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IMN - Q2 2014 Imation Corp Earnings Call

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Eric Martinuzzi *Lake Street Capital Markets - Analyst*

Stan Berenshteyn *Sidoti & Company - Analyst*

Mark Miller *Noble Financial Group - Analyst*

PRESENTATION

Operator

Good morning. My name is Phoenix, and I will be your conference operator today. At this time I would like to welcome everyone to the Imation Corp. Q2 earnings release conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions)

I would now like to turn the call over to Scott Robinson. Mr. Robinson, you may begin your conference.

Scott Robinson - Imation Corp. - VP and CFO

Thank you, Phoenix, and good morning, everyone. We appreciate your joining us for Imation's second-quarter 2014 earnings call.

Before I ask our CEO, Mark Lucas, to report on the Company's progress during the quarter, I'd like to remind everyone that certain information discussed 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 actual results to differ material from any projected results. Risk factors that could cause the result to differ are outlined in the press release issued today as well as our filings with the SEC.

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

Mark Lucas - Imation Corp. - President and CEO

Thank you, Scott, and good morning, everyone. Let me start by saying I am pleased with the encouraging progress we saw in Imation's second quarter. Overall, results met our expectations. The Company's total revenue decline rate moderated, and we again produced improvement in our expense levels. On a sequential basis total Company net revenue and gross margin in the second quarter was essentially flat with the first quarter of 2014.

As you recall, we have two business units: consumer storage and accessories, or CSA; and tiered storage and security solutions, or TSS. In CSA, although secular declines continued in optical media, as we anticipated, revenue for our audio and accessories category grew over 10% from last year's Q2 and was also up sequentially.

Importantly, our growth drivers for future success performed well sequentially. Imation storage solutions and mobile security portfolios posted revenue growth over the 2014 first quarter. Gross margins in the TSS segment also rose sequentially. We are executing on a number of initiatives in both Imation's Nexsan and IronKey portfolios, and that is generating momentum, as we noted in this morning's news release.

Let me go deeper into each of those areas, starting with Imation's storage solutions business. Here we posted sequential gains in all geographies. In order to drive our growth for our entire Nexsan portfolio, especially for the NST and Assureon lines, we are making investments -- not only in the US, but also in Europe and Asia. Year to date we have added sales, engineering, and support professionals in these businesses, increasing our headcount by over 20%.

Further, for the past several quarters we have brought on the new value-added resellers and have actually expanded this channel by 25% to date, which translates into approximately 50 new VARs for us. As we have hired new sales talent in VARs, we have focused on improved education, training tools, and onboarding. We are now beginning to witness the productivity that you would expect to see from our enhanced education efforts.

In storage solutions, as I mentioned last quarter, there are three main Nexsan offerings. First is our NST line, which we are very excited about. And we had a sizable NST win in the second quarter with a large telecommunications-based company in Dallas. Through our NST solution set, we have expanded Imation's footprint with high-capacity storage markets and successfully entered the hybrid storage market as well.

This market is appealing to us because it is growing at more than 20% annually and is expected to capture 45% of the external storage market by 2017. Our NST line uses an architecture that optimizes flash technologies for caching and storage performance. NST is broadening our market reach into the data center by addressing mixed-application workloads cost effectively and in a scalable way.

To make sure we are well positioned to capitalize on NST's growth opportunity, we are advancing a number of feature upgrades. For instance, in the second quarter we introduced NST Smart bundles that are configured for capacity or performance requirements as needed. And we have other new capabilities on our roadmap that I will share with you in the coming quarters.

The second part of storage solutions is the Assureon data archive storage systems. This differentiated suite of products is designed for applications that require high security and long-term file retention. So we are marketing to verticals such as financial services, healthcare, and human resources.

Product security features comply with HIPAA and SOX for users requiring privacy and confidentiality. Assureon had several nice wins in the second quarter, and we are confident that sales in this line will become a larger part of our revenues in the second half.

And third is our E-Series family, which is what Nexsan is best known for and continues to grow. Among the second-quarter wins are systems for the Korean government and one of the leading racing car organizations in the world.

With the E-Series we deliver a solid product that competes effectively with bulk storage. Recently we launched a new configuration in our E-Series V system line of ultra-reliable and efficient storage arrays that offer lower cost and maximum uptime. Including the new E32V, we now have four configurations that could be easily expanded with additional capacity.

