

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

IMN - Q3 2014 Imation Corp Earnings Call

EVENT DATE/TIME: NOVEMBER 04, 2014 / 3:00PM GMT



CORPORATE PARTICIPANTS

Scott Robinson *Imation - VP and CFO*

Mark Lucas *Imation - President, CEO*

CONFERENCE CALL PARTICIPANTS

Eric Martinuzzi *Lake Street Capital Markets - Analyst*

Mark Miller *Noble Financial Capital Markets - Analyst*

PRESENTATION

Editor

+++ presentation

Operator

Good morning. My name is Tiara and I will be your conference operator today. At this time I would like to welcome everyone to the Imation Q3 Earnings Release Conference Call. (Operator Instructions). Thank you. Mr. Scott Robinson, Imation, CFO, you may begin your conference.

Scott Robinson - Imation - VP and CFO

Thank you, Tiara. Good morning everyone and thank you for joining us for our third quarter 2014 earnings call. I am your host for today's call and I'm joined by Imation's CEO, Mark Lucas. We will review our third quarter results and progress on our strategic transformation.

Before that though I'd like to remind everyone that certain information on the call that does not relate to historical information may be deemed to constitute forward-looking statements within the meaning of the Private Securities Litigation Act of 1995. Such statements are subject to risks and uncertainties that could cause results to differ materially from any projected results. Risks factors that could cause results to differ are outlined in the press release issued today as well as our filings with the SEC.

With that I'll turn the call over to Mark Lucas, Imation's CEO.

Mark Lucas - Imation - President, CEO

Thank you, Scott and good morning everyone. As we reported earlier today our third quarter results, excluding the one-time non-cash goodwill impairment charge were in line with expectations. While we have made progress on revenues, operating cash flows and product innovation we still have work to do to position the company for consistent and sustainable growth.

As most of you are aware we've been evolving Imation to position the company as a global leader in high security data storage and data device management. These are the areas where we see long term growth opportunities in the small and medium size business, distributed enterprise storage markets as well as the retail segment. We've been focused on improving gross margins, exiting low margin products, investing in data storage and data security solutions and introducing new secure and scalable storage products.

We have been successful in lowering our operating expenses and maximizing our cash flow. When we started this transformation 90% of our revenues came from our legacy media businesses. Today only 65% of our revenues come from these businesses and we have aggressively scaled back the cost structure of these legacies, resulting in over a 35% reduction of their operating expenses.

Today our global brand portfolio includes the Imation brand, the Memorex brand, the TDK Life on Record brand, the IronKey brand and the Nexsan brand. If you have been to Imation.com recently you will have noticed that we have a new corporate identity, one that is focused on solutions. Our new site incorporates lots of added functionality, provides a compelling user experience and reinforces that we deliver solutions to data storage and mobile security problems for our customers across the globe.

Scott will take you through the numbers on a year-over-year basis but I would like to note some sequential progress in Q3 that indicates our ongoing efforts to generate forward momentum are working. First, the clients in legacy businesses moderated. Imation's overall Tiered storage and solutions revenue and gross margin held steady. Nexsan revenues grew sequentially, consumer storage and accessory gross margins improved in the quarter and overall company operating gross margin rose sequentially to 20.5% from 18.9% in Q2.

Now let me talk more specifically about our TSS business unit where we're investing in our storage solution business including our Nexsan portfolio in order to drive future growth. We are investing in sales, engineering and support professionals around the world. We also continue to strengthen our network of value added resellers or VARs by providing them with enhanced education and training to accelerate their sales of our Nexsan solutions. While Nexsan is not yet achieving its anticipated growth rate we know that customers are faced with managing an ever growing amount of data. We believe this will drive demand for our combined E series and NST portfolios as high performance backup solutions and the Assureon in line for high value data archive solutions.

We continue to have success in winning accounts from a variety of use case applications around the world with customers leveraging our Nexsan products to address their needs for reliable scalable data storage solutions. In the quarter we had a number of new end user account wins in our targeted vertical markets, including government, healthcare and media and entertainment. We also had several new opportunities in video post-production and asset management and going forward we see further opportunities in digital video surveillance and high performance computing.

