THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

IMN - Q4 2011 IMATION CORP EARNINGS CONFERENCE CALL

EVENT DATE/TIME: FEBRUARY 03, 2012 / 3:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Scott Robinson *Imation Corp. - IR*

Mark Lucas *Imation Corp. - CEO*

Paul Zeller *Imation Corp. - CFO*

PRESENTATION

Operator

Good morning. My name is Melinda and I will be your conference operator today. At this time, I would like to welcome everyone to the Imation Corp. Q4 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, you may begin your conference.

Scott Robinson - *Imation Corp. - IR*

Thank you, Melinda. Good morning, everyone, and welcome to our fourth quarter 2011 earnings conference call. I'm delighted 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 fourth quarter results and also provide information as to the progress we are making in regard 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 and 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 our press release issued today, as well as our filings with the SEC. With that, I'd like to turn the call over to Mark Lucas, Imation's CEO.

Mark Lucas - *Imation Corp. - CEO*

Thank you, Scott, and good morning, everyone. On today's call, Paul Zeller and I will look forward to updating you on Imation's progress as the Company continues to execute on strategic transformation. As you know, we're focusing on leveraging Imation's data storage core, while building a platform for growth in secure and scalable storage and audio and video information for AVI.

As I look back on my first full year as CEO, I want to make several comments on our 2011 results and on our Company's progress in implementing our new strategy. You'll recall that when we announced our transformation strategy in February of 2011, I laid out a two-year plan; a plan that targets Imation returning to growth as we exit 2012. We remain solidly on that path. We are pleased with the significant progress we have made on our strategy, particularly in our new product categories.

While we saw declines in our lower margin commodity storage products, our new differentiated products in secure and scalable storage showed encouraging growth. We also saw good traction in differentiated AVI products. As you noted in our press release, our improving gross margins are an important part of our 2011 story and reflect that we're effectively transitioning to higher margin products.

Our decision to exit certain categories, such as video, did create short-term revenue impacts, but we believe that this emphasis on differentiated, higher margin products will result in a stronger portfolio longer-term and we remain committed to this approach. Our progress in 2011 is especially notable given the series of obstacles we faced throughout the year.

As stated in previous quarters, we were hit with significant and unexpected optical cost increases. We were also faced with the challenges of two natural disasters in Asia that impacted component availability. Our Management team did an excellent job addressing these potential supply challenges, avoiding disruptions to product availability for our customers.

Next, I'd like to discuss some of the strategic actions we have taken and progress we are making in our growth categories. First, scalable storage, We see significant future opportunity in this category and we have a clear road map. We are moving beyond removable storage offerings to a portfolio of appliances designed specifically for the storage needs of small and medium businesses, or SMBs.

These businesses are looking for scalable storage solutions that help lower storage costs, meet compliance requirements, and protect and retrieve business data. In August, Imation acquired the assets of ProStor Systems, adding the InfiniVault data archive appliance and related technologies to our scalable storage portfolio. In October, at the Storage Networking World Show, we unveiled our new portfolio of data protection and data archive appliances designed to help data-intensive compliance-driven SBAs retain, retrieve, and recover valuable data.

Then, in December, we acquired Nine Technology's data de-duplication engine; a key software technology platform that will provide further differentiation and cloud connectivity for Imation's data protection portfolio. We are excited with these technology acquisitions and how they are accelerating our progress in developing and launching scalable storage offerings.

More scalable storage offerings are underway in 2012 and beyond. Next, an update on our secured storage area on what we are calling our mobile security portfolio of products. A little over a year ago, Imation's only offerings in USB, flash, and hard drives were commodity-like products with little gross margin opportunity.

Our go-forward direction is to add differentiating security features such as encryption, authentication, and software-central management of devices. These additional layers of security help businesses, governments, and individuals protect their data from loss or theft.

In 2011, we made several key acquisitions, beginning with ENCRYPTX, a leader in encryption and security solutions for removable storage devices and media. We also acquired the assets of MXI Security, including its key security technologies and products. And in September, we acquired the hardware business of IronKey and established a strategic relationship with IronKey for cloud-based, secure storage services.

These acquisitions brought with them new technology skills and secure hardware and software engineering, government-validated encryption, and cryptology. We believe Imation now offers the strongest portfolio of mobile data security solutions available with the largest global reach. Moving forward, we expect to accelerate development of new offerings in channels and data security. And finally, let me move to a discussion of our audio and video information, or AVI products.

As I noted earlier, we have made some tough decisions to exit product areas where the margins were not acceptable and are now focused on higher margin, differentiated products. As a result, we have successfully moved our AVI product gross margin from single-digits to the mid-teens as we have progressed through this past year. We recognize that the increase of digital information in all forms including documents, photos, music, and video creates new opportunities for consumers to store, protect, and connect their digital data.

