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PBI - Q2 2016 Pitney Bowes Inc Earnings Call

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OVERVIEW:

PBI reported 2Q16 revenues of $836m and GAAP EPS of $0.28. Expects 2016 constant currency revenue to decline 1-3% and adjusted EPS to be $1.75-1.82. Co. expects 2H16 constant currency revenue to be in range of 2% growth to 2% decline and adjusted EPS to be $1.03-1.10.

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CORPORATE PARTICIPANTS

Adam David *Pitney Bowes Inc - VP of IR*

Marc Lautenbach *Pitney Bowes Inc - President & CEO*

Michael Monahan *Pitney Bowes Inc - EVP, COO & CFO*

CONFERENCE CALL PARTICIPANTS

Ananda Baruah *Brean Capital, LLC - Analyst*

Kartik Mehta *Northcoast Research - Analyst*

George Tong *Piper Jaffray - Analyst*

Shannon Cross *Cross Research - Analyst*

Allen Klee *Sidoti & Company - Analyst*

Glenn Mattson *Ladenburg Thalmann - Analyst*

Chapin Mechem *NE Investors - Analyst*

PRESENTATION

Operator

Good morning, and welcome to the Pitney Bowes second quarter 2016 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 call, Mr. Marc Lautenbach, President and Chief Executive Officer, Mr. Michael Monahan, Executive Vice President, Chief Operating Officer and 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 2015 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 most of the points we'll 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 Lautenbach - *Pitney Bowes Inc - President & CEO*

Good morning, and thank you for joining our second quarter earnings call. Mike will take you through the specifics of the quarter. As has been the case for the last several years, there were a lot of moving parts to the quarter. From my perspective, there were four themes. Let me discuss each of them.

First, our ecommerce business continued to gain momentum, and the business is positioned for a strong second half. We continued to add new clients and new geographies. I'll come back to this in a moment, however, this business is well-positioned in a rapidly growing market.

Second, in our software business, we still have work to do. In previous communications, I have pointed to the importance of building channel partnerships with systems integrators and other technology companies, and we did make substantial progress on that score in the second quarter. We signed with 11 systems integrators, 2 global, and 9 regional.

Let me give you an example of a relationship with a global systems integrator. In June, we joined forces with Accenture Digital, a world class leader in digital customer experience. Pitney Bowes EngageOne video solution will be offered to Accenture digital clients who are in the midst of their digital transformation strategy.

Clients across verticals and public service industries can deploy EngageOne video to boost customer loyalty, improve new customer onboarding process, spur content development and scale video production. The scale that a partner like Accenture brings to Pitney Bowes gives us opportunity for meaningful progress. On a related point, according to the second quarter Forrester Wave Communications Management port and I quote, video support through Pitney Bowes interactive and personalized EngageOne video solution is best-in-class, close quote.

Also in June, we entered into OEM agreement with IBM. This agreement helps strengthen our position as a location intelligent supplier to a market leader in business intelligence and analytics markets. These relationships and accolades are important for two reasons. First, they confirm that we have good products. Second, getting good products to market requires the right channels. All these partners are best-in-class in their respective markets, and I'm confident they'll be important partners in bringing our products to market.

Let me lay out how I see the software business moving forward. You should see improved license performance as the first step in this business improvement, and we are starting the second half with a much improved pipeline. That will lead to improvements in subsequent quarters, and their related streams. As I mentioned in the last quarter, I expect this business to improve throughout the course of the year. While overall business investment in technology is soft, I still believe we can turn in better performance.

Third, as we discussed on our last call, we deployed our new enterprise business platform in April in the United States. Although we often call this an ERP project, that really does not do justice to the scale of this initiative. The platform affects every aspect of our business, including how sales opportunities are managed, products are configured, leases and bills calculated, financials produced, customer service delivered, and client satisfaction managed. It is a substantial business process and technology reengineering project, and now extends to approximately 80% of our revenue base.

It is already producing benefits to our business, and will deliver substantial benefits to our business over time. It is worth noting that some of the significant products announcements we have made in the last 90 days have been enabled by our new business platform. All that said, the implementation of this platform caused some short-term interruptions to our business, particularly in the high volume portion of our meter business in April.

Mike will elaborate on this more in his comments, but here's the bottom line. The platform now covers the preponderance of our business, and the business case is still intact. In some cases, we can already see that the business benefits will be beyond what we had originally contemplated.

Fourth and most importantly, we have been focused from the beginning on creating long-term shareholder value. I said to my team this last April, that I believe the second quarter of 2016 will be one of the most pivotal quarters in our Company's history, and our transformation efforts to establish those fundamentals that enable long-term success. Let me explain what I mean, based on our strategic pillars, the reinvention of mail, operational excellence, and growth of our digital commerce business.

We made substantial progress in the reinvention of our mail business during the second quarter. A big part of this, as you all know was the launch of the Pitney Bowes Commerce Cloud in April. The response from clients has been very encouraging.

We have already attracted more than 1 million unique visitors to the Commerce Cloud portal. The number of clients using the web to purchase supplies has increased by 25%, and we are seeing incremental demand for our shipping products, particularly our SendPro solution and our APIs. APIs provide a new opportunity to monetize our software assets, as developers and ISVs embed our capabilities in their products. While it will take time for demand to drive recurring revenue streams in these new areas, this initiative is integral to create new value for the small and medium business market and all of our existing clients.

