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PBI - Q2 2018 Pitney Bowes Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 revenue of $861m and GAAP EPS of $0.26. Expects 2018 constant-currency revenue to grow 11-15% and adjusted EPS to be $1.15-1.30.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning, and welcome to the Pitney Bowes Second Quarter Earnings 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 participants in today's conference, Mr. Marc Lautenbach, President and Chief Executive Officer; Mr. Stan Sutula, Executive Vice President, Chief Financial Officer; and Mr. Adam David, Vice President, Investor Relations.

Mr. David will now begin the call with the safe harbor overview.

Adam David - *Pitney Bowes Inc. - VP of IR*

Good morning. 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 earnings press release, our 2017 Form 10-K annual report and other reports filed with the SEC that are located on our website at www.pb.com and by clicking on 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. Also, for non-GAAP measures used in the press release or discussed in this presentation, you can find reconciliations to the appropriate GAAP measures in the tables attached to our press release and also on our Investor Relations website. Additionally, we have provided slides that summarize many of the points we will discuss during the call. These slides can also be found on our Investor Relations website.

Now our President and Chief Executive Officer, Marc Lautenbach will start with a few opening remarks. Marc?

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Good morning, and thank you for joining the call. Our second quarter results represent the continued transformation of our portfolio to growth and that is the headline for the quarter.

Revenue grew over prior year for the fourth consecutive quarter and we drove EBIT dollar growth over prior year. The texture of the growth is important. To put it in perspective, total EBITDA dollars grew and EBITDA growth in our e-commerce business outpaced the EBITDA decline in our

SMB business. Four quarters ago, revenue in our growth businesses outpaced the decline in our legacy businesses. This quarter, the axis have crossed from an EBITDA perspective. One quarter does not make a trend but this is an important milestone.

Stan will give you the segment table highlights, but I will make a few observations. First, we continued to experience strong growth in our Commerce Services business. The revenue opportunity in Commerce Services is compelling, and we continue to get great feedback on our offerings from our clients. We also continue to integrate Newgistics into our business. Newgistics revenue grew double digits on a pro forma basis in the quarter. We knew the Newgistics acquisition was going to be terrific and it is.

Second, EBIT margin in our SMB business improved year-over-year. This was a result of excellent performance in global services and our operational excellence programs. Our software team also performed well. We knew they were well positioned for the quarter as we had several renewals in our pipeline, but the team also had strong closure on small deals.

In addition, importantly, we continued to make very good progress building our indirect channel. Revenue in our indirect channel grew nearly 70% over prior year. Of our total indirect channel pipeline, over half would be classified as left or deals where our partners independently identified and are progressing the opportunity.

Additionally, we recently partnered with 2 large global systems integrators. One would enable is to be the vendor to provide a list management and transaction screening engine for the financial crimes and compliance practice. The other will enable us to expand our footprint within the financial services vertical and help remove the complexity of data for insurance underwriters.

These 2 partnerships are further endorsed in terms of our technology and a key milestone for our indirect strategy.

Let me now provide an update on progress against our 3 strategic pillars: shipping; operational excellence; and leveraging scale and experience.

Let me start with our shipping strategy. Our SMB shipping value proposition is delivered by the new C-Series and that continues to resent well with our clients. We continue to see clients sign up for longer lease terms and a cross-sell on label printers and professional services continues to exceed our expectations.

Overall, we are seeing a higher payment as compared to our legacy product, which bodes well for future revenue streams. Given we are only 9 months into this product cycle and less than 15% penetrated into our existing client base, we continue to be very optimistic about this opportunity. Relatably, within SMB, we saw an increase of 15% over the first quarter and a number of shipping labels printed through our SMB products.

As we have previously mentioned, the C-Series is based on an open android platform, which enables us to bring third-party applications to our clients. We've been working with developers and anticipate an initial launch of new applications in the second half of this year, which will provide a range of new features and services to our clients. More to come on that later this year.

In our Commerce Services group, we processed over 127 million parcels in the quarter, and we now have over 3,500 domestic shippers on our API platform.

Our shipping APIs also continue to ramp up with volumes increasing over 30% from the first quarter and more than tripling from a year ago. Shipping revenue now comprises 30% of our total revenue and is growing 13%.

As a reminder, shipping revenue was only 2% in 2012.

Turning to operational excellence. We're making excellent progress with our spend take up program and we continue to see incremental opportunities. EBITDA margins were up in Global Ecommerce, SMB and software. We are well on our way to achieving the commitments we made on our spend takeout.

Finally, revenue and scale and experience. Much of our revenue growth is delivered via the Pitney Bowes Commerce Cloud. Every business group inside of PB, leverages this efficient, digital delivery mechanism. We continue to leverage our experience in building out our Presort mail business to inform how we build out our parcels network. In addition, we are leveraging our Presort sites to build out Newgistics returns and delivery operations. We're able to leverage our existing sites, shipping lanes and labor across these businesses in order to handle the growing parcel volumes.

