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IMN - Q3 2012 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. Q3 earnings release conference call. (Operator Instructions). Scott Robinson, VP of Investor Relations, you may begin conference.

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

Thank you, Steve. Good morning, everyone, and welcome to our third-quarter 2012 earnings call.

I am your host for today's call where you'll be hearing from our CEO, Mark Lucas, and our CFO, Paul Zeller. On today's call, we will review our third-quarter results and also provide information in regard to the strategic announcements made today.

Before I turn the call over to Mark and Paul for their comments, followed by your questions, I want 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 Reform 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 take you through our quarterly results as usual, but we will also talk about the other strategic announcements contained in this morning's news release.

The backdrop for our discussion today is that we are accelerating Imation's strategic transformation. You'll recall that our plan is to build a platform for long-term growth and improved operating margins. A critical piece in our strategy is to leverage Imation's core strengths in data storage and to develop differentiated products in the large and growing category of secure and scalable storage.

Going forward, we will make investments to advance our technology and capabilities in storage. Progress is never as rapid as we'd like, but the direction is the right one.

As noted in our press release, Imation's traditional media businesses are declining faster than we anticipated. We are taking the following actions. First, we are reorganizing into two channel-focused business units. Second, we are implementing an aggressive cost-reduction program. And third, we will explore strategic options for our consumer brands and businesses.

I will talk about each of these during our time together this morning, but let me start with an overview of our third-quarter financial performance. To be blunt, we are not satisfied with our results. The fact that we faced weak macroeconomic conditions is true, but that does not provide us any comfort.

Revenues overall came in below what we anticipated in most product lines and in all regions. Paul will cover the specifics in his portion of our call. Given the softness in our business and the macroeconomic headwinds, it is now not likely that Imation will return to total Company revenue growth in the near term.

However, I don't want to a tough quarter to mask the progress we've made in developing and launching higher-margin products. Although growth in our new, differentiated products was not where we expected it to be in the third quarter, we did see a continuation of the positive margin trends in those products. And actually, we set an all-time record high for margins in secure and scalable storage.

Let me, at this point, turn your attention to our decision to form two global business units. The first business unit will be tiered storage and security solutions, or TSS. The second will be consumer storage and accessories, or CSA.

This model better aligns the Imation team with our commercial and consumer channels. It will also provide a more focused, customer-centric structure that leads to faster decision making, clear accountability, and more nimble organization and increased efficiency worldwide. The new business unit structure becomes effective at the 2012 year-end.

Included in TSS are Imation's scalable storage hardware and solutions, magnetic products, and mobile security products and solutions.

The consumer storage and accessories business consists of our optical, Flash, and hard drive storage products, as well as Imation's consumer electronics products.

We are fortunate to have two outstanding managers already on board to lead the two units. They are Ian Williams, who will head tiered storage and security solutions. Ian came to Imation in early 2011 from Seagate Technology and he brings the ideal deep storage industry background that we need to build this business. And Greg Bosler, who will lead the consumer storage and accessories group. Greg joined us nearly four years ago. His background is in sales, marketing, and general management, gained through experience at companies like Pioneer Electronics and Thomson Consumer Electronics.

Now onto our cost-reduction program. In conjunction with realigning our business structure, we are moving aggressively to right-size our operations with a goal of cutting approximately 25% of operating expenses. The program we are implementing encompasses process improvements globally, product line rationalization, and infrastructure, and includes a worldwide workforce reduction of approximately 20%.

When I started my comments this morning, I said that Imation has intensified our focus on data storage and data security. That leads to the other decision I want to discuss with you. And that is, because of that focus and the need to direct our resources into data storage, we have decided it is prudent to explore strategic alternatives for our consumer electronics brands and businesses. We will, of course, keep you informed as the situation evolves.

We have made strides in our consumer products business, but we need to focus our attention and resources on data storage and security in all our distribution channels.

