	(190.2)	(615.4)	-
Other Investing Activities	0.1	0.4	0.3	0.0	0.6	(15.5)
Cash from Investing	(27.4)	(3.6)	(6.3)	(198.1)	(626.6)	(43.2)
Long Term Debt Issued	-	-	-	125.0	576.0	21.4
Total Debt Issued	-	-	-	125.0	576.0	21.4
Long Term Debt Repaid	(2.1)	-	(0.2)	(30.1)	(135.0)	(45.7)
Total Debt Repaid	(2.1)	-	(0.2)	(30.1)	(135.0)	(45.7)
Issuance of Common Stock	0.8	1.2	-	-	191.5	-
Repurchase of Common Stock	-	(1.4)	-	-	-	-
Common Dividends Paid	(1.4)	(1.9)	(2.9)	(3.0)	(3.5)	(4.0)
Total Dividends Paid	(1.4)	(1.9)	(2.9)	(3.0)	(3.5)	(4.0)
Other Financing Activities	(17.3)	0.1	2.8	3.3	(20.1)	3.2
Cash from Financing	(20.0)	(2.0)	(0.3)	95.2	608.9	(25.1)
Foreign Exchange Rate Adjustment	-	-	-	-	0.1	0.1
Net Exchange in Cash	(13.4)	(1.9)	40.5	(49.5)	(19.2)	(2.5)
Supplemental Disclosure of Cash Flow Information:						
Cash paid during the period for:						
Interest	696	1,638	1,183	5,989	9,088	21,998
Income Taxes	2,178	3,878	5,945	19,438	11,113	8,751

USD in millions except per share data.

Source: Capital IQ and company financial statements.

Exhibit 3 Selected Debt Covenants of Diamond Foods

“On February 25, 2010, we entered into a new \$600 million secured credit facility agreement that, subject to closing on the Kettle Foods acquisition, we expect will replace our existing \$250 million credit facility. The new credit facility, which has a five-year term, was entered into with a syndicate of lenders ... The proceeds from debt incurred under our new Secured Credit Facility will be used to fund the Kettle Foods acquisition, repay indebtedness under our existing credit facilities and for our ongoing operational needs.

“Our new Secured Credit Facility consists of a \$200 million revolving credit facility and a \$400 million term loan facility. We expect to incur all of the term loan, and approximately \$174 million under the revolving credit facility, at the closing of the Kettle Foods acquisition. The term loan facility will be subject to quarterly amortization of principal, in the amount of \$40 million per year, beginning in the fiscal quarter ending July 31, 2010. The remaining principal balance of the term loan, and any outstanding loans under the revolving credit facility, must be repaid on the fifth anniversary of initial funding. ... Our new Secured Credit Facility also provides for customary affirmative and negative covenants, including requirements that we maintain a maximum consolidated leverage ratio of not more than 4.75 to 1.00, reducing annually over the term of the facility to reach 3.25 to 1.00 on April 30, 2014, and a requirement that we maintain a minimum fixed charge coverage ratio (defined as EBITDA minus capital expenditures, interest charges and cash tax payments, divided by the sum of our interest expense, principal payments and dividends) of 1.10 to 1.00 through October 30, 2012, 1.20 to 1.00 through October 30, 2013, and 1.25 to 1.00 through maturity.

“Our new Secured Credit Facility also contains covenants that restrict our ability to (1) incur liens on our property, (2) incur indebtedness (including guarantees and other contingent obligations, (3) make dispositions of assets, (4) acquire other companies and businesses, (5) make investments in companies that are not our subsidiaries and (6) make restricted payments which could limit our ability to pay dividends.”

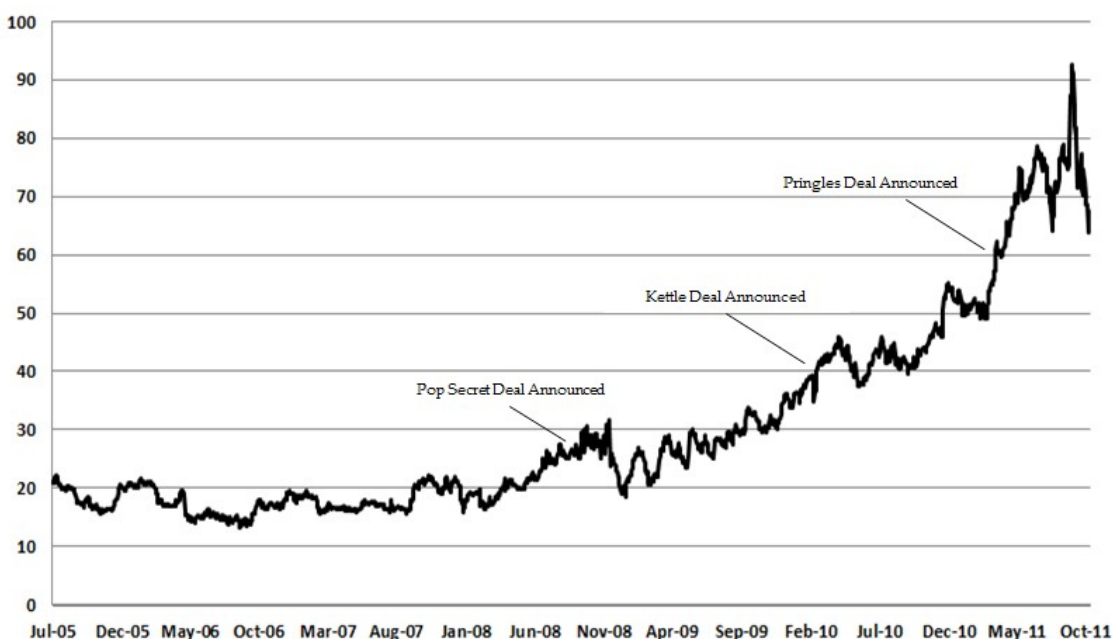
Source: Excerpted from Diamond’s SEC Form 423B5, Filed on March 1, 2010.

