

# FINAL TRANSCRIPT

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## **IMN - Q2 2010 Imation Corp. Earnings Conference Call**

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## CORPORATE PARTICIPANTS

**Tim Gallaher**

*Imation Corporation - Treasurer & IR Director*

**Mark Lucas**

*Imation Corporation - President & CEO*

**Paul Zeller**

*Imation Corporation - SVP & CFO*

## CONFERENCE CALL PARTICIPANTS

**Blaine Marta**

*Globe Capital Management - Analyst*

**Mark Miller**

*Noble Financial - Analyst*

**Chuck Murphy**

*Sidoti & Company - Analyst*

**Jeff Hershey**

*Columbia Management - Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to your Imation announces Q2 earnings conference call.

At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions will follow at that time. (Operator Instructions) As a reminder today's conference call is being recorded.

I would now like to introduce your host for today's conference call, Mr. Tim Gallaher. You may begin, sir.

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**Tim Gallaher** - *Imation Corporation - Treasurer & IR Director*

Thank you, Kevin. Good morning, everyone, and welcome to our quarter two 2010 earnings conference call. On today's call you will be hearing from our CEO, Mark Lucas, and our CFO, Paul Zeller.

Before I turn the call over to them for their comments followed by your questions, I want to remind everyone that certain information discussed on this call that does not relate to historical information may be deemed to constitute forward-looking statements. 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 both the press release as well as our filings with the SEC.

With that I would like to turn the call over to Mark. Mark?

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**Mark Lucas** - Imation Corporation - President & CEO

Thank you, Tim, and good morning, everyone. First, let me comment on the quarter. While we continued to make progress in the evolution of our business model, we clearly need to drive for improved revenue and earnings. While getting better, our results are simply not strong enough.

Now having said that we have been able to continue our return to solid cash flow and we have improved gross margins and costs across our businesses. I believe these improvements are sustainable over the longer term and I think Imation has strong fundamental business practices in place.

As we leverage our data storage technology legacy into our strategy of storing, protecting, and connecting the digital world I have every confidence we will demonstrate improved financial performance.

I was able to meet several of you during May when Paul Zeller and I were out on the road and I want to thank you for the time you spent with us. I appreciate the dialogue we had and I look forward to continuing that with you. I am excited to be leading Imation and have great confidence we can leverage our core capabilities.

Now let me turn the call over to our CFO, Paul Zeller, who will review the financial details of the quarter. Following his summary I will rejoin the call with Paul to answer any questions you have.

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**Paul Zeller** - Imation Corporation - SVP & CFO

Thanks, Mark, and good morning, everyone. Our Q2 results were much like our first quarter's as we continue to build momentum in several important parts of the business. We continued to grow significantly in our emerging storage category that was up 31% in the quarter and 37% so far this year.

Our gross margins were stable overall with some continuing improvements in our growth categories, both in emerging storage as well as electronics and accessories. Operating expenses were well-controlled, working capital indices continued to improve, and cash flows were again very strong in the quarter with our cash balances now over \$250 million and that is up over \$160 million from the year-ago quarter.

That said, we need further improvements before our overall results start coming in line with our long-term financial goals. While the decline rates in our core optical and tape markets were consistent with the first quarter, we need further growth elsewhere to offset these double-digit declines and to deliver total company growth. [And the level of] operating earnings, while encouraging relative to last year, is clearly not sufficient yet to provide a fair return to our shareholders.

We remain very focused on strategies and actions to bring our current results in line with our long-term financial goals.

Now before getting into the details on our Q2 results, I would like to cover some reporting changes we implemented in the quarter. Based on how we are now managing the business around the world we have realigned our corporate segments and our reporting structure.

Essentially we have combined the electronic products segment with our Americas segment. In addition, we have separated the Asia-Pacific segment into North Asia and South Asia regions. Each of these segments has responsibility for selling all of our product lines.

Along with this realignment we have also changed our product revenue disclosures which are now -- first, traditional storage products which includes magnetic and optical and other traditional storage media; second, emerging storage products which include splash and hard disk-related storage products; and then, finally, electronics and accessories.

