

DIAMOND FOODS, INC., #11071163
September 20, 2006, 1:30 p.m. PT
Fourth Quarter 2006 Financial Results

Operator Good afternoon, ladies and gentlemen, and welcome to the Diamond Foods fiscal fourth quarter 2006 conference call. At this time all participants are in a listen-only mode. Following today's presentation instructions will be given for the question and answer session. If anyone needs assistance at any time during the conference, please press the star followed by zero. As a reminder, this conference is being recorded today, Wednesday, September 20, 2006.

I would now like to turn the conference over to Doug Sherk of the EVC Group. Please go ahead, sir.

D. Sherk Thank you, operator, and good afternoon, everyone. Thank you for joining us for Diamond's conference call and webcast to review financial results for the fourth quarter of 2006 which ended July 31.

To begin, please note that we've arranged for a taped replay of this call which may be accessed by telephone. This replay will take effect approximately one hour after the call's conclusion and will remain available until midnight Eastern Time September 27th. The dial-in number to access the replay is 800-405-2236 or for international callers 303-590-3000. The pass code required to access the call regardless of the number you have dialed in from is 11071163 and then press the pound key. In addition, this call is being webcast live with a replay also available. To access the webcast go to Diamond's website at www.diamondfoods.com.

Before we get started, during the course of this conference call the company will make projections or other forward-looking statements that are subject to many risks and uncertainties that could cause actual results to differ materially from expectations. A detailed discussion of the risks and uncertainties that affect our business is contained in Diamond Foods' SEC filings, particularly under the heading Risk Factors. Copies of Diamond's SEC filings are available on line from the SEC, or by contacting Diamond's investor relations representative, the EVC Group, at 415-896-6820, or by clicking on Investor Relations on Diamond's website at www.diamondfoods.com.

The company's projections and forward-looking statements are based on factors that are subject to change and therefore these statements speak only as of the date they are given. The company does not undertake to update any projection or forward-looking statement.

Now I'd like to turn the call over to Michael Mendes, President and Chief Executive Officer of Diamond Foods.

M. Mendes

Thank you, Doug. Good afternoon, everyone. Joining from the management team on our call today is Gary Ford, our Chief Operating Officer, and Seth Halio, our Chief Financial Officer.

We are very pleased with our fourth quarter performance. We achieved the goals that we laid out in May 2006 and we're on a path to accomplishing our long term objectives.

Total sales for 2006 exceeded \$477 million compared to \$462 million last year. And our North American retail business, which is our largest and over the long term most profitable business, grew over 20% in 2006. Our non-GAAP earnings reached 61 cents per share which was at the high end of the range that we projected in May.

Relating to our snack business, we are very pleased with the growth that we've seen this past year and in 2006 we increased Emerald Snack sales by 60% as compared to last year. For the fourth quarter alone total snack sales approached \$17 million. Emerald's 52 week market share has now increased to 3.8% for the U.S. food segment with dollar sales for this period increasing 28% as compared to last year.

One indication of our progress of building out our footprint in this segment is average item per store in the U.S. food segment. Last year we averaged 7.2 items per store. Today we average 10.3 items per store.

We continue to focus on building distribution in the non-grocery segment in channels such as the clubs, mass merchandisers, drug stores and C-stores which represent over half of the category. We're having some advanced discussions with our customers in these channels, but new distribution gains are still pending approval.

One illustration of our success in this area is the drugstore channel where sales have grown 122% as scanned at retail versus same time last year. Just to put some texture around that, we scanned approximately \$4.5 million in sales in the drugstore channel through Emerald Snack products and 2 years ago we virtually sold no products in this channel through our Diamond culinary in-shell products so I think it's a good indication.

As far as our base Diamond business, that business continues to progress very strongly. Diamond's culinary sales grew 15% in 2006 as compared to 2005. Diamond continued to be the category leader for culinary nuts with a branded market share 4 times larger than the number 2 branded competitor.

The results for 2006 illustrate that we are well on our way to transforming the company, continue to emphasize reward for performance. One example of this is the termination of our administrative pension plan, which in part allows us to redeploy financial resources to better align compensation with employee performance. At the same time we will generate cost savings over the long term and minimize future risk and volatility for the company.

