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IMN - Q4 2013 Imation Corp Earnings Conference Call

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PRESENTATION

Operator

Good morning. My name is Tiffany and I will be your conference operator today. At this time, I would like to welcome everyone to the Imation Corp. Q4 earnings release conference call. (Operator Instructions).

Scott Robinson, you may begin your conference.

Scott Robinson - *Imation Corp. - VP, Corporate Controller, CAO*

Thank you, Tiffany. Good morning, everyone, and thank you for joining us today for our fourth-quarter 2013 earnings call. I'm your host for today's call. We will be hearing from our CEO, Mark Lucas; and our CFO, Paul Zeller. We will review our fourth-quarter and full-year results. Before that, though, I would 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 subjects are subject to risks and uncertainties that could cause actual results to differ materially from any projected results. Risk factors that could cause the results to differ are outlined in the press release issued today, as well as our filings with the SEC.

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

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

Thank you, Scott, and good morning, everyone. On today's call, Paul Zeller and I will cover our financial performance and provide an update on the progress we have made in our strategic transformation during the fourth quarter.

Let me start with an overview. We are pleased with Imation's results for our fourth quarter, in which revenue declines in our legacy businesses were lower than anticipated. And as noted in the press release, we did a very nice job with working capital and cost management.

While this is encouraging, we have not yet reached an inflection point in our transformation, as sales in our growth products have not yet offset secular revenue decreases in our legacy businesses.

However, we ended 2013 with some of our lowest inventories ever, and \$132 million-plus in cash. This gives us the financial strength to execute on our strategic transformation. Our strategy will lead to Imation becoming a significant provider of differentiated data storage solutions and information security products.

You may recall that at the end of 2012 we announced the acceleration of our transformation due to the rapid decline of Imation's legacy media businesses. As part of our plan, our goal was to divest the lower-margin Memorex and XtremeMac businesses. I am pleased to report that we sold XtremeMac in late January. This follows the sale of the Memorex consumer electronics business which occurred earlier in 2013. Selling our non-core Memorex and XtremeMac businesses was a key objective for our team in 2013, as the divestitures allow us to focus on higher growth opportunities.

As I have mentioned in the past, we restructured the Company and are going to market through two channel-focused business units that can make quick decisions. They are called first, consumer storage and accessories, or CSA; and, secondly, tiered storage and security solutions, or TSS.

Let me talk about CSA. Our CSA business continues to evolve as the optical market progresses through its lifecycle with corresponding revenue declines. Let me point out that while optical sales decreased, our other consumer businesses did well.

We introduced a new Flash product in the quarter, the Micro USB Flash Drive, which is the first product launched since our shift to mobile computing storage solutions. The Micro USB meets the storage and data transfer needs of the new fast-growing NAS market of mobile device users. It is an innovative new storage offering for consumers, building on Imation's core position in personal storage.

We also unveiled the TDK TREK wireless speakers, which demonstrates our focus on portable, wireless, and weatherproof technology for our target audio market. The TDK audio and accessories business finished the year strongly, with gains over the 2012 fourth quarter.

We have many new consumer storage products on the roadmap for 2014, a few of which have important intellectual property ownership by Imation. While we do not anticipate CSA returning to growth in the near-term, it will remain an important contributor to our earnings and our cash flow.

Turning to the TSS segment, during the quarter this business had overall revenue growth of 5.4% and gross margin growth to 18.2%, up some 13.5% a year ago as a result of our Nexsan acquisition. You will recall we acquired Nexsan last year with the intent of leveraging Imation's deep data storage core and geographic reach with Nexsan's proven storage arrays and unified hybrid appliances to build a platform for long-term growth. In late 2013, we started investing in Nexsan by aggressively hiring technical support and sales talent, introducing new products, and promoting Nexsan solutions globally.

Our magnetic tape business declined, which is consistent with the overall market. We have maintained our market share throughout 2013, and the steep decline rates we saw through the middle of 2013 leveled off in the fourth quarter.

Although our fourth quarter improved, we continue to be constrained by macro factors that have persisted since the third quarter, such as the uncertainty in government spending. We are just now beginning to see improvement in the pipeline for future orders, and we anticipate robust growth from our storage and security portfolio longer-term.