Now as we move forward, we are excited about the opportunities we face and we are confident we can succeed. For example, let me share just two new product highlights. First, Imation has launched a new brand strategy for our mobile security portfolio, built around the IronKey brand. The portfolio includes all security products, technology, and expertise that Imation acquired in 2011.

Second, during our last conference call I said that we are on track for a third-quarter announcement of Imation's PC on a Stick. And that did occur. It has been certified as a USB 3.0-based mobile workspace for deployment of Windows To Go. Microsoft has chosen only a few partners for this product, and we are delighted to be one of them.

As we bring our costs down and we realign our business model and implement efficiencies, we will complete our strategic transformation and become a more profitable company. We will invest in data storage and security to be a top competitor in our chosen market segments, even as we reduce operating expenses. We have already introduced a number of differentiated products that carry attractive margins and we have a team in place to make Imation a successful, global company.

Now I will ask Paul Zeller to provide a more in-depth look at our financials. Paul?

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

Thanks, Mark, and good morning, everyone.

Before getting into our Q&A session, I'd like to provide you with some more detail on both Q3 results, as well as the cost-reduction program we announced this morning.

As Mark mentioned, our results reflected soft economic and business conditions in most regions of the world. We experienced particular softness in US retail, both storage and consumer electronics, and in commercial storage, more broadly speaking. In addition, currency exchange rates were a negative factor in the quarter.

While we continued to see solid margins in our scalable storage, mobile security, and consumer electronic businesses, we saw some modest softness in traditional storage margins.

Our financial condition remained solid with cash at $186 million and no debt, and we now have the Philips litigation totally behind us with the last payment having been made this last quarter.

While there are some encouraging signs in our Q3 results, they were generally softer than we had expected and reinforced the need to right-size our operating expense structure, and I'll provide more detail about the program we announced today and we've been working on for several months.

So now, onto some more detail on Q3. Revenues for the quarter came in at about $248 million. That's down 19.6% from same quarter last year. That decline rate was higher than recent quarters, driven by the macro factors I just mentioned.

If we look at our product categories, starting with traditional storage, we saw a decline of 22% in the quarter. That was driven by optical revenues, which declined at 24%, and that's a higher rate that we've seen in a number of quarters.

In addition to the foreign currency impact I talked about, we are also losing some of the year-over-year comparative benefits of price increases we implemented last year. As you may remember, those had been put in place in response to our supplier cost increases earlier last year.

In tape, revenues declined 11%, which was a lower decline rate than we saw last quarter, but a bit higher than we have seen earlier. The rest of the decline in traditional storage was driven by audio and videotape, which, though small, did continue to decline significantly in the quarter. Secure and scalable storage declined 7.7% in the third quarter versus last year. Commodity Flash revenues drove all of this decline, consistent with last quarter.

We did see modest growth in scalable storage hardware and in mobile security.

Our audio and video information revenues were down nearly 20% in the quarter. This was driven almost entirely by the US where we continue to experience a very difficult retail environment.

Other than CE cases, all categories were down in the US, especially in traditional and digital audio. There was a measurable slowdown in audio demand as our channel partners managed inventories very carefully ahead of the Apple connector change.

Our international AVI business remains strong with mid to upper teens growth in both Europe and north Asia.

From a regional standpoint, our Americas segment revenue declined 17%, and that was driven by optical and audio CE. Europe segment revenues remained particularly soft, down 22% year over year. There were several factors in play here. First, we continued to see broad-based economic softness, which impacted traditional storage as well as scalable storage revenues. In addition, adverse exchange rates were a significant factor, lowering revenues by nearly 10 percentage points in Europe.

North Asia revenues declined 17.7% in the quarter, driven entirely by traditional storage. And in south Asia, revenues declined significantly at nearly 30% year over year. We experienced broad-based softness in this region, with the most significant impact in optical and Flash, and in the Middle East and Australia, regionally.

Our gross margin was 18.4% in the quarter, about flat with last year's third quarter. Though this was down from the last couple of quarters, it's still about a point higher than last year's full-year rate as we continue to see benefits from improved margins in secure and scalable storage, as well as AVI.

