

THOMSON REUTERS STREETEVENETS

EDITED TRANSCRIPT

IMN - Q1 2012 Imation Corp Earnings Conference Call

EVENT DATE/TIME: APRIL 24, 2012 / 2:00PM GMT



CORPORATE PARTICIPANTS

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

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

Paul Zeller *Imation Corp - CFO, SVP*

CONFERENCE CALL PARTICIPANTS

Mark Miller *Noble Financial Capital Markets - Analyst*

Abbott Keller *Kestrel Investment Management Corp. - Analyst*

PRESENTATION

Operator

Good morning. My name is Jay and I will be your conference operator today. At this time I would like to welcome everyone to the Imation Corp. Q1 earnings release. (Operator Instructions). Thank you. Mr. Scott Robinson, Vice President Corporate Controller, you may begin your conference.

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

Thank you, Jay. Good morning everyone, and welcome to our first quarter 2012 Earnings Conference Call. I am happy 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 first quarters results and also provide information as to the progress we're making in regards to 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 discussed in this call that does not relate to historical information may be deemed to constitute forward-looking statements within the meaning of the Private Securities and 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 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 - CEO, President, Director*

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. We are midway through this transformation and we continue to execute on the initiatives we laid out in 2011 and again during our February investor meeting. The action we are taking are designed to build a platform for long-term growth and improved operating margins. As you know we are leveraging Imation's data storage core of traditional storage and developing differentiated products in the categories of secure and scalable storage and audio and video information, or AVI. As we demonstrated at our investor meeting, we have clear product and technology road maps to enable us to deliver growth and margins in these product categories.

We have planned that 2012 will be a year of transition for us. As we have begun the year our first quarter results are in line with our expectations. Traditional storage revenues continue to decline as expected, but we were encouraged by moderating decline rates of optical at 13% and magnetic tape at 6%.

In optical we secured a new distribution placement at Costco, a key win for our America's team as we continue to maintain number one market share in the category.

In tape we continue to see solid demand in an improving market driven by both enterprise users and cloud providers who need reliable and cost effective technology to store the ever increasing amount of data being generated.



In our secure and scalable storage category we are developing differentiated mobile security products and a full portfolio of data protection appliances. Although revenues in secure and scalable were flat overall, our new products still comprised a relatively small base, but our focus on new differentiated products offerings is paying off. Gross margins rose more than 6.5 points to 20.1% of sales in this category compared with the same period last year.

During the first quarter we successfully combined our mobile security acquisitions into a new headquarters in San Jose and are continuing with ongoing integration. Within this group we are developing new advanced software technologies for security applications. For example, we're partnering with Microsoft on an application that will embed an entire Windows 8 operating system on a secure USB flash drive creating what we call PC on a stick. With our growing security technologies and product portfolio we are gaining good traction with our secure storage offerings.

We are also pleased by our progress in new scalable storage products. For example, our RDX based storage products grew more than 40% over our first quarter last year. We are accelerating the development and launch of purpose built data protection appliances to meet the storage needs of small and medium businesses and are moving very quickly to build this portfolio.

Just 12 months ago we had one scalable storage product, the RDX stock and cartridge. Now we offer more than a dozen scalable storage products and just shipped our newest DataGuard R4 and T5R appliances last month. We're looking forward to introducing additional data security cloud connectivity and deduplication features in our scalable storage line as the year progresses.

Let's move to a discussion of our audio and video information category, or AVI. AVI revenues were down during the quarter, but much of this stemmed from planned video product rationalization. We are pleased that gross margins for AVI rose more than 4 points to 17.5% of sales compared with the same period last year. We are especially encouraged by progress in new products.

For example, at a key retailer in the UK we passed the \$1 million mark in sales of our new TDK audio line. And at XtremeMac our Apple-focused line of cases, chargers and audio products we saw growth in the quarter of more than 65%.

Moving forward we plan to launch several new products under our TDK and XtremeMac line which along with our recently introduced products we expect will drive new revenue and improve gross margins in this category.

Overall across all categories in the Company our gross margin of 19.9% is up 2.8 points from our first quarter last year. We are very pleased with this progress.