Now let me update you on Imation mobile security. Here again we reported nice sequential growth. You have heard me describe what we like to call our PC-on-a-stick product and what is formally known as our IronKey Windows to Go solution. This product has a customer's corporate Windows 8 operating system on a secure flash drive that has central management capabilities. Microsoft is our strategic partner and assists us with customer referrals and customer education on how to use the product and its value proposition.

We are seeing some repeat business now in addition to a number of new Windows to Go sales to small and medium-sized organizations. Further, Imation has over 70 Windows to Go pilots or proof-of-concepts currently underway with large enterprise customers as well as government agencies.

The Windows to Go sales cycle, however, is a long one, and orders tend to start small and build over time. It is particularly noteworthy that we now have to Fortune 100 companies that have approved Imation as the solution provider. One of the strongest use cases for our large customers -- they want Windows to Go to implement a BYOD or bring-your-own-device strategy on laptops, beginning with contract workers. What's behind this is our better security and mobility combined with substantial cost savings versus laptop deployment.

Moreover, we just announced our new IronKey W700, the industry's only FIPS Level 3 certified Windows to Go product. This high level of security is a competitive advantage. It is a required certification for most government and Department of Defense and intelligence agencies that have been doing proof-of-concept testing with beta versions in the first half of this year. We have relationships with more than 50 agencies, and we expect a number of them to make their first significant Windows to Go purchases in the second half of 2014.

Now let me turn to Imation's consumer storage and accessories segment, or CSA. In addition to strong cash generation, this business continues to reduce its cost structure and maintain its optical media market share.

Moreover, CSA is focused on introducing higher-margin products. During the second quarter we unveiled a new TDK TREK speaker. The TREK line is our wireless, weatherproof portable audio product line. And it helped drive the 10% growth in our audio and accessories category year over year, as I mentioned a few moments ago. Margins continue to improve as well.

In our first-quarter conference call I mentioned another new higher-margin product, our patented 2-in-1 micro USB flash drive. This product continued to sell well in the second quarter, led by Europe and the Middle East. This is a differentiated offering for us that carries an attractive gross margin.

So what does the second half of 2014 hold for Imation? We don't anticipate our CSA segment returning to growth, due to the secular optical declines. But we will continue to manage this segment well and launch higher-margin products, most notably in audio and accessories.

Our growth businesses are clearly gaining momentum. We expect continued sequential growth in our storage solutions and mobile security portfolios. As our added salespeople continue to get up to speed around the world, we anticipate that the sequential growth we are seeing will lead to a return to year-over-year growth in the near future. This is our top priority as we continue to evolve Imation into a significant player in the higher-growth and higher-margin markets of data storage and mobile security.

At this point, I would like to ask Paul Zeller to say a few words as an introduction to our financial review. You have probably all seen the SEC filing we did earlier this month indicating that Scott Robinson is going to take over from Paul as CFO, but we can't let Paul go without extending our heartfelt thanks to him for his 18 years of service as Imation's CFO and wish him the absolute best of luck going forward. Paul?

Paul Zeller - Imation Corp. - Former CFO

Thanks very much, Mark. Before I introduce Scott, who is going to go through the details on Q2, I would like to take the opportunity to make a couple of comments as I transition out of Imation.

I have been at Imation since the spinoff from 3M, and the last 18 years have been quite a journey. Don't worry, I'm not going to reminisce, but I do have a few comments.

First, I am leaving Imation on very positive terms. It's the right time for a change, and I am looking forward to my next opportunity. As I do move on, I remain a strong believer in the strategy and in the upside opportunity for the Company and its shareholders, and I plan to remain a shareholder. The sequential improvement in storage and security solutions, I believe, is encouraging. So is the continued solid margins and cash flows from our legacy storage businesses.

In terms of the finance team, I couldn't be more pleased to see Scott Robinson taking over as CFO. Most of you already know Scott, and you know how skilled he is. Supporting him is Danny Zheng as our Corporate Controller. These guys are deeply experienced and fully capable. You are going to enjoy working with them, as I have.

I have also appreciated working with you, our shareholders and analysts. And I'm grateful for the confidence you shown in me and in our team and the Company. I will be helping Mark and Scott with this transition over the next couple of months.

With that, let me now introduce Scott to walk you through our second-quarter results.



Scott Robinson - *Imation Corp. - VP and CFO*

Thank you, Paul. It has been a pleasure working with you over the years, and I appreciate all that I have been able to learn from you. I wish you the best.