Looking at margins by category, traditional storage was at 18% to sales, down nearly two points, and optical being the main driver where we're seeing some increased price competition in certain markets. Tape margins were relatively flat year over year, but down from earlier quarters this year. We saw less a positive product mix with more OEM business, which carries a lower average margin, as well as less data center proprietary tape, which carries a higher margin.

Our secure and scalable storage margins, at 22%, were at an all-time high, driven by mobile security and scalable storage hardware, which together averaged 46% to sales and gross margin.

While we did not see the growth we're looking for in these categories, we do continue to validate the attractiveness of the margins in these spaces. Commodity, Flash, and external hard disk margins were solid in the quarter, averaging about 15%. In AVI, margins improved nearly a point from last year to 15.9%. Accessories, both CE cases and headphones, remained our strongest categories with margins in excess of 20% to sales.

Operating expenses totaled $55.8 million. That's down 4%, or $2.2 million, from last year's third quarter. We will be focused on more significant reductions here as we implement our cost-reduction program next year.

We recorded a net $3.6 million benefit in the restructuring and other line, due primarily to an adjustment of an acquisition-related contingent liability. There were no charges recognized in the third quarter related to the new program announced today.

Our operating loss for the quarter was $6.5 million, but if we exclude the restructuring benefit I just mentioned, that's a loss of about $10.1 million. Depreciation and amortization was $9.1 million in the quarter, this EBITDA was slightly negative, excluding the restructuring benefit. Non-operating expenses were just $100,000 in the quarter, due to some investment gains and some lower currency exchange losses.

And on a per-share basis, we had a loss of $0.17 per share, and if we exclude that restructuring and other gain I talked about, it was a loss per share of $0.26 in the quarter.

We ended the quarter with $186 million of cash and equivalents. That's down $24.8 million in the quarter. The main driver was the final payment of $16.5 million in our 2009 settlement with Philips over optical IP issues.

In addition, though our inventory turns improved slightly, inventory dollars were up as expected in the quarter, ahead of a seasonally strong Quarter 4.

We repurchased 430,000 shares during the quarter for $2.5 million, and our authorization stood at 4.2 million at the end of the quarter.

As Mark mentioned a few minutes ago, we announced a change in our operating structure to align our businesses and processes along two product segments, tiered storage and security solutions and consumer storage and accessories. Enabled by that structural change, we also announced a broad-reaching global process improvement and cost-reduction program this morning. And while we've established the goal of achieving a 25% reduction in global operating expenses, we've not worked out all the details yet, but let me provide you with as much detail as I can at this point.

First, as I said, this will be a far-reaching program impacting every region and every function around the world. Second, all categories of costs are being examined, from back office to front office, from external spend to employee-related costs, from headquarters to regions. And third, we anticipate the program could result in cash-related costs of up to $40 million with total charges in excess of that, likely in the range of $50 million to $60 million, but that will depend on the amount of asset write-offs that may be required.

Finally, an adjustment in our cost structure of this size, though clearly needed, cannot be achieved without the painful reality that we will be impacting employee positions. We estimate approximately 20% of global workforce could be impacted as we implement this plan.

As a somewhat unrelated point, other than it does relate to potential charges, we will be doing an analysis of our intangible assets during the fourth quarter, which are composed primarily of brand intangibles from our storage acquisitions in 2006 and 2007. The total of acquisition intangibles is substantial at approximately $325 million. Should an impairment charge be required based on that analysis, obviously it could be sizable.

Before moving to Q&A, I'd like to make a couple of final points. In terms of our Q3 results, there were some important aspects which continue to provide proof that our strategy is sound, especially the margin opportunity we're seeing in secure and scalable storage markets. Having said this, the pace with which we're moving forward organically has been too slow, being impacted by macroeconomic factors around the world, which have impacted all of our businesses, but especially optical storage and CE.