Our E Series and NST Hybrid storage product family, which is what Nexsan is best known for continues to grow now offering more configurations that can be easily expanded with additional capacity. As we move into 2015 we are focused on expanding our efforts to address the market need for intelligent and cost effective ways of managing sensitive data assets and the fast growing high capacity in Hybrid storage markets. In fact we have a number of feature upgrades on our roadmap coming up in 2015.

In Imation Mobile security IronKey, our PC on a stick product is making meaningful inroads in to global markets. We have completed more than 100 proof-of-concept trials for IronKey PC on a Stick and are beginning to see customers launch deployments as organizations recognize the potential of secure cost efficient and easy to use Windows To Go solutions.

In the last few months we've deployed thousands of devices into federal and state governments, schools, hospitals and other enterprises that run Bring Your Own Device or BYOD programs. By giving the employees, contractors or students a highly secure encrypted PC on a Stick rather than new laptops they are able to achieve significant cost savings and improved security.

Imation has over 75 Windows To Go pilots or proof-of-concepts currently underway with large enterprise customers as well as government agencies. As I stated last quarter that Windows To Go sales cycle is a long one. Orders tend to start small and build overtime. We continue to expect a number of agencies will make their first significant Windows to Go purchases this year. I am pleased to share that our fast and rugged IronKey workspace, W700 which offers a responsive and military grade secure work environment on almost any PC received the Editor's choice award from SSD Review and our IronKey workspace W500 was also named the Editor's choice for Windows to Go devices by PC Magazine.

Now let me touch upon Imation's Consumer Storage and Accessories segment or CSA. Declines in Imation's legacy businesses including optical moderated in the quarter and we saw solid margins and cash flows as a result of our continued efforts to aggressively lower our cost in these businesses. Over the last two years we have reduced our operating expenses while our gross margins improved by 3% from Q3 last year.

In our audio and accessories category we experienced strong demand with revenue growth of nearly 15% for the third quarter with strong gross margins. We have a number of new audio and accessory products planned and several of our recent introductions will be in Best Buy stores across the United States for the holiday shopping season.

We were also honored for the second year in a row to have our TDK wireless weather proof speaker be named a best buy by consumer reports. Additionally our two-in-one micro flash drive for which we own significant IP has continued to do and we will be introducing more data storage products for the consumer in the coming months. While we expect our overall CSA business to continue to experience declining revenues in the near-term due to the secular declines in the optical category we are managing the business well for positive cash generation and at the same time introducing several new innovative growth products.

As a whole Imation remains focused on building a platform, based on the company's data storage routes to achieve profitable growth over the long-term. We are very focused on cash generation and preservation and are confident that the current momentum in our storage and security solutions portfolio will continue. I will now turn it over to Scott to take you through the numbers in greater detail. Scott?

Scott Robinson - Imation - VP and CFO

Thank you, Mark. Now I will turn to our financial performance. From an overall standpoint during the third quarter we saw legacy revenue declines moderate, positive operating cash flows and sequential growth in our Nexsan product lines, and we posted continuing improvement in our expense levels. Total company revenue in Q3 was \$175 million which was down 8.8% from the same period last year. Foreign currency exchange rates did have a significant impact on this quarter's revenue compared to Q3, 2013.

Looking at revenue by segment, Tiered Storage and Security Solutions, TSS was essentially flat with last year, decreasing less than 1% compared to Q3, 2013. Our commercial tape media came in consistent with last year indicating that declines in our legacy lines are indeed moderating. While Nexsan revenues did not match year ago levels we are pleased with our sequential growth here and we are confident this will lead to year-over-year revenue gains in the future.

Our Consumer Storage and Accessories, CSA segment revenues decreased 15.1% from the same quarter of last year. This is due largely to the secular declines in the legacy optical business which we have noted in past calls. Consumer storage media was down 18.4% from last year but this was partially offset by a 14.5% rise in revenues from our audio and accessories. The TREK product line made strong contributions to this segment. This is a product area that has shown consistent growth over the past several quarters.