With this in mind, I would like to reiterate our long term goals over the next 5 years. We expect to increase total net sales by an average of 8% to 10% per year. We are confident that we can expand gross margins to at least 20% of net sales and operating margins to 10% of net sales within this period. This should drive our average earnings per share growth in excess of 15% per year.

To provide you with a little more insight on our progress for the business, I'd like to turn the call over to Gary Ford, our Chief Operating Officer.

G. Ford

Thank you, Michael. First, I would like to review our sales and distribution efforts and then focus on our operations.

As Michael indicated, over half of snack nuts are sold through non-grocery channels such as club stores, mass merchandisers, drug, convenience stores and alternative channels. We have been focusing on presenting our unique items in appropriate packaging to these retailers and we are making progress. You will now find on the shelves 9 items in Super Target, 3 items in the regular Target, 1 item in BJ's and 6 items in Kmart, among others.

Innovation in both products and packaging is a key to our snack strategy. We continue to position ourselves with retailers and in the eyes of the consumers as the snack innovator. In 2006 we introduced 3 new trail mix products and new packaging for the club and convenience channels. In 2007, we expect to introduce at least 3 new products as well as new packaging to complement our current offerings. We do expect to introduce more new products in fiscal year '07 versus fiscal '06.

We have been successful in gaining distribution for our 3 new trail mix products and are pleased with our progress. These products were initially introduced in the Northeast and California and based on their high level of acceptance. We are now offering them to retailers in the rest of the U.S.

With respect to the Harmony integration, as we said on the last call we closed our Lemont, Illinois facility and began to move that equipment to the Indiana facility. I am very pleased to say that that move is now completed. The equipment has been installed and it is up and running. This critical relocation project was completed on schedule and on budget. It was very important for us to execute this plan because the in-shell season begins in October.

We are also on track to realize the \$2 million of annualized cost savings from the consolidation of these 2 facilities. In addition, we have now sold the Lemont plant for \$3 million and we will recognize a \$1 million gain in the first quarter.

We are also seeing other operational benefits of the Harmony acquisition. For example, we are improving the supply chain for the Emerald trail mix product as we are now mixing and packaging this product in Indiana. This is just one of several examples of where we have been able to take cost out of the system and improve customer service.

Another example of where we expect to lower cost and improve customer service is by rationalizing our international distribution network. This includes terminating one of our German distributors, for which we took a one time charge in the fourth quarter. We do expect to significantly improve our distribution capabilities in Germany which is our largest market outside of the U.S.

In California we have installed new automated glazing and packaging equipment that will increase capacity and continue to lower our unit cost. We have also streamlined our walnut receiving and processing function by closing one of our local processing facilities.

As it relates to product mix, walnuts continue to represent the most significant portion of our offerings. The walnut harvest is 10 days later than last year and the latest in 10 years. As a result, we expect some sales to move from the first quarter to later quarters.

In September, California issued its objective estimate projecting the 2006 walnut crop to reach 350,000 tons. Last year's objective estimate by the state was 340,000 tons. However, the final 2005 crop was 355,000 tons, the largest ever. While we experienced a period of severe heat during the growing season, the objective estimate indicates the quality of this year's crop will be equal to or greater than last year. Although it is still extremely early in the season, overall we do not anticipate tree nut prices weakening from current levels.

Now I'd like to turn the call over to Seth Halio to review our financial highlights.

S. Halio

Thanks, Gary, and good afternoon, everyone. Since many of our financial results were included in today's press release, I'll mostly be focusing on the highlights. The financial results for the year were at the higher end of the guidance we previously provided. After I review these highlights, I'll close my comments with our fiscal 2007 outlook.

In the fourth quarter our revenue breakdown by product line was as follows. Culinary sales were \$36 million, snack sales were \$17 million and total North American retail sales were \$54 million. Ingredient and international sales totaled \$53 million, and our total sales for the quarter were \$107 million.

For the year, culinary sales were \$189 million, snack sales were \$41 million, and in-shell sales were \$45 million, resulting in total North American retail sales of \$275 million. Ingredient and international sales were \$199 million and our total sales for 2006 were \$477 million.

Our North American retail sales for the quarter grew 34%, and they rose over 20% for the year. Without the impact of the Harmony acquisition, North American retail sales still rose 18% for the quarter and over 17% for the year.