During the quarter, we added our e-commerce, cross-border services into an existing Newgistics site and co-located Newgistics operations within an existing Presort site.

Over the next few months, we expand our Newgistics capabilities to other existing Pitney Bowes locations, and we'll soon open our new Midwest supercenter in Indianapolis. When we acquired Newgistics, they had 9 sites. For this year's holiday peak season, we'll be operating a total of 13 sites.

Finally, we continue to leverage our shipping assets. Our share development organization is the key point of leverage, and we're leveraging a nearly 100 years of experience with post and mail as we move into the shipping market.

Overall, I am pleased with the progress we continue to make, as I mentioned earlier, it's a very important milestone to have EBITDA growth in our e-commerce business outpace the EBITDA decline in our SMB business. We made good progress, but we also know there's more to do. With that, let me turn it over to Stan.

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

Thank you, Mark, and good morning. In the second quarter, we continued to make good progress against our strategic initiatives. We continued to grow revenue, reduce our structure and delever the balance sheet. One of the significant highlights of the quarter is that our EBIT dollars grew over prior year. While still early in this journey, we are starting to see some of the fundamentals of our strategy play out in our financial performance.

Another significant highlight was the sale of our DMT Production Mail and the supporting software business, which will net proceeds of approximately $270 million. And as we previously announced, we will use a majority of the net proceeds to redeem our March 2019 notes of $300 million, that redemption will take place tomorrow, August 2.

This reduces our interest expense, strengthens the balance sheet and preserves capacity for future strategic flexibility.

Turning to our results. As always, unless otherwise noted, my statements going forward will be on a constant currency basis when talking about revenue comparisons and on an adjusted basis when talking about earnings-related items including cash flow.

Reconciliations of all non-GAAP to GAAP measures can be found in the financial statements posted with our earnings press release and on our Investor Relations website. Also, please note that the Production Mail and a supporting software are now reported as discontinued operations in our financial statements.

We have posted reclassified financial statements on our Investor Relations website under Financial Reporting, which provides the last 8 quarters of historical results recast for comparison purposes.

For the second quarter, revenue totaled $861 million or growth of 17% over prior year. This was the fourth consecutive quarter of year-over-year revenue growth both on an as reported and pro forma basis.

Looking at revenue by group. Commerce Services grew revenue 69%. SMB declined 8% and software grew 12%. Adjusted EPS was $0.26 for the quarter. GAAP EPS was $0.26, GAAP EPS included $0.05 of restructuring charges, net benefit of $0.03, primarily related to the further interpretation of the 2017 tax legislation and $0.01 of income from discontinued operations related to our recent divestiture.

Free cash flow was $30 million and GAAP cash from operations was $92 million.

Compared to prior year, free cash flow increased by $22 million largely due to the timing of accounts payable and accrued liabilities.

We also have lower tax payments versus prior year. This was partially offset by higher capital expenditures, along with the timing of other working capital requirements.

Looking at capital allocation, for the quarter, we used cash flow to pay $35 million in dividends to our common shareholders. We paid $12 million in restructuring payments.

Capital expenditures totaled $58 million, which is $18 million higher than prior year driven by investments in our Commerce Services group.

At the end of the quarter, our total debt was just under $3.6 billion, which was about $44 million higher than prior year.

We announced the redemption of our 2019 notes of $300 million, which will take place tomorrow, further delevering the balance sheet and creating strategic flexibility.

At the end of the quarter, we had $746 million in cash and short-term investments.

During the quarter, we repatriated approximately $100 million of non-U. S. cash, and through the end of July, we have repatriated essentially all of the $500 million that we originally communicated.

Looking at the P&L, starting with revenue performance by line item as compared to prior year.

Business services grew 68%, which was largely attributable to the incremental contribution for Newgistics.

On a pro forma basis, business services revenue grew 10%, driven by the continued growth in Global Ecommerce. Software revenue grew 11%. Equipment sales declined 14%. We had declines in financing of 9%, supplies of 7%, rentals of 4% and support services of 2% driven by the performance in our SMB group.

Gross profit was $418 million with a margin of 48.5%. This is a decline of 9 points from prior year, primarily driven by the shifting mix of our portfolio, of which, nearly 2/3 is driven by the addition of Newgistics, which was not in our results last year. The remaining portion of the decline reflects the organic shift to our growth businesses as well as the market headwinds around labor and transportation costs.

SG&A was $282 million or 32.8% of revenue, which was an improvement of nearly 7 points from prior year.

Compared to prior year, SG&A was $7 million lower despite $17 million of incremental SG&A related to Newgistics, which was not in the prior year.

The lower SG&A reflects our operational excellence initiatives around the business.

At a gross level, we continue to reduce spend this quarter and to date, have achieved over 50% of our commitment for 2018, putting us on track to deliver gross savings of at least $120 million this year and at least $200 million by the end of 2019.

