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IMN - Q2 2015 Imation Corp Earnings Call

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CORPORATE PARTICIPANTS

Scott Robinson *Imation Corp - VP, CFO*

Mark Lucas *Imation Corp - President, CEO*

CONFERENCE CALL PARTICIPANTS

Eric Martinuzzi *Lake Street Capital Markets - Analyst*

PRESENTATION

Operator

Good morning. My name is Therese, and I will be your conference operator today. At this time, I would like to welcome everyone to the Imation Corp Q2 2015 earnings press 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 will now turn the conference over to Scott Robinson. Go ahead, Scott. You may begin.

Scott Robinson - Imation Corp - VP, CFO

Thank you, Therese. Good morning, everyone, and thank you for joining us today for our second quarter 2015 earnings call. I'm your host for today's call, and I'm joined by Imation CEO Mark Lucas. We will review our second quarter results and project progress on our strategic transformation.

Before that though, I'd like to remind everyone that certain information discussed on the call that does not relate to historical information may be deemed to constitute forward-looking statements within the meaning of the Private Securities Litigation Act of 1995.

Such statements are subject to risks and uncertainties that could cause results to differ materially from any projected results. Risk factors that could cause results to differ are outlined in a press release issued today, as well as our filings with the SEC. With that, I will turn the call over to Mark Lucas, Imation's CEO.

Mark Lucas - Imation Corp - President, CEO

Thank you, Scott, and good morning, everyone. Yesterday we reported our second quarter results, which were generally in line with expectations and reflect the forward progress generated by our continued investment, innovation, and a focus on higher growth markets.

Before I delve into our financial results, I want to emphasize that the steps we have taken, and the steps we will take in the future, are done with the intention of maximizing shareholder value through the creation of a more focused and streamlined Imation.

Our plan is to continue to focus on a significant market opportunity for secured data storage solutions, helping organizations worldwide safeguard high value data, while addressing scale, availability, and performance requirements.

We will continue taking advantage of the strong demand for comprehensive solutions for securing the mobile workforce, and the growth in consumer need for flexible storage solutions. With this said, the management and the Board also recognize the need for Imation to continue to become leaner and more efficient, as evidenced by our continuing operating cost reductions.

As part of our strategic review process for the Company, we have retained restructuring advisers to help us optimize cost structure, and assist with performance improvement. Now let me turn to Q2 performance, which reflects our continued efforts to bolster our TSS segment, and reduce operating expenses.



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Of note, our gross margin improved to 19.3%, up three-tenths of a percentage point over the same period last year. This improvement was driven primarily by our storage solutions, and mobile security business, which we continue to believe will be a primary catalyst for future earnings growth.

At the same time, we continue to reduce overall operating costs of the Company, and also significantly reduce cash utilization in the quarter. Now I want to discuss our two business segments before turning the call over to Scott, who will walk through the numbers in detail.

TSS revenue declined 11% year over year, which was generally in line with our expectations, due to anticipated negative foreign currency impacts on our storage and security solutions business, and lower sales of our magnetic tape products in our commercial storage media business.

As noted, we continue to believe the many innovative products that comprise our storage and security solutions business will be a key driver of sustained revenue growth. Excluding the foreign currency impact, our Nexsan business grew double digits for the second consecutive quarter.

A portion of this growth can be attributed to a set of new features we introduced in our Nexsan E series family. These strategic enhancements reflect our ability to meet the needs of IT managers who are continuously seeking ways to effectively manage and protect growing amounts of critical data.

Anticipating these needs, the improved E series allows for advanced rebuild times, assist the health monitoring and volume migration. It's also important to note that we continue to see good momentum in our IronKey business, as corporations continue to prioritize investments in solutions that help secure their mobile work force.

We also continue to enhance our recently launched secure data movement architecture, or SDMA, our holistic approach to actively managing high value data files, and safeguarding those files from tampering, loss, or corruption, through their entire life cycle.

During the quarter, we introduced Imation Secure Data Discovery, an interactive software tool that helps organizations identify their high value data, and determine the most efficient way to store and protect that data.

