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IMN - Q1 2013 Imation Corp Earnings Conference Call

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PRESENTATION

Operator

Good morning. My name is Steve and I will be your conference operator today. At this time, I would like to welcome everyone to the Imation Corp. first-quarter 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). Thank you.

I'll now turn conference over to Scott Robinson, Vice President Investor Relations. please go ahead.

Scott Robinson - *Imation Corp. - VP IR*

Thanks Steve. Good morning, everyone, and thank you for joining us today for our first-quarter 2013 earnings call. I am your host for today's call, where you will be hearing from our CEO, Mark Lucas, and our CFO, Paul Zeller. On today's call, we will review our first-quarter results and provide updates about our transformational strategy.

Before that, though, I'd like to remind everyone that certain information discussed in 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 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'd 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 progress Imation made in our strategic transformation during the quarter. As I discussed last quarter, we are continuing to leverage our roots in data storage to build a platform for long-term growth and profitability.

Looking at the 2013 first quarter, we made significant progress on many fronts, including strong scalable storage results and declining operating expenses. But ultimately, our transformation journey continues. Paul will give you more details on our numbers in a few moments, but I want to focus on key elements of our strategy.

An important aspect of our transformation involves rightsizing the organization. Last year, we announced that we are implementing strong cost savings initiatives, including worldwide process improvements, office consolidations globally, product line rationalization, infrastructure efficiencies, and staff reductions. We have taken aggressive steps in all these areas with a goal of reducing operating expenses. And SG&A and R&D expenses were down in the first quarter. Our cost reduction program is working and further reductions are expected to be realized in the quarters ahead.

We also announced in February that we would run a process to divest both the Memorex and XtremeMac consumer electronic brands. That process is moving forward and good progress has been made in identifying interested parties. I want to note that we are retaining our consumer storage business under both the Memorex and TDK brands.

Additionally, effective on January 1, the Company reorganized into two business units -- Consumer Storage and Accessories, or what we call CSA, along with Tiered Storage and Security Solutions, what we call TSS. With these two business segments, Imation is becoming a more customer-centric and nimble organization.

But let me first comment on Consumer Storage and Accessories, or CSA, which is a segment that generates solid cash flows for us. CSA includes consumer storage media, primarily optical and flash, as well storage and electronic accessories focused on storage at the retail level.

We plan to launch a number of new products in the upcoming quarters. In fact, we recently introduced a USB 3.0 external SSD or, solid state drive. It features ultra-quick data transfer in a portable form and is sold under the TDK brand.

Next, our Tiered Storage and Security Solutions group, or TSS, provides strategic opportunities for revenue growth and margin expansion. TSS includes both Imation and Nexsan branded tiered and scalable storage solutions, IronKey branded mobile security solutions, and commercial storage media sold under Imation as well as OEM brands.

I'm pleased to tell you that our recently acquired Nexsan products had a strong quarter and posted double-digit growth. One of the strengths Imation brings to Nexsan is global reach. Currently, we are working with our Asia and Australia teams on the portfolio and are putting the framework in place to expand the brand in these regions as well as in southern Europe. Further, we are investing in the business by adding sales and engineering talent domestically and internationally.

Turning to our Mobile Security platform, we gained a significant win with the Japanese government by landing a contract for the portable workspace product branded PC on a Stick. We also launched several other new IronKey flash drives along with the IronKey Workspace W-500, a high-performance device that helps companies address both telecommuting needs and compliance requirements.

As a result of the positive changes we've made in our TSS business, gross margins for that segment increased to 22% in the first quarter compared to 19.4% last year. When we first announced our strategic transformation in February of 2011, we said we needed to increase our gross margins, and we have been working on that ever since and are pleased with the progress we have made. And as our product lines grow and we launch more products with stronger margins, we will see that percentage continue to climb.

Clearly, we are on the right track. We are committed to achieving growth and profitability and becoming a key global player in data storage and security.

I'll now turn the call over to Paul to provide a more in-depth look at our financials. Paul?

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

Thanks, Mark, and good morning. As we continue to execute on our strategic transformation, we've implemented a few important financial reporting changes effective with our Q1 results. Before I get into the details on first quarter, I'll take a couple of minutes to make you aware of these changes.

