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IMN - Q3 2013 Imation Corp Earnings Conference Call

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## CORPORATE PARTICIPANTS

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**Mark Lucas** *Imation Corporation - President, CEO*

**Paul Zeller** *Imation Corporation - SVP, CFO*

## CONFERENCE CALL PARTICIPANTS

**Eric Martinuzzi** *Lake Street Capital - Analyst*

## PRESENTATION

### Operator

Good morning. My name is Sharon and I will be your conference operator today. At this time, I would like to welcome everyone to the Imation Q3 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. Mr. Scott Robinson, VP and Corporate Controller, you may begin your conference.

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**Scott Robinson** - *Imation Corporation - VP, Corporate Controller, Chief Accounting Officer*

Thank you, Sharon. Good morning, everyone, and thank you for joining us today for our third-quarter 2013 earnings call. I am your host for today's call. We will be hearing from our CEO, Mark Lucas, and our CFO, Paul Zeller. On today's call, we will review our third-quarter and nine-month results.

Before that, though, I would like to remind everyone that certain information discussed on the call that does not relate to historical information may be deemed to constitute forward-looking statements within the meaning of the Private Securities Litigation Act of 1995. Such statements are subject to risk and uncertainties that could cause actual results to differ materially from any projected results. The risk factors that could cause the results to differ are outlined in the press release issued today, as well as our filings with the SEC.

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

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**Mark Lucas** - *Imation Corporation - President, CEO*

Thank you, Scott, and good morning, everyone. On today's call, Paul Zeller and I will cover our financial performance and provide an update on the progress we have made in our transformation into a significant provider of data storage solutions and data security products.

Last year at this time, I talked about our plans to accelerate our transformation, because Imation's traditional media businesses were declining faster than we had anticipated. Because of that industry dynamic, we took a number of actions. We reorganized into two business units, implemented a cost-reduction program and said we would explore strategic options for our consumer electronics brands and businesses.

Then earlier this year, we made a strategic acquisition, Nexsan, and announced our intent to divest the Memorex and XtremeMac consumer electronics businesses. I am pleased to say that we completed the sale of the Memorex consumer electronics businesses on October 15 and we have entered into an agreement to sell XtremeMac by the end of this year.

Selling these lower-margin businesses is an important part of moving the Company forward, and was a key objective for our team in 2013. We are devoting resources to building our data storage and data security offerings and selling them worldwide through Imation's two channel-focused business units, both Consumer Storage & Accessories, or CSA, and Tiered Storage & Security Solutions, or TSS.



Given the secular decline in optical media products, the Consumer Storage & Accessories segment performed as we expected in the third quarter. From a sales standpoint, both audio and headphone sales reached their highest revenues of the year. Moreover, we saw distribution growth in TDK wireless products, and we continue to leverage our strong position as the optical market leader. We have also maintained an emphasis on cost-cutting, and the CSA business is running efficiently with solid margins. Cash generation was particularly strong this quarter, as we achieved reductions in inventory levels.

Let me turn now to the Tiered Storage & Security Solutions portfolio, which in addition to tape media, encompasses data storage and data security. Sales for the quarter were down slightly, as noted in the press release, due to several factors.

First, we saw reductions in US government spending ahead of the shutdown during a quarter that is usually our most significant in terms of revenue from the government. Second, the Nexsan business saw some weakness in OEM revenues due to a short-term disruption of one of our major OEMs. And as other storage solution providers have said, there was some marketplace sluggishness in Q3, with certain customers delaying their purchasing orders.

Specific to the accelerated decline in tape media, we believe we are holding our share, but the business has been affected by industrywide dynamics such as competing formats and continuing improvements in compression and de-duplication technologies.

That being said, TSS is well-positioned and our entire organization is focused on capitalizing on the growth opportunities we face in data storage and data security.

We are aggressively hiring talent to expand our sales footprint globally, and at the same time, we continue to enhance our product line. For example, during the quarter, we introduced the Nexsan NST6000. This is a fully-unified hybrid storage platform to support block and file level data traffic in a single solution, without additional software overhead or licenses. It is ideal for organizations that need highly scalable and high-performance storage that supports SAN and NAS enterprise class workloads at the same time.

We also announced new channel programs to expand sales, marketing and lead generation opportunities for companies and VARs that offer Nexsan storage solutions.

