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The Bottom Line on the Conversion of Diamond Walnut Growers

by

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On July 1, 2005, members of Diamond Walnut voted to approve the conversion of the cooperative to a stockholder-owned corporation, by merging it into its wholly owned subsidiary, Diamond Foods. The analysis below is focused on the decisions Diamond Walnut members faced when they voted on the conversion proposal. While there are numerous economic issues related to this conversion, this analysis is limited to comparing the change in growers' status as members of a cooperative with that as shareholders and/or suppliers of a stockholder-owned corporation.

The history of Diamond Walnut can be traced back to 1912 when chaotic marketing conditions led to the formation of the California Walnut Marketing Association. This federation of local walnut packing cooperatives provided economic stability within the walnut industry. In 1956, it changed its name to Diamond Walnut Growers and built processing facilities in Stockton to expand its production of shelled walnuts in response to changing market conditions. The federated structure evolved into a centralized cooperative and Diamond Walnut became the nation's leading marketer and distributor of culinary nuts. In the late 1990s, Diamond Walnut broadened its product line of culinary and inshell nuts to be a more competitive supplier to U.S. grocery chains. In 2004, Diamond Walnut advanced further into value-added products with the launch of its Emerald line of snack nuts.

On March 24, 2005, Diamond Walnut filed a preliminary prospectus for an initial public offering (IPO) of Diamond Foods' common stock with the Securities and Exchange Commission (SEC) as part of its proposed conversion to a stockholder-owned corporation. The conversion was approved by over 80 percent of Diamond Walnut members at a special meeting on July 1, 2005.

The final requirement to completing the conversion was the sale of at least four million shares of Diamond Foods stock during the IPO at a price of at least $5.00 per share. On July 20, Diamond Foods announced the IPO of 6.0 million shares of its common stock at a price of $17.00 per share. During the first week of trading, share prices ranged between $20.50 and $22.10; 5,027,300 shares were traded during the opening day.

In its S-4 filing to the SEC on June 14, 2005 (the last filing sent to members prior to the vote), Diamond Foods stated that it expected to sell 5,333,333 shares of Diamond Foods common stock in an IPO and raise an estimated $70.9 million in net proceeds (based on the assumed IPO price of $15.00 per share). From these proceeds, approximately $17.1 million would be used to pay off a long-term loan. An estimated $18.6 million would be paid to Diamond Walnut members who elected to receive cash in lieu of stock, while an estimated 6.7 million shares of common stock will also be issued to Diamond Walnut members, for total compensation of $119.7 million. The balance of the proceeds from the IPO

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would be used primarily to develop and market value-added products, and to install new equipment to gain processing efficiencies.

Clearly, the proposed conversion provides significant financial benefits to Diamond Foods. In its prospectus, Diamond Foods indicated that the conversion is driven by the need to increase its financial strength through improved access to capital. Most of Diamond Walnut's equity is currently comprised of working capital retains which the cooperative typically redeems after one year; the Diamond Foods common stock would provide equity of a more permanent nature. Its debt/equity ratio will improve considerably because Diamond Foods' long-term debt is projected to decrease by $15.5 million while its equity increases by $21.6 million (based on the $15 share price). This proposal is very different from Tri Valley Growers' conversion in 1996, which did not access outside equity capital.

"...the common stock that growers will receive has the potential to appreciate in value as well as paying stock dividends."

The impacts of the conversion on current members of Diamond Walnut differ from those on the firm. As a cooperative, Diamond Walnut operates for the benefit of its members, and is owned and controlled by its members. In this analysis, the potential impacts of the conversion on members are assessed by comparing their status as members of a cooperative with that as shareholders and suppliers of Diamond Foods, a publicly traded firm. The analysis is based on information included in Diamond Foods' S-4 and preliminary S-1 registration statements filed with the SEC, respectively, on June 14, 2005 and July 5, 2005. (Relevant changes that have occurred since July 5 are noted in parentheses.)

Potential Positive Impacts of Conversion

While the proposed conversion of Diamond Walnut provides numerous benefits to Diamond Foods, it could also have several positive impacts on Diamond Walnut's current members.