Our new AVI products are designed to provide consumers with a unique, high-quality user experience with this content. And to support this direction, we are adding key skills and technologies. In advanced audio, for example, our team has developed a TDK signature sound profile that provides a unique, high-quality audio experience. We are also developing products with new wireless applications such as speakers, headphones, and chargers, all with Bluetooth connectivity.

We showed many of these products last month at the International Consumer Electronics show in Las Vegas, or the CES. Our XtremeMac brand was recognized with two CES design and innovation awards. AVI is an important part of our go-forward strategy and we are in an excellent position for growth. Our retail placements are strong, our brands are well-regarded, and our products are high-quality and unique. We expect to continue the strong momentum for the AVI line into 2012 and beyond.

As I close my comments this morning, I want to reiterate several points. First, we are making real progress on our strategic transformation. Gross margins are improving, driven by growth in higher-margin, differentiated products in secure and scalable storage and also AVI. Additionally, we remain very disciplined in our approach. Our Management team and employees worldwide are delivering on the actions we set forth in 2011. Our team is committed to this strategy and we are excited at the opportunities our new strategy offers.

Moving into 2012, we have a stronger base of core technologies, products, and skill sets to take Imation to the next level of our transformation. Now, I'd like to turn the call over to Paul, who will provide more financial detail on the quarter and the year. Paul?

Paul Zeller - *Imation Corp. - CFO*

Thanks, Mark, and good morning, everyone. Before getting into the quarter, I'd like to offer a few of my own thoughts about the fourth quarter and the full-year 2011. Like any Company going through a transformation, our financials to of a number of moving parts this year. We have organic growth investments that are hitting our OpEx, as we focus on driving growth in higher margin businesses such as secure storage, as well as scalable storage appliances, and we've ramped up RD&E, as well as marketing and product management investments in these areas.

We made several acquisitions to augment these growth initiatives. These include three in secure storage and two in scalable storage, as Mark just mentioned. We've rationalized some low-margin projects in order to improve margins and focus our resources on higher margin opportunities.

And along the way, we've significantly re-skilled our workforce. All of these actions are fully aligned with our strategy that we laid out early in 2011. We look forward to discussing our strategy in more detail at our upcoming analyst meeting on February 28 in New York. At that meeting, we're going to discuss our progress to date and get into more detail about where we're going in the future.

With that, let me get into the details of the fourth quarter. Our revenues in the quarter were about $342 million, that's down around 14% compared to the fourth quarter of 2010. That decline rate was up modestly from recent quarters, which have been around the 10% level.

There are two main drivers for this -- one related to optical and one related to flash. Our optical revenues declined at a faster rate in the quarter. They were down 21% and that compares to more or less the mid-teens level recently. As we've mentioned for the last several quarters, we've experienced significantly higher costs from our optical supply base earlier in 2011.

We've been passing this on through price increases to our customers around the world. In the quarter, we saw our underlying gross margin percents return to their historic levels and stabilized our gross margin dollar trajectory. But as we had anticipated, this caused some unit volume penalties in the quarter, especially outside the US.

The second factor impacting our revenues was in our standard flash category. Our strategy in this category is to participate selectively before the margin opportunity meets our margin thresholds. With the increased costs for Nand Flash we saw in the second half of the year, we stayed away from certain business which fell below those thresholds.

The bad news is that we did see our decline rate uptick in the quarter. The good news is that in the areas which are strategically critical, namely secure storage, scalable storage, and higher-margin AVI products, we had an encouraging quarter in terms of revenue growth.

I'll get into that in a minute, and I'll do that as I walk through each of our product categories. In traditional storage, revenues declined overall 17.6%, primarily driven by the 21% optical decline I just discussed and an 8% decline in magnetic tape, and that decline rate in tape was pretty similar to recent quarters.

In secure and scalable storage, revenues were down 1%, driven by declines in standard flash, as I just mentioned. If we exclude that lower margin category, the rest of secure and scalable storage grew 38% in the fourth quarter. Our RDX, or removable hard disk, revenues grew about 30%, with the strongest gains in the OEM category from both Dell and Quantum.

Our secure storage revenues grew substantially, aided by the acquisition of IronKey early in fourth quarter and MXI earlier in the year. We're very focused on driving growth in this category, both organically and inorganically, with the completion of three acquisitions in secure storage in 2011 -- ENCRYPTX, MXI and IronKey. We combine that with our organic growth initiatives around the Defender brand and we're building a very solid platform in this growing, high-margin category. Our audio and video information revenues were down 11% in the fourth quarter.

That entire decline was driven by video products and legacy optical storage cases. Both of those declines were expected. In video, as Mark mentioned, we've intentionally exited this low-margin category over the last year and in terms of optical cases, we're seeing significant declines rates as would be expected in this mature category.

If we exclude those categories, AVI grew about 7%, with the strongest growth in TDK audio and headphones overall. We continue to improve the mix in this category as we add higher-margin business and rationalize lower-margin business. From a regional standpoint, our Americas segment revenues declined 12% versus Q4 of 2010. This was driven by optical within traditional storage, as well as the video product rationalization I just mentioned.