First, as we moved forward with our previously communicated plans to monetize our Memorex and XtremeMac CE businesses, we reached a point during the quarter where we concluded that these should be treated as discontinued operations for accounting purposes. As a result, we've reclassified their income statement results to a single line below income from continuing operations in our consolidated P&L. We also recast prior periods to conform with this same presentation as is required by the accounting rules. These rules also require the direct aspects of these businesses, being the revenues, gross margins and direct costs, to be moved below the line, so to speak, but that any absorbed overhead needs to stay in continuing operations. This results in a certain amount of cost penalty needing to be absorbed by our continuing businesses. We anticipated this, however, when we sized the restructuring program we announced earlier.

The second reporting change has to do with our business segment reporting. As Mark just discussed, we are operating the Company through two business units, Consumer Storage Accessories and Tiered Storage and Security Solutions. These have become our segments for accounting purposes versus our previous regional segment presentation. As a result, you'll note that we have presented revenues and profitability by these segments in our results that we released today, and we've also provided prior-year financials by quarter on this same basis to help you understand trends in the business.

When we reorganized the Company along these segment lines, we also made an important philosophical change in terms of functional accountabilities. In our prior regional structure, corporate included RD&E, much of marketing and operations. In our new business unit structure, these functions are fully the responsibility of our business units and the operating results of those segments include those associated operating expenses. Corporate has become more limited definitionally and through our restructuring efforts also is being right-sized.

In addition to the segment data for our two business units, we've also increase transparency by providing additional revenue by product category disclosure. Within CSA, we are now disclosing consumer storage media, which is primarily optical and flash media, and that's separate from audio and accessories, primarily products under the TDK brand. In TSS, we are reporting revenues for commercial storage media -- that's primarily magnetic tape and RDX media -- separate from storage and security solutions which is associated with the Nexsan acquisition and Mobile Security products. We believe these reporting changes around discontinued operations, segment, and product reporting improve the comparability and transparency of our financial information and it makes it easier for our shareholders and analysts to understand our results and to gauge the progress we're making on our strategic transformation.

So with that, let me get into our results, where I believe there are a number of positive signs that we are doing just that, making progress on our strategic transformation. Revenue for the quarter was at $224 million. That's down 14.8% from the prior year. That was driven by consumer storage and accessories, as expected, with slight growth in TSS. It should be noted that revenues were impacted by planned rationalizations of certain product categories as we previously discussed.

Our revenues were also negatively impacted by currency exchange rates, especially the weaker yen. Overall, FX cost us about 2.5 points on our year-over-year comparisons.

From a segment standpoint, CSA revenues declined 25% driven by consumer storage, primarily optical media, which declined somewhat higher than recent quarters as we fully expected. TSS revenues were up slightly year-over-year. Within TSS, commercial storage media declined 22%, driven by magnetic tape. Storage and Security Solutions grew substantially, more than offsetting this expected decline in magnetic tape. This was driven by acquisition revenues from our December 31, 2012 acquisition of Nexsan.

On a pro forma basis, Nexsan revenues grew double digits as we benefited from market share, growth, as well as initial benefits from leveraging Imation's global footprint. This growth occurred in all three main product platforms, NST, E Series and Asurion.

Regionally, we saw our strongest revenue performance in the Americas with both CSA and TSS posting solid revenues. North Asia was also strong, especially in CSA, driven by optical. Europe revenues were generally as expected, South Asia slightly soft but not materially so.

Our gross margins were 18.8% in the first quarter, and were impacted by a $2.1 million inventory accrual associated with rationalized businesses. If I exclude those special charges, gross margins were a strong 19.7% to sales, our highest level in several quarters. Q1 last year was just slightly higher at 20.4%, driven by a particularly high optical gross margin at that time, just after we had instituted price increases. We are pleased with the 19.7% rate, with our best results posted in our Storage and Security Solutions businesses with gross margins in the mid-40s% overall.

Our legacy products gross margins, both optical and tape, were within the ranges we've seen recently. Operating expenses, including research and development as well as SG&A but prior to restructuring and other charges, totaled $54.7 million. That's down 5.5% from the first quarter last year. If we adjust that comparison to exclude the OpEx added with the Nexsan acquisition, the core Imation OpEx was down roughly 20% from a year ago, reflecting various actions we've been taking to reduce costs. That core OpEx is down 8% sequentially from last quarter, reflecting benefits from lower amortization expense associated with year-end intangible asset write-offs, and the very initial benefits from our recently announced restructuring program. The majority of the restructuring benefits are yet to come with the greatest impact in the second half of the year.