And Imation Lock and Key, a new feature of Nexsan [Ensuriion] Secure Archive Solution, that adds a critical layer of administrative security to data storage environments, protecting high value data files from internal and external threats.

Separately, our IronKey portfolio continued to gain successful customer wins, and proof of concept or product trials, with key accounts, including corporate and government IT departments.

Turning to our CSA segment, revenue decreased due to the ongoing decline in sales of optical media products, which was in line with industry trends, while we maintained our number one market share worldwide.

Foreign currency translation also had a negative impact, as over two-thirds of our revenue is from overseas. We continue harvesting the cash flows from our legacy products to facilitate the growth of higher margin data storage and security products that target both organizations and consumers.

As I mentioned earlier, we continue to see a proliferation of data at the consumer level, which has created a real, sustainable demand for the flexible storage solutions we offer. A great example is the debut earlier this year of the link power drive, our nation's first mobile storage product that adds additional storage and power for iOS compatible devices.

We remain committed to delivering innovative, high margin products at retail, which aligns with our goal of becoming a pure play leader in data storage and security solutions.

On a separate and final note, the Board also has improved the implementation of a shareholder rights plan to protect net operating loss carry forwards. Details of this plan were in a press release issued yesterday.

I'll now turn the call over to Scott to take you through the numbers. Scott?



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Scott Robinson - *Imation Corp - VP, CFO*

Thank you, Mark. Let me start by echoing that we were encouraged by the increase in our gross margins and our tiered storage and security solutions segment. We positioned the segment as a significant growth business via key investments in sales, marketing and engineering, as well as past acquisitions.

As Mark said, our Nexsan business, our top priority, grew revenue in double digits when excluding currency impact this quarter, and we are pleased with the momentum we see in IronKey customer trials. Additionally, from an overview perspective, we are taking important actions to streamline the Company, enhance our operations, and generate cash.

For the second quarter, total Company revenue in Q2 of \$150.6 million was down 15.7% in the same period last year. As we have noted in the past, this stems from the fact that our legacy media businesses are in [secular] decline.

During the quarter, consumer storage media revenue decreased 21.2%, and commercial media storage declined 16.1%. As you have heard from other global companies, foreign currency exchange rates continue to have a negative effect on our revenue.

FX reduced over our revenue by 8.1%, or \$14.5 million in the second quarter, compared to the same period last year. Looking at revenue by segment, tiered storage and security solutions came in at \$74.3 million, an overall decrease of 11% versus a year ago quarter.

Of the 11% decline, currency accounted for approximately 5%. In storage and security solutions, revenue decreased by 1% year over year. Commercial storage media and legacy business posted a 16.1% decline from Q2 2014.

Our consumer storage and accessories segment revenues decreased 19.8% from the same quarter last year, through the ongoing secular declines and optical media products that we have talked with you about before, as well as the impact on foreign currency exchange. Foreign exchange was responsible for 8% of the drop.

As anticipated our legacy consumer storage media was down 21.2% from last year, consistent with industry trends. Excluding the impact of foreign exchange, our audio and accessories business was essentially flat, with the same period last year.

Next, I'll move to gross margins. Total gross margins for the second quarter were 19.3%, up 30 basis points from Q2 2014. Importantly, TSS segment margins rose by 2.1 percentage points, to 21%, due primarily to a favorable product mix in both the Nexsan brand and mobile security offerings.

One of the critical components of our strategy is to increase our gross margins, which we have been successfully executing on, as evidenced by our continued improvement over the last few years. CSA margins were 17.6% versus 19% in the same period last year. The decrease in CSA gross margin is primarily due to negative currency impacts in Japan.

As you know, expense control continues to be a company-wide priority. In 2013 and 2014, we reduced our corporate and legacy operating costs by 45%, or \$103 million. Year to date, this number has risen to a reduction of \$109 million, and as Mark noted, we have hired restructuring advisers to optimize their financial performance and assist us in cost reduction initiatives.

SG&A totaled \$36.8 million for Q2, down \$5.7 million compared to the same period last year. Research and development costs came in at \$4.8 million, versus \$4.5 million in 2014 Q2, which reflects our increased investment and higher margin products in our priority businesses.