Taking a look at our North American retail sales by channel for the quarter, sales to grocery and drug stores were 57% of our retail sales, sales to club stores were 37%, and sales to mass merchandisers were 6%.

For the full year, retail sales were as follows: sales to grocery and drug stores were 56% of our retail sales; sales to club stores were 32%; and sales to mass merchandisers were 12%.

Our gross margin for the quarter was 14.5% compared to 4.9% for the quarter in 2005. For the full year, gross margin was 14.3% versus 10.6% for 2005. Please note that gross margin information is presented on a non-GAAP and supplemental basis as described in our filings. For both the quarter and year period, the improvement in margin was primarily due to improved product mix reflecting a higher proportion of retail sales, better pricing and improved margin performance by our snack products. These favorable factors were offset in part by higher cost of raw materials.

This improvement in gross margin is reflected by the significant increase in gross margin per pound shipped. This was 46 cents per pound for the quarter and 36 cents per pound for the year compared to 12 cents per pound for the 2005 fourth quarter and 22 cents per pound for all of 2005.

SG&A expense for the quarter was \$10.7 million compared with last year's level of \$8.1 million. The expense this year includes \$1.2 million of stock based compensation. For the full year, SG&A expense was \$37 million compared to \$33 million in 2005. SG&A expense in 2006 includes \$4 million of stock based compensation that accounts for all of the increase.

Advertising costs for the quarter were \$1.7 million compared to \$3.7 million in 2005 and for the year were \$18 million compared to \$22 million last year.

The lower advertising costs were due to the start up costs incurred in the national launch of Emerald in 2005 and the timing of media advertisements including the impact of the 2004 Summer Olympics.

Other operating expenses in 2006 totaled \$3.4 million and included 3 items. Approximately \$1 million of restructuring and related charges for the closing of our Lemont facility and the consolidation of operations in Indiana, and \$1.4 million related to the termination of 2 contracts as discussed in our release.

Other operating expenses also included \$1 million of professional fees for identifying and documenting approximately \$6 million of state tax credit. For non-GAAP purposes we exclude all of these expenses since they are nonrecurring in nature. As a result of the \$6 million in tax credits, we recorded an income tax benefit for the year of \$1 million. Without the benefit of this credit and other smaller adjustments, our effective tax rate would have been approximately 42%, which is the rate we use for our non-GAAP numbers.

Cash on hand at the end of the quarter was \$36 million, and we had no short term debt. For 2006, \$34 million of cash was provided by operations, and we invested \$9 million in equipment. We also used \$19 million of cash to acquire Harmony and paid our former cooperative members \$17 million for their ownership interest earlier in the fiscal year. So of the \$49 million of cash we had on hand last year, we added \$34 million from operations and used \$45 million to acquire equipment and Harmony and to pay the former cooperative members for their ownership interest.

Our current 2007 outlook is as follows. We expect North American retail sales growth of approximately 15%. Snack sales are expected to grow nearly 100% to \$80 million.

Our overall sales growth will be 8% to 10%. Gross margins for 2007 are expected to be approximately 15%. Stock based compensation expense will be between 19 and 21 cents per share, and we are expecting an effective tax rate of 42%. As a result, we expect GAAP EPS of between 43 and 48 cents per share and non-GAAP EPS of between 50 and 55 cents per share.

The non-GAAP EPS excludes the impact of a one time charge to terminate our administrative pension plan. This non-cash charge is estimated to be approximately 11 cents per share. Non-GAAP EPS also excludes 4 cents per share for the gain from the sale of the Lemont, Illinois facility. Non-GAAP EPS does include the stock based compensation expense.

With that I'd like to turn the call back to Michael.

