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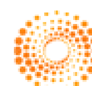
PBI - Q2 2011 Pitney Bowes Inc Earnings Conference Call

Event Date/Time: Aug. 04. 2011 / 9:00PM GMT



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PRESENTATION

Operator

Good afternoon and welcome to the Pitney Bowes second quarter 2011 earnings results conference call.

(Operator Instructions)

Today's call is also being recorded. If you have any objections, please disconnect your lines at this time. I would now like to introduce your speakers for today's conference call. Mr. Murray Martin, Chairman, President, and Chief Executive Officer. Mr. Michael Monahan, Executive Vice-President and Chief Financial Officer, and Mr. Charles McBride, Vice-President, Investor Relations. Mr. McBride will now begin the call with a Safe Harbor overview.

Charles McBride - *Pitney Bowes Inc. - VP, IR*

Thank you. Good afternoon. Included in this presentation are forward-looking statements about our expected future business and financial performance. Forward-looking statements involve risks and uncertainties that could cause actual results to be materially different from our projections. More information about these risks and uncertainties can be found in our 2010 Form 10-K annual report and other reports filed with the SEC, and are located on our website at www.PB.com by clicking on our Company and Investor Relations. Please keep in mind that we do not undertake any obligation to update any forward-looking statements as a result of new information or developments. Now, our Chairman, President and Chief Executive Officer Murray Martin will start with an overview of the first quarter. Murray?

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Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Thanks, Charlie. Good afternoon, and thanks for joining us. Let me start by sharing some thoughts on our performance, and then Mike will follow with the details on our second quarter results. I'll then discuss our guidance for the full year. After that, we will take your questions.

During the quarter, we continued to see the benefits of our ongoing actions to lay the foundation for long-term growth and profitability across our business portfolio. There were 3 positive trends that underscored our progress in executing our plans. First, there was continued growth in equipment and software sales. Equipment sales increases were led by strong sales of our high-speed inserting systems in North America and Asia, as well as good placements of our Connect+ in North America and the UK.

When we launched the innovative Connect+ system last year, we stated our expectation that it would be a key component in driving the future mailing equipment sales. Software growth continued to be fueled by strong demand worldwide for our customer communication and data management software solutions. Software's recurring revenue streams also continued to grow this quarter, as the number of multi-year licensing agreements increased.

The second positive trend during the quarter was that the combined recurring SMB revenue streams of supplies, rental, and financing, declined at a lesser rate than both the prior quarter and the prior year. These declines should continue to moderate as SMB equipment sales improve.

The third positive trend was our improvement in EBIT margin, particularly in our SMB and software businesses. This was despite an unsettled global economic environment. We continue to focus on streamlining our operations and increasing the variability of our cost structure. Our disciplined approach is enabling us to enhance margins, even as we experience revenue softness, particularly in our SMB markets. It is also helping us to better leverage revenue growth, as we saw in our software business.

It's also important to note that, as expected, the quarter's revenue and earnings were reduced by the impact of the fire that destroyed our largest presort facility in the first quarter of this year. The lower mail services revenues associated with the fire at our Dallas presort facility reduced our second quarter revenue growth by approximately 1%, and lowered our earnings per share by $0.03 per diluted share.

The substantial savings made possible by Strategic Transformation have allowed us to make critical investments in new solutions and enhancements to our customers' experience. During the quarter, we continued to invest in the development of the customer communications management market and introduced a number of new solutions. We've added the pbSmartMarketer, and pbSmartCodes to our family of pbSmart solutions, our cloud-based customer communications management solutions for small and medium businesses. pbSmartMarketer is a cloud-based software solution that allows businesses to identify potential new customers modeled after their existing customer base, create customized marketing campaigns, and track and measure the success of those campaigns. PB Smart Codes is a cloud-based software solution that enables businesses to create interactive marketing campaigns, using a unique, quick response, or a QR code. Before I discuss our guidance for the year and provide some closing remarks, Mike will provide an overview of our second quarter financial results.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Thanks, Murray. Our revenue for the quarter was $1.3 billion, an increase of about 1% on a reported basis when compared with the prior year. Revenue would have grown 2%, if it were not for the adverse impact from the February fire at our presort facility in Dallas. Currency was a 3% benefit to revenue growth during the quarter. Breaking down our revenue for the quarter between US and non-US operations, US revenue declined by about 4%.Outside the US, revenue on a reported basis increased 16%, versus the prior year. Excluding the impact of currency, revenue outside the US increased 4%. Non-US operations now represent 33% of our total revenue. While the Dallas fire impacted our first half revenue growth, less than 5 months after the fire, at the end of June, we opened a new facility. This new facility re-establishes our unique ability to achieve a high level of presort discounts

