

**Paul Zeller Comments**  
**Second Quarter, 2006 Results**  
**July 27, 2006**

Thanks Brad and good morning.

We are pleased with our solid second quarter performance. As you've seen in our earnings release, we delivered solid operating and net earnings as well as very strong cash flows in the second quarter coming on top of a strong first quarter. We remain confident in and are reiterating our full year 2006 outlook. During the quarter, we closed on the acquisition of Memorex and we've made significant progress in integrating the acquisition. You'll hear more about this from Frank in a few minutes.

Now, before I get into some of the details on the quarter, I'd like to cover a couple of financial reporting matters.

First, given the closing of the Memorex transaction, we are now providing regional segment financial information as well as revenues by product group in our quarterly reporting. You will find this information in the supplemental data sheet attached to the earnings release and on our web site. This segment breakout is in alignment with the way we operate, and we will be providing this information going forward.

Second, several weeks ago, we filed a Form 8-KA with the SEC containing the required historical financial information associated with the Memorex acquisition. I'd like to make you aware of a few important points about the information contained in the document. First, the full year audited financial information presented is as of March 31, 2005, which was the latest audited financial statements for Memorex International, Inc., and these financial statements are presented in HK\$'s and HK GAAP. There is a footnote which reconciles HK GAAP to US GAAP. These financials are presented as they were previously reported by Hanny and as a result do not line up exactly with the assets we purchased and do not reflect the impact of the various accounting entries that have occurred as part of recording the purchase by Imation. To help in understanding these differences, there are also separate December 31, 2005 financial statements included in the filing which are presented in US \$'s and show a pro forma combination of Memorex with Imation. These financials include an estimate of the impact of the preliminary acquisition accounting entries including the recording of intangible amortization in the P&L as well as the assumed loss of interest income on the cash paid at closing. These financial statements and pro forma adjustments do not include any impact for expected synergies.

Now I'd like to get into a few of the details on our second quarter.

## REVENUE

- Revenue totaled \$365.8 million, representing growth of over 21 percent over the second quarter last year including \$65.2 million of incremental revenue from the Memorex acquisition.
- As a reminder, we closed on the acquisition at the end of April so this represents 2 months of revenue. While it's still relatively early in the integration efforts, we're making great progress and we're on target towards achieving our 2006 outlook for this new part of our business. Frank will get into more of the details of the integration in just a few minutes.
- Excluding Memorex, our revenues for the quarter were essentially flat.
  - We continued to experience solid growth in Mid-range Tape, Optical and Flash
  - With anticipated reductions in some of our more mature product categories
- For the 6 months year-to-date, our base business revenues were up 3.1% versus last year, which is right in line with our full year expectations of 2-4% growth prior to the Memorex acquisition.
- Now let me speak specifically to the Product and Regional revenue information we are now providing. As you can see, the mix of our revenues by product and by region has shifted somewhat with the acquisition of Memorex which as you know, is primarily an Optical and Flash products business and operates primarily in the U.S.
- Magnetic Products revenue was \$156 million in the quarter, which includes Tape and Diskettes and now represented 43 percent of total revenues.
- Optical Products at \$158 million also represented about 43 percent of total revenues.
- Flash products revenue totaled \$28 million and represented about 8 percent of revenues.
- The "Other" category, which includes removable hard disk, accessories as well as other miscellaneous product and service revenues totaled about \$24 million and represented 6 percent of total revenues in the quarter.
- Our Americas region revenue totaled \$186 million in the second quarter, about 51% of worldwide revenues.
- Europe revenues which include the majority of our GDM joint venture revenues, totaled \$125 million, representing 34% of the total.
- And Asia Pacific totaled \$55 million, 15% of total revenues.
- Frank will address some of the key drivers behind these revenues by product and region in just a minute.
- Our overall unit growth versus Q2 last year (excluding Memorex) was about 7.5%.
- This was about equally off-set by the negative impact of price erosion on our year-over-year comparisons which was also approximately 7.5% (in the range we had expected).

- The impact of changes in currency exchange rates was not a significant factor in the quarter.