Our expectation is that our operational excellence initiatives will drive improvement in SG&A as a percent of revenue, which will outpace the decline in gross margin percentage as we continue to reduce spend and as Commerce Services margins improve.

R&D expense was $31 million or 3.6% of revenue. Compared to prior year, R&D expense increased less than $1 million. As our portfolio shifts to growth markets, we also continue to shift our R&D spend to take advantage of these opportunities.

EBIT was $107 million and EBIT margin was 12.4%. Compared to prior year, EBIT grew $4 million, while EBIT margin declined about 1.5 points, driven primarily by the gross profit margin decline as it relates to the addition of Newgistics to the portfolio. Excluding Newgistics, EBIT margin would have increased 70 basis points over prior year.

Interest expense, including financing interest expense, was $42 million, which was $1.5 million higher than prior year due to the timing of new debt issuances and redemptions over the last year.

The provision for taxes on adjusted earnings was $15 million and our tax rate was 23.8%, which was higher than prior year by about 10 points, mostly due to the resolution of certain tax examinations in the prior year.

At the midyear point, our adjusted tax rate is 25.1%, which was within our annual guidance range.

Diluted weighted shares outstanding at the end of the quarter were 188 million, which was about 1 million shares higher than prior year.

Let me now discuss the performance of each of our business segments this quarter. Within the Commerce Services group, revenue was $362 million, which was growth of 69% over prior year.

On a pro forma basis, revenue grew more than 10% over prior year. EBIT for the group was $7 million, and EBIT margin was 1.8%. EBITDA was $29 million and EBITDA margin was 7.9%.

In Global Ecommerce, revenue was $239 million, which was growth of 152% over prior year, and included a full quarter of incremental revenue from Newgistics. Newgistics, on a pro forma basis, delivered 10% revenue growth and benefited from strong performance in both parcel and fulfillment.

Excluding Newgistics, Global Ecommerce generated 18% revenue growth over prior year. We continued to experience good growth across the board in all of our shipping volumes. Volumes through our shipping APIs continued to grow, increasing more than 30% over first quarter and more than tripling from a year ago.

EBIT was a loss of $6 million and EBIT margin was a negative 2.5%, which was driven primarily by investments in market growth opportunities as well as automation, network optimization, simplification and technology upgrades.

These initiatives will drive long-term profitability. EBIT was also impacted by higher transportation labor costs as well as incremental amortization of intangible assets related to the Newgistics acquisition.

EBITDA was $9 million, an increase over the previous year largely driven by the revenue growth. EBITDA margin was 4%, which was also an improvement from prior year despite the higher transportation and labor costs.

Within Presort Services, revenue was $123 million, which was growth of 4% over prior year and driven by higher volumes of First Class mail as well as bound and packet mail is fast processed, but partially offset by lower Standard Class mail volumes processed.

Revenue was also impacted by lower revenue per piece, driven in part, by higher volumes of mail processed from larger clients.

EBIT was $13 million and EBIT margin was 10.2%. EBITDA was $19 million and EBITDA margin was 15.6%.

We experienced lower margins in our Presort business this quarter, partially due to the impact of the macro environment around increased transportation and labor costs.

Incremental investments along with a lower revenue per piece also impacted margins this quarter. Part of the labor increase was driven by our increase in hourly, nonexempt wages for some of our U.S.-based employees as a result of the benefit we received from tax legislation. We also saw an increase in contract labor.

Over time, the increase in wages for our nonexempt employees will drive lower attrition resulting in reductions in contract labor and improved productivity. We are taking actions, and while these higher costs impacting margins this quarter, we'll be able to leverage existing resources around labor and transportation synergies between our Newgistics and Presort networks to partly mitigate some of this impact. We see great opportunity to further leverage these networks, improve productivity and the resulting margins.

Additionally, we are investing in and deploying automation and process improvements that will reduce costs and meet our clients expectations.

Turning to our SMB Group, revenue was $408 million, which was a decline of 8% from prior year. EBIT for the group was $128 million and EBIT margin was 31.5%, which is an improvement from prior year and within the long-term market range. This improvement aligns with our long-term model for this business to generate strong free cash. EBITDA was $150 million and EBITDA margin was 36.8%.

In North America Mailing, revenue was $315 million, which was a decline of 8% from prior year. Equipment and sales declined 16% from prior year. We experience lower sales in our top-of-the-line products due to weaker execution than expected, a lower amount of renewal opportunity coming due in the quarter compared to prior year and a tough year-to-year compare given prior year equipment sales grew double digit.

Last quarter, we talked about staffing issues within our inside sales organization. We continue to address it and saw an improvement in our low- to middle-of-the-line product sales as a result.

Additionally, we entered this quarter with a lower backlog of orders as compared to prior year, which impacted our equipment sales revenue in the quarter.