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nationally. We expect the new site to be operating at full efficiency during the third quarter. In the second quarter, revenue and EBIT were adversely impacted by about $9 million each, as a result of the facility disruption.

As of today, we have received partial payments totaling approximately $25 million from our insurance carriers, of which $15 million was received prior to June 30th. We will not recognize a portion of current and future proceeds related to business interruption and other recoveries in earnings until the allocations of these proceeds are resolved with the insurance company. If the insurance claim is not finalized in the current year, we estimate 2011 adjusted earnings could be reduced by about $0.06 to $0.08 per diluted share, of which $0.05 was already incurred in the first half of the year. Adjusted earnings before interest and taxes, or EBIT for the quarter, was $213 million, which was 5% higher than last year. EBIT margin was 16.2%, an improvement of 60 basis points versus the prior year. EBIT margin would have been even higher except for the Dallas fire impacts. Adjusting for the impact of the fire, EBIT margin would have been 16.7%. We continue to see the benefits of our productivity initiatives across our cost structure.

SG&A expense in the quarter increased about $10 million when compared with the prior year. Excluding the effects of currency, SG&A actually declined by about $7 million, when compared with the prior year. SG&A benefited not only from our ongoing productivity initiatives, but also from lower credit losses, which we have seen continue this quarter. EBIT margins this quarter improved year-over-year in both our SMB and Enterprise Solutions Groups. These improvements are primarily a result of our continued focus on increasing our operating efficiency across all of our businesses. We continue to reap the benefits of the Strategic Transformation actions that we have taken since the fourth quarter of 2009. Through multiple initiatives, including reinvestments in the business, we have significantly increased the variable portion of our cost base, to allow us to leverage future revenue growth, and quickly and cost-effectively respond to a changing business mix. When we add back depreciation and amortization to our adjusted EBIT, adjusted EBITDA for the quarter was $281 million, or $1.38 per share.

Net interest expense in the quarter, including financing interest, was $49 million, a modest decrease of less than $2 million, on lower debt levels when compared with the prior year. The average interest rate in the quarter was 4.68%, 29 basis points higher than the prior year, due to changes in our debt portfolio mix. The effective tax rate for the quarter on adjusted earnings was 33%, versus 31.5% last year. The tax rate for this quarter is in line with our expectations. We expect the average tax rate for the year on adjusted earnings to be in the range of 32% to 34%, excluding the impact of a recent tax settlement with the IRS, which Murray will discuss as part of guidance. The GAAP tax rate for the quarter was 33.3%. Adjusted earnings per share from continuing operations for the quarter was $0.52, which compares with our adjusted earnings per share of $0.48 for the same period last year. Our adjusted EPS would have been $0.55 this quarter, except we had incremental losses of about $0.03 per share this quarter related to the Dallas fire. Also, as we planned, we invested in Volly this quarter, which further reduced our adjusted earnings per share by about $0.01.

GAAP earnings per share for the quarter included restructuring charges and asset impairments that totaled $0.02 per share. GAAP EPS for the quarter also included a less than $0.01 per share reduction each for a tax charge associated with out-of-the-money stock options that expired during the quarter, and a loss from discontinued operations. GAAP earnings per share for the quarter increased 68% over the prior year. Free cash flow was $269 million for the quarter, in comparison to the prior year free, cash flow for the quarter benefited from the timing of tax payments and refunds, and an improvement in working capital. During the quarter, we returned $85 million of cash to our shareholders in the form of dividends. We also repurchased approximately 2.1 million shares of Pitney Bowes Common Stock outstanding, for $50 million. We have $100 million of share repurchase authorization remaining, which we expect to use over the next 6 to 12 months. Additionally we made contributions to the US Pension Fund of about $123 million.