Last month, we announced SmartLink, a digital technology solution that connects our existing install base of postage meters to the Pitney Bowes Commerce Cloud to streamline the client experience, and enable services from the Commerce Cloud. We will continue to innovate in this area.

Next, operational excellence. In one of my very early earnings calls as a CEO, I said that I thought CEOs are sometimes guilty of blaming execution, without looking more deeply at root causes. Things like, do you have the right channels, the right skills? Is the brand positioned correctly, do you have the right systems to enable execution? Over the last three years, we have slowly, sometimes more slowly than I wanted, but methodically addressed these items.

I also said, over time you will see the benefits of these endeavors in the income statement and balance sheet. I still believe that. The benefits never come fast enough, but there's no doubt in my mind that investing in channels, brands, systems, products and our people is the best way for us to build long-term shareholder value.

Finally, growing digital commerce. We've already covered software so I won't rehash it, beyond saying that while we still need to improve, we can deliver results and we made real progress in the second quarter, building channels and pipelines in the second half. In our ecommerce business, we added 15 new retail store fronts in the second quarter, bringing our total to almost 240 worldwide. Last week, we added an additional five stores, and announced that we were adding outbound capabilities in Australia, to our existing outbound businesses in the United States and the UK.

In addition to growing our existing relationships, these new store fronts have positioned this business for sustainable growth going forward. One opportunity that has become particularly hot, is helping US and UK retailers sell into Asia, particularly China. Over the last several months, I've had the opportunity to visit potential clients in India and China, and the demand for our cross-brand capabilities is one of the most impressive things I've ever seen.

Bottom line, while I thought we had the opportunity to do better in the second quarter, we cannot be more pleased with the progress we've made on our strategic agenda, and we've set ourselves up for an improved second half. I'll make a few final remarks after Mike. But at this point, let me turn the call to Mike.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Thank you, Marc, and good morning. Marc outlined how our actions in quarter are in line with our transformation objectives. I want to focus my comments on three things. First, the impact of our enterprise business platform launch in the US on our results in the quarter and forward. Second, the specifics of the second quarter, and third, our outlook for the remainder of 2016.

Let me begin with what we've been calling our ERP program, but is actually a remake of our enterprise business platform, including IT systems, web capability and new product enablement. In fact, at the same time we went live with this new platform, we also brought online new web store capability, client self-service functionality, and our new SaaS-based SendPro product which leverages new subscription billing capability. The new platform we put in place was critical to us launching each of these items. As we look to the future, the long-term benefits of our new systems far outweigh the impact on results in the second quarter.

In April, we launched the new enterprise business platform in the US. The US represents 75% of our consolidated revenue, generates 90% of consolidated business segment EBIT, and covers every one of our business models. As a result, we developed and implemented a robust cutover plan. The results in the second quarter reflect the temporary impacts of that transition.

Our enterprise-based businesses including production mail, presort, software, and cross-border ecommerce were not materially impacted by the transition. However, given the scale and run rate nature of selling to a large installed base in our SMB and shipping businesses, there were impacts to revenue and profit resulting from the transition. This manifested itself principally in two areas. First in sales productivity, particularly inside sales and supply sales where selling days were lost to conversion, training, and early productivity. And second, in financing-related fees as a result of proactive waivers to compensate for delayed billing associated with the system cutover, and client acclamation to new billing formats.

To give you some sense of the work needed to do this transformation, we had to take down multiple older legacy systems, do a phased ramp up of new functionality, train across our sales, service, customer care and back office teams, and then validate the new processes. All of these efforts had an impact on sales productivity.

Our inside sales and supply sales groups initiate and make sales on the same day, often in a single call, so time off the phone is lost sales productivity. So while it's not our practice to provide comments on monthly activity, we felt it'd be instructive to provide insight in this case, given the unique circumstances related to the systems go live. The impact on our results from this change was most pronounced in the month of April.

We began to see productivity improvements in May, as teams adapted to new processes, but we were not yet at pre-go live levels. By June, sales and supplies performance began to normalize closer in line with pre-go live levels. Late June and early July results suggest a return to pre-go live levels, and we will continue to drive further automation and process enhancements throughout the second half.

It is our estimate when comparing monthly activity in the second quarter to pre-go live activity levels in the first quarter of this year, and second quarter of last year, that total revenue was reduced in the second quarter by an estimated $15 million to $20 million or 2 percentage points related to our systems go live activities.

Based on the mix of revenue impacted, we estimate the EBIT margin impact to be about 100 basis points. Overall earnings before interest and taxes or EBIT is estimated to have been negatively impacted by about $9 million to $12 million, or an estimated $0.03 per share. Earnings results for the quarter also included costs of development and deployment of our business platform.

While we continue to make refinements and enhancements to the system and have opportunities for further improvements in productivity, we believe material impacts to revenue related to the US go live are behind us, as we enter the second half of the year. We are pleased that with the cutover in both Canada and the US, we now have approximately 80% of our revenue, and the vast majority of our profit for the Company deployed on our new infrastructure.

