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IMN - Q2 2013 Imation Corp Earnings Conference Call

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CORPORATE PARTICIPANTS

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Mark Lucas *Imation Corp. - President, CEO*

Paul Zeller *Imation Corp. - SVP and CFO*

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 second-quarter 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) Mr. Scott Robinson, you may begin your conference.

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

Thank you, Sharon. Good morning, everyone, and thank you for joining us today on our second-quarter 2013 earnings call. I am your host for today's call, where you will be hearing from our CEO, Mark Lucas; and our CFO, Paul Zeller. On today's call, we will review our second-quarter and first-half 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 Reform Act of 1995. Such statements are subject to risks and uncertainties and could cause actual results to differ materially from any projected results. This 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.

Mark Lucas - *Imation Corp. - 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 our continuing business transformation. We are focused on high-growth market segments in data storage and security and have dedicated teams launching differentiated products to meet customer and prospect needs globally.

Let me first discuss our financials. Imation's second-quarter results were in line with our expectations. As you will recall, an element of our transformation, including separating the Company into two focused and channel-centric business segments earlier this year; Tiered Storage & Security Solutions, or what we call TSS; and then also Consumer Storage & Accessories, or what we call CSA -- I will give you an update on both businesses this morning.

TSS saw revenues increased almost 6% in the quarter. We have stated that a key objective of ours is to raise gross margins, and second-quarter gross margins for TSS were 21.9%, up from 19.6% last year. Second-quarter results reflected important investments we have made in the TSS segment, particularly with the acquisition of storage solutions provider, Nexsan, at the beginning of 2013.

Nexsan showed first-half growth and continues to bring new products to market, such as the recently launched Nexsan Assureon secure automated archive solution. This system helps users consolidate storage tiers, secure data and simplify storage management. Additionally, we had a significant Nexsan sale in the Middle East during the quarter for approximately \$2.8 million.



One of the reasons we are so pleased about this acquisition is that Nexsan participates in markets with blended compound annual growth rates in excess of 10%, markets such as block storage, file systems and archival systems. To capitalize on opportunities in front of us we are adding talent, particularly in the sales force.

We noted that when we announced our purchase of Nexsan in January that one of the real benefits Imation can bring is access to more international customers via our global footprint. We are now engaged in bringing Nexsan product into Imation's established international network.

Imation Mobile Security is another element of our TSS business unit and we have attractive growth prospects in this market as well. We had a large IronKey sale to an Ivy League institution during the quarter which totaled more than \$600,000. We are making additional investments to advance the Mobile Security product portfolio and sales organization.

Our CSA portfolio performed as expected in the second quarter. Cash generation and gross margins for the quarter were strong. Although CSA revenue was down in the quarter at \$116.9 million, this was expected due to the fact that the optical segment continues to be in secular decline.

We recently launched the TDK A33 weatherproof wireless speaker, and it was named a Consumer Reports Best Buy for August this year, beating our competitors on both performance and value. This was very exciting for us.

In another aspect of our transformation, we continue the process of rightsizing organization, which we have talked about in previous quarters. We have an unrelenting focus on cost controls Company-wide and we are making progress each quarter on this initiative. We are decreasing our workforce where needed but continue to hire skilled professionals in key growth areas.

SG&A expenses were down \$800,000 in the second quarter. The reduction was driven by Imation's cost reduction efforts and prior intangible write-offs, which lowered costs by approximately \$8.8 million. The operating expenses added to the Nexsan acquisition mostly offset the declines, as we had planned.

Along with cost reductions, we are moving forward with plans to divest the Memorex and XtremeMac consumer electronic brands. We have made progress on these negotiations and, while it is taking longer than expected, we are confident we will have a resolution. We will retain our consumer storage business under the Memorex and TDK brands.

We are committed to long-term success by becoming a key global player in data storage and security. As a personal proof point of our commitment to the future, you perhaps saw that I recently made an open market purchase of Imation stock. I am optimistic about the Company's long-term prospects.

And 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 Corp. - SVP and CFO*

Thanks, Mark, and good morning, everyone. Our second-quarter results reflect Imation's continuing execution of our strategic transformation. And although clearly we have not yet fully achieved the financial turnaround we anticipate with our strategy, I believe we are taking all the right steps. As Mark said, we have made nice progress and we are pleased about that.

We remain focused on a number of important initiatives critical to this transformation. Those include, first, integrating the Nexsan acquisition and investing in growth, both through the addition of sales and technical talent as well as by leveraging Imation's global footprint and bringing Nexsan products in a much bigger way into international markets.

Second, divesting the Memorex and XtremeMac consumer electronics brands so we can become even more focused on our storage and security business; and finally, completing the cost reduction programs that are key to improving our near-term profitability and creating the right infrastructure for our two separate businesses, CSA and TSS, as we move forward.



So before getting into our future results, just a reminder that our Memorex and XtremeMac CE businesses are presented in discontinued operations. The remaining CE and accessory business in continuing operations is under the TDK Life On Record brand.