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In addition to the change in our product reporting structure, we have also added product gross margin disclosures. These disclosures are aligned with how we are managing the business today and the addition of gross margins by product category will help investors better understand the underlying trends in the business. We have provided the financial history of these new disclosures in Table 6 attached to our earnings release we issued this morning.

Now let me get in to the Q2 results. Our revenues were at \$354.4 million, that was down 11.4% versus the same quarter last year. This rate of decline was moderated from the decline rates we experienced last year which were as high as 20%. We did, however, see a modest increase from the 8% decline rate we saw in Q1 this year.

The most significant driver to this was video electronic products. Our decision to exit the highly volatile TV category in the second half of last year had the most significant impact to our Q2 comparisons. Traditional storage revenues declined about 14% driven by both optical media and magnetic tape. This was almost identical to the Q1 decline rates we saw.

Our emerging storage revenues increased nicely during the quarter, as I had said earlier, up 31% on top of a 43% increase in the first quarter. The majority of this increase was in the flash category but hard disk products were also up year over year.

From a segment standpoint, our Americas segment was down 14% in the quarter. That was driven by continuing declines in traditional storage as well as video products.

Europe was down a disappointing 25% year over year driven by declines in both tape and optical revenues. Our Europe business is more concentrated in our traditional storage category and thus receives less benefit from emerging storage and electronics and accessories. In addition, currency translation was a penalty during the quarter.

North Asia revenues grew 4% with strong volume growth. This region was also aided by a stronger yen versus the dollar. South Asia grew 6% also aided by positive currency impacts.

Overall, when you look at our roughly 11% decline in total revenues it came from about a 3-point impact from lower volumes, a 9-point impact from price erosion, offset by a 1-point positive impact in currency translation.

Our gross margins in the quarter were 16.5% to sales, that is up six-tenths versus last year's second quarter which was at about 15.9%. We improved margins in both emerging storage products as well as electronics and accessories. In the case of emerging storage, margins were up in both flash as well as hard disk products. While we are making good progress here, we still have significant room for improvement as our margins remain in the upper single digits in this category.

In electronics and accessories we continued the gradual improvement we have seen over the last year, almost year and a half. All of the product categories were in the double-digit range and our accessory margins were particularly strong, especially in areas such as headphones.

Our traditional storage margins are very stable year over year with gains in optical products offset by declines in magnetic tape.

As we look at our margins sequentially, we were down slightly from quarter one with mix playing a role as expected. I would like to remind everyone that Q1 does tend to be our highest gross margin percentage quarter due to seasonal mix benefits.

Our operating expenses totaled \$55.4 million in the quarter, that is down \$8.5 million or 13% from second quarter of last year. This was driven by lower legal costs after having settled the Philips litigation in July of last year. It was also benefited by our restructuring and cost control actions.

As a percent of sales, OpEx was 15.6% in the quarter, that is down from 16% last year. We had \$3.4 million of restructuring charges during the quarter, those related to our previously recorded restructuring program. In addition, we recorded a \$23.5 million goodwill impairment charge during the quarter.



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As I just mentioned, we combined the electronics products reporting unit with the Americas unit as part of our realignment. As a result of doing that we were required to test goodwill for impairment. The Americas reporting unit had a fair value significantly lower than book value prior to this combination and, therefore, once we combine the units an impairment was triggered. There is no goodwill remaining on the balance sheet after this charge.

Including these non-recurring charges we had an operating loss of \$23.8 million in the second quarter. Excluding those charges, operating income in the quarter was \$3.1 million and that represents a \$3.6 million improvement over \$0.5 million loss last year, also excluding charges.

Non-operating expenses totaled \$2.9 million in the quarter. That is down from both Q2 last year and from the prior quarter this year driven by lower currency-related costs.