As of the end of the quarter, we had completely paid down our commercial paper balances and we have no debt coming due until September of 2012. About 76% of our debt is now fixed rate, and 24% is floating rate. Let me now update you on our Strategic Transformation program. In the second quarter, we continued to implement initiatives identified by our project team. During the second quarter, our pre-tax restructuring charges of $5 million were primarily for severance-related costs. Approximately 3400 positions have been eliminated since the beginning of the program. Due to the timing of the implementation of different initiatives, the charges related to Strategic Transformation will vary from quarter to quarter, as we experienced this

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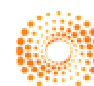

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quarter. We still expect total charges for the year related to the Strategic Transformation program to be in the range of $0.25 to $0.35 per share. We continue to target annualized net benefits for the full program in the range of $250 million to $300 million, in 2012. So that concludes my remarks. Now, Murray will discuss our guidance.

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Thanks, Mike. Turning to our guidance for the year, we are reaffirming our adjusted earnings per diluted share, our GAAP earnings per diluted share, and our free-cash flow guidance. However, we are modifying our revenue guidance for the year based on 2 factors. First, is the impact of the presort facility fire in Dallas, and, second, is the overall economic outlook, particularly given what we have experienced in our SMB markets in the first half of the year. Economic growth is now weaker than we originally anticipated when we first provided guidance. As a result, we now expect 2011 revenue, excluding the impacts of currency, to be in the range of minus-2% to positive-1%. As previously noted, in 2011, we anticipated generating incremental revenues of $0.32 to $0.42 per share from operations, growth and productivity, excluding the impact of SMB stream revenues.

We anticipate lower SMB stream revenues, as a result of lower equipment sales in prior periods, to negatively impact earnings by $0.25 to $0.30 per share. As a result, we expect comparative earnings for the year of $2.25 to $2.40 per share. We also plan to invest $0.05 to $0.10 per share to develop the market Volly, our security delivery system. As a result of improved margins, we continue to expect adjusted earnings per share from continuing operations to remain in the range of $2.15 to $2.35. We also continue to expect 2011 GAAP earnings per diluted share from continuing operations in the range of $1.80 to $2.10. This includes the expected impact of $0.25 to $0.35 per share for restructuring charges and asset impairments associated with Strategic Transformation. Earnings per share guidance assumes recoveries this year of losses related to the Dallas fire.

As part of negotiations to settle the Company's the 2001 to 2004 IRS examination, we agreed with the IRS on the tax treatment of a number of issues, as well as revised tax calculation. As a result, we anticipate paying nearly $400 million of tax and interest for the years 2001 to 2004 by releasing previously funded tax bonds, and as a result this payment will not impact our cash position. Additionally, we expect to reduce tax reserves in the third quarter by about $50 million, with about $30 million recorded in discontinued operations. The impact of this agreement is not included in our earnings guidance for the year. We continue to expect to generate strong free cash flow for 2011 in the range of $750 million to $850 million.

In closing, let me update you on Volly. We are advancing our market development activities with large mailers, and are on track for phased consumer rollout of Volly, our secured digital mail delivery system. In the last 90 days, we have trained more than 50 of our existing sales representatives to sell Volly in addition to their current product portfolio. We have signed agreements with multiple large third-party mailers, representing over 1500 companies that send out billions of pieces of mail annually. We remain confident that the actions we are taking are moving us closer to our goals for the longer-term growth and profitability of our business, despite current uncertain business conditions. We remain focused on maximizing our operating efficiency, enhancing the customer experience, and investing in the growth of our business. Thank you. Now let's take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Ananda Baruah with Brean Murray. Please go ahead.

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Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Hello, guys. Thanks a lot for taking the question. A couple, if I could. The first one is, can you walk us through the pieces of the guidance -- your lowering revenues, sounds like margins are tracking better than you had expected -- is that where the offset comes from? To what extent might Volly be tracking a little bit less of the headwind than expected? You kept the range the same, but there is only $0.01 sort of impact this quarter; and then how does the Dallas warehouse completely fit into the guidance? Thanks.