## **GROSS MARGIN**

- Our gross margins, which came in at 23.0% of revenue, were down 6 tenths from last quarter due mainly to the impact of Memorex which carries a modestly lower gross margin than our corporate average. Given the seasonally softer revenues in Q2 versus Q1, we were pleased with this result and had a solid quarter across the board.
  - Mid-range tape margins continued to improve with solid results in our TeraAngstrom facility in Weatherford, OK.
  - Our Diskette margins improved as a result of last quarter's restructuring actions.
  - Optical margins were improved as well, driven by the higher Memorex margins now in the mix.
  - We did see modest margin declines, however, in Data Center products coming off a seasonally high Q1. Data Center margins were relatively consistent, however, compared to the same quarter a year ago.
- Gross margin was down 2 points from the year ago quarter.
  - This was due mainly to product mix where we saw increases in Optical, Flash and Mid-range Tape which carry lower margins than some of our older Tape formats which experienced revenue declines versus last year.
  - This mix impact was fully anticipated and we were pleased with the 23% gross margin result in the quarter.
- It should also be noted that our Memorex margins were very strong and met our expectations in the quarter across the board ... in Optical, Flash as well as accessories.

## **R&D EXPENSES**

- R&D costs were \$12.3 million; generally in line with our expectations.

## **SG&A EXPENSES**

- Selling, General and Administrative expenses were \$44.4 million, or 12.1% of revenue during the quarter.
  - This was up \$9.1 million from last quarter due to the addition of Memorex SG&A expenses, incremental intangible asset amortization associated with the acquisition and higher stock compensation expense.
  - SG&A was up \$6.4 million from the second quarter last year driven by these same factors off-set by reductions in our base level of SG&A.

- Our worldwide headcount ended the quarter at approximately 2,140 up about 80 from last quarter. This reflects the addition of about 200 Memorex employees off-set by reductions associated with our 2006 restructuring program. Most of the current quarter reductions were related to the manufacturing downsizings announced last quarter.

## **RESTRUCTURING AND OTHER**

- So on the topic of restructuring, during the 2nd quarter, \$8.9 million of restructuring costs were incurred primarily associated with integrating the Memorex acquisition and continued efforts to simplify structure around the world. The majority of the charges, \$6.8 million, related to severance for approximately 90 people. The remainder was associated with lease termination costs and asset write-offs.
- We had originally estimated total restructuring and related costs would range between \$13 and \$17 million for the year 2006. With the \$1.8 million we incurred in Q1, we have now incurred a total of \$10.7 million through the first 6 months. We remain comfortable with the overall range of \$13 to \$17 million for the full year 2006.

## **STOCK COMPENSATION COSTS:**

- We implemented Financial Accounting Statement 123R last quarter which requires the expensing of stock options. We recognized \$2.5 million in incremental stock compensation expenses in the 2<sup>nd</sup> quarter compared to last year. We are estimating the total year impact to be in the range of \$10 to \$12 million from incremental stock compensation costs.

## **OPERATING INCOME**

- We delivered \$18.6 million in operating income in the quarter including \$11.4 million of restructuring and stock compensation costs I just mentioned. Excluding these costs, operating income would have been \$30 million at 8.2% of revenue for the quarter. This represents an increase of 26 percent from operating income of \$23.8 million last year. This was driven by the incremental income contribution from the Memorex acquisition. Our base business was up slightly in operating income year over year once adjusting for restructuring and additional stock compensation costs. On a 6 months to date basis, our base business was up between 3 and 4 percent versus last year (excluding restructuring and stock compensation costs), very much in line with our expectations of 2-4 percent growth.

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

- In the non-operating area, we generated about 200 thousand in income during the quarter compared with \$1.0 million in income in the year ago quarter. This decrease was primarily due to an investment loss associated with a minority equity investment.
- Our tax rate in the quarter was 31.4%, down from the 36.8% rate we experienced last quarter
  - This is due to a one time tax benefit associated with the filing of an amended prior year tax return.
  - Our outlook for full year tax rate is now targeted in the range of 35 to 36 percent as a result.
  - The tax rate for second half is still targeted in the 36 to 37 percent range.
- Now I'd like to walk you through the various factors impacting EPS from continuing operations in order to give you an apple to apples comparison to a year ago as outlined in our press release.
  - On a reported basis, diluted EPS from continuing operations for 2<sup>nd</sup> quarter was 37 cents this year compared to 46 cents in the second quarter last year.
  - Included in this year's result is a 20 cent per share penalty for restructuring and stock compensation costs compared to last year.
  - This year's results were benefited by 3 cents due to a lower tax rate.
  - So adjusting for these items which net to 17 cents per share, EPS on a pro forma basis was up 17 percent to 54 cents per share versus last year.
  - This increase is attributable to the incremental 2 months of Memorex results with the base business remaining relatively flat.
- This analysis relates only to continuing operations. We did have a \$1.2 million after-tax gain in discontinued operations primarily as a result of an earn out payment we received associated with the Specialty Papers business that we sold last year. This was a negotiated finalization of all earn out obligations potentially due from the purchaser of that business.
- So diluted EPS including this amount totaled 40 cents per share in the 2<sup>nd</sup> quarter.