We recorded an \$11 million tax benefit in the quarter associated with our pretax loss of \$26.7 million for a tax benefit rate of about 41%. On a per share basis we had a loss of \$0.42. If we adjust this to exclude the charges I just mentioned, we would have had earnings per share of about \$0.02. That compares to a loss of \$0.05 last year on the same basis excluding charges.

Our financial position continued to improve with cash up another \$27 million in the quarter and up \$88 million since the end of last year. Cash ended the quarter at \$251.3 million and we had no debt outstanding. Our cash flows in the quarter were driven by continued improvements in working capital as well as cash earnings.

I would like to remind everyone that our quarterly earnings carry a depreciation and amortization burden of over \$10 million while capital spending was only about \$2 million in the quarter.

In summary, we were encouraged by the continuing improvements in our operating trends during the quarter with stable gross margin performance and operating costs well controlled. Our balance sheet indices continued to improve and we continued to generate solid cash flows.

At this point Mark and I would be pleased to take your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) [Blaine Marta], Globe Capital Management.

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### Blaine Marta - *Globe Capital Management - Analyst*

Thanks for taking the call. Two questions. Mark, you have been at the Company for a little while now. Can you give us your assessment, your review, of all the operations, all the segments, perhaps even justify the existence of some of the segments?

In the electronics segment, I mean, what are you looking to do? Are you continue to exit, are you going to build? It's not the greatest business in the world. Maybe you could just help us understand your strategic thinking.

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### Mark Lucas - *Imation Corporation - President & CEO*

Sure. Actually, I have been at CEO now for just a little over 60 days, although I had been involved with the Company much longer. I would say operationally we continue to make progress.

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Since I came in as COO about a year and a half ago we have done a lot of working capital management programs. We have done a lot of rescaling in sales, marketing, engineering, and other areas so we continue to evolve the Company to be able to address a very dynamic and fast-paced competitive market out there.

We have just realigned our businesses to look at them and report them the way we have -- will now be managing them going forward. So we have traditional storage, as Paul said, emerging storage, and CE and accessories. And with our stated strategy of being a global technology company that focuses on storing, protecting, and connecting digital data I think each of those three categories plays a very important role in our future.

CE and accessories, when acquired a couple of years ago, was a different model than in the manner in which we want to operate it. It was a low margin, low differentiated product line. We have been evolving that to be a highly differentiated, higher margin CE line. And I believe it has got a great future for us as we move forward as long as we continue to develop the products in a selective and differentiated mode under the Memorex -- primarily under the Memorex and TDK brand names.

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**Blaine Marta** - *Globe Capital Management - Analyst*

Okay. In that business who do you emulate as far as best practices?

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**Mark Lucas** - *Imation Corporation - President & CEO*

Again, we have different models. So the Memorex brand is positioned after the modern mom, and quite honestly there is not a real emulation there because most of the products are not in the CE space modeled for the modern mom. So that means the user interface changes, the design changes. We use light colors and pastel colors. It has received great, great reviews on Best Buy and Wal-Mart, for example; both of which are trying to appeal to their female customer.

The TDK brand is positioned more towards the male audiophile so I would say there you could look at us as the type of JBL-type brand.

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**Blaine Marta** - *Globe Capital Management - Analyst*

Okay. Now speaking of accessories in terms of the business, differentiating yourself.

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**Mark Lucas** - *Imation Corporation - President & CEO*

Yes, in accessories -- we view accessories as a high-margin, opportunistic category that complements the CE and the storage area. So what we try to do there is develop products in the marketplace that our customers, our retailers have said that they want.

So, for example, some of the gaming, the Wii products that we had -- the wheels, the steering wheels, the pads, and so forth -- are simply superior products that have features in them that moms and families have asked for. For example, we have just gotten them place in Toys 'R' Us in a fairly significant manner. Wal-Mart is looking at them as well simply because, again, some of the features and benefits that we have that others don't.

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**Blaine Marta** - *Globe Capital Management - Analyst*

Okay. And then bring us in to your boardroom in terms of what you are thinking as far as uses of cash, reinstating the dividend or acquisitions? What is the talk and the strategic plan there?