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Sure. To reiterate on the guidance -- the only thing that we have changed on our guidance is the revenue growth outlook, and that came down 2 percentage points. Because of the margin performance we've seen to date, we have kept our adjusted earnings per share guidance range the same. So we are pleased with the margin performance of the business to date. We think, because of the fire, which has impacted us, particularly in the first 2 quarters, that now that we have our new facility up and running, it should be a much less of an impact in the third quarter; and should be really a non-issue in the fourth quarter in terms of impact. But obviously the first half impact is reflected in our overall revenue.

And then, certainly the broader economic outlook. So the key is, the revenue guidance has come down a bit, but the earnings guidance remains the same. As far as Volly is concerned, we remain, I think, on track to be within the $0.05 to $0.10 range on a full-year basis. The $0.01 is what it rounds to. Obviously, the dollars can vary a bit from quarter to quarter, based on the level of activity.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Okay. And it sounds like, Mike, you have baked into the guidance that you will get, or at least potentially get, the $0.06 to $0.08 back fully from the Dallas warehouse situation?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

That's correct. The $0.05 is already reflected in our reported adjusted earnings through the first half, but we anticipate at this point to get that recovery.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Okay. Great -- and then, if I could, could you give us a sense of what you have seen from customer activity the last 4 to 6 weeks, both in SMB and in the Enterprise, both US and Europe, with the economic news that's been underwhelming; and then the concerns that are overwhelming everybody from what growth might be in the second half of the year? Any kind of detail there would be great. Thanks.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Sure. We've seen the SMB market to be fairly steady at a lower level than what we had expected. So it hasn't really swung a lot. We had anticipated that it would recover, and it has remained more similar to last year than we had expected. So I think we're seeing that as, at a lower rate, the small businesses are not investing in new; but the renewal continues to stay there. As to the Enterprise space, you'll see in our results that both software and the production mail, which are the large-ticket items, continue to perform well; and it's sort of broad-based. It's a little irregular from period to period, as you look at different countries. But with the broad distribution we see, Europe will be good, or certain countries in Europe, then Canada, then Asia, then the US.

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So we saw strong deliveries in the second quarter, but then we had strong written business in a number of the areas, as well. So we are seeing not that big a variance in our large accounts, and I think that would go back to -- as you recall, back in '08 and '09, there was a lot of things postponed and delayed, and so the refreshes are continuing. When you get into the other areas of Enterprise, which are volume-related, our mail services continues to be strong. We see a little bit of a shift in volume related in the management services business around print volume, which is down period-to-period; but, in general, I would say we have been fairly well on target in the Enterprise space; and then as we saw through the first 2 quarters, a little lighter in the SMB. And I wouldn't say any dramatic change that we've seen in that space -- it's been pretty stable.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

And thanks. That's helpful. One last follow from me -- to that same end. Any comments about linearity through the quarter, both in SMB and Enterprise; and maybe it sounds like you're saying SMB is a bit softer than Enterprise for you. Is it something that you saw? I mean, I know the SMB indicators began to turn over as we got into the quarter. Was it really coincident with that? And over the last 2 to 4 weeks, have you seen any change in business from your customers on either side of your business?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

No, I don't think that we've seen any certainly measurable change in behavior. I think, obviously, the events of the last few days, we'll see how that affects people going forward; but the SMB business tends to be a kind of a fairly continuous selling process, and it's a very localized type of selling process; whereas the Enterprise side, as Murray indicated, there tends to be a replacement cycle. We are seeing some -- particularly in the production mail side -- some take-up in the new color printing, which is contributing to that, as well. But, obviously, it is something we'll stay close to.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Great. Thanks a lot.

Operator

We have a question from Shannon Cross with Cross Research. Please go ahead.

Shannon Cross - *Cross Research - Analyst*

Hello; thank you very much. Good afternoon.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Hello, Shannon.

Shannon Cross - *Cross Research - Analyst*

Hello. I'm not sure how we describe this afternoon after the market today, but we're all here, right? My first question is, with regards to the lease extensions, can you just talk a little bit about the dynamics? Has anything changed, or is that a continuation of what you've seen in prior quarters?