Next I will move to gross margins. Total gross margin for the third quarter were 17.8% compared to the prior year margin of 18.8%. The decrease was due to a one-time write-off of \$4.6 million related to production supplies resulting from our changes in our magnetic tape supply chain. Excluding the charge total company margins rose to 20.5% from last year's 18.8%. CSA margins improved 300 basis points to 21.5% stemming from improved optical and flash margins. TSS segment margins were flat.

As you know expense control has been a company-wide priority for several years. Total company SG&A declined \$3.8 million from last year to \$42.5 million due to our continued cost reduction efforts that reduced operating expenditures associated with our legacy business more than 35% since Q3, 2012.

During Q3 2014 we continued to invest in Imation Storage solution to accelerate growth. Research and development cost came in at \$4.9 million, up slightly from \$4.6 million in Q3, 2013 and reflects Imation's increased investments in higher margin TSS projects. Total special charges in Q3, 2014 including supply chain write-off were \$44.2 million, driven by an adjustment of the carrying value of goodwill of \$35.4 million. I will cover the goodwill adjustment in just a moment.

Special charges in Q3, 2013 were \$11.7 million. These charges are individually listed in table six included in today's press release. The overall operating loss in Q3, 2014 from continued operations of \$55.8 million compares with last year's loss of \$26.5 million. Excluding the impact of these special charges adjusted operating loss would have been \$11.6 million in Q3, 2014 compared to adjusted operating loss of \$14.8 million in Q3, 2013.

Our tax provision was a charge of \$3.4 million in Q3 versus a benefit of \$2 million in Q3, 2013. The tax provision varies a bit from quarter-to-quarter based on the sales in each country which drive the Intra period tax calculations. As a reminder we do not book a tax provision for the U.S. as we have a full valuation allowance related to our U.S. deferred tax assets. Discontinued operations did not impact the P&L this quarter as the operations



from our disposed businesses have been concluded. Ultimately we incurred a net loss of a \$1.49 per diluted share compared to a loss of \$0.86 per diluted share last year including 2013 discontinued operations.

I'd now like to provide some more information about the goodwill adjustment. This is a non-cash charge and has no impact on the future of the business. Our goodwill balance as of June 30, 2014 was \$72 million. Of that approximately 64 million related to our Nexsan business and \$8 million related to mobile security. As Mark mentioned we are making investments to accelerate revenue growth and while our revenues from our Nexsan products grew sequentially in the second and third quarters of 2014 we have not yet achieved our previously forecasted year-over-year growth.

As a result of this and in working with our auditors we conservatively concluded that an increase in the discount rate utilized in the Nexsan goodwill calculations was required. This higher discount rate caused the reduction in the present value of the future expected cash flows, which in turn required an adjustment to the goodwill balance. We will have more information on the goodwill write-off in our 10-Q that we are filing next week.

Let me emphasize that we believe our sequential Nexsan growth will continue and will lead to year-over-year growth in the future. I've also an update on our average to sell our corporate real estate. We have recently switched real estate brokers and initiated a new marketing effort to potential strategic and financial buyers. Our goal is to monetize the building as fast as possible and to do it in a fiscally responsible manner.

Moving on to the balance sheet it remains solid. As noted in my opening comments, cash flow from operating activities was positive in Q3 at \$3.6 million. We ended Q3 at a \$110.7 million in cash with net cash of \$91.4 million, after deducting the \$19.3 million that is outstanding on our credit facility. We are focused on the need for cash management and preservation and therefore are aggressively balancing cash generation and investment for future growth. The company also repurchased 500,000 shares of its stock for \$1.6 million during Q3 and we are authorized to buy back up to 2.4 million additional shares.

