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IMN - Q2 2012 Imation Corp Earnings Conference Call

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PRESENTATION

Operator

Good morning. My name is Scott and I will be your conference operator for today. At this time I would like to welcome everyone to the Imation Corporation 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) Thank you. Scott Robinson, Vice President, Investor Relations, you may begin your conference.

Scott Robinson - Imation Corporation - IR

Thank you, Scott. Good morning, everyone, and welcome to our second quarter 2012 earnings conference call. I am pleased to be 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 second quarter results and also provide information as to the progress we are making on our strategy. 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 disclosed on this 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 results to differ are outlined in the press release issued today as well as in our filings with the SEC.

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

Mark Lucas - Imation Corporation - President and CEO

Thank you, Scott and good morning, everyone. On today's call Paul Zeller and I will update you on Imation's progress as the Company continues its strategic transformation. As we have described in previous calls we have continued to evolve the Company with our focus on building a platform for long-term growth and improved operating margins.

Our strategy includes leveraging Imation's data storage core of traditional storage and developing differentiated products in the growth categories of Secure and Scalable Storage as well as Audio and Video Information, or AVI products.

Let me start with a few comments about our second quarter financial results. As we reported, we saw another decline in revenues. This decline was not a surprise to us and stems from the timing lag between anticipated growth in our newer products offsetting our more mature, traditional storage products.



However, several macroeconomic factors were also in play in the second quarter that impacted these revenues. These included the broad-based European downturn, a soft global IT environment, negative currency impact and a weak US retail environment.

Despite these challenges we are making steady progress in executing our new strategy in line with the plans we have previously outlined. We again delivered gross margin improvement across all product categories. Our gross margin percentage was 19.4%, up more than 2 points from second quarter last year which is a key indicator of our success towards this strategic initiative.

We have also made progress within the specific product categories we have identified for strategic growth which are; Secure and Scalable Storage and also our Audio and Video Information products.

So let's first talk about Secure and Scalable Storage. In this category an important differentiator for Imation is the addition of security features designed to protect data from loss or theft. For example, we have introduced our new Imation CyberSafe technology, a security wrapper that ensures the safety, privacy and control of digital content on scalable storage devices.

Last month we launched a secure RDX product with CyberSafe Pro Technology providing built-in, enterprise-grade encryption. This is just the first application of our CyberSafe technology and our product roadmap includes additional applications across our Scalable Storage portfolio.

One of our growth engines for Secure and Scalable Storage is our new Mobile Security Business composed of our recent mobile security acquisitions that are now integrated and gaining excellent traction. June was the best month-to-date for this new business driven by new customers in the US and Canadian governments, Fortune 500 accounts and several key international accounts as well.

Our mobile security team is developing and launching new, differentiated products designed to address the needs of the mobile workforce. For example, we are partnering with Microsoft on an application to embed an entire Windows 8 operating system on a Secure USB flash drive. This product, which we refer to as PC-on-a-stick, is on track for a second half 2012 announcement.

In this past quarter revenue from our new differentiated products within the Secure and Scalable category grew 48% at strong margins. This move to higher margin, differentiated growth products within this category is a core part of our strategy and an important indicator of our progress.

Now let's move on to our Audio and Video Information or AVI category. Despite the soft consumer electronics market we continue to make progress in AVI. We saw especially strong results worldwide with our XtremeMac brand portfolio of products. With 71% growth in XtremeMac we continued the positive momentum of previous quarters. During Q3 we will introduce our new lineup of wireless audio products under our TDK brand. Our global announcements will coincide with our launch of these products at IFA, which is Europe's major consumer electronics trade show in September.

Going forward our AVI roadmap direction includes integrating wireless connectivity and security to help manage audio and video information in and around the home. Similar to product categories in Secure and Scalable Storage, this shift to higher margin differentiated AVI products is a key element of our transformation.

I would like to close my comments this morning by reiterating that we are solidly on our course with our transformation and remain confident in, and committed to the strategy we laid out just last year. We have planned that 2012 will be a year of transition for us, building a platform for long-term growth and improved operating margins.

We are making steady progress on our strategy as reflected in our gross margin improvement. We are seeing good traction in our strategic growth products and we remain very focused on our goal of returning Imation to revenue growth as we exit 2012.