## **WORKING CAPITAL & CASH FLOW**

- Cash and Equivalents ended the quarter at \$223.8 million, down just short of \$300 million from last quarter driven by the Memorex acquisition.
- Excluding the impact of the acquisition purchase price, Cash and Equivalents were up \$32.3 million in the quarter driven by cash generated from operations which totaled \$30.2 million in the quarter.
- In terms of working capital, total Receivables plus inventory less payables increased \$90.5 million, almost entirely due to acquired Memorex working capital. The base business was nearly flat.
- In terms of working capital days, DSO increased 7 days from the same quarter last year to 53 days. The majority of this increase was due to the relatively higher terms associated with the Memorex business.
- Inventory days of supply ended the quarter at 69 days, up 1 day compared to a year ago.
- Depreciation and amortization totaled \$9.7 million in the quarter, up \$1.8 million from last quarter due to the addition of amortization associated with the Memorex purchase.
- Capex totaled \$3.8 million in the quarter.
- We paid \$4.6 million in dividends during the quarter.
- And paid \$10.4 million to repurchase 268,000 shares of common stock. 2.7 million shares remain under our previous authorization.

### **MEMOREX ACQUISITION ACCOUNTING IMPACTS**

- As previously announced, the cash purchase price paid for Memorex was just under \$330 million. In addition, earn out payments are payable in the future based on the financial performance of the business and range from \$5 to \$45 million. The present value of the low-end of this range has been recorded as of closing.
- We incurred transaction fees which we estimate will total about 2% of the purchase price, or about \$6 million. These primarily include investment banking, legal and accounting fees.
- In addition, costs associated with restructuring Memorex facilities and severing Memorex employees are included in the total purchase price for accounting purposes. As of June 30<sup>th</sup>, we have recorded about \$4.9 million of these charges and expect an additional \$4.5 million as we complete the integration process. As a reminder, these charges are not included as restructuring costs in the P&L and will be included as part of the purchase price.
- So including the earn out, transaction fees and direct restructuring costs, the gross value of purchase price allocated to assets totaled approximately \$345 million. We have assigned approximately \$62 million to net tangible assets, \$200 million to the Memorex brand, \$31 million primarily to customer relationship value, with the remainder, approximately \$52 million, to goodwill.
- Any future changes to the purchase price are expected to increase or decrease goodwill.
- The Brand and Customer Relationship Value are amortizable with the annual expense estimated in the range of \$10 to \$11 million. For the eight months of 2006

beginning at closing, we expect approximately \$7 million of amortization and recorded \$1.7 million in the second quarter.

## **OUTLOOK**

- I'll finish with a few comments about our outlook for the rest of 2006.
- Overall, our targets are for the most part, unchanged from those established coming out of 2005.
- We continue to target total Revenues in the range of \$1.54 and \$1.59 billion including Memorex.
- GAAP Operating Income remains targeted in the range of \$93 and \$98 million and EPS in the range of \$1.70 and \$1.80 per diluted share.
- Our earnings targets continue to include restructuring charges estimated to range between \$13 and \$17 million for the year as well as an estimated \$10 to \$12 million in stock compensation costs that are incremental to prior year's results.
- Excluding these restructuring and stock compensation costs, our targets are for operating income in the range of \$120 and \$125 million, or \$2.20 to 2.29 per diluted share. These targets include the results for Memorex.
- Our tax rate is expected to be in the range of 36 to 37% for the rest of the year.
- Capital spending remains targeted at approximately \$25 million.
- Depreciation and Amortization is targeted in the range of \$38 to \$42 million including approximately \$7 million of amortization associated with the Memorex acquisition.

As a final comment on our outlook, it's important to remember a couple things about the second half of the year and the results for Q3 versus Q4.

- First, Q3 is always a softer quarter than Q4 seasonally.
- Second, the majority of our synergy benefits will be realized towards the end of the year.
- Finally, because of Memorex, we have an increased presence in retail which tends to have a stronger Q4 than Q3.
- As a result, we expect Q4 will be a particularly strong quarter compared to Q3. These comments exclude the impact of restructuring which could vary across the two quarters.

## **SUMMARY**

- In summary, we are very pleased with our second quarter and the first half of 2006. We're on plan towards achieving our 2006 outlook and as Frank will describe in greater detail, we've made good progress in integrating the acquisition of Memorex.

At this point, I'll turn the call over to Frank Russomanno, Imation's Chief Operating Officer.