As I close my comments this morning, I want to take a moment to discuss Imation's transformation. We know of course that to succeed at turning around a company it all starts with strategy. We have a clear strategy and have outlined actions required to attain it. We are leveraging growth opportunities that are emerging from the need to store, protect and connect the world's ever expanding volumes of data.

Additionally, we are uniquely positioned to leverage our extensive global distribution footprint. We have a very strong operational and financial discipline that is enabling us to execute. And as I have mentioned many times before, we have a seasoned team of executive leaders to help drive our Company forward.

But at the heart of any successful turnaround are a company's employees. They fuel the Company with their hard work, their passion and their skills. At Imation 26% of our workforce was new in the last year, bringing new skills in critical areas we need to grow. A full 65% of our employees in research, development and engineering were new in the last year.

We now have a dedicated mobile security team that numbers almost 100, and we have a new solutions sales force. We have highly skilled employees and facilities in 35 countries reaching customers in more than a hundred countries. From the Americas to Europe to Asia our employees are keenly focused on our strategic imperatives and they are delivering on those imperatives. I am confident we will be successful in our transformation.

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

Paul Zeller - *Imation Corp - CFO, SVP*

Thanks Mark, and good morning everyone. As Mark just mentioned as we look at our first quarter, our results came in generally as expected. Our top line was down versus last year but at a lesser rate than last quarter, and we began the year with an operating loss in our seasonally soft Q1. We remain committed to exiting 2012 with topline growth and anticipate showing progress in our year-over-year comparisons as we move through the year.

We continue to see very strong underlying growth in a number of critical growth categories such as RDX, mobile security and consumer electronic accessories. In addition, our traditional storage revenue decline rate was at the lower end of our long-term targets. We did, however, see declines in commodity flash and traditional audio in the quarter which held back our total Company revenues.

On the gross margin front we saw significant improvements in almost every product category driving total Company margins to nearly 20%. Margins were up in optical, in tape, RDX, mobile security and CE accessories. In addition, we had a better mix given the declines in our commodity flash and traditional audio products I just mentioned both of which carry lower than Company average gross margins. So with those overall high level comments, let me walk you through some of the detail in the quarter.

Our revenues in Q1 were just shy of \$282 million, that's down 11% compared to first quarter last year. This rate of decline was improved from the 14% we saw in the fourth quarter. This was primarily due to our traditional storage category where we saw lesser rates of decline in both optical and tape formats.

So looking at each of our product categories, traditional storage, which as you know includes both optical and tape media, declined 13% in the first quarter. Optical revenues were down 13% which is a lesser rate than we had seen recently. This reflects the benefits of channel price increases we've been taking over the last several quarters in response to supplier cost increases we absorbed mid last year.

In tape, revenues declined about 6% which is equal to the full year decline rate we saw last year and slightly better than the Q4 decline rate which was 8%. We continue to see evidence that the overall tape market is improving driven by cloud storage requirements.

As I mentioned earlier, commodity flash revenues within secure and scalable storage declined and overall secure and scalable storage was flat. We saw strong flash competitor price reductions early in the quarter which drove down overall pricing in the marketplace such that even with higher units sales our revenue dollars declined. We're managing inventory very tightly in this business which allowed us to maintain acceptable margins despite this pricing volatility.

We have consistently communicated that this category is one in which we will participate selectively where the margins are acceptable. We did that very effectively in the quarter, but it did hold back the overall secure and scalable storage growth rate, and it masked some very strong and encouraging in both RDX as well as mobile security.

RDX, a removable hard disk platform had revenues that increased nearly 45% in the quarter on top of 32% growth last year. Clearly this format is gaining traction with OEMs and end-users.

Mobile security revenues continued to ramp driven primarily by secure flash products, but also with contributions from secure external hard disc. Our audio and video information revenues were down 12.7% in Q1.

Though we continue to see growth in accessories, especially head phones and cases, the impact of rationalized categories including video continue to impact our comparison. This is the last period where quarterly comparisons will be impacted since we were essentially out of video after first quarter last year. Our most important near-term priority in AVI has been to improve the quality of our revenues as we have rationalized out of lower margin categories and focused on launching higher margin differentiated offerings. As you will see in a minute our gross margins clearly reflect our progress in this regard. We also saw declines in traditional audio products reflecting a continuing challenging retail environment.