Turning to the quarter, we did see some improving trends in several parts of the business this quarter, as compared to our first quarter results. But in addition to the impacts of our enterprise business platform, software continued to underperform as Marc mentioned. Within global ecommerce our cross-border ecommerce business grew organically at a double-digit rate over prior year, and improved at the EBIT margin from first quarter performance.

The shipping solutions business was down year-over-year, in part as a result of the enterprise business platform cutover. International mailings revenue comparison continues to improve from prior trends. Production mail saw an improvement in its revenue comparison and EBIT margin. Presort services also continued to show revenue growth, though at a lower rate than the prior quarters. Our software business continued to experience lower license sales year-over-year, as we take actions to improve our channel effectiveness.

As Marc outlined we are improving sales efficiency, and are making good progress expanding the indirect channels to improve our market access. As he noted, we added a total of 11 new and regional systems integrators. These actions will take time to be fully reflected in the results, but we've already increased our pipeline of deals during the second quarter.

I also wanted to highlight that the work we have done thus far to invest in, and change our business operating infrastructure continues to be balanced with our commitment to managing total return to shareholders. During the quarter, we repurchased approximately $66 million in shares of our common stock, and continued to pay a competitive dividend. This brings our year-to-date total share repurchase to about $195 million or a little over 10 million shares. And at the end of the quarter, we have about $20 million remaining on our authorization of $150 million.

Let me now take you through the high level second quarter financial results. And then, I'll provide details on each of the segments results, and provide an update on our 2016 guidance. Please note that a reconciliation of GAAP to non-GAAP financial measures can be found in the financial schedules appended to our earnings press release and earnings slides, which are posted on the PitneyBowes.com website under the Investor Relations section.

Turning to the results, revenue for the second quarter totaled $836 million, which was a decline of 4% on a constant currency basis adjusted for market exits, and a decline of 5% on a reported basis. The revenue impact of the systems cutover reduced consolidated revenues by an estimated $15 million to $20 million or about 2 percentage points of growth. Revenue in our SMB segment group declined 7% on a constant currency basis adjusted for market exits, and declined 8% on a reported basis.

Within SMB, North American mailings revenue comparison to prior year was adversely impacted by an estimated 5 percentage points, due to the temporary business impact of cutover to the new enterprise business platform in the US. Revenue in our enterprise business solutions group grew 1% on a constant currency basis adjusted for market exits, and was flat on a reported basis. Digital commerce solutions revenue grew 12% on a constant currency basis, and 11% on a reported basis.

Adjusted earnings per share from continuing operations were $0.39. When compared to the prior year, our adjusted earnings per share results this quarter were impacted by the estimated $0.03 impact that I discussed earlier, related to the disruption caused by the system integration cutover, $0.02 of incremental ERP expense, and $0.02 of income recorded in the second quarter 2015 for our Imagitas business that was subsequently divested last May. GAAP earnings per share were $0.28, which include $0.09 in restructuring charges recorded in the quarter, and a $0.01 loss from discontinued operations.

Free cash flow was $86 million and we generated $95 million on a GAAP basis in cash from operations. Free cash flow was slightly favorable to prior year, as favorable working capital and lower capital expenditures were partly offset by lower net income. Free cash flow was also impacted by delayed billing and collections activity associated with the systems cutover. These impacts are expected to normalize in the second half of the year.

During the quarter, we returned cash to shareholders in the form of share repurchases and dividends. We spent $66 million on the repurchase of our common stock, buying 3.5 million shares in the quarter. We also paid $35 million in dividends to our common shareholders. Additionally, we made $12 million in restructuring payments. The Company also received $18 million of cash from investing activities related to the sale of a building in Troy, New York.

Turning to the income statement, adjusted earnings before interest and taxes or adjusted EBIT was $154 million this quarter, which was $26 million lower than the prior year as a result of the reduced revenue related to systems cutover, as well as incremental ERP and R&D expenses, the sale of Imagitas, and the software revenue decline. Adjusted EBIT margin was 18.4%. Adding back depreciation and amortization, adjusted EBITDA was $199 million for the quarter.

SG&A for the quarter was $289 million, which was $17 million or 5% lower than the prior year. As the percent of revenue, SG&A was 34.5%, which was nearly flat to last year. SG&A declined in absolute terms year-to-year, primarily driven by lower employee-related costs. This quarter included incremental ERP and marketing expenses. Also when compared to the prior year, current year SG&A includes a full quarter of amortization expense associated with the acquisition of Borderfree.

In support of the savings objectives related to our enterprise business platform rollout, we recorded a pre-tax restructuring charge of $[17] million at the end of the quarter for actions taken to improve operational efficiency and productivity across our business portfolio. In addition, we recorded an asset impairment charge of $8 million in the quarter. Also R&D expense increased from prior year by $6 million as a result of bringing new solutions like SendPro, SmartLink and the Commerce Cloud to market concurrent with our infrastructure rollout. In addition, investments in ecommerce R&D were up from prior year due to the integration of our technology platforms.

Net interest expense, which includes financing interest was $34 million, which was a decline of about $5 million when compared to the prior year, which is the result of the actions we have taken to manage our debt portfolio. Average outstanding borrowings during the quarter were about

$200 million higher than the prior year. The average interest rate this quarter was [4.46]%, which was about 80 basis points lower than the prior year. The effective tax rate on adjusted earnings for the quarter was 35.7%, which was 320 basis points higher than the prior year's tax rate. This reflects increased tax attributable to a change in the mix of earnings.