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**Mark Lucas** - *Imation Corporation - President & CEO*

Well, obviously I can't bring you into our boardroom but I would say to you that we are very pleased that we are building up cash. If you went back a year ago, just over a year ago, we were much, much lower in our cash build than we are today. So this is not something that we have been sitting on or hording for a very long time period.

Given the current economic climate, we, the management team and the Board, want to be very cautious in terms of what we do. So we are going to continue to consider all options but there is no definitive agreement as to what we are going to do at this point.

**Blaine Marta** - *Globe Capital Management - Analyst*

I would think any acquisitions you might do would be on the smaller nature or would you see anything medium or large size?

**Mark Lucas** - *Imation Corporation - President & CEO*

I would say to you that at this point in time we want to be, again, very judicious and very cautious moving forward and we don't intend to make any big bets.

**Blaine Marta** - *Globe Capital Management - Analyst*

Thank you very much.

**Mark Lucas** - *Imation Corporation - President & CEO*

Thank you.

**Operator**

Mark Miller, Noble Financial.

**Mark Miller** - *Noble Financial - Analyst*

You saw a significant decline in Europe, like a lot of firms, but some firms reported that decline was earlier in the quarter and things seemed to be improving as the quarter ended and they went into July. I am just wondering about the linearity you are seeing in Europe.

**Paul Zeller** - *Imation Corporation - SVP & CFO*

Hey, Mark. This is Paul. Europe was disappointing for us, to be honest. It did have a much more negative currency element to it, but beyond that it was difficult in our core media categories. There were some unique events that we think are more quarter two specific, but in general I think we have some room to improve in Europe.

From a linearity standpoint, without getting into the details, I would say it was actually a bit more of a June issue that it was an April or May and I think a bit more unique to June rather than long standing. But, clearly, we can't live with a 25% decline rate in any of our regions long-term and we think we are going to moderate from that as we look to the future.

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**Mark Miller** - Noble Financial - Analyst

Was wondering also if you could give us a little more color on what went on with data center products?

**Mark Lucas** - Imation Corporation - President & CEO

Yes, data center was down sequentially, as one might expect, because we tend to see a little bit bigger data center business in first quarter than second. Year over year data center and the rest of magnetic had a quarter much like we had in first quarter. We were down 14-some-percent overall in tape.

And data center has the same megatrends that we have been talking about, Mark, in terms of over time the move somewhat away from proprietary formats. But we do like our position with Oracle in terms of the T10000 program. We like the fact that we are the path to market for both the major OEMs in the market and that we have a major share in data center. So it's a good business for us.

**Mark Miller** - Noble Financial - Analyst

One thing, and I don't know if this would be a thought, any ideas if you can monitorize your IP portfolio or do anything with that?

**Mark Lucas** - Imation Corporation - President & CEO

We look at all options, Mark, and I think that -- we got time looked at, do we think we should use some of our IP and move towards a licensing model, especially maybe even some of our brand intellectual property. When it comes to that, though, we believe there is more for us to add value to the shareholder by managing those brands ourselves and driving value that way.

In terms of the technology side of things, we do license some of our technology and license other technology, as you would I am sure realize in the industry, so we do get some value for our technology. And we continue to develop more of it so it's an important asset to the Company.

**Mark Miller** - Noble Financial - Analyst

Thank you.

**Mark Lucas** - Imation Corporation - President & CEO

Thanks, Mark.

**Operator**

Chuck Murphy, Sidoti & Company.

**Chuck Murphy** - Sidoti & Company - Analyst

Good morning, guys. I guess first wanted to thank you for the new segment reporting. I think it's going to help with the transparency.

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I was just wondering though if you could help me tie out the new way you report with the old one. I noticed it looks like maybe magnetic you took something out of there and put it into the emerging storage. Is that correct?

**Mark Lucas** - *Imation Corporation - President & CEO*

No, I don't believe so. Is there a particular issue that you are trying to tie out? Maybe we can help you with that.