From a regional segment standpoint, our Americas segment revenue declined 12% versus Q1 of last year. This was driven by optical within traditional storage as well as the video product rationalization I just mentioned. Secure and scalable storage grew over 60% in the Americas driven by our secure storage acquisitions and RDX growth.

European revenues declined 6% in the quarter driven by traditional storage partially offset by strong growth in both secure and scalable storage and AVI.

North Asia revenues declined 8% in the quarter also driven by traditional storage. We did also see growth in AVI driven by accessories in North Asia.

In South Asia revenues declined 21%. This region was particularly impacted by flash product declines.

Our gross margins in the quarter were 19.9% to sales. That's up 2.5 percentage points both year-over-year and sequentially. We saw improvements in every major product category again both year-over-year and sequentially.

In traditional storage our margins were up 1.1 points year-over-year to 20.3%. The main driver was optical products where we saw the benefits of channel price increases that we've implemented over the last several quarters.

In secure and scalable storage, margins improved nearly 7 full points from a year ago to 20.1% to sales with improvements in every category including RDX, secure storage, flash and external hard disc. In addition, we were benefited by mix as we saw substantially growths in RDX and security with declines in flash and external hard disc.

In AVI margins improved over 4 points versus last year to 17.5% to sales. The main drivers were accessories as well as a better mix as we exited lower margin categories such as video.

Our research, development and engineering expenses totalled \$6.4 million in the first quarter and that's up \$1.7 million from last year's first quarter reflecting our planned increase investment in technical skills in support of our strategy, and that includes the impact of recent acquisitions.

Selling, general and admin expenses totalled \$57.3 million, up \$7 million from a year-ago. The majority of the increase relates to our 2011 acquisitions including noncash amortization expense. In addition, we increased demand generation spending in the quarter. We recorded \$1.3 million in restructuring and other charges in the first quarter and that related primarily to previously announced programs.

Our operating loss for the quarter was \$8.9 million. If I exclude the charges I just mentioned, we had an operating loss of \$7.6 million. That included \$9.3 million in depreciation and amortization and adjusted for that, EBITDA was \$1.7 million excluding charges.

Non operating expenses were \$2.3 million for the first quarter of 2012 compared to \$2.1 million a year-ago. Our income tax provision for the first quarter was \$1 million, and on a per share basis we recorded a loss of \$0.33, and it's \$0.29 cents excluding the charges.

We ended the quarter with \$216 million of cash and equivalents. That's down \$6.9 million from year end.

In summary we're seeing continued progress as we implement our strategy. Though our revenues declined and we recorded an operating loss in the quarter, these were expected as we continue our transformation including investments for future growth. The growth we're seeing in certain key categories is encouraging as is the continuing improvements quarter after quarter in our overall margins.

Especially encouraging our the significant improvements in gross margin in both secure and scalable storage as well as AVI. We remain committed to and confident in our strategy and in our long-term financial goals of returning the Company to growth and continuing improvements over time in our gross margins and overall profitability.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). The first question will come from Mark Miller of Noble Financial. Your line is open.

Mark Miller - Noble Financial Capital Markets - Analyst

I would just like to give you some congratulations on the progress you're making on the margins. I want to talk a little about the cloud. One thing that I hear from a lot of people they're focused on tablets and flash memory, but the point is a lot of the storage that's going to come off the tablets is going to go onto the cloud. And that's an opportunity not just for disc drives, but also for tape. I'm just wondering how you could portion that out between what percent is going to go on hard drives, what percent is going to go on tape on the cloud?

Mark Lucas - Imation Corp - CEO, President, Director

Hi, Mark, it's Mark. Yes. Absolutely. Tape in terms of archiving for cloud service providers is very, very important. In fact, Google is the largest user of tape in the world right now.

We are looking at it in two different ways. If you want active archiving or back up, typically hard disk is the better alternative. If you want deep archiving, then tape is by far the most economical long lasting and best alternative. How that splits out is evolving over time, but I would still say that tape has a lion's share of the market and will continue to do so.