Liquidity of common stock. Members of cooperatives typically lack liquidity in their investment in their cooperative; they cannot freely sell their ownership interests. Although the proposed conversion terminates the user-financed relationship between Diamond Walnut and its members, growers can own part of Diamond Foods as shareholders along with the executive officers, employees and other investors. They received common stock, allocated proportionate to their patronage for the two crop years with the highest patronage out of the last six crop years. (During the vote, members requested to convert 936,721 shares into cash, instead of the estimated 1,333,333 shares.) For the first 360 days after the completion of the stock offering, members have restricted ability to sell their shares.

The distributions of stock and cash to members are compensation to members for their ownership of Diamond Walnut. Members have invested directly in Diamond Walnut by providing revolving fund retains and working capital retains, and indirectly by funding the development of new products and marketing programs as expenses deducted before determination of their net proceeds. Between fiscal years 2000 and 2004, Diamond Walnut invested a total of $48.6 million for brand development through advertising. These expenses represent an average annual reduction of approximately $.037/lb. to members' net proceeds.

Stock dividends and appreciation. Members of cooperatives typically do not earn dividends on their investment in a cooperative, nor do they usually gain appreciation from their investment. Cooperatives are structured to provide returns to members primarily on the basis of their use of the cooperative rather

While the proposed conversion of Diamond Walnut provides numerous benefits to Diamond Foods, it could also have several positive and negative impacts on Diamond Walnut's current members. (Photo by Julie McNamara) than on their investment in the cooperative. Unlike the revolving fund and working capital retains that members previously invested in Diamond Walnut, the common stock that growers will receive has the potential to appreciate in value as well as paying stock dividends.

Since Gold Kist, the nation's third largest integrated chicken company, converted from a cooperative to a publicly traded company in September 2004, its stock price has risen from $10.15 to $23.95. Shares of the former cooperative, Calavo, have ranged in value from $7.10 to $13.00 since they began trading publicly in 2002.

"The conversion transfers the market power currently held by Diamond Walnut's members to Diamond-Foods..."

Diamond Foods expects to pay a $0.03 per share dividend for the first quarter. Future stock dividends and gains in value of Diamond Food's stock will represent returns from its marketing investments and gains in efficiency. Diamond expects to become a significant force in the healthy snacks category. The additional equity capital will enable the firm to increase its sales by investing in new products, advertising and distribution to capitalize on consumers' growing awareness of the health benefits of nuts and enhance its ability to compete against the snack nut market leader, Planters, a subsidiary of Kraft Foods.

Dietary trends are strengthening demand for nuts in culinary uses and as nutrient-rich snacks. In July 2003, the Food and Drug Administration approved the health claim that eating one and a half ounces of most nuts may reduce the risk of heart disease when they are part of a diet low in saturated fat and cholesterol. USDA's Dietary Guidelines for Americans 2005 specifically lists walnuts as a source of omega-3 polyunsaturated fatty acids. For the 52-week period ending July 31, 2004, ACNielsen identified nuts as the second fastest growing category in the U.S. grocery channel, with a 13.7 percent sales increase over the previous year. The Walnut Marketing Board's reports reinforce these sales trends; they indicate domestic shipments have risen 26.7 percent over the past four years.

Board expertise. Board members are responsible for the performance of the firm they govern. One of the major drawbacks of the user-control principle practiced by cooperatives is that the boards of most agricultural cooperatives are homogeneous in composition. Currently, all 13 members of Diamond Walnut's board are producers who, as a group, lack experience with the marketing and financing issues that are increasing in complexity as Diamond Walnut pursues its value-added marketing strategy. Diamond Foods' board includes five outside directors with considerable financial management and marketing expertise, as well as extensive experience in the packaged foods and dietary products industries, to guide the firm's growth in the healthy snacks category.

Thus, the conversion offers several potential financial benefits to members. In addition to having a board with broader expertise to provide strategic oversight, members benefit from the marketability of the Diamond Foods' stock and its potential for dividend payments and capital gains.