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Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

It is a continuation. I think it's relatively consistent with what we saw in the first quarter. I think our preference would have been to see that come down a little bit more. So perhaps it's 1 place where we're seeing some of the hesitation on the part of small and mid-sized businesses; but obviously the important part is to continue the relationship with them, and these are very valuable transactions, as you see, as reflected in the improvement in equipment sales margins. So they're good transactions, but we hope to see more uptake of new equipment as we go forward in the second half.

Shannon Cross - *Cross Research - Analyst*

And is it still a 2-year extension?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Generally, they can be 2- to 4-year, and they probably average on the longer side than the shorter side.

Shannon Cross - *Cross Research - Analyst*

Okay, and then can you talk a little bit about, in terms of the cash flow -- you had very strong cash flow, you noted timing of tax payments this quarter. How are you thinking about cash flow for the full year? Because it seems like you're very much well on track to make, at least, certainly the low end and pretty comfortably the high end of your cash flow. So is there something that we should think about in the next couple of quarters?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Sure. As far as the tax payments are concerned, we did have some tax benefits related to our pension contributions that we made in the quarter, so that there's an effect in there for that. But to your point, we feel good about the cash flow right now, and we're probably trending more towards the higher end of our range; and we think it should be, again, another good strong cash flow year.

Shannon Cross - *Cross Research - Analyst*

Okay, and then a follow-up to cash flow, is on the capital structure. I think your -- I can't remember the exact number, 74%, something like that, in terms of fixed at this point -- How are you thinking about the capital structure, use of cash, clearly remains dividends and share repurchase; but any more color on how you're thinking about it, especially from a debt standpoint.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Yes. From a debt standpoint -- obviously, at the end of the quarter, we didn't have any commercial paper outstanding. That tends to fluctuate during the period, but at the end of the period we were able to eliminate that. We don't have any debt coming due until September of next year. So we're kind of locked. It really wouldn't be cost effective to buy that out early. So we're kind of set on that. So we will have free cash flow to, obviously, reinvest in the business. We will spend about $100 million in cash this year, on principally severance payments related to our Strategic Transformation program. So that is 1 other use as well. I think the good news is, going forward in 2012, as we see some of those programs come to conclusion, that usage going forward should be somewhat less. And as we get into 2012, we'll look at our refinancing or pay-down options related to the debt that's maturing in '12.

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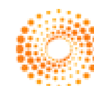

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Shannon Cross - *Cross Research - Analyst*

Okay. Great, and then my final question for Murray. Can you talk a little bit about what is going on with the US Postal Service in terms of the closures. I think they have announced about 11% of the locations -- if I remember the number -- are closing. Any opportunities that might be there for Pitney, or any concerns? How we should think about some of the restructuring that's going on in the Postal Service; and then how it might impact your company? Thanks.

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Well, First of all, I think that any restructuring in the Postal Service that enhances their economic structure, is a positive; not only for us, but for the industry. Secondly, when it come to these very small post offices, it really has no effect to our basic delivery of mail. The people there still get their delivery. It's strictly an access site. And what they're actually doing is providing alternate access. So when they close a physical facility, they actually, in many cases, are providing more access points around that facility than there was in the post office. That, actually, as you rightly alluded, could provide us with opportunities, when it comes to self-service, since we do supply kiosks; and also, if there are smaller sites that open, to service as post offices, it would open the potential for meter activity, as well. So we don't see it as a negative, but we see more opportunity there than there would be in the current form.

Shannon Cross - *Cross Research - Analyst*

Okay. Great. Thank you very much.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Thank you.

Operator

We have a question from Chris Whitmore with Deutsche Bank. Please go ahead.