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| M. Mendes | <p>Thank you, Seth. In order to achieve our long term objectives it'll be critical to invest in our brands, our innovations and our ability to effectively service our customers. We all recognize the increasing cognitive load that we as individual consumers are subject to due to the volume, variety and intensity of advertising today. In order to be effective in this environment, we will need to continue to invest in bold and innovative consumer campaigns that distinguish our products from the competition. We need to continue to strive for true innovation that satisfies distinct consumer demand.</p> <p>2007 will be a critical investment year particularly for our snack business. Our investments in 2007 will be key to position us to achieve our long term goals. We will continue to make investments needed to build a strong business, which will be vibrant and viable in the future. With that I'd now like to open the call up for questions.</p> |
| Operator | <p>Thank you, sir. Ladies and gentlemen, at this time we will begin the question and answer session. If you have a question, please press the star followed by one on your pushbutton phone. If you'd like to decline from the polling process, press the star followed by two. You will hear a three-tone prompt acknowledging your selection and your questions will be taken in the order they are received. If you are using a speaker phone equipment, you will need to first lift the handset before pressing the numbers. One moment please for the first question.</p> <p>Our first question is from Diane Geissler with Merrill Lynch.</p> |
| D. Geissler | Good afternoon. |
| Management | Hi, Diane. How are you? |
| D. Geissler | I'm well. If I look at the schedule that you've included on the non-GAAP basis, comparable 2006 versus the 2007 outlook, that 47 cents, that is your non-GAAP including stock based comp? |
| S. Halio | That's right so the 47 cents has the impact of expensing stock compensation. |
| D. Geissler | Alright, perfect. And the professional fees was how much on a per share basis for tax credit? |
| S. Halio | It was about \$1 million or about 4 cents or so per share, a little under 4 cents. |
| D. Geissler | Alright and then I guess, sorry for all these housekeeping questions up front, but the tax rate next year at 42% why ... I guess I sort of look at it and think if you spent all this money on professional fees and you have these tax credits, why is it still 42%? |

- S. Halio Because we took the \$6 million benefit of the tax credits this year so we've already in the financial statements recognized the benefit.
- D. Geissler Yeah, I'll have to go through it. You have a lot of moving pieces this year. In the time allotted between the announcement and the call, there just wasn't time to get through it all.
- I guess then just on the base snack business, it sounds like you're making progress. Obviously we've talked quite a bit over the summer about some of the new account wins. Could you talk a little bit about how you see 2007 rolling out with maybe some of the things that you're working on but haven't publicly announced who your partners are there and what we should look for in terms of some of the non-grocery channels? Just a little bit more color on how you expect that to play out maybe through the quarters.
- M. Mendes Diane, this is Michael. I'll try to take that. Let me just frame it broadly. We're looking at virtually doubling our snack business to \$80 million. The first component part of that will be taking our existing distribution and increasing the velocity of product that's currently on the shelf.
- The second component is where we have distribution expanding that with new items such as trail mix, smoked almonds, other items we've mentioned in the past.
- A third and critical component is gaining distribution in retailers in the food channel and in the non-food channel. We've made some nice progress as Gary mentioned in his part of the conversation, in the mass merchandise and club channel. We've been spending a lot of time speaking with customers who we want to market products with in the future in the channel and have been working hard on making sure we have the right product mix to offer those customers, but we don't have any new news today to talk to you about on those channels.
- And then the final component is also the convenience store side of the business, where we've now modified our offering and we have made some progress there.
- I would say that the one component that we hadn't talked about in the first half of the year that's now a factor for us is the Harmony business. In the Harmony acquisition we now have a snack offering for the produce segment and so I think the final component with the Harmony business is to take that business which is in distribution in approximately 30% of the U.S. and expand that distribution further in the U.S. and also expand breadth of distribution for those items.
- We have ample opportunities to achieve our objective by succeeding to a

limited degree in some of these areas or if we succeed to a significant extent in one of these segments .

D. Geissler Okay, but I guess if I look at sort of what you booked in this year, versus where you think you'll be at the end of the next year is there any one of those sort of 4 items that you defined here that you see really driving that doubling of snack or is it more about increasing the velocity with the existing accounts, or is it more about new channels? Is there kind of a way to think about where the incremental revenue will come from or is it kind of broadly based across those 4 initiatives?

M. Mendes I think they'll increase broadly against these initiatives. What I didn't mention was new products and new product sets we are going to be introducing into the market. Gary talked about some new product introductions that we're planning for this coming year. That's another component.

We really see things spread out amongst most of those pieces. I think new distribution probably has the opportunity to provide a bigger portion of it, but I wouldn't say it's a two-fold of the other components or anything of that sense. I'd really say the growth will broadly come from those areas that I had mentioned with perhaps new distribution contributing the largest component of that.

