

## **Paul Zeller Comments Third Quarter, 2006 Results October 24, 2006**

Thanks Frank and good morning.

I'd like to echo Frank's comments; third quarter was another solid quarter for Imation. We saw significant overall revenue growth of 42% driven by the Memorex business but also by solid growth in our base business. Our gross margin percentage declined as expected due to product mix but so did our operating expense ratios, equaling a record low 14.1% of revenue. Operating income was a strong \$28.3 million and diluted EPS was 53 cents per share, both well above prior year levels driven by both Memorex and the base business. We continued our strong cash flows with cash ending the quarter at \$245 million. On the strength of this solid quarter coming on top of solid results in the first half, we have raised our 2006 outlook for both revenue and earnings.

Now let me walk you through some of the details beginning with revenue.

### **REVENUE**

- Which totaled just short of \$425 million (including about \$110 million from Memorex). This represented growth of over 42 percent over the third quarter last year.
- We were pleased with this revenue performance which showed strength for both Memorex and the base business.
- Our Memorex results were solid & met our expectations. We saw good results in all three of their product categories, Optical, Flash and Accessories.
- Our base business grew 5.4% in the quarter compared with Q3 2005 with YTD growth now nearly 4%.
  - We continued to experience solid growth in Optical, Mid-range Tape (driven by LTO), and Flash products,
  - Which more than off-set anticipated reductions in some of our more mature product categories such as Diskettes and certain older Tape formats.
- Our overall unit growth versus Q3 last year (excluding Memorex) was about 12%.
- This was partially off-set by the negative impact of price erosion of approximately 8%.
- The impact of changes in currency exchange rates was a slight positive on year-over-year comparisons, adding about 1 point to growth.
- Magnetic Products revenue (which includes Tape and Diskettes) was \$161 million in the quarter, down 7% vs. last year with Mid-range Tape growth off-set by declines in other tape formats and diskettes as I just mentioned.
- Optical Product Revenues, including Memorex, totaled \$191 million, an increase of over 90% due to the Memorex acquisition as well as growth in Imation brand optical as well as our Global Data Media Joint venture.

- Flash product revenue totaled \$46 million, nearly 3 times last year's third quarter due to both Memorex and Imation brand growth.
- The "Other" category, which includes accessories, removable hard disk as well as other miscellaneous product and service revenues, totaled about \$26 million, up over \$15 million from last year driven relatively evenly from the Memorex acquisition and base business growth.
- Our Americas region revenue totaled \$248 million in the third quarter, about 58% of worldwide revenues. This compares with 48% in the same quarter last year. The increase is due to the impact of adding Memorex which is predominantly a U.S. business.
- European revenues (which include the majority of our GDM joint venture revenues), totaled \$125 million, representing 30% of the total.
- And Asia pacific totaled \$51 million, 12% of total revenues.

### **GROSS MARGIN**

- Our gross margins, which came in at 20.8% of revenue, were down 2.8 points from last year's third quarter.
- This decrease was due to changes in product mix which came in two forms.
  - First, the addition of Memorex's upper teen's gross margin into the mix was a factor.
  - In addition, the relative contribution of our Optical base business revenues, which increased in relationship to Tape, was also a factor.
- Excluding the impact of product mix, gross margins were improved in all product categories with the exception of Entry Level Tape where you may remember that in late 2005, we renegotiated our distribution agreement with Exabyte impacting our margin percentage.

### **R&D EXPENSES**

- R&D costs were \$12.6 million; generally in line with our expectations and consistent with earlier quarters this year.

### **SG&A EXPENSES**

- Selling, General and Administrative expenses were \$47.4 million, or 11.1% of revenue during the quarter.
  - This was up \$3 million from last quarter due to having a full quarter's worth of Memorex SG&A, including amortization expenses for acquisition intangible assets.
  - SG&A was up \$13.6 million from the third quarter last year driven by Memorex expenses and incremental Stock Compensation costs, off-set by core spending reductions.

- Our worldwide headcount ended the quarter at approximately 2,110, down 30 from last quarter. Since December 2005, our headcount has stayed essentially flat even with the Memorex acquisition.

### **RESTRUCTURING AND OTHER**

- As you're probably aware, we are in the midst of implementing a restructuring program which we announced in January. The program is primarily associated with Memorex integration and we had previously signaled an expectation that the program would be in the range of \$13 to \$17 million.
- We had recognized \$10.7 million in costs through June of this year.
- Due to the timing of the underlying activities, there were no new charges in the third quarter. We do, however, expect to incur an additional \$1 million or so in the 4<sup>th</sup> quarter and then \$1 to \$2 million in early 2007 as we finalize the program. We now expect the total program to range from \$12 to \$14 million with majority (around \$11 to \$12 million) accruing in 2006.
- Year-to-date, we have spent approximately \$9 million in cash associated with this program, with \$5 million in the 3<sup>rd</sup> quarter.