Chris Whitmore - *Deutsche Bank - Analyst*

Thanks very much. I wanted to follow up on the improvement you saw in recurring revenue streams. It looked like most of the improvement was driven by supplies. I was hoping you could flush out the trend you are seeing in supplies, and talk to the sustainability of growth in supplies, given the ongoing trends we're seeing in mail volumes.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Sure. So supplies really has 3 components to it. Our traditional mail ink for postage meters. There is other third-party supplies that we provide. And then the newest stream of supplies that we have are related to our IntelliJet printers; and as we begin to build a base of those printers -- which are high-speed, high volume color inkjet printing engines, that we partner with HP to market to high volume mail producers -- that will build a new revenue stream for us. So some of the moderation is the fact that we're seeing more stability in our traditional mail inks, and then the growth in some of these other supply categories. The other thing I'd note about some of the other elements of recurring revenues -- in terms of growth in our businesses overall, we saw a good growth in Canada from an equipment standpoint. We had positive growth in Europe from an equipment standpoint; and that's translated into improvement in our financing revenue, as well. In fact, in Europe it was flat year-over-year. So we are seeing, in a number of markets, that the impact of sales improvements do end up filtering through to the recurring revenues. So those are some of the key drivers.

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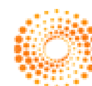

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Chris Whitmore - *Deutsche Bank - Analyst*

Should we expect the supplies line to grow in the back half of the year?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

That's certainly a possibility. It depends on, certainly, the mix of business we do. The IntelliJet ink streams will build as we build an installed base, but we have seen moderation in the mail inks. So that is certainly a possibility in the back half.

Chris Whitmore - *Deutsche Bank - Analyst*

Okay. And in terms of the sales of equipment placements -- and I'm thinking about meters specifically -- can you talk about the mix trend you're seeing in terms of those shipments? Are you seeing that mix improve or deteriorate? And maybe can you comment on pricing in the competitive environment as well?

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

I think what, Chris -- it's Murray -- we're seeing the high end continuing, the mid- and high end continuing to be positive. The lower end meter space, where you have some people that are less, that do very low volume, that is susceptible in this type of market; but in the mid- to upper, it's certainly doing pretty well. When it comes to price realization, we're continuing, as you can see in our margins, to see continued realization of price. So I think margins in the industry are holding fairly well.

Chris Whitmore - *Deutsche Bank - Analyst*

Okay. So, sometimes your competitors talk about some market share gains. You don't seem to be seeing any pressure on your market share, is that correct?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Market share sort of fluctuates a little bit by region, by month, by quarter. So we see gains in market share in some places, period-to-period, and maybe a minus here or there. Overall we see market share as relatively flat on a global basis.

Chris Whitmore - *Deutsche Bank - Analyst*

Okay. And my last question is also on guidance. The range in the back half of the year is about 20% or so on the EPS line. Seems unusually large. Does that reflect greater uncertainty around the back half of this year, or maybe you can give us a little more color on why such a wide guidance range.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

I think it's more a matter of just maintaining our annual outlook, as opposed to getting into a particular quarter guidance, or whatever. So I wouldn't read anything more into it than we have just maintained our annual guidance through the first half.

Chris Whitmore - *Deutsche Bank - Analyst*

Okay. Thank you very much.

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Operator

We have a question from Charles Rabile, a private investor, please go ahead.

Charles Rabile - *Private Investor - Analyst*

Yes, Many of the analysts out there are suggesting that your dividends may be reduced or eliminated; but from what I have heard, it appears your free cash flow will more than cover adequately any dividend, matching previous dividend declarations. Am I correct there?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

We have a long history of generating very solid free cash flow. Our guidance for this year projects solid free cash flow, and we have a track record of increasing our dividend for 29 consecutive years. That's been an important part of the total mix of return to shareholders.

Charles Rabile - *Private Investor - Analyst*

That's what keeps me in there.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

It's what keeps me in there, too; and so, obviously, we think we think we're in a good position to continue to support the dividend.

Charles Rabile - *Private Investor - Analyst*

Okay. Thank you very much.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

You're welcome.

Operator

We have a question from Hale Holden, with Barclays Capital. Please go ahead.

Hale Holden - *Barclays Capital - Analyst*

Just fairly quickly on the Volly. Assuming it's adopted at your highest expectation, isn't it, at its core, cannibalistic to your core mail stream? As we shift more billing and electronic mail over the Web, doesn't it reduce the volume that you push through the bigger service centers?