Mark Miller - Noble Financial Capital Markets - Analyst

Good. A little puzzling to me that you saw a bigger year-over-year revenue decline in Americas where it seemed like our economy is doing better than Europe where you saw a smaller revenue decline, and is there any product rationalization, or what's going on with the difference that Americas seem to be somewhat of a larger decline than Europe?

Paul Zeller - Imation Corp - CFO, SVP

Mark, this is Paul. US we have a much more significant consumer presence, especially with the Memorex brand, and we did see some softness in traditional audio as we talked about. And so overall you have to remember there is a little different mix in the US than in other regions and that was part of the reality of the US change versus other parts of the world.

Mark Miller - Noble Financial Capital Markets - Analyst

Okay. SG&A expenses you're attributing that to new products. Is that going to stay in terms of percentage of sales at that level?

Paul Zeller - Imation Corp - CFO, SVP

What I would say on SG&A, Mark, is it's more consistent in dollar level, and so it will vary as a percent to sales depending on the strength of the top line in the quarter. It's always much better in the latter half of the year, and especially in fourth quarter.

Our SG&A and OpEx in general is not that variable based on revenues. There's not that many parts of our OpEx that really are directly tied with revenue levels.



So in a first quarter we will not get as much leverage when it's seasonally not as strong, and fourth quarter we will get a significant amount of leverage over that OpEx. When you look at our OpEx spending there's clearly an element of it that we have built over time that's directly tied to building growth platforms, and as you know, we have had a significant [respilling] of our R&D organization, and to a degree in sales and marketing, and we feel very good about the results we're starting to see from those investments.

Mark Miller - *Noble Financial Capital Markets - Analyst*

And one final question. Your tax rate has been jumping around a lot, and any help there going forward?

Paul Zeller - *Imation Corp - CFO, SVP*

Yes. It's complex when you look at it as a percent against pre-tax, but if what you remember is that we in general have net operating losses in Europe and the US, and we're not able to generally get the benefits of those net operating losses, and so any losses we might have in the US tend not to give us any tax benefit, and yet our International operations have a normal distribution margin associated with them through our transfer pricing, and those do attract a modest amount of income tax expenses. It's quite small. But so even in a period where we have a loss like we had in first quarter, you will see a small amount of tax expense because of just how the accounting works.

Mark Miller - *Noble Financial Capital Markets - Analyst*

Do you think we will stay at that level over the next couple quarters, or will the rate go up?

Paul Zeller - *Imation Corp - CFO, SVP*

I think in dollars it will be relatively consistent. The rate will vary as the bottom line does.

Mark Miller - *Noble Financial Capital Markets - Analyst*

Thank you.

Paul Zeller - *Imation Corp - CFO, SVP*

Thank you, Mark.

Operator

(Operator Instructions). The next question is from Abbott Keller of Kestrel Investment Management. Your line is open.

Abbott Keller - *Kestrel Investment Management Corp. - Analyst*

Thank you. What are your thoughts on share repurchase going forward?

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

Abbott, this is Mark Lucas. We are continuing looking at buying back shares. We continue to have an authorization of 1.1 million -- I'm sorry -- 1.2 million shares available to us. We have Board meetings once a quarter, talk about it every quarter and it is definitely high on our radar screen.



Abbott Keller - *Kestrel Investment Management Corp. - Analyst*

Did you purchase any shares in the previous quarter?

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

No, we did not.

Abbott Keller - *Kestrel Investment Management Corp. - Analyst*

Okay. Reason?

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

I'm sorry?

Abbott Keller - *Kestrel Investment Management Corp. - Analyst*

Reason for not repurchasing?

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

Well, I think the reasons and how we deploy cash in any quarter there's a variety of reasons, and we look at that on an on going basis, and I think our general comment we've made in the past I think is still relevant, which is we believe whether it's organic investment, inorganic investment, share buyback, even dividends are all reasonable and appropriate uses of cash and we will consider them quarter by quarter.

Abbott Keller - *Kestrel Investment Management Corp. - Analyst*

Okay. Thank you.

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

Thank you.

Operator

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

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

Well, thank you everybody for participating, and we look forward to talking to you again next quarter. Thank you.



Operator

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

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2012, Thomson Reuters. All Rights Reserved.