So, moving on to our results, Q2 revenue was \$211.7 million. That's down 15% from last year's second quarter. Currency translation was a negative factor this quarter, lowering revenue in dollar terms by approximately 3.5%.

Our Consumer Storage & Accessories segment revenues decreased 27% in the quarter, driven by consumer storage media, primarily optical, which declined 29%. Audio and accessory revenues under the TDK brand were up 2%.

Tiered Storage & Security Solutions segment revenues rose 7%, driven by the Nexsan acquisition. Within TSS, commercial storage media revenues, primarily magnetic tape, were down 18%, somewhat better than we saw in Q1. Storage and security solutions revenues were up significantly, as expected, based on the addition of Nexsan revenues from that acquisition.

Regionally, we had our most significant declines in Asia, which was somewhat below our expectations. In the Americas, we saw somewhat better-than-anticipated results, especially in CSA. Europe saw a recovery, as expected, with revenues nearly flat year-over-year.

Gross margins were 26.4% to sales in the second quarter, reflecting the benefit of a significant adjustment to levy reserves in Europe, which added \$13.6 million to pretax profits and 6.4 points to our gross margins. Let me take a minute and give you a bit of background on our European levy situation.

As we've discussed over the last several years, back in 2010 the European Court of Justice had a ruling that copyright levies were only to be due on the sale of optical media to individual users and not on commercial sales. Since we have been required to and had paid such levies for years on all of our revenues, we began withholding levy payments from the various European levy collecting societies at that time.

We recognized benefits in 2011 for the reversal of the commercial-related levy accruals we had on the books and we ceased recognizing additional liability for commercial-based levies at that time. Since then we have also been withholding payments on consumer-based levies, given our belief that we had a valid right to offset these obligations against the substantial claims for our past overpayments of commercial levies that had occurred prior to the point when we began withholding them.

As of the end of first quarter 2013, we had approximately \$30 million of these accruals in other current liabilities. Our strategy has been to continue withholding these levy payments while we wait for the various local countries to apply the ECJ ruling. This will be a jurisdiction-by-jurisdiction assessment over time.

In the second quarter, we reached this point in Italy and reversed the Italian portion of the levy accrual for \$13.6 million, as I said. We base this on the culmination of various events in Italy, including a positive court ruling in a related case. We will continue to evaluate the facts and circumstances in various other countries to ascertain whether there are further levy accrual reversals that may be warranted. In the meantime, we are pleased with this outcome that boosted gross margins and operating profitability by \$13.6 million.

Gross margins excluding this benefit were about 20% to sales, in line with our expectations. We saw solid performance in optical media and in Nexsan, as well as mobile security products.

Operating expenses totaled \$50.8 million in the second quarter. That's down from \$52.8 million on the same basis in the second quarter of 2012. This reflects a significant savings from our OpEx reduction program of roughly \$12.5 million, or 24%, partially offset by Nexsan's operating expenses that were added with the acquisition, as Mark noted.

We incurred \$5.1 million of restructuring and other charges in the second quarter of 2013. Those were primarily driven from the charges related to our restructuring program announced last year.



Operating income from continuing operations excluding these charges totaled \$5.1 million and benefited from the levy accrual adjustment I just mentioned. Non-operating costs were just \$700,000 in the second quarter as we carefully controlled currency costs. Tax expense was \$1.1 million, and that led to a reported loss per share of \$0.04 from continuing operations and \$0.13 including discontinued operations. If we exclude the restructuring and other charges, we had earnings per share of \$0.11 from continuing operations.

Cash ended the quarter and \$94.4 million with net cash at \$74.4 million after deducting the \$20 million outstanding on our credit facility. During the quarter, we spent \$6.7 million related to our restructuring program and \$2.5 million buying back about 650,000 shares of Imation stock. We saw solid working capital performance during the quarter, which helped offset the majority of these cash outflows.

In addition, we closed on an incremental credit line earlier in July in Japan that should add up to \$30 million of liquidity over time on top of our existing US- and Europe-based facilities.

In summary, our Q2 results reflect continuing execution of our strategic transformation. We are investing in growth in both our Nexsan and mobile security businesses. We see solid gross margins across the board, but especially in optical, Nexsan and mobile security. Operating expense reductions are on track and we delivered \$12.5 million of year-over-year reductions, and our cash performance remains solid.

So we remain focused on the important initiatives we have outlined and on driving improvements in our financial results over time.

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

QUESTIONS AND ANSWERS

Operator

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

Mark Lucas - Imation Corp. - President, CEO

Let me close by reiterating that Imation's second quarter was in line with our expectations. We have shared with you this morning the important progress we have made on our strategic transformation, including reducing our costs and raising our gross margins. More work in front of us and we are confident that we will build a successful portfolio of differentiated products for the growing data storage and security markets.

I will look forward to reporting further improvements when we release our third-quarter results this fall. Thank you very much.

Paul Zeller - Imation Corp. - SVP and CFO

Thanks, everyone, for their time. Have a good day.

Operator

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



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