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Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Yes, Volly would actually provide a shift. So today, we would estimate about 10% is digital, that we don't participate in. And as we look forward over the next decade, we believe there will be some shift. And what Volly does is it puts us in a position to capture that shift; as well as capture the shift from high-volume mail that we do not deliver today. So when you look at our production mail equipment, we have a global share of less than 50%. So that would provide us an opportunity to take all of that digital, as well. So we also, when we look at the shift from physical to digital, to Volly, we would not expect that people will go to 100% digital. So there's going to be a long tail on hybrid, regardless of what the range of transition might be; and people will continue to need to produce physical mail.

Also, you have the standard mail side of the business, which does not substitute into digital; and it is continuing to show positive growth over an extended time period. So we see that sort of mail continuing to be there; and what this does, is it really keeps us in more of the end-to-end process. So we really go from the origination of the mail, and all of the software tools there, to the location of where it goes, whether it is physical or digital; and then the demographic and psycho-graphics around that, for enhancing the value of that communication, to help people deliver more value to their customers and to find new customers. So we see it, yes, there will be some cannibalization, but we also see incremental opportunity in that total end-to-end process.

Hale Holden - *Barclays Capital - Analyst*

So if we assume the transition is going to happen, and that you want to be able to control the transition from physical to digital -- obviously, there is always risk in any transition that another competitor comes in. Who would you line up as your main competitors when you're pitching Volly to customers?

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Well, today it is very difficult to identify a major competitor. In the US, for example, in transaction mail, we participate in 74% of the transaction mail; and so there is no one else that's close to dealing with that with the customer base. So we're involved with those customers in creating the physical, and we believe it places us in a fairly unique position, from those long-term relationships; and considering that those customers will continue to have to produce physical. So to have a solution that delivers in a hybrid form, both physical and digital, and allows you to manage it as 1 process, is a significant advantage that anyone new coming in would struggle with.

Hale Holden - *Barclays Capital - Analyst*

And then, I guess, my final one is, how are you asking your customers to pay for Volly? Is it getting bundled into the larger contracts right now as an add-on, so that you can maintain the relationship with the transition, or is there a separate charge for it?

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Well, when you think about the delivery of a physical mail piece, you have the production of the mail piece, which we participate in. You have the paper, the envelope, and the postage are sort of the segments of that. We only participate in a small portion. So the cost to deliver would be less than the total cost of physical, but we would participate in more, in a bigger portion of that than we do today.

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

And it would be free to the consumer to access it.

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Hale Holden - *Barclays Capital - Analyst*

That's perfect. Thank you. Awfully big picture of Jim Cramer on the front page of the Volly website, but other than that, it looks good. (laughter)

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

We'll take that under advisement.

Operator

We have a follow-up from Ananda Baruah with Brean Murray. Please go ahead.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Thanks for the follow-up, guys. Mike, could you maybe walk us through what the different pieces of the incremental operating margin strength is? I'm assuming it is a little bit better than what your expectations were the last quarter. How much of it is mix, how much of it is, maybe, cost save ahead of schedule, how much of it is other stuff? Can you actually give us a year-to-date update on cost synergies realized?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Yes. In terms of -- let me address the 2 parts in order. I think the best way to look at where you've seen the improvement, is to look at our gross profit. We increased that year-over-year. In fact, our gross profit this year was the best second-quarter gross profit since 2008. So what we've been able to do is really shift the mix of our revenue, and yet still maintain strong margins in the business. Within those margins are reflected some of the benefits of the transformation initiatives that we put underway; in terms of how we service our product, the cost of the product. A lot of our procurement activities are baked into that. And then there is obviously some benefits in our SG&A expenses, as well, in terms of seeing reduced costs there on a constant-currency basis; our absolute levels of SG&A expenses are coming down.