**Chuck Murphy** - *Sidoti & Company - Analyst*

It just looked like if I took the way you reported magnetic last quarter versus this quarter, it looked like a very sharp sequential decline. I didn't know if it was because -- that had to do with the change in segment reporting.

**Mark Lucas** - *Imation Corporation - President & CEO*

You know, it may be that audio video products has moved into a different category. Maybe we can check on that and get back to you. That is a magnetic product but it's not tape specifically.

If you look inside of traditional storage products, I know AV is in there. I think, though, it has moved from the magnetic to the other storage category within that. Do you follow me?

**Chuck Murphy** - *Sidoti & Company - Analyst*

So AV might be going from the old magnetic to the new other traditional storage? Is that --?

**Mark Lucas** - *Imation Corporation - President & CEO*

Someone just confirmed that for me. That is exactly what has happened so there is a bit of a sequential issue. We have recast all the numbers and if you look at the new numbers, they would reflect it this way going back.

**Chuck Murphy** - *Sidoti & Company - Analyst*

I got you, okay. And then is the electronic and accessories category roughly the same as what it was before?

**Mark Lucas** - *Imation Corporation - President & CEO*

Yes.

**Chuck Murphy** - *Sidoti & Company - Analyst*

All right. I know I have kind of asked a lengthy question here so I will have to take a look at it and ask you guys a little bit later. All right, that is all I had. Thanks.

**Mark Lucas** - *Imation Corporation - President & CEO*

Okay. Thanks, Chuck.

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**Operator**

Jeff Hershey, Columbia Management.

**Jeff Hershey** - Columbia Management - Analyst

Good morning, everyone. Paul, you have mentioned long-term financial goals a couple of times. Can you just share those with investors here on the call what the long-term financial goals of the Company are now?

**Paul Zeller** - Imation Corporation - SVP & CFO

Sure. One of the charts in our investor relations presentation we were out on the road talking to folks about and out on our website, I referenced the long-term goal we have of bringing our return on invested capital in line with our weighted average cost of capital. And I have talked about that being somewhere in the low teens, 10% to 15% range.

In order to do that with the asset turns that we are generating and we believe we can generate, we need to see our operating margins move significantly beyond the 1% to 2% range at best we have been experiencing. And we need to be in the 4%-plus range. That is clearly a long-term financial goal this company has to have.

Then we have been pretty clear over time that the total company revenue has to turn around and start growing at some stage. And so as we look at our long-term goals, clearly, it's for some degree of revenue growth at margins that are 4%-plus.

**Jeff Hershey** - Columbia Management - Analyst

Okay. And do you think you can do that internally or do you need to go out and make acquisitions to achieve those goals?

**Mark Lucas** - Imation Corporation - President & CEO

You know, I think we will look at all the options as we have talked about and we were pretty clear about that as well in terms of cash deployment strategies. Clearly in the near term, organically, growing the total company is going to be a challenge. We are working hard on a lot of those growth categories and you are seeing some really good results in emerging storage.

If you pulled out the TV issue out of video, you would see a much bigger picture there in the electronics area as well. But when 70%-plus of your revenues are in traditional storage and some level of legacy decline that has been difficult to offset in the near term. And for the near-term future that will also be true.

We are working hard at it and we clearly believe over time we can get this company to grow. We will look at both organic and inorganic actions to do that.

**Jeff Hershey** - Columbia Management - Analyst

On the electronics and accessories, the business is still in decline and you referenced some of the TV products. When do we fully lap those issues and when should we start to see that category growing?

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**Mark Lucas** - Imation Corporation - President & CEO

Yes, it takes till about fourth quarter of this year when we are comparing -- well, fourth quarter of last year we still had some TV revenues as we are selling through some of our excess inventories. It was higher in second and third quarter last year, but there were still TV revenues in fourth quarter of last year. So it really will take till 2011 till we have a totally clean comparison in terms of that rationalization.