Given this, we've had to face several key realities. First, we no longer believe it likely we'll see growth in total Company revenues in the near term, as Mark mentioned. And second, we need to reduce costs to improve profitability and to support the strategy longer term. While we focus on this program, we remain firmly committed to our strategy, focused on secure and scalable or tiered storage, and continue to evaluate inorganic investment opportunities to drive this further and faster.

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

QUESTIONS AND ANSWERS

Operator

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

Mark Miller - *Noble Financial Group - Analyst*

The concern being cash, you suffered a hit this quarter because of the Philips settlement. You're talking about up to a $40 million charge, cash charge, for the restructuring. Certainly, your stock price has been supported by your net cash position and you're also talking about investing.

I'm just wondering, you mentioned the options for consumer electronics. Can you give us any color there in terms of the sales of that unit? Is it profitable, not profitable? Is it positive cash flow? I'm just wondering about the attractiveness of that unit for a spinout.

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

Well, if you look at that business, it has been improved significantly over the last really 18 months, I would say.

Though it does still consume quite a bit of kind of overall infrastructure resources, it's a relatively complicated business model, so I think the revenues and the gross margins are substantially healthier than they were. It's still not adding overall to value of the Company in the way we'd like it to.

And more importantly, it doesn't allow us to be as focused on our core storage markets. That's really the reason for the announcement today, Mark, on looking at a broad array of strategic options.

So in terms of the business itself and the value, that's something that, as we go through a process, I think we'll become more aware of, and that's why you look at a process. I will say that we think that business is very valuable and certainly is something that we would evaluate among all the options we're looking at, depending on if there were an option to monetize the business at an appropriate manner. That is one of the options, of course. And that we'll find more about over time.

Mark Miller - *Noble Financial Group - Analyst*

Any other thoughts about how to improve the cash position, terms there? Or is cash flow going to be negative next quarter and you expect this to turn it positive? Just, again, the concern is cash.

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

Yes, I get it. And the $186 million in cash was actually very much in line with what we expected for third quarter, maybe even slightly better.

The reality is third quarter is a quarter when we build working capital for a stronger fourth quarter, seasonally. And obviously, as you mentioned, the Philips settlement final payment. Fundamentally, the business still carries a relatively high D&A burden, as you know, from $35 million to $40 million. We see no change in the capital spending requirements of the business. Really, $10 million is a reasonable kind of range.

So there is a fundamental cash generative capacity in the business model that we believe very much remains intact. We do see the losses we've had over the last several quarters is something we need to deal with, and that's why we've announced the restructuring program that I think is an appropriate reaction to a softer macroeconomic reality and some declines in optical, especially, at a little bit higher rate than we had anticipated. So I think we're doing the right things to make sure the business model remains solid going forward.

Mark Miller - *Noble Financial Group - Analyst*

I was wondering if you can provide a little color about this acquisition adjustment charge (multiple speakers)

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

Yes, when you record an acquisition, there are a number of different related assets and liabilities recorded at the time, one of which, as at the time the acquisitions were booked, are some contingent liabilities that are based on whether we achieve certain financial objectives. We are not achieving all of those financial objectives, and we put a pretty conservative accrual on the books and we're able to reverse some of that.

Mark Miller - *Noble Financial Group - Analyst*

Specifically, what acquisition was that for?

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

It's related to security acquisitions.

Mark Miller - *Noble Financial Group - Analyst*

Okay. I listened to the Western Digital conference call, and you did say the traditional storage products is more optical. I realize that. But Western Digital went to some extent indicating that they think there are inroads to replace tape drives with magnetic drives now. That's maybe occurring, but I'm just wondering what your feeling is.

Are you seeing an acceleration of that? But certainly Western Digital was indicating that they thought that transition was occurring and more and more people were going to magnetic drives rather than using tape storage. I'm just wondering what you're seeing.