Recurring revenue streams declined largely around financing, rentals and supplies. However, the rate of decline in our streams has moderated in the first half of this year as compared to prior year.

We saw a growth in services and a growing backlog per professional services revenue, largely as a result of our shipping-related products. Our C-series is getting good traction in the market. Since launching the product and through the end of the second quarter, we have shipped nearly 42,000 units, which is less than 15% of our overall opportunity, signifying that we have a great opportunity ahead to place this new product line. We continue to see good shipping label of printer attach rates, longer lease terms and higher average payments relative to our legacy products.

Total gross profit margins of 72% have performed within a tighter range over the last 4 quarters.

EBIT was $115 million and EBIT margin was 36.6%, which is an improvement over the prior year, largely as a result of the spend reduction actions that we have taken. This is the first time EBIT margin has improved year-over-year since the fourth quarter of 2015. EBITDA was $133 million and EBITDA margin was 42.1%.

In International Mailing, revenue was $93 million, which was a decline of 7% from the prior year. Equipment and sales declined largely driven by weakness in the U.K. and Italy, but partially offset by growth in Germany. Recurring revenue streams also contributed to the overall decline. EBIT was $13 million and EBIT margin was 14.2%, which was less than a point lower than prior year. The decline was driven by lower gross margins due to the mix of products sold, partially offset by lower expenses.

EBITDA was $17 million and EBITDA margin was 18.7%.

In Software Solutions, revenue was $92 million, which was growth of 12% over the prior year. Revenue benefited from growth and data, Customer Information Management and Location Intelligence, in part, implementation of the new revenue standard or ASC 606.

We saw strong execution in both our large and small deals this quarter. Additionally, we are starting to see a change in behavior where deals are shifting from license revenue to subscription revenue.

The indirect channel continues to make progress and grew their revenue nearly 70% in the second quarter as compared to prior year. As Marc mentioned, we are experiencing good lift on deals generated solely through our partnered channel. EBIT was $18 million and EBIT margin was 20.1%. The margin improvement from prior year was driven by the higher revenue and lower expenses. EBITDA was $21 million and EBITDA margin was 22.7%.

Let me now update you on our annual guidance. We are reaffirming our annual guidance of revenue on a constant currency basis in the range of 11% to 15% growth, adjusted EPS to be in the range of $1.15 to $1.30. Free cash flow to be in the range of $300 million to $350 million.

As a reminder, this guidance excludes DMT Production Mail and the supporting software, which will be accounted for as discontinued operations.

Let me provide some further color on what we expect in the second half of the year.

From a timing perspective, historically, the fourth quarter has always been our biggest quarter on revenue earnings and cash flow. Given our portfolio has quickly shifted to growth around shipping, the seasonality of our business has shifted even more to the fourth quarter. Especially with the holiday season in our Global Ecommerce and Newgistics businesses.

We continue to invest in items around automation and network optimization, particularly within our Commerce Services businesses. We expect us to recognizing some of the benefits as well as more synergies related to our Newgistics business in the lateral part of the second half of the year.

We are on track to achieve our spend targets and expect those savings to continue through the second half of the year.

In addition, as we start to lay the foundation for 2019, we have engaged a third party to assist us in achieving the remaining portion of our gross spend reduction program of at least $200 million.

Given the shift of our portfolio and some of the quarterly dynamics, we expect our third quarter earnings to perform similarly to the second quarter.

Let me wrap up. Earlier this year, we communicated actions we were taking around our portfolio, operational excellence and capital allocation in order to continue to move our company to sustainable growth.

As of the midyear point, we have divested our DMT Production Mail business, reduced spend across the organization, repatriated $500 million in cash from overseas and reduced debt, all while continuing to grow the business. While we have made good progress, we know there is more work ahead, and we are reaffirming our guidance for the full year.

With that, we will now take your questions. Operator, please open the line.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from the line of Ananda Baruah with Loop Capital.

Ananda Prosad Baruah - *Loop Capital Markets LLC, Research Division - MD*

Yes. A couple, if I could. No particular order here. I guess, Marc, you talked of software performing well, and it seems to show up in the numbers and you guys mentioned strong closure rates. Could you just speak to specifically the traction that you're getting there? Where you are in the

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initiative? And how we could -- we should think about what left to go with initiatives and how those might manifest? And then I have a follow-up or 2.

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Sure. I was pleased with the software performance in the second quarter. We knew we had a series renewals, which candidly is an impending event, which you can almost count on. But underneath that, the closure of small deals was particularly strong and that was something that's much more attributable to our direct sales force. And then as Stan mentioned, and I alluded to as well, the indirect channel and when I say indirect channel, I'm really talking about our efforts to attract, enable and ultimately sell with Regional System Integrators, Global Systems Integrators went well. So we saw a good lift from that channel in the quarter and through the first half. And if I had to characterize where we are in that journey, I'd say we're still in the early innings. So if you think about the kind of lift we're expecting in that channel, I'd say we're in the second or third innings, so much more in front of us. But as we look at the pipeline, I find that encouraging. And as I said, those 2 platform deals with the Global Systems Integrators tell you a lot about what the market thinks about our technology. Those are, obviously, big investments from those Global Systems Integrators. They could choose anybody they wanted. And while the revenue will materialize over time because those deals tend to be Software-as-a-Service or ratable-like, we thought it was a strong endorsement.