In our Mobile Security area, a highlight for the third quarter was our introduction of the Microsoft Windows-To-Go IronKey workspace W500. This product features hardware encryption with enterprise-grade deployment and device management options. It is a fast, durable and secure USB drive that allows IT departments to meet the needs of a flexible and mobile workforce, while protecting the organization with always-on hardware encryption. Mobile Security is a growth area, and we have technology to address this attractive market.

Overall, the Tiered Storage & Security Solution segment saw gross margin increase 1 percentage point in the quarter to 19.3%, as we added higher-margin storage and security solutions products. We expect this to continue as our mix shifts to higher-margin Nexsan and IronKey products. We said that margins would improve, and they are, but you know that we are striving for further gains going forward.

Over the past few quarters, I have talked about how we are continuously examining Imation's expenses and making adjustments, when necessary, as part of our transformation. During the third quarter, we continued to cut staffing levels in legacy Imation businesses and administrative areas due to the secular decline in optical and tape media. But we have added investment in priority initiatives to address higher-growth and higher margins, primarily in the TSS area.

I said before that we have committed to long-term success by becoming a key global player in data storage and data security. With our exit from non-core operations and a keen focus on targeted growth sectors, we are on the right track.

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



**Paul Zeller** - *Imation Corporation - SVP, CFO*

Thanks, Mark. Good morning, everyone. Before I get into the details on Q3, I would like to reinforce a couple of points that Mark just mentioned.

With the completion of the Memorex CE transaction and the signed LOI associated with XtremeMac, these are important accomplishments for our transformation. One of the most important subtexts of our strategy is focus, we need to focus on fewer and better opportunities, and through these divestitures of these non-core categories and through the establishment of the separate autonomous business units, we have a much more refined focus in two key areas.

In CSA, we are focused on consumer media and accessories, with a clear directive to manage for cash. And we made excellent progress in the quarter with improved inventory levels and strong cash flows as a result and it was a main driver behind our \$14 million increase in cash during the quarter.

In TSS, we are laser-focused on high margin growth. And while we experienced some headwinds in the quarter, primarily around tape products and the government sector more generally, we continue to see exciting opportunities in both storage as well as security solutions, as Mark laid out.

We believe we are taking the right actions in each of these segments and laying the groundwork for our continued transformation.

So our revenue in the quarter was \$191.9 million. That is down 15.6% from last year. Q3 does tend to be our weakest quarter of the year, driven especially by seasonal slowness in Europe. In addition, currency translation was also a negative factor, lowering revenues in dollar terms by approximately 4%.

Our revenues in Consumer Storage & Accessories represented 56% of the total, and they decreased 23.8% in the quarter. This was driven by Consumer Storage media, primarily optical, the overall category declining 27%. Audio and accessory revenues under the TDK brand were up 26% to \$11 million, driven by increased sales really in all product categories.

Tiered Storage & Security Solutions revenues represented about 44% of total and decreased 2% in the quarter. The main driver was a particularly soft quarter in commercial storage media, primarily magnetic tape, which was down 25%, as Mark discussed earlier.

Our Storage & Security Solutions revenues were up significantly, as expected, with the addition of Nexsan revenues from the acquisition. Both our Nexsan business as well as Mobile Security were impacted by general softness, most notably in the government sector, as we have discussed.

Gross margins were 18.8% in the quarter, roughly equal to last year's 19% margin in third quarter. Improvements in TSS margins, driven by the addition of higher-margin Nexsan revenues, was about offset by declines in CSA margins, primarily in the flash category, as well as hard disk. Optical margins remained solid, up from last year and about equal to last quarter.

Operating expenses totaled \$50.9 million in the third quarter. That was about flat with last year, and it reflects two offsetting factors. First, we reduced OpEx significantly by \$11 million, or 22%, driven by our restructuring actions. Offsetting that is a combination of the OpEx we added with the Nexsan acquisition, which was not in our base last year, plus incremental investments we are making in these growth categories.

We recorded \$11.7 million of restructuring and other charges in Q3. The most significant item was a \$10.6 million non-cash charge associated with the windup of a legacy defined-benefit plan in the UK. We have been evaluating this transaction for quite some time, and with the general improvement in financial markets, which has increased the trust assets, and a modest increase in long-term interest rates, which has helped lower the liability calculation, this was an opportune time to trigger the transaction and we were pleased with the results.

We had previously anticipated this transaction could require from \$5 million to \$10 million of cash, and in actuality, it was accomplished for almost no cash, so we were pleased with the outcome.

