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AN ANALYSIS OF THE POTENTIAL IMPACTS OF THE PROPOSED CONVERSION OF DIAMOND WALNUT GROWERS ON ITS MEMBERS[1]

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SUMMARY

On July 1, 2005, members of Diamond Walnut will vote regarding the proposed conversion of Diamond Walnut from a cooperative to a publicly traded corporation by merging Diamond Walnut into its wholly-owned subsidiary, Diamond Foods. The conversion requires approval by a majority of Diamond Walnut's members. Diamond Foods expects to sell 5.3 million shares of common stock at $15/share in the initial public offering. Members will receive an estimated 6.7 million shares of common stock in Diamond Foods and $18.6 million in cash for their interest in Diamond Walnut, with a total estimated value of $119.5 million. The stock sale will enable Diamond Foods to invest in marketing programs to capitalize on consumers' interest in healthy snacks, as well as to install efficiency-improving equipment.

If the conversion occurs, growers will cease to be members of Diamond Walnut; they will become shareholders and/or suppliers of Diamond Foods. Some potential impacts of the proposed conversion on Diamond Walnut's current members were assessed and are presented in this report. Possible positive impacts include:

- Members of cooperatives typically lack liquidity in their investment in their cooperative; they cannot freely sell their ownership interests. After a one year holding period, their Diamond Foods common stock will be freely tradable.
- Members' shares of Diamond Foods stock may generate dividend payments and appreciate in value, unlike their current investment in Diamond Walnut.
- Diamond Foods will be governed by a board of directors with extensive expertise in marketing consumer products and broad financial management experience.

Possible negative impacts of the proposed conversion include:

- Growers may lose majority voting control and will be governed by a board which initially will include only 3 growers among the 9 directors.
- Because the firm's mission changes from maximizing net proceeds to members to maximizing returns to shareholders, growers could receive below-market prices through

[1] This report is intended to serve as an unbiased analysis by the author of some of the issues associated with the proposed conversion of Diamond Walnut Growers from an agricultural cooperative to a publicly traded corporation. It does not provide specific legal or financial advice. Individuals should consult their own experts to evaluate the impacts of this proposal on their own specific situations.

multi-year marketing contracts that provide no price protection. In the long term, Diamond Foods could purchase walnuts from foreign sources to lower its costs.

- Members will vote on the conversion without knowing the actual value of the stock or how much cash they will receive. In order to complete this public offering, at least 4 million shares must be sold at a price of at least $5.00 per share. Another cooperative, Gold Kist, obtained less than 50% of the expected proceeds from its initial public offering last September.

The long-term relative financial impact of the conversion will vary with 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 stop 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.

Introduction

In 1912, chaotic marketing conditions led to the formation of the California Walnut Marketing Association . This federation of local walnut packing cooperatives became a basic pillar supporting economic stability within the walnut industry. In 1956, it changed its name to Diamond Walnut Growers and began building processing facilities in Stockton to expand its production of shelled walnuts in response to changing market conditions (Jewett and Voorhies). 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 US grocery chains. In 2004, Diamond Walnut advanced further into value-added products with the launch of its Emerald line of snack nuts.

Studies by economists have determined that agricultural marketing cooperatives tend to concentrate in commodity-oriented markets (Gruber, Rogers and Sexton). Diamond Walnut has stood out recently among agricultural cooperatives as a marketer of value-added products. On March 24, 2005, Diamond Walnut took another step to strengthen its marketing program by filing the preliminary prospectus for an initial public offering (IPO) of Diamond Foods' common stock with the Securities and Exchange Commission. The conversion is subject to approval by a majority of the members of Diamond Walnut at a special meeting on July 1, 2005. It will not occur if the public stock offering is not completed.