Ananda Prosad Baruah - *Loop Capital Markets LLC, Research Division - MD*

Okay, excellent. Yes, and actually the indirect channel question was the next one. So thanks for I guess just kind of tackling that. And I guess just kind of housekeeping here, you made -- mentioned towards the end of the call or Stan did, that you guys are engaging a third party to achieve -- I'm paraphrasing here, achieve the cost -- your cost action targets. Can you just get more specific on that so it's clear about what exactly it is that you're doing? And then you spoke to labor and transportation cost, and you're addressing it. Any -- can you give us any sense of what kind of headwind that could be going forward as you address it? One, you think you can get them kind of fully offset based on some of your initiatives over a period of time and then that's it for me.

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

Sure. Thank you, I'll take that one. So let's start with the spend. As we said in the prepared remarks, we are off to a very good start here in the first half on spend. And our attainment through the first half puts us on track to at least achieve and you noticed, we changed language here to, at least, in both the current year as well as over the program. And that's really based on the traction thus far. So we're ahead on the attainment. It's not going to be a straight line or some pockets that are lumpy. But in those spend actions, what we start to go under is looking at next year, we wanted to get more systemic and go up to more process-oriented. So we've engaged a third-party spend for a few months now, and we've looked at a number of different areas and some of these are very tactical around labor and transport, and I'll talk about that more in a minute. And then some are a little bit more strategic around how to do things like quote-to-cash and manage that entire process. So we're encouraged. We've already started the pilots, we ran several this week as a matter of fact. And we're encouraged by the start and we think that leaves us very well positioned, both for the year, and we said at least $200 million over the period. Let me comment a little bit on labor. So labor was a headwind predominantly in our Presort Newgistics business. And part of this, if you recall, early this year, we announced an increase in our nonexempt wages for some of our U.S.-based employees and that was part of the benefit received from tax reform.

We planned for that. So that was part of what we are looking for, for the year. But in the spot markets and going out for contract labor and looking at the rates that we had to do for that as well as dealing with the volume of business that's come through, that has been a headwind for us in Q2. Now there are a number of items that we look at as we deal with this. So first, the you'll notice our CapEx is up a bit. So we've been investing in automation. Let me give you a couple of examples. We are investing in auto sleevers, which is something that's part of our Presort production line and those will save headcount approximately 4%. We have 38 sites, multiple sleevers per site. So you can see that would make a dent in that. We also have a program underway, which -- we're refreshing our sorters in that business, and we're seeing roughly 20% productivity or throughput improvements through those new sorters, further improving that activity. And we're a firm believer that this part of our workforce is important and in Presort, we believe that these increases will help us in retention, and that retention, in turn, will yield a productivity and less dependence on contract labor. And on transport. We used transport, we have partially an own fleet and partially we contract out. So obviously fuel costs are out there, we deal with that ongoing. The spot market and transport has increased fairly significantly in a relatively short period. One of the initiatives that we have that we actually ran a pilot on this week is how to optimize some of our routing. We're very encouraged with those early results. But this is an area between both labor and transport that the early stages of our Newgistics and Presort synergy, we see a lot of opportunity, both on labor to share the labor across. We opened up a joint center this past quarter in both Newgistics and Presort as well as transport, and we're seeing early signs of some really good traction there.

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Let me just make a couple of additional points to what Stan said. As you know, since you followed us for a while, we've always had a belief that we should be in the topical quartile in terms of efficiency of various functions. That requires, candidly, insights from third parties in terms of where you have opportunities. And in some ways, this is new, but in many ways, this is just consistent with how we operate since I've been here. The second point I'd make about -- the expense profile overall. If you look at the decline in gross margins, that's roughly offset by the decline in SG&A. So part of that's just a remix into the business but part of that's also a function of the expense initiatives that Stan mentioned. The other point that I'd make on software just to give you a little bit more color. I do think we're in the early innings, second or third. As Stan said, our business has always been historically skewed to the fourth quarter. Software is no different. We had a large deal in the third quarter of last year. So I think you'll see more evidence in the second half but it will be skewed towards the fourth quarter for sure.

Operator

And we do have a question from the line of Kartik Mehta with Northcoast Research.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

Marc, as you look at the E Global -- Global Commerce business, (sic) [Global Ecommerce] sorry about getting my words out this morning. But I look and obviously, you had fantastic revenue growth. But because of investments, EBITDA margins are a little bit subdued. And I'm wondering, if you -- if it's possible for you to say, hey, if it wasn't for the investments, this is what incremental margins are because that business is growing and just trying to understand what the potential is for that business?