Our cash position remains strong and including share repurchase activity we ended the quarter at \$211 million.

Now I would like to turn the call over to Paul Zeller to comment further on the quarter's financials. Paul?



Paul Zeller - *Imation Corporation - SVP, CFO*

Thanks, Mark, and good morning everyone. As Mark just said we faced some challenging headwinds this quarter and I will get into some more detail on that in the next couple of minutes.

Despite those challenges we continue to make important progress on key aspects of our strategic transformation. Our intentional focus on gross margins continued to bear fruit as we grew higher margin business and rationalized lower margin business. Margins were up across the board in Traditional Storage, in Secure and Scalable Storage and in AVI.

Our differentiated, higher margin Secure and Scalable Storage revenues grew 48%, as Mark mentioned, on the back of a strong finish in our Mobile Security Business. Our AVI business outside of the US was particularly strong in both the TDK brand as well as XtremeMac.

Finally our cash position remained strong at \$211 million as of June 30. So with those high-level comments let me walk you through some of the detail on second quarter and I will start with the top line.

Revenues for the quarter are \$270.6 million. That is down 16% compared to last year. That decline rate was higher than recent quarters driven by the macro factors Mark just mentioned. If we look at each of our product categories starting with Traditional Storage, it declined 19.6% in the second quarter with optical revenues within that declining at 15.1%. That decline rate is similar to prior quarters and roughly as expected.

In tape revenues declined 18.8%. We clearly saw indications of the impact of softer IT spending overall in this category. In addition to these economic factors we intentionally focused on higher margin, newer formats in the mid-range tape segment which had the effect of lowering the top line but improving gross margins. In fact, our Tape gross margin percentage was at the highest level in over a year and margin dollars declined at a much lesser rate than top line.

As a final comment on tape I would like to remind everyone that our year-over-year comparisons this quarter are particularly difficult. Last year's second quarter was benefitted by transitional Tape volume that came our way due to competitor manufacturing issues associated with the Japan tsunami. It was difficult to measure this with complete accuracy, we believe our decline rate in Tape would have been more in line with recent quarters adjusting for that impact.

The rest of the decline in overall Traditional Storage was driven by Audio and Video Tape which though it is small, it did decline significantly in the quarter. Secure and Scalable Storage declined 9.7% in the second quarter versus last year. Commodity flash revenues declined again in the quarter.

As we mentioned last quarter we saw strong Flash competitor price reductions earlier in 2012 which drove down overall pricing in the marketplace such that even with higher unit sales for us our revenue dollars declined.

External Hard Disk was also soft during the quarter. These declines masked some very strong and encouraging growth in the rest of Secure and Scalable Storage. If we exclude Flash and EHDD the rest of this category, as I said, grew 48% drive by Mobile Security Business from our acquisitions last year.

Our Audio and Video Information revenues were down 6% in Q2. This was driven entirely by the US where we experienced a very difficult retail environment. We continued to see growth in accessories and especially headphones and cases, especially outside the US with both TDK and especially the XtremeMac business.

Our international AVI business grew 30% in the second quarter though this was not enough to offset the challenging retail environment in the US.

From a regional segment standpoint, our America's segment revenues declined 8.6% versus the same quarter last year. This was driven by expected declines in Traditional Storage in the range of 10% and a more significant decline in AVI as discussed earlier. Secure and Scalable Storage revenues for the America's increased significantly in the quarter.

This was a difficult quarter for our European segment which saw revenue declines of 28%. Three main factors drove this. First, broad-based economic softness which impacted both Optical and Tape in Traditional Storage, as well as Scalable Storage revenues. Second, adverse exchange rates were a factor with the weakening of the Euro. Finally, weak Flash revenues driven by pricing as I just discussed.

North Asia revenues declined 20% in the quarter driven by Traditional Storage as well as FX rates. In South Asia revenues declined 18%. This region has been particularly impacted by Flash revenue declines.

Our gross margins in the quarter were 19.4% to sales. That is up 2.6 percentage points from last year. We saw improvements in every major product category as we did in first quarter. Traditional Storage margins were up 1.8 points to 19.8%. Optical products were up driven by the benefit of channel price increases implemented over the last number of quarters in response to supplier cost increases mid last year.