As we have stated before, we continue to significantly reduce R&D expenses in connection with our legacy media products. Total special charges in Q2 2015 were \$1.5 million, down \$3.7 million from the \$5.2 million in the same period last year.

This quarter's charges were primarily from consulting costs associated with our proxy contest. The overall operating loss in 2Q 2015 from continued operations was \$15.9 million, compared with last year's loss of \$20.1 million.



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Excluding the impact of special charges, adjusted operating loss would have been \$14.4 million in Q2 2015, compared to adjusted operating loss of \$14.9 million in Q2 2014. Income tax expense was \$200,000 in Q2 2015, compared with an income tax benefit of \$1.6 million in Q2 2014, which was due primarily to the mix of taxable income by country.

Discontinued operations had no effect in Q2 2015, compared with an after-tax loss of \$1.6 million in Q2 2014. The prior year included the results of sales of two non-core businesses, [ExtremeEc, and Memorex] consumer electronics.

Ultimately we incurred a net loss of \$0.42 of diluted share from continuing operations in Q2 2015, compared to a loss of \$0.48 of diluted share in the same period last year. Excluding the impact of special charges, adjusted loss per diluted share from continuing operations would have been \$0.39 in Q2 2015, compared with a loss per diluted share of \$0.35 in Q2 2014.

Moving on to the balance sheet, we continue to actively manage our legacy businesses to generate significant cash flows. Also during the quarter, Imation received proceeds of \$1.2 million from the sale of our Weatherford, Oklahoma facility, which was a prior manufacturing site.

A number of anticipated factors contributed to a small reduction in cash during the quarter, including ongoing investments in storage and security solutions growth initiatives, and seasonal working capital changes and payments, as well as currency impacts.

We ended the quarter at \$89.8 million in cash, which was down \$6.4 million from Q1 2015. We were pleased to see that our cash decline moderated significantly from Q1. In summary, we are committed to completing Imation's strategic evolution into a peer play, global leader in data storage and security solutions.

We are working with a restructuring adviser, who is supporting our improvement efforts and cost reduction programs. We are exercising ongoing expense control as we continue to invest in the tiered storage and security solutions segment, which will serve as a foundation of profitable growth over the long term.

Now with that, we will be happy to take your questions. Therese, can you queue up the questions, please?

QUESTIONS AND ANSWERS

Operator

Yes. (Operator instructions). Our first question comes from Eric Martinuzzi with Lake Street Capital.

Eric Martinuzzi - Lake Street Capital Markets - Analyst

Thanks for taking my question. Given the FX impact, I'm more inclined to ask questions sequentially about the revenue sequential, because I think the FX impact has been roughly equivalent in Q1 and Q2. Is that correct?

Scott Robinson - Imation Corp - VP, CFO

Slightly higher in Q2, but not significantly more.

Eric Martinuzzi - Lake Street Capital Markets - Analyst

Okay, and so just sequentially, the consumer storage media, historically that has been down sequentially. It was actually up sequentially, and again, as you said, slightly more difficult FX. What's going on there? Is this just lumpiness of orders, or is there some stabilization?

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Scott Robinson - *Imation Corp - VP, CFO*

I think generally it's lumpiness of orders. There is maybe some usual impacts in Japan, where they had some orders delayed, and that moved from quarter to quarter. But generally it's lumpiness, and we wouldn't say one quarter's worth of activity would prove any sort of new trend in optimal decline rates.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. And then has been, just looking back over the last three quarters, again, I understand it's been impacted by FX, but we've been running at about a low 20% contraction, so it sounds like you're comfortable with that as kind of the secular trend. Is that correct?

Mark Lucas - *Imation Corp - President, CEO*

Yes, Eric. Hi, this is Mark. Yes, we would say in the 20% plus range for optical declines, that is the total market trend.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. And then on the tape side, it's been about mid-teens decline, same thing there.