Together with an ongoing emphasis on working capital and cost management in the TSS segment, we will continue to focus on building our Nexsan and IronKey product revenues. In the fourth quarter, we launched the Nexsan E-Series V storage arrays, which provide [classic] performance and more efficient capacity growth, and serve as a scalable back-end storage for Nexsan's NST unified hybrid storage appliances.

Further, in our IronKey portfolio, we are seeing increasing interest for our Windows To Go solutions. Through our strong partnership with Microsoft, we are attracting new Windows To Go customers in both the public and private sectors globally, and significantly increasing deployment of our proof of concepts.

In other notable news, earlier this week we announced a new partnership with Ingram Micro, the world's largest technology distributor, to recruit and support new resellers for our Nexsan storage solutions. This allows partners in the US to capitalize on the growing need for scalable storage to support strategic IT initiatives; and, in turn, expands the footprint of Nexsan solutions.



Looking at the full 2013 year, we made strides in our transformation and continue to move away from legacy media businesses to focus on growing consumer and commercial storage solutions. We are committed to long-term success and becoming a key global player in data storage and information security, and we have rebalanced our portfolio through the strategic acquisition of Nexsan and by selling two lower-margin businesses.

We have taken steps to right-size Imation's infrastructure and reduced operating expenses, excluding acquisitions, by more than 30% or \$67 million in 2013. While difficult, we knew these actions were necessary to build Imation for long-term success.

With that, I will now turn the call over to Paul to provide a more in-depth look at our financials.

Paul?

Paul Zeller - *Imation Corp. - SVP, CFO*

Thank you, Mark, and good morning, everyone. Our results showed positive signs of progress during the quarter. Our topline decline rate moderated, driven by Flash and audio products in our consumer storage and accessories segment and an improved market in magnetic tape. And we had improved earnings [dated] by better gross margins across the board in CSA and in tape, as well as continued operating expense savings. In addition, earnings and cash flows benefited from several one-time items in the quarter.

So, before I get into the details on the fourth-quarter results, I would like to walk you through these one-time items. First, as we had signaled in earlier quarters, we had been working on the sale of excess real estate in Camarillo, California. This property was the site of a tape manufacturing facility that was closed in 2008.

We closed on this transaction during the quarter, receiving approximately \$10 million in cash, and we recorded a \$9.8 million gain. Second, we settled a long outstanding dispute with a bank in Brazil, which resulted in a \$2.5 million cash gain also in the quarter. And, third, we also had restructuring charges recorded of about \$2.8 million. Consistent with our past practice, all three of these special items, which net to a gain of \$9.5 million, have been excluded from our pro forma results.

In addition to these special items, we also recorded a \$9.5 million gain from the reversal of a European levy accrual due to a favorable ruling in a French Levy case. Consistent with our past practice, this benefit has been included in our pro forma results and was recorded as part of gross margin in our P&L.

So, in total, between the special items and this levy benefit, we had \$18 million of benefits in our reported fourth-quarter operating results. When I am referring to our pro forma results, it will exclude the \$9.5 million of special items that include the levy benefit. Having said that, even with the levy item, I will be careful to identify its impact as I discuss our results.

So with that preamble, let me get into details on our finish for 2013. Quarter-four revenues totaled \$232.8 million. That was down 12.7% from the same quarter of 2012. That decline rate improved from the roughly 15% decline rates we have been seeing in the earlier quarters in 2013. And this was despite a larger negative impact from currency translation in Q4, which was a penalty of about 5 points to our year-over-year comparisons.

Revenues in our consumer storage and accessories segment, or CSA, represented 56% of total revenues, and decreased 23% in the quarter. That's similar to Q3's decline rate. This stemmed from consumer storage media, primarily optical, which declined 25.5%, with the optical media category continuing to experience roughly 30% declines.

Audio and accessory revenues under the TDK brand rose 6.7%, driven by the success of our A33 wireless TDK speaker system. Tiered storage and security solutions, or TSS, had revenues representing 44% of total, and increased 5.4% in Q4. This reflected the addition of revenues from the Nexsan acquisition, which closed at the end of 2012, as well as better results in tape media, which declined at a lower rate than we had seen in recent quarters.