Late last year, we announced a restructuring program associated with our cost savings initiatives. And in the quarter, we recorded $4.2 million of restructuring and other charges. We continue to estimate charges to total between $50 million and $60 million over time with cash costs of approximately $40 million. Cash charges in the first quarter were $4.5 million, after just short of $1 million in the fourth quarter.

Our recorded operating loss for the quarter, including the special charges I just mentioned, was $14.7 million. If I exclude those charges, that's an operating loss of $10.5 million in the quarter.

Non-operating expense was $500,000 in the first quarter, down nicely from the $2.3 million we saw in Quarter 1 last year. That's driven by currency-related losses we saw last year.

Our loss per share from continuing operations was $0.39. And if I exclude the special charges, that's a loss of about $0.31 per share. Our discontinued operations category had a $5.5 million loss, $1.1 million of that from restructuring charges. That leads to an overall final net loss per share totaling $0.52.

We ended the quarter with $98.2 million of cash and equivalents, down $10.5 million in the quarter. This decline was expected, driven by restructuring cash payments and seasonal rebate payments.

In summary, our first-quarter results demonstrate that we are making solid progress on our transformation. We began operating through our business unit structure in January 1 and made good progress in making the necessary organizational changes to support this direction. We made good progress in integrating our Nexsan acquisition and we're pleased with the initial signs, both in terms of revenue momentum and gross margin performance. We made progress in our actions to increase our focus on storage as we continue the sales process on our CE businesses. And finally, we made significant strides forward in right-sizing OpEx in support of our new organization. We clearly have more work to do and our results are not where they need to be long-term, but we're also clearly moving in the right direction.

With that, we'd be pleased to take your questions. Thank you.

Operator

(Operator Instructions). Mark Miller, Noble Capital Markets.

Mark Miller - *Noble Financial Group - Analyst*

Good morning Mark and Paul. I just had a question about the impact of product rationalization on your sales. Can you give us -- quantify that in terms of what impact that was on your sales this quarter?

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

There's a couple of categories where it was most notable, probably the most significant in the remainder of our audio and accessories business around the TDK brand. As we mentioned coming out of fourth quarter when we announced the plans to look at options around the Memorex CE and XtremeMac business and talked about that in the first quarter as well, we also said that we would be focusing our TDK accessory business more tightly. And as a result, we saw more significant declines in that business, and really good declines rather. We are focused on better opportunities, higher margin and not so much on marginal opportunities.

The other category is some of the revenues associated with our organic growth efforts in the Tiered Storage arena. With the Nexsan acquisition, we've become more focused on the Nexsan product portfolio, rationalizing some of our product categories.

Mark Miller - *Noble Financial Group - Analyst*

Maybe I missed this, but what was your cash flow from operations?

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

Cash flows -- we don't actually disclose that until later in the quarter. I will say, overall, that it was about what we expected, and that we had some cash flows to support restructuring. And the first quarter is a quarter where we tend to see larger rebate payments. A lot of our rebate programs are annual programs with the cash requirements coming just after year-end. So all things considered, I think it was a solid start to the year and right where we expected it to be.

Mark Miller - *Noble Financial Group - Analyst*

You mentioned that you'll be introducing a solid state drive. That area is very competitive, as you probably know. I'm just wondering how you're going to compete in that area with early significant competition.

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

Actually, in terms of the external drives at retail, it's not as competitive. We're pretty much one of the first companies to come in with it, so we will be going up against the decline of the external hard drive market for consumers in that area. So far, we've gotten terrific response to it. We just -- in fact, we have not even introduced it in the US yet. It got introduced in Canada. And we are just right now in the pipeline of getting distribution on the shelves of it, so it's hard to tell. But we are pretty bullish on it. It is USB 3.0, so if you don't have it, you don't necessarily see the speed advantage. But if you do have USB 3.0, it is super fast. It's amazing how fast you can transfer photos, videos and so forth.