D. Geissler Alright, so still some reliance on distribution, new distribution wins?

M. Mendes Obviously with the non-food channel representing over half of the snack nut category and we're in distribution in over 80% of U.S. food stores. We are quite modest in our penetration of those other channels so that would probably be the largest opportunity out there.

D. Geissler Alright and then just quickly on crop and its impact on the flow of some of your products. It sounds like that's probably more a produce segment issue. Is there a way for us ... is there any quantification over how much you see shifting from the first quarter into the second quarter because of the lateness of the crop this year?

S. Halio Diane, this is Seth. I would say it's a little hard to be with exact preciseness right now, but if you look historically the last 2 to 3 years, the first quarter has been about 37% or so of the entire year and the first half of the fiscal year it's been about 62% or so the last few years.

D. Geissler We're talking strictly the produce?

S. Halio No, total, so sales in the first quarter represented 37% of the total year's sales and 62 or so percent of the first half. And I would say this year, given the lateness of the crop as well as some of the new product introductions we're

doing on the snack side, I would expect those percentages to go down. So a lower percent of the total year sales will be in the first quarter and the first half than historically, so we're taking some of the seasonality out as well.

D. Geissler Right, okay.

S. Halio Thank you.

D. Geissler I think that's it for now. Thanks so much.

Operator Thank you. Our next question is from Eric Larson with Piper Jaffray.

E. Larson Good afternoon, everyone.

Management Hello, Eric.

E. Larson Just a couple questions. I think Michael mentioned that you're looking at a substantial investment again next year in marketing spend for your snack nut business. This year obviously your advertising was down in nominal dollars and as a percent of sales. What would you expect for '07? Would that be growing more in line with sales or will it still decline as a percent or how would you characterize it?

M. Mendes Eric, in terms of an absolute dollar spend, it'll probably be higher than this past year, but as a percentage of sales it'll still go down. With our advertising activities there's sort of an episodic nature of advertising.

In 2004 we had the Summer Olympics where our media spend at the Summer Olympics was in our 2005 budget and we didn't have a Summer Olympics in our most recent year so there's some of that type of effect in terms of timing of the media spend that affected advertising.

I think though when you look at our total consumer support, I think it might be more beneficial to characterize both promotion and advertising as a total resource tool that we're using to drive product with consumers and through our retail activation. That's been a term that we've been using around the office about really trying to in effect market effectively with consumers at point of sale and a lot of those activities are part of our promotional spending which is contra revenue and it's not part of our advertising budget.

So our total investment against our brand and driving our retail business definitely increased from 2005 to 2006, It's just that when you subset that specific advertising component, the actual dollars on a GAAP basis were down for that subset as a total investment.

E. Larson Then characterizing your total investment for '07 how would you look at

that?

- M. Mendes I think it's reflecting our projections for next year that Seth had laid out. We plan to provide ample investments in our snack business in particular related to the area of promotion and sampling and other activities as we enter the market to get traction with consumers. I think as you could imagine, when you're first into a market with a new product with the consumer you need to try to drive trial of the product. Once consumers try the product, you build a pattern, then I think that you have the opportunity to spend less on those type of consumer support events and increase the profitability over the long term.
- I think though that's going to be our next component. Then also when you're developing new items, there's cost of packaging development, artwork, all the materials in the production. When you're running your production line for the first time in new products and they're processed products, there's costs there that you don't incur once your business is mature.
- E. Larson Okay, good. In terms of pricing capability, do you think you have pricing opportunities this year for your products?
- M. Mendes Related to our overall business or just snack and culinary?
- E. Larson I mean where in your portfolio do you think you may have the ability to use some pricing and how might that benefit your total sales base?
- M. Mendes I question whether we're going to get a significant opportunity to get the benefit of pricing. I think that most of our growth will be based on volume.
- E. Larson Good. Then the question on gross profit per pound. You saw a substantial improvement in Q4 and about a 10 cent per pound improvement for the year. Can you give us an idea of how much of that was strictly higher snack nut sales and how much may have come from just base improvement in running your operations? And I know you got promotion stuck in there too so you've got a lot of moving parts there. But can you give us a little flavor as to a breakdown of how that gross profit per pound broke out?
- S. Halio I would say in terms of the snack gross margin, in 2006 we did have a small gross margin, positive gross margin this year versus a negative gross margin last year as we went through the initial national roll out and start up and so forth, so a large portion of the margin improvement came from that.
- I would say a next factor was we were able to take earlier in fiscal 2006 price increases particularly in our culinary business. And then lastly I would say there were some other cost reduction activities in the business that improved our margin as well.