Gross margins were 23.8% in the fourth quarter, aided by the levy accrual adjustment I just discussed. If we exclude that gain, margins would have been 19.7%, still up 3.6 points from the fourth quarter of 2012, and up 0.9 points sequentially. As Mark said, our strategy has been to focus on higher-margin categories, with the most notable example being the Nexsan acquisition. And we have exited lower-margin categories, such as the low-end consumer electronics with the divestitures of Memorex CE products and XtremeMac.

In addition, we consciously focused on higher-margin products within existing categories such as CE accessories, where we have exited less differentiated SKUs and added higher-margin products, notably the A33 Bluetooth speaker. And we're seeing the benefits of this change in strategy.

In our CSA business, even after pulling out the levy gain, margins rose both sequentially and year-over-year in all major categories. In TSS, while storage media and magnetic tape improved, our storage and security solutions margins were down, driven by some of the issues Mark talked about earlier.

Operating expenses totaled \$43.6 million, prior to restructuring and other items. That's down \$6.8 million from the fourth quarter of 2012, despite adding operating expenses with the acquisition of Nexsan. We continue to see the benefits of cost reduction work that we announced in late 2012. That implementation is now nearing completion.

We recorded a net \$9.5 million gain in special items, as I noted earlier, driven by the California land sale. And, including that gain, we recorded operating earnings of \$21.1 million in the fourth quarter. Our prior-year results included a significant loss due to the write-off of acquisition intangible assets from years ago.

Excluding these special items, our quarter-four operating earnings were \$11.6 million. And even if we exclude the levy gain beyond that, that is up and gross margins, we still had a positive operating income for the first time in over two years.

Non-operating costs were breakeven, as currency gains about offset bank fees and other items. We recorded a \$1.9 million tax expense in the quarter, and discontinued operations within that \$2.5 million loss, bringing net income to \$16.7 million and earnings per share to \$0.41 on a US GAAP basis. If I exclude the restructuring net gains, net income was \$10 million; and earnings per share, \$0.25.

I should note that our results released today include estimates for our discontinued operations results, and are subject to change prior to filing our 10-K in March.

Cash ended the quarter at \$132.6 million, with net cash at \$112.6 million after deducting the \$20 million outstanding on our credit facility. This represents an increase of \$24 million during the quarter, driven by improved earnings, working capital reductions, and the sale of our Camarillo real estate. Our inventory days of supply were down 5 days in the quarter, on top of a 6-day reduction in Q3, ending the quarter at 61 days or 6 turns.

So, in summary, our fourth-quarter results show the benefits of the continued execution of our transformation strategy. We are investing in growth in both our storage and our security solutions businesses, though we continue to see some softness, especially in the government sector. We saw improving trends in our commercial storage media business, and growth in both Flash media and consumer electronics and accessories within CSA.

Gross margins continued to improve as we focused on higher-margin categories and higher-margin products within our categories. Operating expense reductions are on track, helping to fund growth investments in our TSS businesses. And our cash performance was especially strong during the quarter, with cash up \$24 million to more than \$132 million. We remain focused on the important initiatives we have outlined and on driving improvements in our financial results over time.

So with that, we would be pleased to take your questions. Thank you.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Eric Martinuzzi, Lake Street Capital Markets.

Eric Martinuzzi - Lake Street Capital Markets, LLC - Analyst

Thanks. Congratulations on the good finish to a challenging year. I was happy to see the sale of the XtremeMac. Is there anything you can tell us about the purchase price there, now that that one is sold?

Paul Zeller - Imation Corp. - SVP, CFO

Yes, Eric, it was generally in the range we had talked about, little bit less. And we had talked about, over a period of several years, the total expectation of value from both the divestitures being something in the neighborhood of \$19 million. That is probably a few million less than that. But, nonetheless, I think it was a good transaction to complete, if nothing else, to gain our focus. And, along the way, we monetized some inventory, which also helped. So, nothing really notable; maybe a little bit less than we had hoped for.

Eric Martinuzzi - Lake Street Capital Markets, LLC - Analyst

Okay. And then I know it was a December 31, 2012, acquisition of Nexsan, but in your 10-K are you going to be reporting a pro forma combined? Sometimes in the financial statements there is a pro forma combined revenue number for the acquired property, had it been around January 1, 2012. Is that going to be reported?