Diamond proposes to sell 5.3 million shares of common stock in the IPO and raise an estimated $72.4 million (based on the assumed IPO price of $15.00 per share). From these proceeds, approximately $17.1 million will be used to pay off a long-term loan. An estimated $18.6 million will be paid to Diamond Walnut members who elect 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. The remaining balance of the proceeds from the IPO will 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 benefits to Diamond Foods. In its Prospectus, Diamond Foods indicated that the conversion of the cooperative to a publicly-traded corporation is driven by the need to increase its financial strength through improved access to capital. The majority of Diamond Walnut's equity is currently comprised of working capital retains which the cooperative typically redeems after one year; the common stock that Diamond Foods is proposing to issue provides equity of a more permanent nature.

On April 30, 2005, Diamond Walnut's debt/equity ratio was 2.22; the pro forma balance sheet indicates that it would drop to 1.45 with the conversion. This considerable improvement occurs because Diamond Foods' long- term debt is projected to decrease by $15.5 million while its equity increases by $16.1 million (based on the $15 share price). This proposal is very different from the Tri Valley Growers experience in 1996, which involved the conversion of member equity to capital stock but did not access outside equity capital.

The impacts of the conversion on current members of Diamond Walnut are not the same as those on the firm. Diamond Walnut's current business structure as a cooperative affects both its business practices and its relationship with its members. The conversion will change this relationship. As a cooperative, Diamond Walnut operates for the benefit of its members, is financed by its members and is controlled by its members. In this analysis, the potential impacts of the proposed conversion on the 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. Except where noted otherwise, the analysis is based on the information included in the Diamond Foods' S-4 and its preliminary S-1 registration statements that were filed with the Securities and Exchange Commission, respectively, on June 14, 2005 and May 2, 2005.

Potential Positive Impacts of Proposed 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. Members of cooperatives typically lack liquidity in their investment in their cooperative; they cannot freely sell their ownership interests. Also, they typically cannot gain appreciation from their investment because cooperatives are structured to provide returns to members primarily on the basis of their use of the cooperative rather than on their investment in the cooperative. Under the proposed conversion, members of Diamond Walnut will be granted shares of common stock and will no longer face these constraints. As it seeks to increase sales of value-added products, Diamond Foods will be governed by a board that will include outside directors with considerable experience with value-added products.

Liquidity of common stock

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 will receive common stock, which will be distributed proportionate to each member's property interest in Diamond Walnut as determined by the member's patronage for the two crop years with the highest patronage out of the last six crop years. Diamond expects to distribute 6.7 million shares of common stock and $18.6 million in cash to members. Members may request to have some or all of their stock converted into cash; however, only the proceeds from sales in excess of 4,000,000 shares (and less than 5,333,333 shares) can be used to meet members' requests for cash. If no cash is distributed to members, they will receive 8,060,207 shares.

During the first 360 days after the completion of the stock offering, members must receive permission to sell their stock from the IPO's managing underwriter. Diamond Foods' S-4 states: "Our financial advisors have recommended these restrictions as they are common practice to promote an orderly initial trading market for shares of public companies." (p.9).

The distributions of stock and cash to members, valued at an estimated $119.5 million, are compensation to members for their ownership of Diamond Walnut. Members have invested in Diamond Walnut by providing revolving fund retains and working capital retains, as well as funding the development of new products and marketing programs as expenses deducted before determination of their net proceeds.

As shown in Table 1, members invested a total of $52.9 million for brand development through advertising expenses between fiscal years 2000 and 2004. These expenses represent an average annual reduction of $.038/pound to the members' net proceeds. Nevertheless, Diamond Walnut generated a price premium for its members while making these substantial expenditures in advertising. The premium averaged $.034/pound between 2000 and 2004 and was highest in 2000 at $.063/pound. Diamond Walnut's price to members was lower than the field price only once during the past five years, a $.005/pound shortfall in 2001.