Mark Miller - *Noble Financial Group - Analyst*

All right, so it's an external product. Finally, were there any mix-up, mix-down sound effects on your TSS revenues?

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

Not really that I can think of. There were in our CSA revenues. We had pretty strong growth in flash media and flash carries somewhat lower gross margin than optical in that category, and that hurt our gross margins percentage-wise but helped our gross margin dollars. TSS, I think the most significant year-over-year impact would be the addition of all that Nexsan revenue in the 40% gross margin. And that has had a very beneficial gross margin impact. That will be there all year as we compare against a prior year without those Nexsan revenues, but we also anticipate and have plans to continue to improve gross margins in those categories.

Mark Miller - *Noble Financial Group - Analyst*

Thank you.

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

One example I would say is our product -- our new products that we're launching in Nexsan is in that part of our category as well as in Mobile Security carry very nice gross margins. We are not launching any new products that don't have 40-plus% gross margins, so I think that's always a helpful trend.

Mark Miller - *Noble Financial Group - Analyst*

Thank you.

Operator

Chris McGinnis, Sidoti & Co.

Chris McGinnis - *Sidoti & Co. - Analyst*

Good morning. Just a couple of questions I guess. One, what's the -- can you maybe break out the organic growth rate in the new business -- the pure storage outside of the Nexsan acquisition?

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

Yes. So, first of all, let's put it into pieces. First of all, let's take the acquisition piece itself, the Nexsan revenues. As I mentioned earlier, obviously that's driving all of the growth because it's inorganic. But I think the fairer way obviously to look at that is to look at what was their performance prior to the acquisition a year ago, and how did we perform in our first quarter after the acquisition? And we were very pleased. We had double-digit growth and what we were hoping to see in terms of the market opportunity but also the opportunity that we have to leverage those products in broader categories and regionally around the world.

If you look at the rest of the categories in TSS, the most significant overall dollar revenue coming from our storage media, princely around tape. That did decline relatively significantly. As we expected, it declined 22% overall. And that clearly held back overall growth in the category.

If you look at some of our organic growth efforts in tiered storage, those are some of the areas that we have rationalized, as I talked about. So, that had a minor negative impact as well.

Chris McGinnis - *Sidoti & Co. - Analyst*

I guess just moving to the restructuring, could you maybe walk through, one, the cash costs, how they'll flow through the year? And then secondly, I guess you already mentioned this, but the $50 million to $60 million of take-out, how much do you think it will really benefit and fall to the bottom line by the end of the year or even if you look out into '14?

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

Okay, let's start with the cash costs. We've signaled that restructuring program would cost us something in the order of $40 million in cash. I would suggest most of that will happen in 2013, but not all of it. And we've seen the start of that with $4.5 million in the first quarter. But it will ratchet up as we get throughout the rest of the year. I think second quarter will likely be larger than first, and then the second half having the balance of that. And clearly some of that will occur even into 2014.

The actual benefit from the program in terms of OpEx take-out, we saw some benefit in first quarter. I think the best way to measure that is to look at our sequential decline of operating expenses after adjusting for the Nexsan acquisition. It's a little tricky because we've added in SG&A and R&D with the acquisition. And our objective is really to reduce OpEx on the core business, and if you do that adjustment, sequentially we were down about 8% in terms of the OpEx. And some of that 8% driven just by amortization cost reductions, and that's really not part of our restructuring program. We've always said that's an additional cost reduction. So we are just getting started, and I think we should see incrementally more and more of that kind of 25% overall OpEx reduction occurring throughout the year incrementally more in second quarter, but the majority in the second half. We would hope to be exiting the year reaching that kind of cost reduction level.

Chris McGinnis - *Sidoti & Co. - Analyst*

And I guess lastly, on the selling of the XtremeMac and the other consumer side, can you maybe give a time frame? It sounds like negotiations are going well. Is that next quarter you're thinking or later in the year?

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

We are trying to move as fast as absolutely possible, Chris. We announced it in February, you can kind of guess yourself in terms of the time it takes to run a process and complete a transaction. It doesn't happen in just three months, but we are making good progress and we will continue to move as quickly as we possibly can. I think it's in everybody's best interest to do that so that we can refocus our energies as well as for the health of the long-term state of those businesses.

Chris McGinnis - *Sidoti & Co. - Analyst*

Thank you.