In summary, our Q3 results show positive cash flow from operations, ongoing cost controls and effective management of our legacy businesses. We are encouraged by Imation's sequential growth in our high potential Nexsan portfolio. We will continue to invest in our growth drivers as we concurrently manage our legacy business to maximize cash generation.

Now we'll be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Eric Martinuzzi with Lake Street Capital.

Eric Martinuzzi - Lake Street Capital Markets - Analyst

Thanks. My question has to do, first off with the commercial storage media tape, can you peel that back a little bit, is there any one time anomalies in there because to me that was the biggest surprise in the revenue, the fact that, that was flat year-on-year. If there was distribution supply chain benefits, anything one time orders of customers anything like that?

Mark Lucas - Imation - President, CEO

Good morning, Eric, this is Mark. No, there were no specific anomalies. IBM did have a very strong quarter with us, and we actually had a fairly weak quarter a year ago. So the comparison was a little bit easier on a year-over-year basis for tape in particular. But no, we actually have seen an overall moderation in the decline rates of tape.



Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay, that's welcome or least long on [account]. So I know you don't give guidance but the running it flat is probably too optimistic, is a mid-single-digit decline more appropriate for this business line?

Mark Lucas - *Imation - President, CEO*

We've seen one quarter of it Eric, so I'd like to get a couple of quarters under our belts before we start diagnosing how the decline rates will continue. So let's see what's in the fourth quarter, if we see similar results in the fourth quarter I think we could safely say that, yes, that's the decline rate will be probably in that area.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay and then shifting back to the CSA, consumer storage media, that remained a high-teens decline rate there. It was actually less of a decline rate than the first half of the year, so some relief there but did that sustain, any changes in the demand environment there to get either more or less the current high teens low 20s declines there?

Mark Lucas - *Imation - President, CEO*

Yeah, well, yeah we are seeing a moderation of declines since the first half. I think some of this is a bit of stabilization in retail linear footage. There has been a lot of shrinkage of categories over the last 24 months and it's fairly stabilized right now within the different retail outlets around the world. So we would expect it to continue to decline but you are right as we see it most products, we've gone back and looked at case studies and what happened to audio tape, what's happened with floppy disks and other things like that, and we see the tails moderate longer on in the product life cycle. So we are expecting the same thing to continue here.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay, and then diving down on the storage and security segment, you talk about Nexsan as well as IronKey product, or the Imation, sorry Imation mobile security, historically Nexsan has dominated that revenue segment. What percent is Nexsan of the storage and security these days?

Mark Lucas - *Imation - President, CEO*

Well, we don't disclose that exactly right now Eric, but I would say it's still the majority of it.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. But Nexsan was up sequentially and the total was down sequentially?

Mark Lucas - *Imation - President, CEO*

Well, Nexsan was actually up sequentially. I'd have to refer to Scott here on this in a second but Nexsan has grown with -- we're slowly building momentum since Q1. So Q2 was growth over Q1, Q3 was growth over Q2. We expect Q4 to have growth over Q3 and I would also put my faith in that returning to year-over-year growth no later than the first quarter of next year.



Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. All right. To counter my point there in bringing that up was that if in fact we are up sequentially on Nexsan and we're down sequentially in total, that means that while we maybe long on design wins and proof-of-concepts and some of these other things they're really in a more substantial decline sequentially, so--

Mark Lucas - *Imation - President, CEO*

Well, there are a couple of miscellaneous categories in there Eric but I will say this on the Windows to Go, IronKey product we stalled a little bit in Q3 when Microsoft introduced Windows 10. If you recall that our PC on a Stick Windows to Go product is a Windows 8-based product, 8 and 8.1. And it's primarily large enterprise and Federal Government targeted markets. So when Microsoft said we're going to be introducing Windows 10 the adoption of Window 8 and 8.1 has basically stalled and therefore it has affected the rollout of our IronKey product within approved accounts.