Paul Zeller - Imation Corp. - SVP, CFO

Yes, Eric, we are looking at that -- probably. We're just finalizing, and are looking at some of the rules; but, yes, we think we will be reporting a year-over-year comparison.

Eric Martinuzzi - Lake Street Capital Markets, LLC - Analyst

Okay, and do you have that number now, or are you going to wait until you get the K buttoned up?

Paul Zeller - Imation Corp. - SVP, CFO

So, we will provide that in the 10-K. I think, overall, we're going to stick with the comments we've made about liking what the early indications are in terms of the pipeline; but, clearly, seeing some softness during the quarter led by the government issues and some of the other things we've talked about in the last two quarters.

Eric Martinuzzi - Lake Street Capital Markets, LLC - Analyst

Okay, and I do want to go a layer deeper on the revenue. We did see some nice relief there in Q4. Certainly, the secular declines in both sides of the business, the optical as well as the magnetic tape. I'm curious to see, does the relief rally here, does that seem to sustain -- by relief, I mean the rate of decline being less than maybe it had been throughout the middle of the year. If you can address those in order -- optical first, and then tape.

Paul Zeller - *Imation Corp. - SVP, CFO*

So, if you think about optical, first, the decline rates we saw in optical in fourth quarter were very much what we've been seeing recently, kind of that 30% decline range. So really no change in that view of the market.

As we had said, magnetic tape did improve in terms of its decline rate. Instead of being in the mid- to upper-20s, it was in the lower teens. I think there is an open question about whether it is going to continue to decline. Will it decline double-digit, starting with a 1 or a 2? I think the jury is out a bit on that.

We saw some particular strength in Flash in the quarter, and that helps. But as you know, Flash is one of those categories where you might have it one quarter and it might not be as good a market the next quarter, where it's a little bit of an in and an out category for us. So that is a little bit harder to predict, but right now we were able to get some more business at good enough margins, and that helped.

And then, finally, the CE and accessory category is one that I think we did see some growth, and I think that is something that should continue. We have got better placements with some of the new TDK audio products, and personal audio continues to be solid.

Eric Martinuzzi - *Lake Street Capital Markets, LLC - Analyst*

Okay, and then lastly for me, it was good to see the sequential growth on the storage and security within TSS, so that was -- I assume that's normal seasonality for that business.

What about normal seasonality headed into Q1? Most of my enterprise storage and security-related companies see anywhere from a 10% to 15% decline, budget flush Q4 versus restarting the new year Q1. Do you have any history there? Can you give us any expectations?

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

Yes, good morning, Eric, it's Mark. I would say that, yes, we would probably follow that same typical trend. It's just the seasonal way that IT spends.

The one area is that Windows To Go is such a nascent market that it's gaining speed rather quickly. So the Windows To Go portion of the entire portfolio, we would continue to see grow. But I'm not sure that that would be big enough quite yet to offset any seasonal softness in the other markets.

Eric Martinuzzi - *Lake Street Capital Markets, LLC - Analyst*

Okay, thanks for taking my questions.

Operator

(Operator Instructions). Stan Berenshteyn, Sidoti & Company.

Stan Berenshteyn - *Sidoti & Company - Analyst*

Can you please tell me about the levy ruling, and whether that will impact future gross margins?



Paul Zeller - *Imation Corp. - SVP, CFO*

Yes, Dan, good morning. This is Paul. The levy ruling was in France. And France was one of the countries where you may remember we were maintaining an accrual, and awaiting further evidence about our sense that we wouldn't have to pay that accrual, and we had been signaling that for some time. And with the ruling in France, it gave us the confidence to reverse that accrual.

That does mean that as we sell product in the future to the extent that a levy continues to be paid in that country, we believe we continue to have a right of offset on that, and would be withholding that payment from the levy authorities in the country as an offset to the past commercial claims we have.

So that could have a modest benefit to our gross margins. It is probably -- we are already seeing that, for the most part, in our fourth quarter; so maybe not significant different from what we experienced already in fourth quarter, but from prior periods, yes.

Stan Berenshteyn - *Sidoti & Company - Analyst*

Okay, and what about -- you mentioned that Nexsan is expanding the salesforce. And can you just comment on the size of the expansion?