In Tape margins were also improved. As I said, they were at the highest levels we have seen in over a year. In Secure and Scalable Storage margins were again at 20% as in the first quarter which was improved over 6 points from a year ago. Mobile Security margins were nearly 50%.

In AVI margins improved over 2 points versus last year to nearly 17%. The main drivers there were accessory margins and a better mix of products with accessories becoming a larger part of our overall portfolio.

Our research and development expenses totaled \$6.2 million in the second quarter. That is up \$1.2 million from last year's second quarter. This increase reflects our planned investment in technical skills in support of our strategy and includes the impact of recent acquisitions.

Selling, general and admin expenses totaled \$52.2 million. That is up \$4.3 million from a year ago. The majority of the increase here relates to our 2011 acquisitions including non-cash amortization expense. We recorded \$4.3 million in restructuring and other charges in Q2 and the majority of that relates to the previously approved programs.

Our operating loss for the quarter was \$10.3 million. If I exclude the charges I just discussed that is an operating loss of about \$6 million. Depreciation and amortization was \$9.4 million in the quarter and thus EBITDA was \$3.4 million X charges.

Non-operating expenses were \$1.8 million for second quarter and that compares to \$2.5 million in the same quarter last year. Our income tax line was essentially flat about \$100,000 benefit and on a per-share basis then that is a loss of \$0.32 per share and excluding the various restructuring and other charges that is about a \$0.20 loss per share.

We ended the quarter with \$211 million of cash and equivalents. That is down \$5.1 million in the quarter. We repurchased 410,000 shares in the quarter for \$2.4 million under our new enhanced share authorization which now stands at 4.6 million shares remaining.

In summary, we are seeing continued progress as we implement our strategy. The growth we are seeing in key categories is encouraging especially against the backdrop of a challenging economic environment. The quarter-after-quarter improvement in gross margins in all categories is an important proof point that our strategy is working.

We remain committed to and confident in that strategy and in our long-term financial goals and returning the Company to growth.

With that we would be pleased to take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Mark Miller with Noble Financial.



Mark Miller - *Noble Financial - Analyst*

First of all, good job on the margins again. That is encouraging. I am just wondering about linearity during the quarter. I don't know if you saw the other day, you mentioned Flash contributed to weakness in certain areas at Toshiba, the second largest Flash manufacturer in the world cut production 30%. Are we still sliding down in certain areas?

Mark Lucas - *Imation Corporation - President and CEO*

Good morning, Mark. This is Mark.

Mark Miller - *Noble Financial - Analyst*

Hi.

Mark Lucas - *Imation Corporation - President and CEO*

Actually we are seeing prices increase right now in the Flash industry. So we are looking at some stabilization. Our market share is holding up and as we are able to realize the price increases that are happening in the marketplace we would expect a reversal of the current trends in the past couple of quarters.

Mark Miller - *Noble Financial - Analyst*

What about in the Storage market also in terms of are things seeming to be getting better from where they were at earlier in the June quarter?

Paul Zeller - *Imation Corporation - SVP, CFO*

I think that the broad statement, this is Paul by the way.

Mark Miller - *Noble Financial - Analyst*

Hi, Paul.

Paul Zeller - *Imation Corporation - SVP, CFO*

The reality is Q2 is a pretty difficult IT spending quarter. I think you are seeing that from a lot of the others in the industry. We are seeing it from a lot of the industry benchmarks we look at.

We clearly saw that impact both in Tape and RDX in general. I think there is a lot of uncertainty about that going forward. I don't know that we have any terrific insight on linearity within the quarter in that regard except that clearly on an overall basis IT spending was soft especially in terms of server placements.



Mark Miller - *Noble Financial - Analyst*

I was interested, the intel a lot of people connected to the PC area, and I realize you are in a different area but also some of the storage guys are saying that besides the macro economy there is so many product transitions; Windows 8, Ivy Bridge, Ultrabooks going on that a lot of the PC OEMs are being very, very conservative and I am just wondering if you are seeing the same thing in the server storage area?

Mark Lucas - *Imation Corporation - President and CEO*

I think overall we see the impact of what clearly looks like a soft server placement reality in second quarter. As to what exactly is driving that I am not sure we have all of that insight but it clearly was a soft quarter and I think you are hearing that from others.

Mark Miller - *Noble Financial - Analyst*

Thank you.