So we are still getting the handle on that. We actually think long-term that's a good thing for us because Windows 10 is more enterprise friendly than Window 8. Our customers have welcomed it and are very enthusiastic about it. It's simply putting a headwind on our rollout of the PC on a Stick.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay, and then last question from me, it sounds like you have a more aggressive but still fiscally responsible tone on the real estate. I know in calls past you have talked about trying to get the space leased out, to have a stronger negotiating point on facility sale. Is that a change there?

Mark Lucas - *Imation - President, CEO*

No, we are continuing to do that and we actually have several prospects that continue to walk through the building and that are showing some promise, but we are going down dual track. So we are trying to lease the building up to improve its financial viability to financial buyers, looking at strategic buyers and basically marketing on a national basis and we're actually quite pleased with our new broker on this. He is already showing a lot of energy both locally and nationally.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay, thank you for taking my questions.

Mark Lucas - *Imation - President, CEO*

Thank Eric.

Operator

Your next question comes from the line of Mark Miller with Noble Financial Capital Markets.

Mark Miller - *Noble Financial Capital Markets - Analyst*

Good morning.



Mark Lucas - Imation - President, CEO

Good morning, Mark.

Mark Miller - Noble Financial Capital Markets - Analyst

How are you? Just talking about you had to take this goodwill write-off, I am just wondering compared to when you originally purchased Nexsan what caused you to kind of the growth estimate to be lower than what it is currently? I mean where did you think you were going to get more growth and why, which resulted in this lower adjustment?

Scott Robinson - Imation - VP and CFO

Sure, hi Mark this is Scott. So a few things to respond to your question; as we said we have been somewhat disappointed that we have not been able to grow year-over-year and that while we are growing sequentially the year-over-year growth has not yet come and that we expect the year-over-year growth to come in the future.

I would say a few things we have noted that our global growth was a little bit slower than we originally anticipated and we've also said that we've made a few changes. We've had a little bit slower ramp up in our hiring of new sales personnel than originally forecasted. So when we put all those things together and looking at our performance our sequential growth versus year-over-year growth we decided with our auditors that we should really increase that discount rate and when you increase the discount rate on your valuation you reduce the value and that discount rate really resulted in the need to adjust the carrying value of the goodwill.

Mark Miller - Noble Financial Capital Markets - Analyst

Okay, thank you. We've talked about in the previous questions about Windows 8, Windows 10 and I am just wondering there is a lot of thinking about what's going on with the PC spec, there has been an [after flow] from the introduction on Windows 8 and just was wondering and that might now be ending. I am just wondering in terms of linearity if that was an impact at all on you? And in terms of linearity, in terms of Nexsan sales did they accelerate we exited the quarter, was it flat compared to the beginning of quarter?

Scott Robinson - Imation - VP and CFO

Generally, Mark both our Nexsan and Windows to Go sales are back-end loaded. I would say it's typical of other IT sales cycles you see quarter-by-quarter and that there is a lot of activity, the last month of the quarter and we generally see higher sales in that month than in the first two months of the quarter.

Mark Miller - Noble Financial Capital Markets - Analyst

And finally you indicated, I know you are in a lot of foreign countries and that plays a lot of pressures or puts changes in terms of your tax rate. Are you expecting to be in a net tax rate over the next couple of quarters? You were in a tax benefit situation for quite a while.

Scott Robinson - Imation - VP and CFO

Yeah, I would say we're going to balance around, as I noted in my comments we are into a period of tax allocation, will vary based on the sales level in each countries. But I could see either a small provision or a small benefit in any one particular quarter. I don't think it will be massive moves but there certainly will be some fluctuations just based on the sales in each of our countries where we are paying taxes.



Mark Miller - *Noble Financial Capital Markets - Analyst*

Thank you.

Mark Lucas - *Imation - President, CEO*

Thank you Mark.

Operator

And I will now turn the call back over to you sir, for closing remarks.

Mark Lucas - *Imation - President, CEO*

Well thank you all for joining this on the Q3 call and we look forward to talking to you again in February for the Q4 call. Thank you.

Operator

Thank you for joining today's conference. You may now disconnect your lines.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2014, Thomson Reuters. All Rights Reserved.