Mark Lucas - *Imation Corp - President, CEO*

That is correct.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

All right. And then shifting over to the gross margin commentary, you did talk about some improvement there on the TSS side on a year over year basis. Is that simply because of the decline in the tape, in other words a mix shift, where the Nexsan and the security products are a greater percentage of the revenue, or is there another thing going on there?

Mark Lucas - *Imation Corp - President, CEO*

Yes, no, I think you've identified both areas. The mix is going down as tape declines, and so we're shifting to a more higher product margins. We're also showing improved margins in the Nexsan and IronKey portfolios as well.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. Now that business, I would have thought would have been up sequentially. It was down sequentially in Q1, it was 32.3, and storage and security was 29.0. Again, I understand you had some FX impact there, but is there an explanation for that? Does that business seasonally see a Q2 down tick? And if so, what's the seasonal expectation for SNS for the remainder of the year?

Mark Lucas - *Imation Corp - President, CEO*

We actually have a medical solutions business in Japan that was very, very soft in the second quarter, and that impacted those results. But outside of that, we did have sequential quarter to quarter growth, again in our strategic businesses, and we'd expect that to continue.



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I might add, I think especially the Nexsan portfolio, in the quarter that was particularly challenging for most storage companies. It did, in my opinion, very well.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay. And then stepping away from some of the P&L items, and going to some of the more strategic or board level things, you talked about bringing on a restructuring adviser. Has that person been on the planning stage? Have you implemented any actions on the restructuring side that we should know about as far as cost assumptions going forward?

Mark Lucas - *Imation Corp - President, CEO*

We are actually working with a couple of different firms, Eric, and they have been in here for a while, but we're still in the planning mode, so there is nothing to report. We're also utilizing them to work with us as we look at our strategic review process and options strategically for the Company, and how to best maximize shareholder value. So it's a multi-pronged approach.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay, that's actually where I was headed next. On the strategic review, it's sort of nothing to say until (technical difficulty).

Mark Lucas - *Imation Corp - President, CEO*

I would say you're right. There's nothing to say until there is something to say. I would tell you we're actively working on it. There's many, many projects and research things that are going on, the Board is actively involved and being very thoughtful as they consider all the options.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

All right. And then the shareholder rights plan, what is the strategic thinking there?

Mark Lucas - *Imation Corp - President, CEO*

Well it's simply that we have \$400 million of net loss carry forward, so we want to protect those. And so all this does is help to do that, and that, for our shareholders, not allow them to disappear.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

And what would cause them to disappear in the absence of that rights plan?

Scott Robinson - *Imation Corp - VP, CFO*

Eric, there's a tax code section 382 that has to deal with limitations on net operating loss carry forwards, and --

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

...turnover to 5% shareholders, is that the deal?



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Scott Robinson - *Imation Corp - VP, CFO*

Exactly, it's a turnover to 5% shareholders, and we tried to outline that in our press release issued last night, and there was an 8K filing this morning with the full rights plan.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

Okay, and then lastly here, Mark, obviously you've already got a given notice of a September, I think it's the 24th or so that you plan to step aside. Has there been any clarity on the CEO succession plan?

Mark Lucas - *Imation Corp - President, CEO*

Well actually the filing, Eric, said that I cannot leave before September 22nd, and there has been no date that has been set. I will tell you that I'm working actively with the Board on a search for the next CEO, and we are making progress.

Eric Martinuzzi - *Lake Street Capital Markets - Analyst*

September 22nd, got you. Okay, all right. Thanks for answering my questions.

Mark Lucas - *Imation Corp - President, CEO*

Great, thank you.

Operator

Thank you. (Operating instructions). Okay, and I would like to turn the call over for any closing remarks that we may have today.

Mark Lucas - *Imation Corp - President, CEO*

Thank you, all, for your questions and participation on our call this morning. As we move in our direction to become a pure play leader in data storage and security solutions, the Board, its advisers, and management, will continue working together to implement various business initiatives to drive performance improvement, and enhance shareholder value. Thank you.

Operator

Ladies and gentlemen, thank you for joining today's conference. Thank you for your participation. That does conclude the conference. You may now disconnect.



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