Now I'd like to discuss our second quarter results for each of our business segments. This information can also be found in our earnings press release, and the slides that we post to the PitneyBowes.com website under the Investor Relations section. For SMB Solutions, in North American mailing, revenue was $322 million and EBIT was $142 million.

As I discussed earlier, we have estimated this quarter's revenue comparison to prior year was negatively impacted in the range of $15 million to $20 million, or about 5% due to the revenue reduction related to the enterprise business platform implementation, and its impact on equipment sales and recurring revenue streams. Of the estimated revenue reduction, the split is roughly two-thirds equipment sales, and one-third for the recurring revenue streams.

I should note these temporary impacts related to the system cutover in the quarter are not ongoing changes in the end market. Therefore on a reported basis, equipment sales and recurring revenue streams declined from prior years at a greater rate versus prior quarter trends. EBIT margin was 44.2% which was 50 basis points lower than prior year, mostly the result of the lower revenue.

In international mailing, revenue was $106 million and EBIT was $13 million. The segment's year-over-year revenue performance continues to improve. Equipment sales grew from prior year, most notably in France, Italy and Japan, in part due to improved sales productivity from the go-to-market changes especially in France.

The decline in recurring revenue streams was also the lowest we saw in seven quarters. Overall, constant currency revenue adjusted for market exits was flat to the prior year. EBIT margin was 12% which was 80 basis points lower from prior year, primarily due to the equipment sales mix of business.

Turning to enterprise business solutions, our overall segment group's revenue was flat on a reported basis, and grew 1.5% when adjusting for production mail market exits, which is in line with our long-term outlook for the segment. In production mail, revenue was $96 million and EBIT was $13 million. Equipment sales grew over prior year, due to higher sorter equipment installations.

Support services and supplies revenue declined, in part as a result of some in-house mailers shifting their mail processing to third-party outsourcers and the recent market exits. EBIT margin was 13.5% which was an improvement of 320 basis points from prior year, and mostly driven by service delivery cost management initiatives. In presort services, revenue was $116 million and EBIT was $21 million. Revenue benefited from the higher volume of First Class mail processed, as well as expansion into the St. Louis, Chicago, and Portland markets, but was partly offset by lower volumes of standard mail processed.

EBIT margin was 18.3%, which was a decline of about 240 basis points versus prior year, primarily as a result of the USPS rate change and increased labor costs. For digital commerce solutions, in software solutions revenue was $90 million and EBIT was $10 million. Revenue declined from prior year, due to lower licensing revenues and lower data-related revenue.

As Marc outlined and I noted earlier, we are actively signing up new systems integrators and reseller partners, as part of our continued focus on expanding the indirect channel, and improving sales efficiency to improve the pipeline of deals. EBIT margin was 11.2% which was a decline of 510 basis points versus prior year, mostly due to the lower licensing revenue which has a high margin. We are taking actions to further improve our software margins.

In global ecommerce, revenue was $105 million and EBIT was $4 million. Results this quarter included a full quarter of Borderfree revenue, as compared to one month of revenue in the prior year. Revenue benefited from strong growth in the UK marketplace business, and the launch of new retail store fronts. Outbound US marketplace package shipments grew in the quarter, despite the stronger US dollar versus prior year.

When adding pre-acquisition Borderfree revenue back to the prior year, for comparative purposes organic growth in our cross-border business was 11%. This compares favorably to the first quarter, which was slightly down from prior year. The improved second quarter performance is due to the growth in outbound volumes in both the UK and the US.

Shipping revenue declined from prior year, in part as a result of the enterprise business platform cutover and lower license sales. EBIT margin was 3.5%, which was a slight decline of 40 basis points versus the prior year. This was due to the amortization of acquisition-related intangible assets, investments for growth in the business, and a lower mix of our higher margin domestic shipping business which more than offset synergy savings. This business remains on track to achieve its synergy run rate objective by year-end.

One thing of note, I'd like to also address is the impact of Brexit on our global ecommerce business. Due to the vote passing late in June, we did not see any material impact on our results in the second quarter. It is still early days, and difficult to determine the longer term impact to the business. However, in the short-term, the weakened British pound has created additional opportunity for our UK outbound business, but has an opposite impact for US goods into the UK, as the goods have now become more expensive.

We'll continue to monitor this situation. Early July results suggest that the UK outbound growth is being more than offset by the decline in US outbound to the UK. Over time, expansion and globalization of our cross-border ecommerce business will create natural hedges that should moderate the impacts of currency movements.

That concludes my comments on our financial performance for the quarter. Now I would like to discuss our updated annual guidance, and provide some insights for the second half of 2016. Based on year-to-date results, particularly in software along with the second quarter temporary impact in North America mailing, as a result of the new Enterprise business platform cutover, the Company is adjusting its annual guidance. We will take the added step this one time, to provide further details on both our second half and full year guidance.

For full year 2016, we now expect revenue on a constant currency basis to be in the range of a 1% decline to 3% decline when compared to 2015, adjusted earnings per share to be in the range of $1.75 to $1.82 which excludes the year-to-date charge of $0.13 related to restructuring, asset impairments, dispositions expense and discontinued operations. Free cash flow to be in the range of $400 million to $450 million.