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Yes. I'll start with the end of your question. And so when we were together at Analyst Day, we talked about Commerce Services and Global Ecommerce having long-term margins of that 10% to 15% range. We still think that's the right long term view, if you look at the EBITDA margins, you're right, they were less than the ultimate model but there were also up year-to-year, and importantly, outpacing the declines in SMB. And I'm going to keep coming back to that point because I think that's important. If you provide -- only provide a little bit more color, if you think about that road to get to the 10% to 15% ultimate margins, 80% of that half -- 80% of that is driven by scale. So the sooner we can get to the volume that we -- the long-term volume has contemplated in our model, the sooner we get to those margins. So while it's been a touch of a journey to get here, we continue to be encouraged by how quickly we'll pick out new customers, new volume and again, we couldn't be more pleased with the feedback we're getting from our clients.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

So Marc, as you look at that business, do you anticipate this level of investments for 2018, 2019? Or do you think it will be longer than that? Just because you have this opportunity to get a lot of market share and where we make this business a lot bigger.

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

We, for sure see continued investment (inaudible) balance of this year. Kartik, I think that will go into next year as well as get into 2020. I think the investments will begin to moderate. But again, if you look at the EBITDA margins, while not at the ultimate objective. We're getting close to that double-digit range.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

And then as you look at the Presort Business, Marc, obviously, you had some labor issues and other things that Stan talked about. But is this a business that you think after you do automation and some of the investments that you can sustain the margins you had previously?

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Yes. Again, we put out a long-term model at Analyst Day. There's nothing that we've learned or seen about this business that would tell me we're different than those long-term margins. There was the mix issues in the quarter and the half and as you pointed out, some headwinds on labor and transportation. But those are more than offset by the automation opportunities that we see in front of us.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

And then Marc, just the last question on North America Mailing. As you look at the market and maybe what the market is declining and you look at your performance. Do you think -- how would you characterize -- it needs performance relative to how the market is performing?

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Yes. So let's start up a level here because I think it is important to have this is context. As we stated in 2013, our strategic intent here was to drive that business for cash. As you look at the quarter and using EBITDA as a proxy for cash, EBITDA was down $5 million on a year-to-year basis and grew $155 million in the second quarter of last year, went $50 million second quarter of this year, so down $5 million. So as you contemplate that performance relative to the strategic intent, you would say that's getting close to where we had hoped.

Underneath that, you see the streams moderating so I think streams were down low single-digit, that's kind of in the model. And then what's conspicuous is equipment sales. So equipment sales, I'd be the first to admit, through the first half of the year is not what we had aspired, not in our long-term model. Second quarter did have a difficult compare and there were some specific issues on top of the line. So if you look at the -- answer to your question over the last couple of years, I would say the business is performing -- began to perform consistent with our strategic intent. And if you look at equipment sales over the last couple of years, which we kind of grossed over, they were flat. So I tend not to get too excited about numbers over a 90-day period because there was -- there's noises in the numbers. So I think both are true, we've come a long way there in terms of the streams in the cash stabilizing. But it's also true that we've got opportunity and we do believe we'll do better in equipment sales in the second half of the year.

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

I think the only thing I'd add to that Kartik is, we brought shipping into this equation within North America. It's really early days. We quoted some of the numbers on the improvement in shipping and that opens up a new opportunity for revenue streams and it leverages our investments across our enterprise, that start with software and Location Intelligence, go to the APIs through Global Ecommerce and also land here in SMB. So we see a good opportunity to introduce that new stream into SMB, and we're very early stage there.

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

And to that point, I mean, we'll begin to announce and deliver other third party in Pitney Bowes absence or the CSD model in particular, which gives us another opportunity to stabilize that stream.

Operator

And we do have a question from the line of Shannon Cross with Cross Research.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal & Analyst*

I'm focused on cash generation and drivers. So I guess the first, when you think about second half cash flow and you're thinking about improvement in equipment sales, how are you thinking about the contribution from finance receivables? And where else can you kind of, I guess, pull working capital -- well, that would be a negative, but try to drive incremental working capital benefit in the second half?