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

Mark, this is Mark Lucas. Our customers, IBM and Oracle, for example, are actually seeing their business increase in terms of selling tape drives to their customers. And so, we see an increase in use of magnetic tape, actually.

So obviously, we have different media bias than Western Digital has, but I think if you talk to many of the customers in this market place, they will say that tape is very much alive and is growing.

Mark Miller - *Noble Financial Group - Analyst*

Okay. Thank you.

Operator

(Operator Instructions).

Joe Jaspan - *Hawkeye Capital Management - Analyst*

Hello. This is Joe Jaspan from Hawkeye Capital. So, can you just give us a sense of what the ongoing annual savings would be from the cost-reduction program?

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

Yes, as you heard, Joe, we're targeting 25% reduction in overall OpEx, if you kind of look at a general run rate of where we are at. It's roughly $50 million up to $60 million of savings when we fully implement the program.

That will take some time. But we'd expect to be at that run rate sometime in the second half of 2013, but seeing benefits as we get into early 2013.

Joe Jaspan - *Hawkeye Capital Management - Analyst*

Okay.

Operator

(Operator Instructions). Chris McGinnis, Sidoti.

Chris McGinnis - *Sidoti & Company - Analyst*

Hi. Just on the amortization and the intangibles, can you just walk through the three segments that the business is today, and where that kind of -- or how that plays out in terms of weight?

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

So the majority of the remaining acquisition intangibles on the balance sheet are brand related and principally associated with the Memorex and TDK transactions consummated in 2006 and 2007. And so, the majority of that is fundamentally related to our traditional storage business, though there are brand intangibles also related to the AVI business, but the larger dollar amount associated with principally the optical business.

Chris McGinnis - *Sidoti & Company - Analyst*

And it seems like there will be a pretty big impairment charge, which should be really positive for you, I would think, in terms of -- in some ways, right?

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

Well, yes, we're going to do that analysis. I think with the downturn in optical, that is a sign that could point to that possibility, but we need to do that analysis and we felt it prudent to make sure people were aware of that, and that there probably was some risk there. And if there's an impairment, you're right. It could be quite large.

Chris McGinnis - *Sidoti & Company - Analyst*

I understand the strategy on the consumer side, but I think it was about a year ago you came out with this new plan. I understand there's obviously some pressure on the consumer side, but can you just talk maybe a little bit of how you're thinking of why now to change the strategy again? I understand that the demand is somewhat an issue, but, Mark, with your background on the consumer side, why not continue through the strategy and why think about divesting it, if that's what it ends up being?

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

Yes, Chris, that's a great question. We continue to look at how AVI fits into the overall portfolio that we have.

And quite honestly, we have to narrow our focus. We have to do fewer things better. And we have made great progress in AVI, and I'm very proud of the product road maps, the margin increases, the inroads we've made. We have a very large headphone business now around the world under the TDK and XtremeMac brands.

So, yes, we've taken something that was not in the best of shape and we've improved it and done really well with it. But as we look forward, our strategy is data storage and data security. And we have to say, if we have to focus our monies and focus our investments, where is the best return on investment for shareholders? Where are we going to get the better return?

And we believe that by focusing on the data storage area, we can accomplish that. So hence, we had to make some decisions, and so we're going to look at different options. No decisions have been made yet. We're simply announcing that we're looking at options.

Chris McGinnis - *Sidoti & Company - Analyst*

And then, just lastly on the scalable and storage, I understand the market is a little bit more difficult, but can you just talk about maybe the growth? You said it was modest growth. Is that including acquisitions or ex-organic growth in that secure and scalable?

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

In the scalable part of that, it's all organic growth. It's not large enough yet, but it is scaling. In mobile security, much of that driven by acquisitions, but we also, as you know, had our own business that we had kicked off prior to the acquisitions, and it's all integrated at this point. But it would include the benefits from the acquisitions last year in mobile security.

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

Yes, Chris, Mark again. Overall, the business climate in the commercial market place, both enterprise and government, was soft around the world in the third quarter. So we're not alone here.