We are also narrowing the range of our annual tax rate on adjusted earnings, and now it's expected to be in the range of 33% to 35%. For the second half of the year, we expect constant currency revenue to be in the range of 2% growth to 2% decline, compared to the constant currency decline of 4% experienced in the first half of the year. We expect adjusted earnings per share to be in the range of $1.03 to $1.10, and free cash flow to be in the range of $254 million to $304 million.

To achieve improvement in the second half as compared to the first half of the year, we expect the North American mailing business to return to a more normalized level as we progress throughout the second half, and our enterprise solutions group is expected to perform similar to the first half. And digital commerce solutions performance levels, subject to no material changes in key currency valuations or any new material impacts from the Brexit decision or Canada post labor negotiations, are expected to improve from the first half performance levels.

We expect software license revenue growth to improve, as a result of the progress we are making in channel efficiency and channel partner engagement. For global ecommerce, we expect constant currency revenue in the second half to grow double-digits post the anniversary of the Borderfree acquisition. This will be driven by continued transaction volume growth, as well as the acquisition of new, and expansion of existing retail clients.

Adjusted earnings per share in the second half when compared to the first half, will benefit from the expected revenue improvements, reduced marketing and ERP spend, and particularly in the fourth quarter the early benefits from the in from structure cost savings. Free cash flow in the second half, as compared to the first half will benefit from the recovery of delayed billing and collections activity, related to the systems cutover.

I would also like to provide an update on our overall ERP project. With the US launch, we now have the majority of our revenue, profit and transactional activity on our new platform. In the second half of 2016, in North America, we will focus on optimization of the platform, driving revenue from our new Commerce Cloud solutions enabled by the platform, and delivering the savings opportunity related to the program.

In addition, we've begun the implementation, planning, and integration for our international rollout in 2017. We are still on track to achieve the targeted levels of expense and benefits in 2016. To date, in 2016, we have expensed about $20 million, and have recognized some early benefits. We expect some benefits to come in during the third quarter, but the majority to materialize in the fourth quarter.

Additionally, we will spend incremental CapEx in 2016 related to the ERP program to enhance automation of manual processes, increase web capabilities for client self-service, and add new functionality. This added capital is not expected to increase the Company's overall CapEx spending for the year, due to lower spending in other areas. We will provide a more detailed update on the overall program performance and benefit realization at our Analyst Day later this year. That concludes my remarks. Operator, please open the line for questions?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Ananda Baruah, Brean Capital.

Ananda Baruah - *Brean Capital, LLC - Analyst*

Hey, guys. Good morning. Thanks for taking the questions. Hey, just a couple if I could. The first one, just wanted to go back to your remarks on the ecommerce business, and get a couple clarifications. First off, could you, Mike, could you go back over the organic growth commentary for this quarter, and what you said the related organic growth was for the year ago quarter? And then, I have a follow-up to that, thanks.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Sure. In terms of the ecommerce organic growth, looking at the cross-border business, it was 11% in the second quarter, and that compares to it being slightly down in the first quarter. One of the main drivers, obviously has been the improving comparison of the US dollar, relative to the other currencies that we sell to outbound in the US. In addition to that, very strong growth in our UK outbound business, and the addition of new retailers to the marketplace -- or the retail component of our business. So we've seen that improve, in terms of growth in outbound volumes from both markets. So we feel good about the direction of that, now that we have a better currency comparison.

Ananda Baruah - *Brean Capital, LLC - Analyst*

And the cross-border growth of 11%, that includes everything, that you just spoke of? It includes UK outbound, as well as the Borderfree outbound, and your traditional eBay outbound (multiple speakers)?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Correct. So we think of the traditional eBay as a marketplace, and the Borderfree component more as the retail. That's inclusive of both of those pieces.

Ananda Baruah - *Brean Capital, LLC - Analyst*

Okay, awesome. And then another clarification, was I accurate in interpreting your remarks, that the FX headwind from US outbound into the UK, is actually being for the most part, offset by the FX tail winds from your UK business outbound now as well?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Yes, if you look at, and again, given the change in the value of the pound in the last several weeks, given the Brexit vote, it's early days to know exactly what the pluses and minus will be. But the weakening of the British pound has actually made purchases from the UK grow, because of the less -- lower cost to buy from the UK. And the flip side of that is, UK is an important outbound market from the US, and that's made the goods from the US a little more expensive into the UK. So it's actually, in early days, a slight negative, given the amount of volume outbound from the US. But as the UK grows, that obviously diminishes.

Ananda Baruah - *Brean Capital, LLC - Analyst*

Okay. Got it. You mentioned, you made comments just a moment ago about, for Border [recent return goal is] by the end of the year. And so, could you context that for us a little bit? The overall margins for the business are -- I think was 3.5% this quarter, which is a decent snapback. If I recall, the [Maponics] acquisition, the returns commentary you guys made for Border, I believe was mid teens or 15%, over the first 18 months of the kind of acquisition close. I would just love to get a sense of what we can expect, for the margin as we go through the second half of the year? And sort of what it means to you guys to kind of hit your return targets for Border, as to your remarks for -- by the December quarter? Thanks.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Sure. Let me just approach it from a high level. So if you think about it, from an acquisition standpoint, what we said upfront was, we would get $20 million, $25 million of synergies out of the business. If you look at the amortization associated with the intangibles of the business, that runs at about $18 million a year. So getting those to be offset -- so we've gone from, basically flat to a little bit positive in the first quarter in that business. We think the leverage and the growth in the volumes is ultimately what drives the margin.