Turning to our financial performance, from an overall standpoint we saw several encouraging signs in the second quarter. Imation's total Company revenue decline rate moderated. Our gross margins rose slightly on a sequential basis, and we posted continued improvement in our expense levels.

Total Company revenue in Q2 was \$178.6 million, which was down 15.6% from the second quarter of 2013 but flat with Q1 of this year, as we noted in the release. Foreign currency exchange rates did not have a significant impact on this quarter's revenue compared to Q2 2013.

Looking at revenue by segment, our tiered storage and security solutions revenue decreased 11.9% compared to a year ago. However, it rose sequentially. This was true for our tape business as well.

Our consumer storage and accessories revenue decreased 18.6% from the same quarter last year, due largely to the expected secular declines in optical media products, as Mark mentioned. Consumer storage and media was down 21.2% last year, but this was partially offset by a 10.4% increase in audio and accessories revenue, with the TREK product line making strong contributions. This is a product area that has shown consistent growth over the past several quarters.

Next I will move to gross margins. Though lower compared to Q2 last year, total Company gross margins rose slightly on a sequential basis. As we noted in last year's Q2 call, we had benefited from a levy reversal, a nonrecurring event, which led to a 26% margin in Q2 2013. The margin without the levy was about 20% compared to 19% margin this quarter. Sequentially, margins increased slightly from the first quarter.

At the business segment level CSS gross margin was 18.9%, down from 21.7% a year ago, due primarily to lower revenue levels. Sequentially, CSS gross margin rose from 18.3% in Q1, which was good to see.

CSA gross margin was 19% versus 30.2% in Q2 2013. Again, last year's CSA margin included a benefit of 11.6 points from the levy accrual reversals. Excluding the reversal benefit, CSA margins were slightly higher than a year ago.

As you know, expense control has been a Companywide priority for several years. Total Company SG&A declined \$2.2 million from last year to \$44.3 million due to our continued cost reduction efforts.

The SG&A associated with our legacy business has dropped more than 25% from Q2 2012. This has more than offset our additional investments in Imation storage solutions. Research and development costs came in at \$4.5 million, up slightly from Q2 2013, and reflect Imation's increased investments in higher-margin CSS projects.

The overall operating loss from continuing operations of \$20.1 million compares with breakeven operating income last year. Again, last year's results are chiefly due to the \$13.6 million levy accrual reversal.

We did incur a tax benefit in the second quarter of \$1.6 million. This was due largely to a mix of taxable income by country, as no tax provision is recorded related to the United States, as the Company maintains a valuation allowance related to our US deferred tax assets.

Discontinued operations loss was \$1.6 million, improved from a loss of \$3.3 million in Q2 2013. This includes the results of XtremeMac and Memorex consumer electronic businesses, both of which have now been sold.

Ultimately, we incurred a net loss of \$0.48 per diluted share compared to a loss of \$0.04 per diluted share last year. Our year-ago results benefit from the levy accrual reversal we discussed earlier.

Imation's balance sheet remained solid. We ended Q2 with \$114.7 million in cash and net cash of \$94.7 million after deducting the \$20 million that is outstanding on our credit facility. The Company also repurchased \$900,000 worth of Imation common shares during Q2, and we are authorized to buy back up to 2.9 million additional shares.

Further, we have listed our campus headquarter buildings for sale and continue discussions with potentially interested parties. Our goal is to monetize the property in a fiscally responsible manner.

In summary, our Q2 results show many areas of positive momentum, results that stem from the continuing execution of our strategic transformation. We are encouraged by the sequential growth in our Nexsan and IronKey product portfolios as well as our audio and accessories category. We will continue to invest in our growth drivers as we concurrently manage our legacy businesses to maximize cash generation.

Let me add that I'm very excited about my new role at Imation. I believe our future is bright, and I will work tirelessly to achieve success for this organization.

Now we would be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Eric Martinuzzi.

Eric Martinuzzi - Lake Street Capital Markets - Analyst

It's Eric from Lake Street Capital Markets. Bon voyage, Paul; and congratulations, Scott, on the new role.

Revenue-wise, just curious to know -- obviously, everything grew sequentially: the Nexsan, the mobile. I'm just curious. Within S&S, that growth, what was most responsible for that? And then what do you think is most responsible going forward? It sounds like you've got some good pipeline there.

Mark Lucas - Imation Corp. - President and CEO

Actually, the growth is pretty well uniformly spread across products and geographies, which is really encouraging. It's not like we have one hotspot; it's growing everywhere. I would say the Nexsan product portfolio contributed the majority of the growth in that segment, Eric, but we did see it across every one.