Operator

Eric Martinuzzi, Lake Street Capital Markets.

Eric Martinuzzi - *Lake Street Capital - Analyst*

Thanks. I wanted to dive into the Tiered Storage and Security Solutions segment a little bit deeper. You talked about the commercial storage media being down pretty substantially but kind of in line with your expectations. Where do you see that trending? Is it -- was the year-on-year change sort of what we should expect for the near future, or do you see any relief there?

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

If you look at the historic kind of level of declines we've been seeing in the magnetic tape business for instance, this is probably on the higher end of that but it bounces around quarter by quarter. A lot of it depends on when the next generations of tape media are launched. We also distribute both IBM and Oracle branded media for them, and so it depends a bit on their trends. We've seen declines anywhere from upper single digits to lower teens on good quarters to into the low 20s% in a softer quarter. So, I think it will be at least in the teens I would say.

Eric Martinuzzi - *Lake Street Capital - Analyst*

Okay. And as far as next gen, it might put a wrinkle in that. What's the timing of next gen?

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

The next gen is not scheduled this year. We're talking probably sometime later in 2014. We are actually seeing continued strong demand on tape drives, the hardware, through IBM and Oracle. So tape still is a legacy product that's not going away. Simply, the problem is the density is increasing faster than the usage rates, and so at some point in time, it could be very possible that the decline rates level off because we still believe and most of our customers and suppliers believe it is the most efficient economical way to archive data.

Eric Martinuzzi - *Lake Street Capital - Analyst*

And then with MTS as the other -- the Storage and Security Solutions, I think you guys had said that Nexsan has been running around $80 million annually or so. It looks like, if I do the math there, that's about the size of the step-up year-on-year. Is that to say the Mobile Security products are not growing as fast as you thought?

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

Yes, they were relatively flattish. There wasn't as much growth as we maybe would've hoped to have seen. I think we see a lot of good indicators on opportunity in that, especially Windows To Go and PC on a Stick, as well as our efforts to broaden the category there beyond just high-security into kind of the medium security realm. But I think, year-over-year, no, we didn't see a lot of growth from the Mobile Security business.

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

One of the things that makes it challenging is we didn't actually form the Mobile Security group until the end of March last year. So we were still in the first quarter of 2012, still in the process of combining three different businesses together into one. So it had not really -- it's a little hard to look at year-on-year comparisons until we get into the second quarter.

Eric Martinuzzi - *Lake Street Capital - Analyst*

Understand. My final question is on Nexsan. I think you guys -- I can't recall the exact number, it might've been around 50% investment on the sales side on Nexsan. Just curious if you could give us an update on how that expansion of the sales and marketing force is going, where you are and where you hope to be by year-end.

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

We have recruiters and, both internal and externally, working right now. We are working on expanding the domestic sales force. We are also adding in Europe and in Asia. In fact, there's a lot of meetings that's occurred over in Japan, Korea. In fact, we just got our first order in Korea already, which is encouraging. China as well, Australia is also in queue. The European group is adding salespeople. We are adding people in our R&D facility in the UK. And our primary development area, which is in Montreal, has -- I don't know -- probably adding somewhere between 15 and 20 headcount as we speak right now. So, it's just a matter of trying to recruit and get the people on board.

Eric Martinuzzi - *Lake Street Capital - Analyst*

Was I right with that 50% number, and was that sales or was that OpEx in general?

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

Are you referring to what kind of uptick in overall headcount would be anticipated with the investment? Is that where you're going?

Eric Martinuzzi - *Lake Street Capital - Analyst*

That's correct.

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

I think we are still sorting through that a little bit because we are merging the two organizations together. Most of Nexsan people are staying. We have -- we are downsizing some Imation people in that process, and so the puts and takes are still in process. So, it's a little hard to tell exactly what that number is, but overall there is a significant increase.

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

And we are committed to investing for growth in this category. It's a good market opportunity and the product roadmap is good. We are liking everything we see in that regard, so this is a real opportunity.

Eric Martinuzzi - *Lake Street Capital - Analyst*

Thank you.

Operator

I'm showing there are no further questions at this time.

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

I appreciate participating in the meeting today, and we look forward to staying in touch with all of you. Thank you. Have a great day.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.