Our operating loss from continuing operations, excluding the charges I just mentioned, was \$14.8 million, and adjusted EBITDA on that same basis was a loss of \$8.9 million. Nonoperating costs were \$1.7 million in Q3. That was up from \$100,000 in last year's third quarter, and that quarter was benefited by a one-time investment gain. We recorded a \$2 million income tax benefit in the third quarter that was driven by a discrete tax benefit associated with the UK pension buyout. That all led to a loss per share of \$0.42 from continuing operations ex charges, and beyond that, a loss of \$0.21 from discontinued operations.

In our discontinued operations, we recorded a \$5.5 million asset writeoff in anticipation of the divestiture transactions, and that drove the majority of that \$0.21 loss.

On that topic, as Mark mentioned, we completed the sale of the Memorex consumer electronics business in mid-October and signed a letter of intent to sell the XtremeMac consumer electronic business shortly thereafter. And this transaction is anticipated to close by the end of the year.

We expect to receive approximately \$19 million of total proceeds from discontinuing these businesses over time. We expect about \$10 million of that spread between fourth quarter of this year and early 2014, and the balance over the next several years.

Cash ended the quarter at \$108.4 million, with net cash at \$88.4 million, after deducting the \$20 million outstanding on our credit facility. This represents an increase of \$14 million during the quarter, driven by strong working capital performances, especially in our CSA business. We achieved this outcome despite spending \$5 million in cash on restructuring during the quarter.

Our inventory days of supply were down six days during the quarter to 66, and that is the lowest level we have seen in years.

So in summary, our Q2 results reflect the continuing execution of our strategic transformation. We are investing in growth in both our Tiered Storage & Security Solutions businesses, and though we saw some softness, we remain optimistic about the prospects in both of these areas.

Gross margins remain solid and should improve as our mix moves towards higher-margin TSS categories. OpEx reductions are on track and delivered \$11 million of year-over-year reductions, which helped fund incremental growth investments in Tiered Storage & Security Solutions. And our cash performance was especially strong during the quarter, with cash up \$14 million to \$108 million.

We remain focused on the important initiatives we have outlined and on driving improvements in our financial results over time. So with that, we would be pleased to take your questions. Thank you.

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## QUESTIONS AND ANSWERS

### Operator

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

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### Eric Martinuzzi - Lake Street Capital - Analyst

Thanks, and congratulations on the progress on the discontinued ops sales. That is good to hear.

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### Mark Lucas - Imation Corporation - President, CEO

Thanks, Eric.

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**Eric Martinuzzi** - *Lake Street Capital - Analyst*

Just curious to know, the legacy business here, you guys had a pretty good quarter on the optical side. When you talk about a little bit worse than expected in the TSS, could you give us a layer deeper there between the tape and the S&S side, what your expectation would be for whether or not that continues in tape into next quarter, and whether or not that continues for Nexsan and IMS into next quarter?

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**Mark Lucas** - *Imation Corporation - President, CEO*

Yes, sure, Eric. It's Mark. The tape had actually a very, very challenging quarter, and we have been doing a lot of research with all our -- both our suppliers, our distributors around the world, and it is pretty consistent.

All our independent market research says that we are maintaining our market share, but the market is going down. All of a sudden -- we were seeing historical rates of call it high-single-digit declines in tape. In the third quarter, we saw over 20% declines. And be it IBM, Oracle, Quantum, all these guys that we are talking to, as well as suppliers in Japan, Fujii, Maxell, everybody is seeing the same thing.

Nobody is really sure exactly what is going on, because the whole data storage market seemed to get a little bit sluggish near the end, especially in terms of decision-making. So to be honest with you, the jury is out right now. We are taking a look at that.

The same thing is also, I would say, true with both IMS and Nexsan, is that they got off to a really strong quarter, and then it just seemed decisions kind of stalled out at the end. Federal government was the big chunk of it, but even beyond that --- it is not that orders were lost, it is just that everything got kind of put on hold and failed to close. So they are still in the system and we are still really optimistic, but it just kind of -- everything slowed down in September.

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**Eric Martinuzzi** - *Lake Street Capital - Analyst*

You had talked last quarter that the -- kind of that the S&S business on a six-month basis had actually shown growth. I am assuming on a nine-month basis it did not. If we had had a kind of normalized Federal business, do you think that would've changed that calculation?

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**Mark Lucas** - *Imation Corporation - President, CEO*

Yes, absolutely. You know, both Federal government -- and again, what I don't have clear visibility to is why some of the corporate enterprise customers just kind of delayed their decision. I think it was all total uncertainty about the economic situation and what is going on.