We still have some synergies left to go, through the balance of the year to get, so we see margin upside. The 15% margin is a long-term objective for the digital commerce solutions business. I would say, we're where we expect to be, with the acquisition in terms of sort of the rate and pace of achieving the synergies, as well as beginning to see the growth in the volume of the business.

Ananda Baruah - *Brean Capital, LLC - Analyst*

Okay. That's really helpful. Thanks a lot. I'll cede the floor for now.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Thank you.

Operator

Our next question is from the line of Kartik Mehta with Northcoast Research.

Kartik Mehta - *Northcoast Research - Analyst*

Hey, good morning, Marc and Mike. I wanted to ask you -- you talked about the ERP system now impacting about 80% of revenue. And I was wondering, the confidence level, why the remaining 20% will go well, and according to your plan and in time?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Sure. I mean, the simplest answer to that is the most complex implementation of the program is in the US. Because we have the broadest range of business models, the highest volume of activities. So getting it right in the US accomplishes two things really. One is, it obviously gives us a lot of experience in doing the cutover process, and converting data and all that. Second, we're maturing platform. And so, when we go to the other markets, we have a much more complete and fully featured solution, and we've got people who have been through the process of implementation. So that strengthens our view of our ability to bring that into the other markets.

Kartik Mehta - *Northcoast Research - Analyst*

So Mike, if you look, what do you think went wrong? It seems as though -- I believe you had the Canadian ERP solution in first, if I remember right, and that went well. As you look, was it just the scope of the project, because the US is such a large market, or was it something else that resulted in this not going as well as you would have liked?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

I wouldn't say that it didn't go well at all. I would say, it went quite well. The impacts we're talking about here, are really due to lost selling days. If you think about inside sales and supplies, every day is a selling day. And so, as part of a natural cutover, you take systems down, and you go through training, those are lost selling days. So we don't think at all that this was problematic. We think it actually went quite well, that in three months, we're back where we started before, and have opportunity for further improvement.

Kartik Mehta - *Northcoast Research - Analyst*

Okay. And then, finally, could you just provide maybe a little bit granularity, about the earnings cadence you would expect in the third and fourth quarter? I know you've said fourth quarter, you'll get the biggest benefit. But to us, to understand what type of benefit, it seems like fourth quarter has to be a pretty good quarter for you guys, from a year-over-year earnings standpoint. I just want to make sure that I understand maybe the cadence of earnings?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Yes, it will definitely be more weighted to the fourth quarter for a couple reasons. One is, and probably most significant is, the benefits associated with the ERP rollout. So there's a couple things that happen, one is productivity in the back office. We obviously ramped up resources to ensure we went through the cutover process smoothly. We'll ramp down those resources over time.

We'll begin to get the benefits of taking the old systems down, and those types of things. So those benefits will be skewed to the second half. We'll also continue to see improvement in the productivity of our sales organizations, back office organizations, finance, IT, as we, as people get more familiar, more comfortable with the systems. So we clearly, see a heavier benefit from that in the fourth quarter.

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

I'd like to say, add to Mike's comments about the implementation I've had an opportunity to see probably a 100 of these implementations. This is about as good as it gets.

So if you think of the life cycle of these systems and processes that we're deploying, it's measured in a decade or so. To have 60 days of interruption for a decade of benefit of $100 million-plus, I'll take that trade every time. It certainly wasn't helpful for the quarter, but it is right thing to do, was the right thing for the long-term of the business. And just the simple scale of the United States is so much greater than Canada, and Canada was so much greater than everything else, that was -- and this was the difficult deployment that we really had to focus on.

Kartik Mehta - *Northcoast Research - Analyst*

All right. Thank you very much. I appreciate it.

Operator

We have a question from the line of George Tong, Piper Jaffrey.

George Tong - *Piper Jaffray - Analyst*

Hi, thanks. Good morning.

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

Good morning.

George Tong - *Piper Jaffray - Analyst*

Can you elaborate on when you expect North American SMB revenues to return to more normalized declines of about 2%?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

So we've talked about the normalized run rate of the SMB business being kind of minus 2% to minus 4% from a market perspective. And if you look at, over the last several quarters, we've certainly been in that range, and we believe now having gone through the sales force change, as well as now the systems change, that we should be able to return to that level, sort of pre impact and post our change in go-to-market. And then, obviously, we've begun to bring new products to market, that should provide us some enhanced opportunities as well.

George Tong - *Piper Jaffray - Analyst*

Got it. And then from a timing perspective, would you expect 4Q to be the quarter where you see the sort of 2% range, and 3Q more of a transitional quarter?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

In terms of absolute numbers, I'm not going to do that by quarter, but certainly, the fourth quarter we think we're fully back on track. We think the third quarter certainly will be a significant improvement from this current quarter, as a result of seeing that late June or early July, we were pretty much back on track to where we were prior to the go live.