**Jeff Hershey** - Columbia Management - Analyst

Okay. And then finally, when do you think the Board will come to a conclusion regarding the cash balances? Imation is a company that used to have a nice, healthy dividend. There is no dividend now; we didn't buy back any stock during the quarter.

I know you are deliberating and thinking about options, but can you lay out a timeframe for when you might be able to articulate that to shareholders?

**Mark Lucas** - Imation Corporation - President & CEO

Yes, I guess I can't be really specific on timeframe but what I will say is look at our track record historically. When we have excess cash that we don't have an appropriate and accretive use for, either organically or inorganically, we have recognized that the cash on our balance sheet is not getting the return our shareholders want and we have looked at other strategies, including both share repurchase and dividends.

That is not promising what we are going to do or when we are going to do it except that we understand, we get the math. We understand that you don't want a lot of cash just sitting on a balance sheet not deployed and we get that math.

**Jeff Hershey** - Columbia Management - Analyst

Okay. I didn't know whether you are going to be deploying the majority of that cash going forward through acquisitions or it's going to be a more balanced approach. That would be helpful. It sounds like it's going to be a more balanced approach in reference to a question cited earlier, but I would appreciate your comments on that.

**Mark Lucas** - Imation Corporation - President & CEO

We are looking at all the options and I think we are going to have more to say as time goes on.

**Jeff Hershey** - Columbia Management - Analyst

Okay. Appreciate it. Good cash flow generation and good luck.

**Mark Lucas** - Imation Corporation - President & CEO

Thank you.

**Paul Zeller** - Imation Corporation - SVP & CFO

Thank you.

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**Operator**

Mark Miller, Noble Financial.

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**Mark Miller - Noble Financial - Analyst**

Just wondering number of storage; Intel and some other PC firms are seeing kind differentiated demand that in the consumer area there is weakening there but at the same time business volume has stepped up and has continued to -- expected to be strong going forward. I am just wondering what you are seeing in your storage products.

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**Mark Lucas - Imation Corporation - President & CEO**

As you know, Mark, one of the benefits that we have is our breadth. We are in all the regions of the world, we are in a lot of different channels, and we carry a number of important brands to market. And so the good thing is we have a nice exposure across consumer and commercial channels.

I think we are not seeing a significant difference in one part of the business or another. I think one of the benefits, as I said, is that we have a bit of a diversification that helps moderate any changes one way or another. But I don't think there is anything dramatically different between the businesses as we see it.

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**Paul Zeller - Imation Corporation - SVP & CFO**

One area, Mark, that we shared with you when we saw you in May that had very, very good response to it is our flash security devices that are FIPS certified. Under the Defender series, we launched those a couple of months ago and they are getting rave reviews and a lot of interest on that commercial side. So that is one area of commercial business that we are very bullish on.

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**Mark Miller - Noble Financial - Analyst**

Are you being impacted by the -- there is very strong demand right now for flash. Is that having any effect at your business there? Flash chips I should say.

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**Mark Lucas - Imation Corporation - President & CEO**

We are really not into the commodity USB flash business. What we are really focusing on here is differentiated security products, of which flash is one of them. So I am referring probably more to the interest on the data security side.

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**Paul Zeller - Imation Corporation - SVP & CFO**

We do, Mark, as you know, we do have more broad business in USB flash in certain parts of the world. Clearly, we need to buy, write, and maintain minimal amounts of inventory so that as there is changes in the whole cost side of it we are matching that with our sell-through.

And so we try to manage inventories very tightly in flash. We understand that volatility can be very high in this category and we need to be very tightly managed because of that.

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**Mark Miller** - Noble Financial - Analyst

Thank you.

**Operator**

(Operator Instructions) There are no further questions at this time.

**Mark Lucas** - Imation Corporation - President & CEO

Great. I would like to thank you all for participating in today's call. As I stated earlier, I really am excited about leading Imation and I am very confident in our opportunities ahead. I look forward to talking with you again next quarter to discuss our progress. Thank you.

**Operator**

Ladies and gentlemen, this does conclude today's presentation. You may now disconnect.

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