E. Larson Okay, good. And this is just a clarification question. The \$1 million professional fee charge, that was a fourth quarter charge, is that correct?

S. Halio That's correct, Eric.

E. Larson Thank you, guys.

Operator Thank you. Our next question is from Ken Zaslow with BMO Capital Markets.

K. Zaslow Good afternoon, everyone.

Management Hello, Ken.

K. Zaslow Just a real straightforward question. If I include the stock based compensation, your fourth quarter number is 10 cents? If I was to exclude all the other extraordinary stuff, but include that ... what is that number? 47 cents minus all the other quarters?

S. Halio I get about almost 12 cents, Ken.

K. Zaslow Okay, 12 cents. On the Harmony side the run rate is \$10 million for '07, but in the fourth quarter you enjoyed \$6 million so are you actually getting better product from that than you expected?

M. Mendes You know, Ken, I think that we are pleased with the start in that business, but a portion of this is as we are running the business, we are evaluating the performance of the SKUs, we're taking price action items that might have some margin issues. I'm not saying that all the sales that we got out of Harmony in Q4 will be sales that will be conducted in the future. But I would say that we are pleased with the base business that we talked about, and I think it's something to grow off of.

 I think the exciting thing for us is to see these businesses intermingle. We're well on the way on our Emerald co-branding concept related to the Harmony business so that Harmony can get the benefit of Emerald as basically an endorser brand of Harmony, and we are beginning to incorporate that brand as part of our snack brand portfolio.

K. Zaslow So the base business, if I was to look at 2006, what would you consider a base business for which you will grow for next year?

M. Mendes From last year's business?

K. Zaslow Yeah, I'm just curious on that.

M. Mendes I would say probably \$44 million, with \$34 from the Emerald business and about \$10 off of that Harmony base, so I'd say \$44 million would be the basis that we're building off of.

K. Zaslow And just one more kind of nitpicking type of question. Last year in the first quarter you also had this shift, I think it was \$5 million last year in terms of out of the first quarter into the second quarter. Is that the same magnitude we're going to have again?

M. Mendes Ken, I think 2 things might happen. Last year the in-shell sales did move to the other quarter. I think on a year like this rather than that product being a later in-shell shipment, I think what will happen is it will move into the shelling pool so those in-shell nuts that aren't sold for the holiday season, rather will be sold the next quarter as in-shell sales. I think what we'll see is that part will move to the shelling pool so that'll be spread over the remaining quarters. I think that there will be more of a movement. The movement out of the first quarter will spread among the next 3 quarters versus just going to the next quarter.

K. Zaslow Okay. I guess getting more into strategy which is probably more interesting. The build up of your new products that you've gone into the new distribution channels, have they all been distributed now and we're at a run rate or are we still going to see ... you know the ones that you announced last quarter, is everything up and running?

M. Mendes No, that's actually not the case. I would say that probably a half to two-thirds of those items are on the shelf. As far as our trail mix business, we are now scanning in about 15% of U.S. food stores if you include drug and food together.

Our approved distribution for those items are now in more than a third of U.S. food stores and so we're constantly in the process of expanding that out so we have some nice opportunity to continue to build off of our trail mix for example, as we roll that item out.

We made a conscious decision with the trail mix to position that product in the planogram and in the set with our retailers when they were doing their next normal reset versus us paying to cut the products in at a separate time of the year. That's very expensive and while they're very good items, they probably don't drive the kind of volume that would support that kind of investment. So there's going to be more distribution coming from the trail mix items this year as those products continue to move on the shelf.