Eric Martinuzzi - Lake Street Capital Markets - Analyst

Okay. And then when you say you've got significant transactions with Windows to Go, what is a typical enterprise-size deal?

Mark Lucas - Imation Corp. - President and CEO

The way it typically works is you have a company -- a Fortune 100 company that says, I am interested in moving to the Windows to Go or PC-on-a-stick product for mobile security. And they do the technical specification test and the proof-of-concept, and they test it out.



And we have not lost one of those. Every single one of those, the IT departments have had their jaws literally drop with the level of security and performance that we are delivering.

So then we go to a business unit within the organization, and they do a actual in-market trial with their employees. And typically they start with contract workers who will want to have access through the firewall, and this is a way to do that using the PC on a stick.

Then that rolls out to other employees throughout the organization. So it's probably -- once we get the initial order, it's typically somewhere -- we are seeing, at least they are estimating, somewhere between 20- to 24-month rollout. And the aggregate value of these orders can be millions of dollars. They will start in the tens of thousands of dollars, and it will build as they roll it out to employees.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. And then the secular decline businesses -- and I misspoke there; the consumer storage media was actually down sequentially. But both the CSM -- the consumer storage media and the commercial storage media -- that's a lower decline right then I had been modeling. And on the consumer side probably the lowest decline on a year-over-year basis in quite some time.

Are we at the point yet we are able to, with any certainty, predict that maybe this is the -- you know, we've stabilized at a certain decline rate? Or is it still too much of a wildcard? And address both the consumer and the commercial, if you would.

Mark Lucas - *Imation Corp. - President and CEO*

Yes. And actually, I think it's similar in both of them, Eric. We don't know. One quarter does not make a trend. We are looking at that very closely. There are some indications that perhaps the decline rates are moderating and going to continue to moderate as the tail of these businesses stabilize a little bit.

What we are wrestling with a little bit, also, though, is as the unit decline rates stabilize, the average selling prices are becoming more competitive, so putting pressure on margins that we have to maintain. So it's a balancing act. And we don't have the answer yet. I think we need a couple more quarters to be able to accurately forecast how this is going to turn out.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. And then within the expense side, I notice we had roughly flat revenues, but yet our operating expenses were up sequentially. It looks like the bulk of that was within SG&A. What's driving that?

Mark Lucas - *Imation Corp. - President and CEO*

That's all the investments in our security and storage solutions business. So we have been adding a lot of people; we've been adding engineering talent -- all those different things that go along with investing in that business. So our overall expenses in our legacy businesses and in our corporate structure has actually continued to decline quarter on quarter. It's just being offset by these other investments.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. And then lastly, and I don't know if you even have an answer, but we are now down to a net cash balance here, \$95 million. You just had a quarter where the cash burn -- the adjusted EBITDA number was a negative \$9.5 million.

Is there anything in sight at the Board level? Are you targeting, at some point -- hey, we need to cut the expenses, grow the revenue; and if it hasn't happened by quarter X, we've got to just do something more dramatic so that breakeven is actually on the horizon?



Mark Lucas - *Imation Corp. - President and CEO*

Yes. We do all kinds of what-if plannings. We have contingency plans. We monitor our cash very carefully, and we are very committed to keeping a very healthy cash balance for the Company.

And so we have our plan of record that we move forward with, which is to invest and return to growth. However, we, as any good business plan does, has contingency plans and says, okay, if something doesn't pan out exactly how you want to do it, you move to plan B or plan C. And we continually work on those and have those available to us. I will say to you and shareholders is that we are very committed to keeping a very healthy cash balance.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Right, but no target date for breakeven?

Mark Lucas - *Imation Corp. - President and CEO*

No, not at this point.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay, thanks for taking my questions.

Operator

Stan Berenshteyn from Sidoti & Company.

Stan Berenshteyn - *Sidoti & Company - Analyst*

Good morning, gentlemen, and congratulations to both Paul and Scott. So just a couple of questions. First, gradually we've seen the inventory levels taper off. And they've acted as a source of cash, I think, aside from last quarter.

Is this trend going to continue? Or what is the sweet spot for inventory levels, given the trajectory of the declines in the legacy business?

Scott Robinson - *Imation Corp. - VP and CFO*

This is Scott. So as you noted, the inventories have come down from Q1, or are basically stable from Q1 and down from year-end. And we think that the inventory levels will need to continue to come down as the legacy businesses decline. It's something we focus on every day.