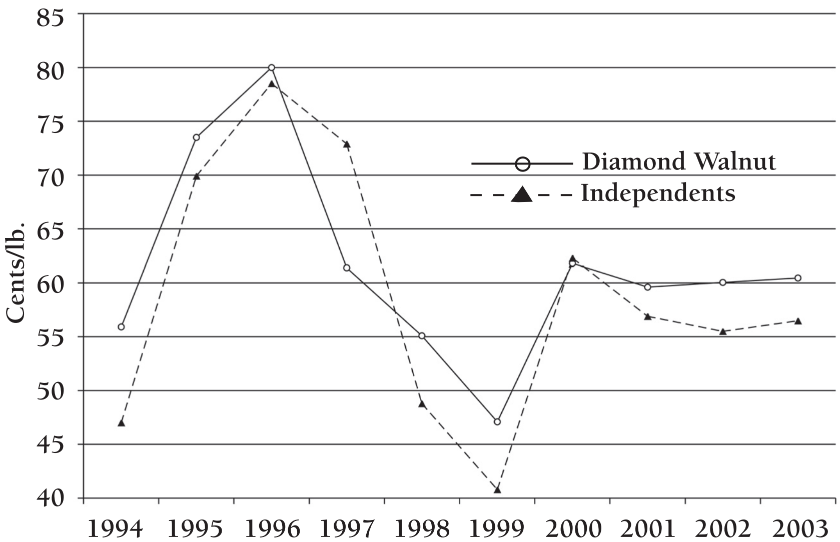
Potential Negative Impacts of Conversion

The conversion terminates the user-control, user-benefit and user-financed relationship between growers and the cooperative. This change has potential negative impacts on Diamond Walnut's current members.

Decline in grower control. As a cooperative, Diamond Walnut is controlled by its members. The conversion will result in some loss of grower control. Three of the thirteen members of Diamond Walnut's board have been appointed to the new Diamond Foods' nine member board, since companies listed on the NASDAQ are required to have a majority of outside directors on their boards. There will also be a Grower Executive Council, comprised initially of the ten members of the Diamond Walnut board who did not become members of the Diamond Foods board. However, this body will provide input solely in an advisory capacity regarding walnut grading and overall grower support and service.

Currently, Diamond Walnut's grower members have voting rights proportionate to their deliveries during the past two crop years. With the conversion, growers were expected to hold 6,726,874 shares of the 12,666,667 shares (53.3 percent) of common stock to be issued initially (including shares issued to grower members on the Board and the Grower Executive Council). If no member shares were exchanged for cash, growers would have held 57.8 percent of the stock initially, and potentially even more, if they purchase some of the 5.3 million shares to be sold to the public. Conversely, if all of the options granted to

Figure 1. Average Returns to Walnut Growers



Source: Diamond Walnut

the executive officers and board members are exercised, then growers would own 49.5 percent of the 13,621,667 shares of Diamond Foods stock issued. Since there are provisions for additional public offerings and employee stock purchases as well as the annual issuance of stock shares and options to board members, growers could lose majority control unless some of them choose to purchase additional stock. (After the vote and the IPO, growers actually hold 51.6 percent of the shares.)

Maximizing shareholder value. Growers have had market power as members of the cooperative. Prior to the creation of the federated cooperative in 1912, growers were bidding against each other as members of rival local cooperatives. Members have earned a premium over the independent handlers' average price during eight of the past ten years (Figure 1). During the past five years since Diamond Walnut began broadening its product mix, its price premium has averaged $0.034/lb.. Its returns to members were lower than the average price paid by independents only once–a $0.005/lb. shortfall in 2001, which followed the highest premium paid ($0.063/lb.) in 2000.

The conversion transfers the market power currently held by Diamond Walnut's members to Diamond Foods because the firm's "…mission will shift from delivering annual net proceeds to members to maximizing long-term shareholder value" (S-4, p.18). Members of Diamond Walnut who become shareholders of Diamond Foods can benefit from dividends and stock appreciation. As suppliers, however, they could be adversely impacted by Diamond Foods' strategy to maximize shareholder value by improving gross and operating margins. Diamond Foods cautioned growers that: "Payments under the new Walnut Purchase Agreement could be less than payments members are historically accustomed to receiving under the existing Marketing Agreement." (S-4, p.15). "…[E]ach March (following the harvest), Diamond Foods will determine a purchase price based on market conditions, quality, variety and other relevant factors." (S-4, pp.36-37). This statement provides Diamond Foods considerable latitude in establishing the price it will pay growers.