Secure and scalable storage grew 45% in the Americas, driven by our secure storage acquisitions. Europe revenues declined 18% in the quarter. There, we felt the impact of both the optical unit challenges and the flash rationalization I discussed earlier.

North Asia revenues declined 12% in the quarter. That was entirely driven by the impact of pushing through optical price increases in the fourth quarter. Excluding that impact, revenues grew modestly in North Asia, driven by both secure and scalable storage, as well as AVI. In South Asia, revenues declined 20%, again impacted by both the factors I've discussed.

Our gross margins in the quarter were 15% to sales and that's up 2.3 percentage points from the fourth quarter of 2010. However, both those quarters had inventory-related charges associated with our restructuring actions. Adjusting for those charges in both periods, the quarter four gross margin in 2011 was 17.3%, up a full point from quarter four 2010.

Looking at margins by product category, traditional storage margins for the quarter were at 19.1%, up 0.7 from quarter four 2010. Within there, tape margins were flat and optical margins increased by about a point. Secure and scalable gross margins continued to improve ending the year at 18% in the fourth quarter; our highest margin ever in this category. This was an improved a full 6 points year-over-year and nearly 2.5 points sequentially.

Our mix shifted relatively significantly in the quarter, driven by rationalization in standard flash with relatively lower margins on the one hand and the strong growth in RDX and secure storage with higher margins on the other hand. We're very pleased with this performance and we've seen sequential quarterly improvement in margin percentage in this category for two years running as we have continued to move towards higher-margin and higher growth business in secure and scalable storage.

In audio and video information, our margins were 11% in the fourth quarter, which was down both sequentially and year-over-year. We took the opportunity in this seasonally strong quarter for AVI to right size our inventories in certain categories. That resulted in a $3 million margin penalty in the fourth quarter.

If we exclude that, AVI margins would have continued the sequential and year-over-year improvements we've been seeing for over a year. Our RD&E expenses totaled $6 million in the fourth quarter, up $2.2 million from a year ago and that reflects our planned increased investment in technical skills in support of our strategy and that includes the recent acquisitions.

Our RD&E headcount has increased by 60 in 2011, including the technical skills acquired with MXI and IronKey. Selling, general and admin expenses totaled $52.9 million, up $4.3 million from last year, driven by our acquisitions and incremental organic investments. We recorded $4.7 million in restructuring and other charges in the fourth quarter.

These expenses related mainly to our previously announced restructuring program and a pension settlement charge, offset by a $2 million gain due to an amendment of our long-term disability plan. When we add these charges net the $4.7 million to the inventory charges I already talked about related to restructuring, the total was $12.3 million impact from all such charges in the fourth quarter and those charges were roughly split 50/50 between cash and non-cash.

Our operating loss for the quarter, then, was $12.1 million, but excluding those charges I just discussed, there was a slight operating income of $200,000. With the $9.5 million in depreciation and amortization we saw in the quarter, our EBITDA was then $9.7 million, excluding charges.

Non-operating expenses were $1.5 million for the fourth quarter; that compared to $3.7 million in the third quarter. Currencies were particularly volatile in the third quarter and that led to higher than normal currency losses, then, and we had little impact from currencies in non-operating in the fourth quarter.

Our income tax benefit for the fourth quarter was $700,000 on a pretax loss of $13.6 million. The reason we didn't see a larger tax benefit from that loss is that we maintained a valuation allowance related to US deferred tax assets. Our tax provision outside the US was benefited by $5 million from the removal of a valuation allowance on that operating loss in the Netherlands.

On a per-share basis, we recorded a loss of $0.34. If we exclude the various restructuring and other charges I mentioned earlier, that represented a loss of $0.14 in the quarter.

We ended December with $223 million of cash and equivalents, down just short of $10 million in the third quarter. We generated about $15 million in operating cash flows during the quarter, driven by the $9.7 million in EBITDA I just mentioned; offsetting that was the $21 million spent on acquisitions. On that topic, as Mark said, we've completed five acquisitions in 2011.

The total cash payments were $47 million during the year and let me give you the detail on that. ENCRYPTX, which closed in the first quarter, was a cash payment of $1 million, MXI, in the second quarter, $24.5 million, the InfiniVault business from ProStor closed in the third quarter for $500,000, IronKey closed in the beginning of the fourth quarter for $19 million, and finally, the technology acquisition from Nine Technologies closed late in the fourth quarter for $2 million. Certain of these acquisitions do carry potential earnout payments, as well.

In summary, we're seeing continued progress as we implement our strategy. The growth we're seeing in certain key categories is encouraging, as is the continuing improvements quarter-after-quarter in our margins in these growth categories. 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 operating margins. With that, we'd be pleased to take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) It would appear we have no questions at this time.

Scott Robinson - *Imation Corp. - IR*

Thank you everybody for your interest and we look forward to talking to you again soon. Have a good day.

Operator

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