And it goes in cycles where we will take it down, and then we will have to work on another project to decrease the inventories even further. But that's something we are very focused on, which is to decrease inventory levels consistent with the declines we are experiencing in the business. So I would expect as the revenue levels drop, the inventory levels will also need to drop accordingly.

Stan Berenshteyn - *Sidoti & Company - Analyst*

Okay. And is there any plans for share repurchases or any outlook on dividends, given the cash balance?



Scott Robinson - *Imation Corp. - VP and CFO*

Well, as you probably saw, we bought a few shares back during the quarter. That's something we look at every quarter with the Board. As Eric just mentioned and Mark noted, we focus on our cash every quarter; we watch that very closely. We do still have 2.9 million shares remaining in our repurchase program. And that's something we'll look at on a quarter-by-quarter basis and announce at the end of each quarter.

Stan Berenshteyn - *Sidoti & Company - Analyst*

Great. Thank you; I will jump back in the queue.

Operator

Mark Miller of Noble.

Mark Miller - *Noble Financial Group - Analyst*

I would also like to extend my congratulations to Scott; and best wishes, Paul, for your future. I was wondering if you can give me a little more color on these design wins, the Nexsan NST and Assureon products, in terms of the customers -- what type customers they are geographically? You said there were improvements across all geographies. But just if you can give us a little more color on the wins there?

Mark Lucas - *Imation Corp. - President and CEO*

Yes. Unfortunately, Mark, we can't. Our customers don't allow us to disclose their names. Otherwise, I would really like to do that, because they are pretty impressive.

But we had wins in Asia with the Korean Defense Ministry. That was a combination of our NST and E-Series line. We had wins in the United States across all three types of product portfolios. In the financial industry, a major Southern bank, we won a deal with Assureon. We won with a major telecommunications company out of Texas. And we won with a very, very well-known car racing group in the United States.

In Europe we also had wins with, again, across both E-Series, Assureon, and NST. The most notable one was with, actually, the government of Norway. And I can't get into too many details there.

And again, we had other customers throughout Europe that just don't let us disclose their names. So what's encouraging to me is that this is not just US-centric; it's around the world. And there are a variety of different application mixes that we are winning. And so it's a very healthy start.

Mark Miller - *Noble Financial Group - Analyst*

Any possibility from any of those customers for follow-on orders?

Mark Lucas - *Imation Corp. - President and CEO*

Oh, absolutely. One of the great attributes we have is the scalability of our system. So the E-Series is designed to be able to scale out and be very economical in doing so, unlike some of our competition. And so that's one of the primary selling attributes that we say.

Mark Miller - *Noble Financial Group - Analyst*

I'm just wondering -- secular decline has moderated. Could you -- we are hearing from other firms, international firms, that they are seeing revivals in Europe, and Asia remains strong. Could this be a strengthening of the global economy also impacting that? And what are you seeing in terms of strengthening in the global economy?

Mark Lucas - *Imation Corp. - President and CEO*

Well, we've certainly seen spending, if not stabilize, increase slightly. Again, I hate to make a generalized global comment, but you look at different marketplaces: Japan, it looks pretty strong right now for us; Korea, it looks pretty strong; Australia is doing well.

And actually, in Europe, as well -- I mean, if you look at the big countries there, UK, Germany, France are doing really well. The Nordic countries seem to have economic recovery going; that's with the Benelux region as well.

Interestingly enough, also the Middle East was, at least up until the latest issues and crisis there, was doing pretty well. We haven't seen that decline yet but anticipate there could be some disruption in the Middle East.

And southern Europe is still, I would say, soft. So Spain, Italy, Greece, the Eastern European countries remain a little bit soft.

Mark Miller - *Noble Financial Group - Analyst*

Any impact on the Russian sanctions or the situation in Ukraine?

Mark Lucas - *Imation Corp. - President and CEO*

There is not, because we didn't do very much business in Russia. And so that's good and bad, I guess. But in this particular case, there was no significant impact.

Mark Miller - *Noble Financial Group - Analyst*

Thank you.

Operator

There are no further questions at this time. I will turn the call back over to the presenters.

Mark Lucas - *Imation Corp. - President and CEO*

Thank you, everyone, for your participation on today's call and for your questions. We are pleased to report sequential revenue growth in Imation's storage solutions and mobile security businesses, and we look forward to sharing further progress with you in our October call.

Operator

This concludes today's conference call. You may now disconnect.

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