George Tong - *Piper Jaffray - Analyst*

Got it. That's helpful. You've touched on new software sales channels with partnerships with system integrators. Can you discuss any other steps you've taken to improve further improve software sales execution?

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

Sure. Let me kind of divide this into a couple of different layers. As we talked about earlier in the year, we brought in new leaders, they are continuing to evolve the team. I would characterize those changes as on the edges, but certainly not anything terribly disruptive, and we're continuing to invest in the products. So if you look at the second quarter, you would see R&D spending gone up. And it certainly had a lot of different contributors to it, but our digital commerce business including software was an aspect of that. And we're working at, what I would say is tuck-in type of acquisitions.

So we made an acquisition in the second quarter of a company called Maponics, fairly small in size, but it helps our products get better. So we're evolving the management team. We're continuing to invest in the products and, obviously our central focus has been channels. My thesis all along has been, we've got the right products. So we need to continue to invest in those, but we've got to get the channels to get us to these new markets.

George Tong - *Piper Jaffray - Analyst*

Very helpful. And then, lastly in global ecommerce, can you discuss your plans to launch any potential new outbound shipping countries beyond the US and UK? And any other discussions you've had to add to large marketplaces to supplement growth?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Yes. So George, we just announced in the last week, that we are beginning outbound from Australia, so we have a number of retailers that we're beginning that process with. So we continue to look at opportunities to expand globally, that is our next and newest market. And we'll continue to look at other markets as we go forward.

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

I would also say, our thinking has shifted a touch on this subject, in that if you'd asked me a year ago, what were our primary drivers of growth in ecommerce? I would have said, the addition of more outbound countries. Actually, am now starting to think that the best and closest opportunity for growth is what I said before, and that is outbound from the United States, outbound from the UK, outbound from Australia, but into markets like China and India. Given the consumer and the middle class evolution in those places, coupled with the strong brands that we have partnerships within the US and the UK, that has become the most obvious near-term opportunity for growth. So we'll double down on some of those outbound lanes from markets we're already in, in order to facilitate growth into markets that have good engines or growth.

George Tong - *Piper Jaffray - Analyst*

Very helpful. Thank you.

Operator

Our next question comes from the line of Shannon Cross, Cross Research. Shannon Cross, your line is open.

Shannon Cross - *Cross Research - Analyst*

Oh, sorry about that. Marc, I wanted to follow up on the last question, or actually the last comment you made. Because I'm curious, what specifically can you do to drive more sales outbound into China and India? What do you think the retailers need from a support standpoint, and just sort of how does that market ramp up?

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

So I think that we have a couple of different levels to it. If you look at China as an example, we'll work to facilitate partnerships with companies in China, potentially marketplaces but other partners, as well that can carry the brands that we have from the US and the UK into those markets. So I would see it as an expansion of partnerships that we already have, and as you know we have relationships with Alipay and [TiMo] in China. We'll [put] more activity with those partners in those spaces. And likewise in India, China becomes a pretty good metaphor for kinds of partnerships. So what can you do with marketplaces in India, that help carry the very strong brands from the US and UK into those marketplaces.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Shannon, I would add to that, that because we present their whole portfolio of goods from often the US/UK outbound, we can also help them selectively present certain product categories into certain markets, where we know there's a high propensity for buy against that. So when you think about the broader Pitney Bowes portfolio and our ability to help clients identify growth opportunities and that, with our customer engagement solutions and the like, one of the benefits is helping them get the right products, to the right market, not necessarily their entire portfolio or even the retailer brand itself, but subsets of their offerings into given markets. So we see that as a significant value add, beyond the traditional process of just pricing and outbound transaction, and getting it delivered.

Shannon Cross - *Cross Research - Analyst*

Okay, great. And then, I'm curious on SG&A, what's a normalized level for SG&A? I assume it was down a little bit more than normal this quarter, because you had the missed sales. But obviously 34% is getting down closer to the low 30% level, you talked about, maybe high 20%s at one point, that goes back a long time. But I'm just kind of curious as to how you're thinking about with ERP implementation, and all of the puts and takes with the branding and that, how we should think about SG&A when we get out a year or so?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Yes, I clearly, the benefits that we will get from the implementation of our platform will show up predominantly in the SG&A line. So we believe that on a percentage of revenue basis, we'll continue to drive that number down as we go out. Obviously, the fourth quarter will see more improvement than the third quarter. And then, to your point of a year out, as we begin to get the larger share of the benefits of that system, we should see that number coming down further.

Shannon Cross - *Cross Research - Analyst*

Okay. And then, Mike, how are you thinking about cash flow on sort of -- again I hate to keep use the word normalized, because we never, the world is never normal. But when you think about cash flow, you reduced it a bit this year, with some puts and takes in that. How should we think about maybe working capital benefits offset by -- I don't know, investment -- just can you give us some color? I know you don't want to guide a year out but?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

I would say, the simplest way to look at it, and we talked about this in our last Analyst Day, is that the single biggest variable going forward will be the growth in earnings. And so, if you think about the way, our balance sheet is evolving, finance receivables, as the mailing business stabilizes, it should stabilize more. That's one of the drivers of free cash flow coming down over the last few years. We have less inventory dependency on the business as that grow. The cash cycles for those businesses are shorter. So we should see a fairly stable contribution of working capital, and other balance sheet-driven items. And the big variable will be earnings growth.