Exhibit 4 Diamond Foods Segment Reporting

Figures in USD millions	2006	2007	2008	2009	2010	2011
Snack	40.7	79.6	88.6	188.9	321.4	553.2
Culinary and Retail In-shell	286.5	297.2	335.4	276.2	249.0	262.9
Total Retail	327.2	376.8	424.0	465.1	570.4	816.1
International Non-Retail	62.4	69.1	48.0	68.9	69.2	119.0
North American Ingredient/Food Service and Other	87.6	76.7	59.5	36.9	40.5	30.8
Total Non-Retail	150.0	145.8	107.5	105.8	209.8	149.9
Total Net Sales	477.2	522.6	531.5	570.9	680.2	965.9

Source: Diamond Food 2011 and 2008 10-K

Exhibit 5 DMND Stock Price Since IPO, July 21, 2005 to October 31, 2011



Source: NASDAQ, DMND Historical Stock Prices, Accessed 13 November, 2012.

Exhibit 6 DMND Stock Percent Short Interest at Quarter End

Year	March	June	September	December
2008	2.11%	1.82%	6.36%	15.17%
2009	15.21%	8.87%	14.34%	13.15%
2010	13.24%	19.30%	24.86%	26.19%
2011	25.79%	28.05%	38.20%	45.44%

Source: Capital IQ, Accessed 15 November, 2012.

Exhibit 7 Pringles Deal Price

	At time deal was struck	Current (Sept. 2011)
Diamond share price	\$51.47	\$90.37
Shares to be exchanged	29.1	29.1
Share exchange value	1,498	2,630
Estimated debt assumption	850	700
Total deal value	2,348	3,330
Pringles FY 2011 EBITDA	243	243
Pringles valuation EV/EBITDA	9.7	13.7

Source: Off Wall Street Consulting Group report on Diamond Foods, Sep 25, 2011.

Exhibit 8 Pringles Historical Results

FY end June 30	2006	2007	2008	2009	2010	2011
Revenue	1,298.3	1,339.3	1,534.4	1,396.4	1,367.4	1,455.7
COGS	830.2	890.9	1,077.9	1,049.3	886.9	924.0
Gross Profit	468.1	448.4	456.5	347.1	480.5	531.7
R&D	NA	NA	NA	23.6	22.7	22.3
Advertising costs	NA	NA	NA	66.6	100.5	105.8
Other SG&A costs	NA	NA	NA	189.6	190.9	205.4
SG&A	297.3	301.5	334.9	279.8	314.1	333.5
Other ope expenses	(1.6)	1.0	(0.2)	7.4	(0.5)	0.8
Operating profit	172.4	145.9	121.8	59.9	166.9	197.4
D&A	NA	NA	NA	74.2	46.5	45.9
EBITDA	NA	NA	NA	134.1	213.4	243.3
Gross margin	36%	33%	30%	25%	35%	37%
Operating margin	13%	11%	8%	4%	12%	14%
Y/Y rev growth	NA	3%	15%	-9%	-2%	6%
Revenue CAGR						
2006-2011	NA	NA	NA	NA	NA	2.3%
Volume	NA	NA	NA	NA	-5%	7%
Price	NA	NA	NA	NA	2%	-2%
Mix	NA	NA	NA	NA	1%	1%

Source: Off Wall Street Consulting Group report on Diamond Foods, Sep 25, 2011.

Exhibit 9 Off Wall Street Estimated Diamond Market Share

Year	Acres	Tons/Acre	Change in Yield/Acre	US Production (mm lbs.)	Estimated Diamond Walnut Demand (mm lbs.)	Estimated Diamond Market Share
2001	204,000	1.5	-	610	289	47%
2002	210,000	1.34	-10%	564	260	46%
2003	213,000	1.53	14%	652	296	45%
2004	214,000	1.52	-1%	650	294	45%
2005	215,000	1.65	9%	710	287	40%
2006	216,000	1.6	-3%	692	279	40%
2007	218,000	1.5	-6%	656	262	40%
2008	223,000	1.96	30%	872	313	36%
2009	227,000	1.93	-2%	874	283	32%
2010	227,000	2.22	15%	1006	277	28%
2011	227,000	2.14	-4%	970	246	25%

Source: Off Wall Street Consulting Group report on Diamond Foods, Sep 25, 2011.

Exhibit 10 Estimated Discounts Taken by Diamond for Walnuts

Crop harvested Oct-Dec	Est. DMND walnut offtake (millions lbs)	Estimated discount to fair market value/lb**	Estimated payment discount**	Cumulative estimated payment discount
2006	279	\$(0.125)	(34.8)	(34.8)
2007	262	\$(0.125)	(32.7)	(67.6)
2008	313	\$(0.125)	(39.1)	(106.7)
2009	283	\$(0.125)	(35.4)	(142.1)
2010	277	\$(0.45)	(124.8)	(266.9)

Source: Off Wall Street Consulting Group report on Diamond Foods, Sep 25, 2011.

Exhibit 11 Off Wall Street Revenue Estimates for Pop Secret and Kettle Foods

	2006	2007	2008	2009	2010
Pop Secret	85.4	94	103.4	13.5	-
Kettle Foods	245.1	269.6	296.6	257.9	174.4

Source: Off Wall Street Consulting Group report on Diamond Foods, Sep 25, 2011.

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