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

Stan, hi, it's Mark Lucas. We are investing significantly. We're going to, by the end of 2014, our salesforce will probably be in the neighborhood of 30% larger than it is today. It's really a question of how fast we can hire qualified people to get out there and sell this.

We think it's been -- it is a huge opportunity for us here, because the product is very well-established and very well-respected. We just need a little bit more emphasis on getting out there. So we are really excited about it.

Stan Berenshteyn - *Sidoti & Company - Analyst*

Great, and last question. In terms of the Ingram Micro partnership, can you provide some more color on the nature of the partnership?

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

Yes, the agreement we reached with Ingram Micro is for them to distribute Nexsan products to a reseller network. And what we have said to them is that we're going to protect our current resellers, so they cannot go after them. They have to add net new resellers. And we monitor all that they do add on there.

They are very excited about it. They wanted to pick a partner that they can grow. They believe that they are very underdeveloped in this category. And when they looked at all the different partners out there, they came down to -- we want to partner with Nexsan and really grow this. So they are looking to make this, longer-term, a several hundred million dollar business for them in this area, and so we're really excited about their partnership.

Stan Berenshteyn - *Sidoti & Company - Analyst*

Great. Thank you very much, guys.

Operator

Mark Miller, Noble Financial Capital Markets.



Mark Miller - Noble Financial Group - Analyst

I just was wondering, you stated the storage and security was more due to seasonal growth. But we have seen in a couple of areas the disk drive firms, and I also believe Intel were reporting somewhat weaker than anticipated seasonal growth -- in fact, no growth at all, if you look at Western Digital and [C8's] server drive shipments. Can you add any thoughts to that? Because it looks like the server market in a lot of areas was not a strong.

Mark Lucas - Imation Corp. - President, CEO

Yes, hi, this is Mark. Mark, we would say that, yes, there was softness in the fourth quarter. We were especially negatively affected by lack of government spending. If I look at our storage solutions business and our security business, they had probably several between 20% to 40% of their business is government related or government-funded in some way, even if it's through a third party. Those businesses were especially soft in the fourth quarter.

The business didn't go away, but the projects were simply put on hold and were not completed. Now, that with the budget resolution on January 16, we are now seeing those things start moving again, so we're expecting a rebound in that. But I would say that there was softness in the fourth quarter, yes.

Mark Miller - Noble Financial Group - Analyst

I just have also seen or heard from other people that they are also seeing some improvements in the government business. Just was wondering, in terms of geographically, we have got a couple of reports -- more in China, about people are concerned that China is starting to show some slowness. I am just wondering what you are seeing geographically in terms of strength and weaknesses?

Mark Lucas - Imation Corp. - President, CEO

Yes, we actually do very little business in China right now. We'd made the conscious decision to focus on other developing markets. So, in North Asia we have been concentrating on both Korea and Japan, and those businesses are doing quite well. So I don't think that we are -- we have the experience base here to comment on China.

Mark Miller - Noble Financial Group - Analyst

Okay. Flash pricing seems to have stabilized. In the past, you have kind of gotten caught with price changes. Do you think that is going to continue? Is that benefiting you also?

Mark Lucas - Imation Corp. - President, CEO

Very difficult to tell. Yes, you're right; it is stable right now. Volatility happens overnight, though, in this marketplace. What we are very careful of is managing our inventory supply, so we don't get caught with any surprises. So we're very much just-in-time delivery on Flash, in both our consumer and our commercial marketplaces. So we can react and change our pricing, virtually overnight. So I think we will be in -- continue to be in good shape.

Mark Miller - Noble Financial Group - Analyst

And maybe I missed it, but if Paul could give us cash from operations?

Paul Zeller - *Imation Corp. - SVP, CFO*

Yes, so we don't disclose that yet until we get to the 10-K, just because there is always some moving parts as we are finalizing the cash flow statement. But, obviously, cash was up \$24 million. About \$10 million of that was Camarillo, right, so -- and \$2.5 million, the litigation. The rest of it generally coming from operating-related factors; EBITDA, as well as working capital improvements.

Mark Miller - *Noble Financial Group - Analyst*

Okay, thank you.

Operator

There are no further questions in queue at this time. I turn the conference back over to our presenters.

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

I want to thank everybody for participating in the call today, and taking the time to chat with us. And I look forward to updating you again, following the close of our first quarter. Thank you.

Operator

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

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