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

Sure. It's a good question, Shannon. Thank you. As we look at cash flow generation there's a couple of items. As you mentioned, as equipment sales go up, obviously that would be an increase use of cash through finance receivables. I kind of consider that a good cholesterol version, we always want to increase finance receivables over time. If we take a look at our cash generation in the Q2 and first half, if we take a look, there are 2 items that impacted us in the first half that we think we cover in the back half of the year. The first one's around Presort. So Presort, we have 2 situations that we think resolve itself as we go through the second half. The first one is, client puts deficit, we think this is just a timing issue as we close out the quarter and we have some AR collections that we need to do the combination of those 2 and this is not getting down to some level or bend to, it's really just getting back to the norm, we think would drive roughly $30 million of cash back in the half of the year. We also anticipated a tax refund in Q2, that we now anticipate will come in the back half of the year for roughly $16 million. The 2 of those, if you take those, would put us well within the historical range. And then as we think about cash in the back half of the year, you'll see that our CapEx, that was on a heavier side here in first half, we're investing for that automation, system upgrades, automation within Presort, et cetera. As we look through the year between that and other working capital improving our DSO, we think that's what will lead to the cash generation back half of the year along with, obviously, net income.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal & Analyst*

And then I guess, Marc, can you talk about cash usage? Seems like I ask this every quarter, but when you look at the dividend, what you're paying out, the kind of business you're trying to grow on the commerce side, which clearly you're getting revenue growth out of, but require significant investment at least in the near term. How do you sort of balance the dividend yield, and again, what you've done on the balance sheet with where you want to be in, say, 2 years?

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Yes. It's a good question. So once again, we think it's important to our investment thesis that we have a competitive dividend. Competitive in the context that we look at it means relative to your free cash flow. So I anticipate that the mix of the business is going to continue to evolve for sure organically, but also potentially through nonorganic types of opportunities. As I become convinced and the board becomes convinced that the portfolio is stabilized, then we'll take a look at the dividend to see how the dividend should set into the total equation of capital allocation. So right now, we're in a point of flux as we get through this moment, and then we'll make a judgment about how the dividend fits into our overall scheme. I think the other point I'll make about Commerce Services long term, the way that we contemplated that business, there are some investments now. But if you look at the magnitude of those investments, so if you think about a typical quarter or of CapEx, it's $40 million to $45 million. So Stan said, we're $57 million, which is a little bit heavier than normal. But the point that I would make overall is, as we think about Commerce Services, we think of that business as being self-sufficient from a capital perspective. So we'll not take big capital infusions from Pitney Bowes enterprise in order to sustain that business.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal & Analyst*

Okay. And during this call, and in discussions with you, I've heard the word automation numerous times, which tends to lead to restructuring. So I'm curious with the incremental -- the improvements and the discussions you're having with the third party that you brought in, are we looking at another large restructuring program in the future? Or how do we sort of think about how you move to more automation and what it looks like a couple of years out?

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

Shannon, as we go through and look at that, first of all, we are investing in automation. If you think about those areas of the business that we're investing in, those areas naturally have higher turnover. So we think we can probably manage that through time. As we look on a broader set of what's out there for our business model, we'll evaluate that as we go through for any potential restructuring needs. If you look back at our history, we've taken it when it's necessary to migrate the business model faster. As we take a look at where we are right now, the automation and the areas of Presort Newgistics are high labor areas, we think we manage that through normal attrition.

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

The other point that I'd make about -- Presort and automation particular is, they've got a reasonable number of contract labor in there. So it's approximately 20% of the total. So there's a fair amount that you can do with your variable labor as it relates to automation without restructuring.

The way I think about restructuring, probably, as I look at the overall expense takeout programs, they kind of use that as a perimeter for how to think about restructuring.

Operator

And we do have a question from the line of Allen Klee with Maxim Group.

Allen Robert Klee - *Maxim Group LLC, Research Division - Senior VP & Senior TMT Analyst*

I don't know if you can answer this question in detail maybe qualitatively, it relates to SMB. I thought it would be helpful if we could understand when a lease comes due for a postal meter, what percent renew with the same thing? What percent switch to your newer version of SendPro? What percent switch to kind of a lower digital stand-type offering? And what percent kind of dropped service? And how have these numbers kind of changed versus prior quarters?

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

Let me start. As we take a look at -- if you come up to the end of a lease and look at what happens, you kind of outline the multiple scenarios. One, the client could trade up to a new box. I think evidence of that as we take a look at nearly 42,000 placements of some SendPro C-Series is a good example of what can happen. And that's a positive thing. We've seen the take rates be better than history, we've seen longer lease terms and a higher overall value in particular as we add ship. So I think that's a positive sign for what happens there. Another alternative is that the client's happy with a product that they have, we call that a customer privilege lease and we extend that lease for a period of time. That's also a viable option for a client if it fits their need and they don't have additional shipping needs. Now we've brought in digital connectivity even to the older machines that introduces the ability for them to do online printing of shipping labels as necessary. We've also introduced for clients that are somewhat in the middle of a product called SendPro Enterprise, which merges our online capabilities with the machines capabilities across multiple areas. The other alternative is the client could have reduced needs and could trade down. So we, obviously, will go client needs here and try to help them. Introducing shipping into this equation allows us to expand that relationship even if they keep the same machine or go to a lower level machine. But the client simply doesn't have the volume anymore to deal with a traditional meter application. We have an online offering that enables them to put print postage and it also enables them to do multicarrier shipping at a very reasonable price. And then of course the last one is potentially that they could choose not to reengage. I think when you take a look at our overall revenue, one thing to look at is a positive indicator as we've seen the streams, remember, it's roughly 75%, 80% stream driven. We've seen those stream's rate of decline start to moderate and if you look in particular the last 2 quarters, they've improved their rate of decline from a year ago. So I won't get into specific percentages, I think we need to look at in context of take rates on new machines, the improvement in the rate of decline on the stream revenues and then the continued offerings that we continue to bring out in terms of shipping and maring those capabilities, new financing offerings we bring out which expand the relationship with the client.