We did have some pretty nice wins, though, that haven't shown up in revenue yet because we just won the contracts. But we won a contract with the Department of Homeland Security. We won a contract with the Army. We won a contract with a major European bank, all in the secure area. So there are some very positive signals for the future of this business.

Chris McGinnis - *Sidoti & Company - Analyst*

Right. And then, just lastly, I don't know if this strategy has shifted, but -- due to the change in, I guess, the realignment of the business. But on the acquisition strategy, you know, you mentioned earlier in the year that you would consider spending about the same as last year.

With the questions earlier about the cash and you've got $40 million going out the door next year just on the restructuring side, how does that change your opinion on that? Do you need these -- do you need those acquisitions to really round out that portfolio in the scalable to compete? Can you just give me some thoughts around that and maybe your plans if those acquisitions are still on the table?

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

Yes. Sure. We continue to look at all different options in the marketplace. We are continuing to invest organically to grow these businesses, but to the extent where we can add value economically through inorganic activities, we're going to take a look at them.

It's really a speed issue. If we can acquire something that speeds up our transformation, it speeds up our growth, and it's a good return on investment and good potential shareholder value, then yes, we are going to consider and look at those things. But we do this in the context of return and consistency with speed and strategy.

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

Chris, I think it's somewhat telling that we haven't announced any immediate acquisition in the first half of 2012 because we are looking for things that really make sense and accomplish the objectives Mark just mentioned. So we are not about doing acquisitions for acquisitions' sake. But to the extent an acquisition supports the strategy and, as Mark said, speeds up the transformation, we think it could make sense for our shareholders.

Chris McGinnis - *Sidoti & Company - Analyst*

Thank you.

Operator

Mark Miller, Noble Financial Capital.

Mark Miller - *Noble Financial Group - Analyst*

I just wanted to talk again about the secure and scalable. You said the thing that negatively impacted that was basically Flash. Is that just the Flash pricing?

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

Yes. I think, you know, our Flash strategy -- the commodity Flash strategy -- is a bit more of a participate where there is a rational margin and selectively.

And depending on the market conditions and where pricing is and where costs are, there is more or less of that at any given point in time, and the Flash opportunities haven't been quite as good this year as they were last year in the same quarter, so there have been some decline in Flash.

The good news is we are accomplishing the objectives of that strategy in that space, which is make sure we focus on good, positive gross margins -- and they are really as good as they have ever been in our Flash markets -- by making sure we go after good business and not marginal business. And that will cause a little bit of revenue ups and downs over time, but we think it's the right strategy and the positive strategy.

And it did hold back the overall year-over-year comparisons in secure and scalable storage as a result.

Mark Miller - *Noble Financial Group - Analyst*

All right. So just to summarize, the scalable, you were seeing year-over-year organic growth. Mobile security was grown, but more by acquisitions, but this was offset by what was going on in the Flash space. Is that an accurate summary?

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

Fair, yes.

Mark Miller - *Noble Financial Group - Analyst*

Just wanted to check. The cash charge for Philips was $16.9 million?

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

$16.5 million.

Mark Miller - *Noble Financial Group - Analyst*

$16.5 million. And then, finally, inventories went up, and I'm just wondering if you can just add a little color on that, sequentially.

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

Yes, so they did in dollar terms. They actually went down in days of supply, which is a forward metric looking at demand coming in the next quarter. That's how we calculate our turns or our days of supply.

And so, we actually expected an increase in inventory because we tend to have our largest quarter in the fourth quarter. And so, really, no problems there.

I'd say our inventories, if anything, have gotten healthier over time. But I will also say that we still have opportunities across time to improve our inventories. I think there is more work to be done there, but no particular issues at present, and, frankly, were expected.

Operator

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

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

Thank you. And let me close by reiterating that we are confident we have the right strategy to be successful in the growing markets of data storage and data security, and we are accelerating our strategic transformation through the important steps we announced this morning. Thank you all for your time.

Operator

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