Mark Lucas - *Imation Corporation - President and CEO*

Thanks, Mark.

Operator

Your next question comes from the line of Chris McGinnis with Sidoti & Company.

Chris McGinnis - *Sidoti & Company - Analyst*

Good morning. Thanks for taking my question.

Paul Zeller - *Imation Corporation - SVP, CFO*

Good morning, Chris.

Chris McGinnis - *Sidoti & Company - Analyst*

I just wanted to ask, in light of a seemingly slowing economy in the US obviously there are some real difficulties in Europe, the confidence to kind of hit on the plan by year-end to exit or at least begin 2013 in a positive or at least in a positive trend on the revenue side could you maybe just walk through that a little bit? Obviously you are having some strong demand with your new products but will that really stave off the top line decline in the other parts of the business?

Mark Lucas - *Imation Corporation - President and CEO*

I will take a start at the answer and then turn it over to Paul. I would say to you, "Yes." Macroeconomic factors are always difficult to predict. I wish we had a crystal ball and knew exactly what was going to happen in Europe and the IT industry but I would say to you that we continue to remain very confident because we have a very robust product roadmap going into the second half of the year.

We will be making a lot of introductions and as we talked about if you look at the growth we had in our key strategic areas in Scalable Storage and Security they were all very strong in the first half of the year regardless of the macroeconomic factors. That inflection point of where that growth



will offset declines in traditional storage is difficult to predict exactly but we continue to be committed to making that happen as we exit this year. Paul, do you want to add to that?

Paul Zeller - *Imation Corporation - SVP, CFO*

The only thing I would add to that is if you look at the decline rate in second quarter and compare it to first quarter at face value it looks like we lost ground and some of the economic factors clearly were impacting us there.

There are a couple of other factors to remember. One is FX rates were negative in second quarter compared to first quarter. As we mentioned last year we got a pretty good uplift in second quarter last year from the impact Sony experienced from the tsunami and that transitional volume impacting second quarter last year made our comparisons pretty difficult in this particular quarter. Roughly speaking I think if you adjust for that we were more like first quarter in terms of a decline rate in our second quarter performance.

Still need to execute on all of those product introductions and gain a hold on offsetting the traditional storage declines as Mark talked about but that is a little bit of a normalization comment on second quarter.

Chris McGinnis - *Sidoti & Company - Analyst*

I appreciate that. Secondly, just on the strength you are seeing in the Secure and Scalable, how are the inroads being made with the resellers you have talked about in the past? The traction, is that picking up? It seems like with the rate of sales.

Paul Zeller - *Imation Corporation - SVP, CFO*

It is. Our network of ours is increasing daily. We have very robust training programs in place. Our product portfolio as it fills out becomes more relevant to them. This is happening not only in the US but in Europe and around the world as well.

This is the result of the re-skilling of our sales force and our field sales engineering capabilities. We are seeing that take some traction right now. As always we are pushing really hard. It never happens fast enough but we are definitely seeing some progress.

Chris McGinnis - *Sidoti & Company - Analyst*

Lastly, on the share repurchase, have you made any additional share after the quarter ended?

Mark Lucas - *Imation Corporation - President and CEO*

We update that, Chris, at the end of every quarter. I will remind you we are generally buying shares between the period after earnings release until we get to Quiet Period at the end of the quarter. So in general, as we are approaching the earnings release we are in blackout on open market purchases.

Chris McGinnis - *Sidoti & Company - Analyst*

Sure. Thank you very much. I appreciate it.

Paul Zeller - *Imation Corporation - SVP, CFO*

Thanks, Chris.



Mark Lucas - *Imation Corporation - President and CEO*

Thanks, Chris.

Operator

Your next question comes from the line of Mike Neary with Neary Asset Management. Your line is open.

Mike Neary - *Neary Asset Management - Analyst*

Just a couple of questions. CapEx for the rest of the year and then going forward for next year, what does that look like?

Mark Lucas - *Imation Corporation - President and CEO*

The general capital spending rate we have seen historically is I think the right kind of range looking forward which is roughly \$10 million annually. We are about half-way to that six months to date so I think that is a pretty good trend rate to kind of use for modeling.

Mike Neary - *Neary Asset Management - Analyst*

Okay. With these new product introductions in the second half, what do you expect to happen with R&D spend and SG&A?