Growers who contract with Diamond Foods through the new Walnut Purchase Agreement will have their current Diamond Walnut marketing agreement extended by three, five or ten years, and must deliver their entire crop to Diamond Foods for the duration of the contract.

Thus, they will place themselves into a "monopsony" situation; by signing the exclusive contract, they have only one buyer for their walnuts. The contract offers no price protection or guarantee to pay market prices; the monopsonistic conditions make the contracting growers vulnerable to price manipulation.

In the longer term, Diamond Foods could also improve its operating margins through foreign sourcing, thereby reducing demand and depressing prices for California-grown walnuts. Diamond Walnut is already purchasing hazelnuts from Turkey, pecans from Mexico and pine nuts from China. Although the U.S. remains the dominant exporter of walnuts, China has displaced the U.S. as the world's largest walnut producer. Mexico is currently a small supplier to the U.S. The interests of investor shareholders seeking to increase profits by reducing raw product costs can conflict with those of the grower-shareholders trying to maximize their revenues as suppliers.

Uncertain compensation. Members voted on the conversion without knowing how much compensation they would receive for their current ownership in Diamond Walnut, because of the issuance of common stock. The estimated IPO price of $15.00 per share used in the preliminary registration filings yields

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$119.5 million in compensation (including $13.1 million in cash). However, the initial share price could be higher or lower. Diamond Foods advised members that it is not required to obtain new member approval unless it proposed to complete the IPO for fewer than 4,000,000 shares or at a share price below $5.00. At the $5.00 minimum price, members would receive only $40.3 million for their ownership interest in Diamond Walnut. (Based on the actual IPO price of $17, the aggregate value to members for the shares and cash paid in the conversion totaled $154.3 million, which exceeded expectations.)

In 2004, Diamond Walnut advanced further into value-added products with the launch of its Emerald line of snack nuts. ***(Photo Courtesy of Emerald Nuts)***

The cooperative, Gold Kist, filed registration documents for its IPO of 18 million shares using an estimated market price of $15.00 per share. After members approved the conversion, Gold Kist completed its IPO for 12 million shares at $11.00, yielding net proceeds of $119.4 million instead of the projected $248.4 million. It issued the unsold 6 million shares to its members and paid members $88 million in cash, rather than the estimated $120 million. However, Diamond Foods is in a different industry and its offering is considerably smaller.

The termination of the user-control, user-benefit and user-financed relationship between growers and the cooperative could have negative impacts on Diamond Walnut's current members. Members' compensation for their ownership in Diamond Walnut is dependent on the share price and the number of shares sold during the IPO. Members who become shareholders will share control with other shareholders who are not growers. The restructured business will operate for the benefit of the shareholders and growers will have no price protection in their multi-year supplier contracts.

The Bottom Line

The prototype 100-acre member discussed at grower meetings in April would receive $10,759 less for his crop as a Diamond Foods grower than as a Diamond Walnut member, assuming that Diamond Foods pays the average market price and Diamond Walnut would have paid its $0.034/lb. average premium. However, a portion of the Diamond Foods grower's revenue will not be retained as member equity. With the conversion, the grower will earn $972 annually from the 8,104 shares of Diamond Foods stock he holds if a $0.03 per share dividend is paid quarterly. Although the dividends do not offset the grower's reduced crop revenues, the grower could earn significant capital gains by selling his stock if Diamond Foods has strong financial performance and its stock price increases accordingly. If the stock price remains at the estimated $15/share value, the prototype grower will receive $121,560 when he sells his 8,104 shares.

The long-term relative financial impact of the conversion will depend on an individual member's specific circumstances. In particular, members with diversified operations may have more capacity and tolerance for risk than members whose livelihood depends solely on their production of walnuts. Members who are planning to cease growing walnuts soon are likely to find the conversion to be more attractive that those members who expect to produce walnuts for at least ten more years. The length of time that a grower holds his stock could considerably affect his ability to offset his cumulative reductions in crop revenues (net of dividend payments) with the capital gains earned by selling his stock.

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