### **STOCK COMPENSATION COSTS:**

- We implemented Financial Accounting Statement 123R at the beginning of this year which requires the expensing of stock options. We recognized \$2.7 million in incremental stock compensation expenses in the 3rd quarter compared to last year's 3<sup>rd</sup> quarter and \$7.0 million in the first 9 months. We are estimating the total year impact to be approximately \$10 million.

### **OPERATING INCOME**

- We generated \$28.3 million in operating income in the quarter including these stock compensation costs. Excluding these costs, operating income would have been \$31 million at 7.3% of revenue for the quarter. This represents an increase of 31 percent from operating income of \$23.6 million last year. This increase was driven by the Memorex acquisition as well as modest earnings growth in our base business.

### **NON-OPERATING EXPENSES, INCOME TAX AND EPS**

- In the non-operating area, we generated about 1.1 million in income during the quarter compared with \$1.7 million in the year ago quarter. This decrease was primarily due lower interest income on lower cash balances.
- Our tax rate in the quarter was 37%, up from the 34% rate we experienced last year
  - Our outlook for full year 2006 tax rate remains targeted in the range of 35 to 36 percent.
  - The tax rate for the 4<sup>th</sup> quarter is targeted in the 36 to 37 percent range.

- These targets are subject to adjustment should certain potential tax matters be resolved during the 4<sup>th</sup> quarter.
- Diluted EPS from continuing operations was 53 cents in the 3<sup>rd</sup> quarter, up 10% vs. 3<sup>rd</sup> quarter last year. This increase would be over 20% adjusting for a 5 cent per share impact from incremental stock compensation costs in this quarter's results compared to last year.

## **WORKING CAPITAL & CASH FLOW**

- Cash and Equivalents ended the quarter at \$245.2 million, up over \$21 million from last quarter driven by strong cash generated from operations which totaled \$38.6 million in the quarter and included a working capital timing benefit of approximately \$10 million that will reverse in the fourth quarter.
- In terms of Q4 cash flows, there will be a couple of additional factors in addition to this \$10 million that will hold back quarter stand-alone cash flow performance
  - First, we expect to make about \$6 million in additional payments associated with the restructuring programs in Q4, and
  - Second, we do expect to grow working capital dollars associated with what should be a seasonally strong Q4 especially with the greater exposure to retail through Memorex.
- In terms of Q3 working capital, Days Sales Outstanding at 53 days and Days of Inventory Supply at 69 days, both remained unchanged from last quarter. Both of these indices are up from prior year levels due primarily to the impact of Memorex which carries higher working capital needs than our base business average.
- Depreciation and amortization totaled \$10.5 million and Capex \$5.0 million in the quarter.
- We paid \$4.9 million in dividends during the quarter.
- And spent \$10.2 million to repurchase 257,000 shares of common stock under our existing Board authorization which now has 2.4 million shares remaining.

## **OUTLOOK**

- I'll finish with a few comments about our outlook for the rest of 2006.
- As I mentioned a few minutes ago, on the strength of the solid 3<sup>rd</sup> quarter results as well as the solid results in the first half, we have raised our 2006 outlook for both revenue and earnings.
- Revenue is now targeted in the range of \$1.57 to \$1.6 billion for the year or \$445 to \$475 million for the 4<sup>th</sup> quarter. So we have effectively increased our prior guidance ranges by \$30 million on the low side and \$10 million on the high side. The prior ranges were \$1.54 to \$1.59 billion in revenue for 2006.
- We have included a table in today's earnings release which reconciles our Outlook prior to restructuring and Stock Compensation costs to a GAAP basis of reporting including these charges.

- On a GAAP basis, Operating Income is now targeted in the range of \$105 to \$108 million for the year and diluted EPS from continuing operations in the range of \$1.96 and \$2.02 per share.
- These targets assume restructuring costs in the range of \$11 to \$12 million and stock compensation costs of approximately \$10 million for the year.
- Excluding these restructuring and stock compensation costs, our targets for the year are for operating income in the range of \$127 to \$130 million, or \$2.35 to 2.41 per diluted share. This implies operating income for 4<sup>th</sup> quarter in the range of \$33 to \$36 million. We have effectively increased our prior earnings guidance ranges by \$7 million on the low side and \$5 million on the high side. EPS ranges have been increased by 12 to 15 cents per share as well.
- Capital spending is now targeted to be approximately \$20 million, down from \$25 million in our previous guidance.
- Depreciation and Amortization is targeted in the range of \$38 to \$40 million including approximately \$7 million of amortization associated with the Memorex acquisition.

## **SUMMARY**

- In summary, we are very pleased with our third quarter and look forward to finishing the year strong.

At this point, we would be happy to take your questions.