K. Zaslow Have you had any more successes that are notable that we should know about?

- M. Mendes Nothing really we can speak to at this time, Ken, but we're working hard on it and we're pleased with the way the product's moving in these non-grocery channels that we do have distribution so that's been our focus and we keep working on gaining that new distribution.
- K. Zaslow Do you think the retail takeaway is matching your distribution or your volume?
- M. Mendes I would say that it depends. I think it depends on if you analyze the data on a daily basis or weekly basis. I think that a lot of people try to focus on too short of a period of time. For example if you look at the last 12 week IRI data period which ended August 13th and you compare it to last year and you drew conclusions based on that, one thing that would be flawed in your assumption is that last year we ran a national coupon program and this year during that period we didn't run the national coupon program. And given that that is a lower volume time for those sales activities, that kind of 12 week analysis throws you off and that's why we'd like to focus on 26 or 52 week trends, which as I mentioned earlier, we're up from 3% market share last year to 3.8% and we're very pleased with the direction.
- When you look at the items per store and the long term distribution, the long term share improvement, we're making good progress on that front. We're constantly working to fortify our product line with the kind of products that our customers and our retail partners value so we're pleased with our direction.
- K. Zaslow And my last question, the quality of the crop as well as you saying that there are higher commodity costs coming in, is it because of the pecans, the hazelnuts or ...? Because it sounds like what you're saying is that our walnut crop is going to be bigger than a year ago so you'd expect prices to come down. Is that a quality issue or is it a pecan, hazelnut and other nut issue?
- G. Ford Ken, this is Gary. What I said was it's extremely early in the season and we do not anticipate tree nut prices weakening from their current level. Actually the quality of this year's crop early on and what the objective estimate indicates is that the quality will be equal to or actually better than last year.
- K. Zaslow So why wouldn't the price come down?
- M. Mendes Ken, I think when you need to consider that last year's crop was a 355,000 ton crop, this year's estimate's a 350,000 ton crop and we've just started. So I think that with the crop that's estimated today being projected as being smaller than last year's actual crop, I would say that wouldn't be data that would indicate the prices going down, but I would say that it's too early to say because the objective estimate is just that, it's an estimate.

I think the state does a great job trying to get data for this type of exercise, but one of the factors that they're trying to gauge is bearing acreage which is very difficult to secure and that's a big factor in that estimate. I think that in January when the state comes up with their final crop, there will be a lot more visibility on what that total crop supply is. But I think with the information today, it's way too early for people to be talking about prices going up or down or significant change versus last year.

K. Zaslow And what about the other trees, pecans, hazelnuts. How does that all look going forward?

G. Ford Well the almond estimate is 1,050,000,000 pounds which is a big crop. The almond price has adjusted itself a while ago so we expect where it is now to be fairly stable from this point on.

Pecans, the estimate's 175 to 200 million pounds. That's an average crop for the off year, remembering pecans are alternate bearing. Plus or minus a little bit, we don't see a whole lot of change there. And in cashews we look to that to be fairly stable to where it is currently.

K. Zaslow Great. I appreciate it.

Management Thanks, Ken.

Operator Our next question is from John Koller with Oppenheimer & Close.

J. Koller Good evening, gentlemen.

Management Hi, John.

J. Koller A couple of quick questions. You quoted a cash figure of \$34 million and no short term debt. What is long term debt?

S. Halio We have a \$20 million senior note with a couple institutions.

J. Koller Right, there's no change in that then?

S. Halio No change in that.

J. Koller Okay. And do you have a capital expenditure figure or estimate for next fiscal year?

S. Halio We haven't fully vetted that out yet. I would say this year we're at about \$9 million. I would say it's approximately plus or minus that number.

J. Koller Okay. And if I'm looking at the EPS figure, GAAP EPS was 43 to 48 cents

for '07 and that includes 4 cents for gain on sale of the Illinois facility so if you back that out you're looking at 39 to 44. Is that accurate?

S. Halio Yeah, and that also includes 11 cents of noncash pension termination expense so we backed that out for our non-GAAP numbers as well.

J. Koller Okay, great. And the advertising expenditure, the decline year-over-year, I'm still trying to understand what happened there. If you guys are trying to roll out a new product, it seems to me that a decline in advertising spending doesn't necessarily make much sense in nominal dollar terms. I was wondering if you could help me understand that a little bit.

M. Mendes Let me take you through that a little bit more, John. In 2005 we were launching the Emerald snack product line and one of the expenses for example in 2005 was an advertising expense on the shelf trays where if you look on the shelf you'd see these trays that have the Emerald brand and you place the canister on them. We bought these shelf trays to put on all the shelves throughout the country so that was a 2005 expense. That was part of the launch, it was more of a one time infrastructure cost.