Paul Zeller - *Imation Corporation - SVP, CFO*

I think we have put in place the key skill sets and done a lot of the re-skilling that we need to do. OpEx is higher than it has been traditionally because of that. That investment is an important investment. For the most part those skills are in place and I think as we look forward that organic investment is what is going drive those new product introductions and the ability to turn the revenue trend around.

As we look further to investment and growth I think that is more likely to come inorganically than it is organically. I think we have done the right things and we are doing the right things to build out the skills and competencies internally.

Mike Neary - *Neary Asset Management - Analyst*

Okay. I think it is great that your compensation, a lot of it and a lot of the Board's compensation these days is from the stock. You do have a share buyback in place and you are buying back a little bit of stock. I guess my question is, given your cash position and how much your compensation is based on the stock why aren't you a lot more aggressive?

I understand the restriction in terms of timing but you could always tender for what you have, 4.5 million shares, buy them immediately and then assuming you get them all do another stock buy-back and tick away at that. But at this rate you are not reducing your share count. I guess I'm just trying to understand that a little better.

Mark Lucas - *Imation Corporation - President and CEO*

Mike, it is something that is discussed at the Board level in great detail. I will tell you that we are committed to buying back shares at a modest level for the foreseeable future. That is our commitment to our shareholders. We continue to assess levels on a quarterly basis but we are committed to continuing the program.



Mike Neary - Neary Asset Management - Analyst

Okay, but at that rate are you going to actually reduce your share count or is that simply offsetting share grants that you are making?

Mark Lucas - Imation Corporation - President and CEO

Again, each quarter we take a look at that. There is not a set policy in place right now other than the fact that we will continue to purchase them.

Mike Neary - Neary Asset Management - Analyst

Okay. So in terms of why you aren't being more aggressive you are not giving me a reason.

Mark Lucas - Imation Corporation - President and CEO

Again, as we look at this, Mike, there are all types of use of cash. We are looking at investment organically. We are looking at investment inorganically. We are looking at share repurchase. We have a portfolio of options as to what to do with our cash. It is a very dynamic world and it is changing every day so we are not committing to a specific policy other than we will continue to buy back shares on a modest basis and continue to reevaluate what exactly that amount is.

Mike Neary - Neary Asset Management - Analyst

Okay. There were some questions I believe on the last call or the call before that in terms of your return on investment on the acquisitions you have made so far. Can you give some better transparency on that? Have they been successful so far? What kind of payouts have you seen and how does that influence your thinking for future acquisitions?

Paul Zeller - Imation Corporation - SVP, CFO

Mike, let me start on that and maybe Mark can add some commentary. We fundamentally justify our acquisitions on returns over time that need to be in excess of our cost-of-capital and that is double-digit and allowing for risk we like much more than our average weighted cost of capital before we will invest our shareholder's cash.

So that fundamental financial analysis is the underpinning to our evaluation. You asked a good question. Okay, we have done some recent acquisitions and how are they working out? What I will tell you is that we are tracking very nicely in terms of driving improvements in the trend rate in our Mobile Security business. That is important to our long-term future.

Some of the acquisition spending last year was more technology-based and more building blocks I would say. In that type of acquisition, the metrics are a little different and it is almost a build-versus-buy kind of analysis when you think about bringing in core technology elements. But we are fundamentally financially disciplined in how we evaluate acquisitions and that will continue as we evaluate opportunities in the future.

Mark Lucas - Imation Corporation - President and CEO

I just want to add from my perspective I am very, very pleased with the acquisitions. We made three security acquisitions last year which we integrated into one group and that just got done in January. They are off and running. When we are looking at 50% gross margins and more importantly that software development and expertise that we have is providing the basis for security across all of our Scalable products.



So it is going to be the basis of our differentiation and it is one of the drivers of growth in our gross margin line. It is definitely paying off as we can see in the numbers of our growth in those categories as well as our gross margins across the whole Company.

Mike Neary - *Neary Asset Management - Analyst*

Okay, thank you.

Paul Zeller - *Imation Corporation - SVP, CFO*

Thank you.

Operator

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

Mark Lucas - *Imation Corporation - President and CEO*

I appreciate everybody dialing to our call today. Thank you for your interest. We look forward to talking to you again soon. Have a good day.

Operator

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

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