Table 1
Diamond Walnut Financial Results, 2000-2004

	Fiscal Year Ending July 31,					average 2000-2004
	2000	2001	2002	2003	2004	
Diamond's deliveries (million lbs)	257.4	218.8	279.0	252.1	297.4	260.9
Diamond net proceeds/lb	$0.471	$0.618	$0.596	$0.600	$0.605	$0.578
Average independent price/lb	$0.408	$0.623	$0.569	$0.555	$0.565	$0.544
Diamond's premium/lb	$0.063	($0.005)	$0.027	$0.045	$0.040	$0.034
Diamond's advertising expenses (000)	$7,393	$10,697	$9,791	$9,383	$15,635	$10,580
Diamond's advertising/lb	$0.029	$0.049	$0.035	$0.037	$0.053	$0.038

Source: Diamond Walnut

Stock dividends and appreciation

Unlike the revolving fund retains 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 payment of stock dividends. Furthermore, capital gains from the sale of stock will be subject to a maximum tax rate of 15% (IRS Publication 17). 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 $22.96. Shares of the former cooperative, Calavo, have ranged in value from $7.10 to $13.00 since they began trading publicly in July, 2002.

Diamond Foods expects to pay a $.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 will enable the firm to increase its sales by investing in new products, advertising and distribution that will capitalize on consumers' growing awareness of the health benefits of nuts and enhance its ability to compete against the snack nut market leader, Planters, which is owned by 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 first qualified health claim for conventional food, stating 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 2nd fastest growing category in the US grocery channel, with a 13.7% sales increase over the previous year (ACNielsen Strategic Planner). The Walnut Marketing Board's reports reinforce these sales trends; they indicate that inshell equivalent tonnage of walnut shipments for the first 10 months of the crop year increased steadily for the 2001 through 2004 crops, rising from 230,116,000 pounds for the 2001 crop to 302,937,000 pounds for the 2004 crop. Domestic shipments have risen 26.7% 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 have a homogeneous composition, since they tend to be comprised solely of producers. Currently, all thirteen members of Diamond Walnut's board are producers, who, as a group, do not have experience with the marketing and financing issues that are increasing in complexity as Diamond Walnut pursues its strategy as a marketer of value-added products. The proposed board of Diamond Foods includes five outside directors with considerable financial management and marketing expertise, as well as extensive experience in the packaged foods and dietary products industries.

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

Potential Negative Impacts of Proposed Conversion

The proposed 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 over the firm. Three of the thirteen members of Diamond Walnut's board will be appointed to the new Diamond Foods' nine member board.[2] There will also be a Grower Executive Council, which initially will be comprised of the ten members of the current Diamond Walnut board who do not become members of the Diamond Foods board. However, this body will not have any governance authority over Diamond Foods' business practices with growers; it will provide input regarding walnut grading and overall grower support and service solely in an advisory capacity.

Currently, Diamond Walnut's grower members have voting rights proportionate to their deliveries during the past two crop years. With the conversion, growers will receive one vote for every share of common stock they hold. Under the proposal, growers are expected to hold 6,726,874 shares out of the 12,666,667 shares of common stock to be issued initially. However, an additional 606,640 shares of restricted stock will be issued to the Executive Officers (subject

[2] The Securities and Exchange Commission requires that companies listed on the NASDAQ have a majority of independent directors on their boards. http://www.sec.gov/rules/sro/34-48745.htm

to a three year vesting period) and directors, including members of the Grower Executive Council. If the members do not exchange any of the 1.3 million shares for cash as allowed, they will hold 61.2% 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 the Executive Officers and board members are exercised and the members exchange all 1.3 million shares for cash, then growers will own 47.7% of the 14,228,127 shares of Diamond Foods stock issued. Thus, the possible range of initial grower ownership of Diamond Foods stock is broad. Since there are provisions for annual issuance of stock shares and options to board members and for employee stock purchases, growers could lose majority control unless some of them choose to purchase additional stock.