Year-to-date, we've probably seen about $80 million of incremental benefits from transformation; and roughly $200 million, I think, at the end of last year. We talked about $120 million of savings through the end of 2010 in the program. So roughly about $200 million of benefits in the program. 1 of the things I'd emphasize, though, is that those benefits are captured and in the numbers; but more importantly, we've created more variable costs -- meaning, we've outsourced a number of functions. We've used more SAS-based solutions as opposed to capitalizing a lot of big software or equipment. We have reduced the number of physical locations; and those things allow us more flexibility as we go forward, to continue to adjust cost without incurring severance and other things that might normally come with changing priorities in the business. So I think we've created some additional flexibility from that standpoint.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Okay. Thanks, that's helpful. And then, in terms of thinking about how to -- for 2012 modeling purposes, what is a prudent way for us to think about what the incremental investments for Volly and other things could be? Should we just say, it might be the same, and just leave it at that for now? I guess that gives us -- the hedges are over/under a little bit. And could you maybe talk about what the levers could be that might push it, either stronger or softer, than kind of what it is this year?

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Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Sure, the investments that we're making in Volly this year are really driven by 2 things that Murray touched on earlier. 1 has been the basic development of the product, and the refinement of that, and the market research around that to really understand consumer preferences, billers' needs, and those types of things. And the second -- and to build out the infrastructure support and things needed for it. The second is to begin the selling process, to engage mailers, and then to on-board them with the technology to enable them to be able to deliver digitally into Volly. The variable costs, as we go forward into 2012, will really be around marketing expense; and that will be driven by how much we market directly, versus market through participating billers, perhaps as they encourage their customers to choose the way that they want to deliver or receive digitally. So we'll learn our way into that a little bit more as we engage with the mailers and understand their marketing plans, and develop our own marketing plans, and get to the consumer experience on that. So at this point, I think, assuming the same as this year is probably a safe thing to do. Obviously, we'll have better insight when we give 2012 guidance.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Okay. That's helpful. Thanks. And 1 last 1 from me, and then I'll get off again -- is, on the buy-back, the $50 million was -- I think it was a third of what you had going into the quarter on the authorization? And last quarter you talked about taking up to 6 quarters to use the whole thing. So with the stock where it is now -- I know it is -- the whole market is down -- but where the stock where it is now, can you update your thinking on stock buy-back generally; and philosophically, how stock buy-back fits into how you guys are thinking about use of this capital right now?

Michael Monahan - *Pitney Bowes Inc. - EVP and CFO*

Yes, stock buy-back has always been a variable for us in terms of what priorities we have around cash utilization or capital utilization. When we increased the authorization of the $150 million, we said it would be over 12 to 18 months; so 4 to 6 quarters. Obviously, we have begun to do some of that already. With the stock price down, obviously, it's going to be 1 of the things that we consider as we move into the second half, as options to deploy excess cash.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Great. Thanks a lot.

Operator

There are no further questions. Please continue.

Murray Martin - *Pitney Bowes Inc. - Chairman, President and CEO*

Thank you. I would just like to, in conclusion, summarize a number of things that we've covered. First, there are 3 positive trends that we saw during the quarter that underscored our progress in laying the foundation for long-term growth and profitability. They were continued growth in equipment and software sales, led by high-speed inserting and Connect-plus; the combined recurring SMB revenue streams of supplies, rentals and financing that declined at a lesser rate than both the prior quarter and prior year; the improvement in EBIT margin, particularly in SMB and our software business, despite the unsettled economic environment. We also continued to reap the benefits, as Mike touched on, of our Strategic Transformation actions, which has significantly increased the variable portion of our cost structure, and allowed us to reinvest in our business.

During the quarter, we also expanded our new cloud-based SMB products; and there is more to come for both the SMB and Enterprise customers. Our progress with Volly continues to be on track for a phased consumer rollout. In the last 90 days, we

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trained 50 of our existing reps, and we have currently signed agreements with large third-party mailers, representing over 1,500 companies that send out billions of pieces of mail. So we see that as on track, and we look forward to the coming year as we look to where Volly could go as it rolls forward. Thank you.

Operator

Ladies and gentlemen, this conference will be made available for replay after 7.00 PM Eastern today, until August 18 at midnight. You may access the AT&T executive playback service at any time by dialing 1-800-475-6701 and entering the access code 208088. International participants may dial 1-320-365-3844, and entering the access code 208088.

That does conclude our conference for today. Thank you for your participation and for using AT&T Executive Teleconference Service. You may now disconnect.

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