The other issue is again our media spend. We had this Olympic event. We have events over time, and when things fall in the fiscal year is another other component. And the final bit is the mix of GAAP designation between advertising and promotion. I don't want to be critical of GAAP, the contributors to this fine document, but I would say when you take our total promotion and advertising resources that we spent against the brand in '06 versus '05, that has increased quite substantially versus last year. I think that kind of frames it more broadly, John, and hopefully we'll keep getting more color on that as we go forward. But we are very much supporting the brand.

The question becomes what are you doing to support the brand and what's effective? What can you do to coordinate with the retail activity events? These are the things that are driving our decisions. We may come up with a concept that is less cash intensive on the media front, for example, part of the things that we did on this year's Super Bowl program, we did as an online marketing outreach versus a television media buy. We were trying to get a little more granular in the way we got to the consumers, because we were trying to split up really what is the existing snack demographic which tends to be older and tends to be more of the primary household shopper versus the new snack demographic, younger snackers who really don't see snack nuts at top of mind.

How do we target them? One of the ways that we did that last year, which was more cost efficient, was using internet medium as part of our mix versus straight national television. So that's a little bit of context behind some of that activity.

J. Koller Okay. One last question if I could. Given the stock price decline, I'm wondering, the stock option expense going forward if you could let me know or if there's a way we can get a back of the envelope calculation as far as what that might or might not be?

S. Halio In our guidance we gave out we think the stock based compensation expense will be in 2007 at 19 to 21 cents per share.

J. Koller Right, okay. Great, thanks a lot.

Management Thank you.

Operator Thank you. Our next question is from Jeff Kanter with Vardon Capital Management.

J. Kanter Good afternoon, gentlemen.

Management Hi, Jeff.

J. Kanter Seth, a quick question. If I do the math quickly the volume sold, that figure that you didn't release in your Q, about 34 million pounds or so? Is that fair? Do you have that?

S. Halio Bear with me for a second, Jeff. For the quarter 34, that's a good assumption.

J. Kanter Okay. In reference to the last question, I mean given the stock price if my numbers are right, option expense was what, around 15 cents in 2006?

S. Halio Yeah.

J. Kanter Okay, so why would it be going higher? What am I missing?

S. Halio There's several factors which go into it. Things like new grants that occurred during the year so you didn't have the full impact in fiscal '06 as well as we have an employee stock purchase plan which gets rolled into those numbers as well and then other things like timing of terminations and things like that. That's our best estimate today.

J. Kanter That's fair. Just curious. And again for 2007, we should be looking at ad spend again in the \$20 million-ish type of range?

M. Mendes I think that's a good area, maybe slightly higher than this past year, but in that area, correct.

J. Kanter Okay. Your cash EPS, if you back out everything, was about 63 cents or so

for 2006 ... 62 cents. If I just take the 47, 48 cents or whatever and I add the 15 cents to it. You're looking for a cash EPS this year of 69 to 76 cents and your guidance though is for the top line to keep on chugging along, gross profit improvement.

Is there something in your guidance that would ... if you run the math, unless you're just trying to build a cushion after a challenging year, is there something that I'm missing in your earnings algorithm because it seems like the goal for not too much earnings growth, particularly if nut costs stay flat, is conservative. Is it or am I missing something?

S. Halio I don't recognize what you call cash EPS, but I would say in terms of the guidance we did give, a couple things. One is we are investing in our snack lines this year as Michael took you through during the call. Secondly, if you go to the higher end of the guidance of the 55 cents, that's a 17% increase over fiscal 2006 on 8% to 10% sales growth so despite the investments, we are dropping a fair amount to the bottom line and there's still some challenges in terms of higher raw material costs.

J. Kanter Okay, fair enough. Thank you very much.

Management Okay, thanks.

Operator At this time I'd like to turn the call back to management for additional remarks.

M. Mendes Thank you, everyone, for participating in our call today. We look forward to speaking with you on our next call. Thank you.

Operator Thank you, sir. Ladies and gentlemen, this concludes the Diamond Foods' fiscal fourth quarter 2006 conference call. If you'd like to listen to a replay of today's conference, please dial 1-800-405-2236 or internationally 303-590-3000 with access number 11071163 followed by the pound sign.

Thank you so much for your participation and have a pleasant day. You may now disconnect.