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. If the conversion occurs, the market power currently held by Diamond Walnut's members will transfer 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 can become shareholders and/or suppliers to Diamond Foods. As shareholders, growers 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 included the following words of caution in its S-4: "Payments under the new Walnut Purchase Agreement could be less than payments members are historically accustomed to receiving under the existing Marketing Agreement." (p.15). In paying growers for their walnuts, Diamond Foods proposes "…The same grower payment schedule, delivery terms, and walnut grading system will be used. However, …each March, 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 marketing agreement with Diamond Walnut extended by 3, 5 or 10 years, and must deliver their entire crop to Diamond Foods for the duration of the contract. Members who sign such multi-year agreements place themselves into a "monopsony" situation (because they have signed the exclusive contract, there is only one buyer for their walnuts). The purchase agreement offers no price protection or guarantee to pay market prices; the monopsonistic conditions make the contracting growers vulnerable to price manipulation. Although demand for walnuts has been increasing and causing market prices to rise, the conversion could cause a decline in overall market prices because Diamond Walnut handles a relatively large share of the state's walnut production (between 40% and 46% during the past ten years).

In the longer term, Diamond Foods could also improve its operating margins through foreign sourcing, thereby reducing demand for California-grown walnuts. Diamond Walnut is already purchasing hazelnuts from Turkey, pecans from Mexico and pine nuts from China. Although the US remains the dominant exporter of walnuts, China has displaced the US as the world's largest walnut producer (USDA). Mexico is currently a small supplier to the US. It could reduce its input costs by sourcing some walnuts from China and Mexico as growers' marketing agreements expire. 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

There is uncertainty regarding how much compensation members will 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 draft registration filings yields $119.5 million in compensation to members (including $18.6 million in cash for the 1.3 million shares that can be exchanged initially for cash). However, the initial share price of $15.00 could be higher or lower. Diamond Foods' S-4 includes the following statement: "We are not required to obtain new member approval unless we were to propose to complete an initial public offering of fewer than 4,000,000 shares or at a price of less than $5.00 per share. As a result, you should make your decisions about the conversion assuming an offering on those terms." (S-4, pp. 2 and 36). At the $5.00 per share minimum price, members will receive only $40.3 million in stock.

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 the conversion was approved by a 96% positive vote of the membership, Gold Kist actually completed its IPO of 12 million shares at $11.00, yielding net proceeds of approximately $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 (Gold Kist S-4A, October 6, 2004). Clearly, Diamond Foods is in a different industry and its offering is considerably smaller. However, a shortfall in the IPO can have a significant impact on the amount of cash and the value of the stock that members receive in exchange for their ownership interest in Diamond Walnut.

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 investor shareholders, outside directors and the Executive Officers. The restructured business will operate for the benefit of the shareholders and growers will have no price protection in their long-term supplier contracts.

Conclusions

Members of Diamond Walnut are being asked to make three different, but interrelated, decisions concerning the proposed conversion:

- approval/rejection of a conversion agreement between Diamond Walnut and Diamond Foods;
- election to receive cash for part or all of their shares of Diamond Foods; and
- extension of their existing marketing agreements with Diamond Walnut by three, five or ten years to market all of their walnut production to Diamond Foods.

If Diamond Walnut does not convert, members will receive a stream of net proceeds, adjusted for equity retains and redemptions. If Diamond Walnut converts, members who keep their Diamond Foods common stock and sign Purchase Agreements will earn receive a stream of payments for their walnuts and quarterly dividends (if paid) and proceeds from selling their shares of Diamond Foods stock at some time in the future. There are elements of uncertainty with both sets of financial flows.

The prototype 100 acre member discussed at grower meetings in April would receive $10,761 less for his crop as a Diamond Foods grower than as a Diamond Walnut member, assuming that Diamond Walnut's return would have been $ .034/pound higher (Diamond Walnut's average premium for the 1999-2003 crop years—see Table 1). 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 $.03/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.

The long-term relative financial impact 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 considerable affect his ability to offset his cumulative reductions in crop revenues (net of dividend payments) with the capital gains earned by selling his stock.

There is no certainty in any of the potential positive or negative outcomes or the financial flows discussed above. It is vitally important that Diamond Walnut's members weigh these potential impacts and the uncertainty discussed above, relative to their individual situations, when making their decisions. Members should also consider other information provided by the cooperative and by professionals, such as attorneys and accountants.