You know, as we are digging into the Federal government stuff here, too, what is a little bit concerning is that some of the government contracts are still pending because they are concerned that January 15, the government might shut down again. So there is some now talk about delaying decisions until post January 15. Now we, again, have not had clear visibility to that, but we are hearing some of that rumbling right now.

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**Paul Zeller** - *Imation Corporation - SVP, CFO*

Eric, this is Paul. One other thing that was specific to the quarter is at the end of the quarter, we did see some softness in a particular OEM as they were going through some issues at the end of the quarter. And we saw some order disruption that we think was more almost logistical and procedural than from a business standpoint. But that also nicked us a bit in the kind of storage solutions category.

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**Eric Martinuzzi** - *Lake Street Capital - Analyst*

And back to the kind of follow-on question to that, I understand what happened in September. The expectation for December, is it kind of more of the same, can't really tell, or is there a seasonal bounce here? Are we sequentially up in Q4 versus Q3 on S&S?



**Mark Lucas** - *Imation Corporation - President, CEO*

Right now, our sales force is telling us that they are pretty optimistic about Q4. I think the wildcard again is the Federal government, but I think the other factors that we are looking at are pretty positive.

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**Paul Zeller** - *Imation Corporation - SVP, CFO*

Yes, all things being equal, we clearly should normally have a sequential bump between Q3 and Q4.

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**Eric Martinuzzi** - *Lake Street Capital - Analyst*

Okay. And then lastly for me, you had some good progress there on the cash balance rising. I guess given that both the Memorex and the XtremeMac didn't -- the progress there didn't happen until after the quarter closed, what is kind of a -- what is the pro forma cash, I guess, for Memorex? And then what would it be, assuming this incremental -- or maybe you can't comment on the XtremeMac until that one closes. But I am just trying to get a feel for where is our cash right now.

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**Paul Zeller** - *Imation Corporation - SVP, CFO*

Yes, so let's talk a little bit about third quarter, and then I will try to address some of your go-forward questions. You know that we have incentive programs that really are broad-based. And one of the critical factors in our program is that we include cash and working capital days as a part of the metrics our business units have, especially in our CSA business. And Greg and his team did a really good job in third quarter in driving our inventories down to really levels we haven't seen in a very long time.

And I think it's just better supply-and-demand planning, it is the whole gamut, SKU control, all of that. And so I think we had a very good result, some of that being in taking some inventory out that maybe should have been out in the past and just getting more efficient.

If you look forward -- and we talked a little bit about the impact from the sale of the businesses -- as we said, as we discontinue those businesses, we think there is about \$19 million of total cash proceeds we will deliver over time. About \$10 million of that, we are going to see spread between fourth quarter and early 2014. But some of that also depends on the realities of XtremeMac and the timing of the closure and the like.

So yes, I can't talk with specifics, because one of the transactions isn't closed, but that is certainly a positive. And it is a positive, yes, because we are monetizing some businesses and we can redeploy that cash. But it is also a big positive because we are doing this for a reason, which is to really focus on our growth categories. And I think that intangible benefit is really important.

I guess the final thing I will say -- and you referred to it in your report -- about some of the hidden value elements that exist on the balance sheet. And let me speak to the real estate side of things. We continue to work on the Camarillo property sale. We have been disclosing that in the 10-K and such. And we still anticipate that should close in 2013, roughly a \$10 million benefit. There is always a chance it will slip into 2014, but we feel good about the transaction. We are at the very tail end of it. So we are just through some final governmental approvals and things at the local level, but things look good.

And we have kicked off the process we have been talking about related to the headquarters facility, in terms of looking at options for monetizing and getting cash out of the significant infrastructure here in Oakdale. And so I think we are doing the right things in that regard as well.

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**Eric Martinuzzi** - *Lake Street Capital - Analyst*

Got it. Thanks for taking my questions.



**Mark Lucas** - *Imation Corporation - President, CEO*

Thanks, Eric.

**Operator**

(Operator Instructions). We have no further questions at this time. I'll turn the call over to the presenters.

**Mark Lucas** - *Imation Corporation - President, CEO*

Let me close by saying that while we have seen significant declines in the legacy optical and magnetic tape businesses, we are focused on higher-growth, higher-margin data storage and information security solutions. We are taking the right actions, and with urgency, to build the Company for long-term success and we are confident in our strategy.

I'll look forward to updating you again when we release our fourth-quarter and full-year results in early 2014. Thank you.

**Operator**

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

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