Allen Robert Klee - *Maxim Group LLC, Research Division - Senior VP & Senior TMT Analyst*

And do you still have confidence in the longer-term outlook of the declines for the segment?

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

We do. And again, that's over -- it's over time. And when we look at this, again, I would look at a couple of leading indicators. So Marc mentioned, I look at kind of equipment sales almost like if you would may, equivalent to services business, the signings or the equipment sales in any 1 quarter, they're certain important. What's really important is what's happening to that receivable base over time. And I think looking at a point in time, I could give false indicators in both directions. So if you take a look, we had a difficult compare this year in Q2. If you recall last year as we launched a new product, we have it easy here. We have a new product out here, so we are anticipating better performance in...

Operator

And we do have a question from the line of Glenn Mattson with Ladenburg Thalmann.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Most of the questions have been answered. I'm curious have you pointed out what long-term gross margins will look like when all the shifting has occurred over the next, say, 2 years or something like that? I mean, I know it's declining a bit here but just kind of where would you expect this to settle out when things normalize?

Stanley J. Sutula - *Pitney Bowes Inc. - Executive VP & CFO*

Yes, Glenn, I'd point you back to -- first of all, thanks for the question. I'd point you back to our Analyst Day and if you look at the long-term model as we look at EBIT margins, we expect that Global Ecommerce in the 10% to 15% range, Presort to be greater than 15%, SMB in total to be 30% or 35%, software, you get the leverage from that model, 15% to 20%, and I think that's what we still expect over the long term. I think if you take a look at our total margins, you're seeing an impact now as we shift in that Newgistics portfolio, it's kind of different margin profile. But what I would point to is couple of points, if you take a look at the last 3 quarters on gross margin, they've been within a point of each other. And if you take a look at had what been some of our more volatile and North America Mailing, you take a look at that, that margin has really stabilized over the last 4 quarters. So I think you're seeing some signs of that shift as we go through. EBIT margin continues to benefit from the cost actions that we're taking and you saw that in the form of growing EBIT dollars and that the EBITDA basis with the Global Ecommerce outpacing the decline in SMB. So I think you're seeing signs in our financial model of our long-term strategic model starting to manifest themselves. That's going to continue over time. And we'll continue to take out the spend to reset our structure for the long term. So it's a journey, it's not a point in time, not going to predict a point where we exactly get there, but I think we've got some good signs of progress.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

And Marc, do you have any -- are you involved in discussions or do you have any concerns kind of significant disruption, potentially, maybe inside the Presort business as it regards to legislative changes around the post office. Can you talk about that at all?

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Yes. We watched that closely, obviously, and I have been to Washington as have several of my colleagues several times over the last month to give our point of view. If you think about what they're trying to achieve, they're trying to achieve a postal system that has long-term vitality. If you think about what Presort does, Presort's at its core, a work-share program that is designed to take cost out of the entire system. So while I think it's too early to tell how the legislation turns out if there is any, we do think that Presort is well positioned from a historical perspective because of their work-share orientation.

Operator

And at this time, there are no further questions in queue. We'll be turning the call back to Mr. Lauterbach for closing remarks.

Marc B. Lautenbach - *Pitney Bowes Inc. - President, CEO & Director*

Sure. Thank you for your time this morning. I'd make just to a broad contextual remark. We've talked about how transformation to play out and what the anatomy of a transformation looks like and there is a certain predictable personality of transformations that work. The first is new leaders, followed by quick wins, followed by sustained investments, followed by investment growth, followed by profitable revenue growth. If you look at that pattern, you can clearly see that inside of Pitney Bowes. I think that bodes well for the ultimate success of this transformation. The second quarter was important in terms of our growth businesses and the profit associated with those growth businesses outpacing the decline in our legacy businesses. That said, we're not done. We're not out of the woods, we're not declaring success, I'm not even declaring an inflection point, but I do think the pattern is important. So we're encouraged. I would say the second quarter was a step forward. But it's nowhere near as good as it can be. So more in front of us but we're pleased with the progress so far. So talk to you in 90 days. Thank you.

Operator

And ladies and gentlemen, today's conference will be available for replay after 10 a.m. today through September 1. You may access the AT&T teleconference replay system at any time by dialing 1 (800) 475-6701, entering the access code 451176. International participants may dial (320) 365-3844. That does conclude your conference for today. Thank you for your participation, and for using the AT&T Executive TeleConference service. You may now disconnect.