Shannon Cross - *Cross Research - Analyst*

Okay, great. And then, my final question is just on the Canadian labor negotiations? How do we think about the potential impact there? Is it mainly on the shipping side, or is there something that could come through on the SMB mailing as well?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

I would say it's principally on the ecommerce side. So to the extent that there was concern about using Canada Post by ecommerce players, they might divert transactions away from them, or slow down their ecommerce activity. Early on in this process, there was I'd say more noise about a disruption. Both sides have indicated they want to negotiate this, so we continue to monitor that. And we'll see what the potential impact is, but we're hopeful that, that will come to resolution.

Shannon Cross - *Cross Research - Analyst*

Great. Thank you very much.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Thank you.

Operator

We have a question from the line of Allen Klee, Sidoti.

Allen Klee - *Sidoti & Company - Analyst*

Yes, good morning. How would you characterize the impact of the advertising campaigns that you've done, and any thoughts on changing your prior guidance of the spend on it?

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

Well, I'll take the first half, and I'll let Mike take the second half. As I had mentioned, I believe earlier in the year, did some brand health work after the advertising had been launched. And we saw, I would say, meaningful improvements in consideration rates, and that's precisely what we had hoped for. So this is something that we'll rollout over years, not months or quarters, but early indications are that investments in the brand have paid off. So we'll contemplate how we move forward with investments, given the realities of our business in the second half. But there's no doubt that this is something that, our focus is going to continue to be on enhancing our brand.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

So in terms of how to look at it in the financials, I think early on, we had talked about sort of the first and fourth quarters being more elevated. Last quarter, we said we would pull some of that second half forward to the second quarter which we did do. So we expect kind of second half to be more in line with prior year spend. And then, as Marc said, going into 2017, we'll evaluate the level of spend going forward.

Allen Klee - *Sidoti & Company - Analyst*

Thank you. And then, any commentary on the performance of your digital stamp and multi-carrier solutions?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

I would say in digital stamp, we have two products. One is more of a postal-oriented product, pbSmartPostage, and we recently launched SendPro which is a multi-carrier shipping SaaS platform. We had good success, that just launched in late April, good early success with the shipping platform selling into our customer base, and really expanding the value proposition there. And pbSmartPostage, we continue to add new customers there, albeit we're still relatively a small part of, or small share in that overall market. So we do see continuing opportunity on both those fronts.

Allen Klee - *Sidoti & Company - Analyst*

Okay, thanks. And then, as you -- as part of your strategy in software is to push the channel, do you think that has an impact on the longer term margin outlook for software?

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

No. Well, it will rebalance the margin between cost and expense. So what you may find in some of these relationships, that we offer some discounts off of the pricing of our software as a benefit to these systems integrators. But the flip side is, that it allows us to have a different SG&A profile. So from a net perspective, it will work out the same, although it might be slightly rebalanced.

Allen Klee - *Sidoti & Company - Analyst*

Okay. And lastly, for your ERP rollout internationally, how do we think about when you're timing that for next year?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

We'll probably update further at the Analyst Day that we're going to have in the early part of December. But we're continuing to look at balancing the opportunities to enhance the North American piece with the international rollout. The other important piece of it is the data cleansing process, and so we're in the midst of that now. So we'll finalize the timing of that as we go forward, and we'll give a further update in December. But we feel good about the opportunities in North America for getting our cost benefits as we go out.

Allen Klee - *Sidoti & Company - Analyst*

Thank you.

Operator

We have a question from the line of Glenn Mattson, Ladenburg Thalmann.

Glenn Mattson - *Ladenburg Thalmann - Analyst*

Hi. Just with regards to Australia, can you say is that something you expect to contribute this year? Also can you tell us how big you expect that outbound market could get? And then lastly, in the past you've talked about rolling out other markets in line with your biggest customer in ecommerce, or your biggest partner, and now you're saying the thinking has changed a little bit. So I just wonder, has their thinking changed also or how's that going?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

So in terms of Australia, when you think about the largest outbound markets, obviously the US and UK are either the largest or top five types of markets. Australia is one of the top 10 markets, but obviously smaller than the US and UK. As we've seen in both the US and UK, there's a ramping process that takes some time to roll itself out. Once you get the first few retailers out there, then we look to add around that. We've been very pleased with the ramp up in the UK, and so we'll expect over time, Australia to grow. I don't expect it to be a huge contributor in the second half of the year, but certainly, begin to lay the ground work for some sustainable revenue over time.

In terms of expansions into other markets, I think as Marc mentioned, we're obviously going to go where our partners and all see opportunity, and want us to go where we think we can [create a reasonable footprint], and a profitable business. But we're going to balance that with the opportunities to really optimize the outbound opportunity around the world. I'd add that, both in the UK and the US, we've expanded the number of countries we're outbound to. In the UK, it's now over 80 markets, and the US, it's over 100 markets.

Glenn Mattson - *Ladenburg Thalmann - Analyst*

Okay. Thanks very much.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Thank you.

Operator

And our last question is from Chapin Mechem with NE Investors.

Chapin Mechem - *NE Investors - Analyst*

Hi, good morning. I'm wondering if you can address your plans for the [PBI H] preferred shares?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Yes, we're still evaluating that. We think there's likely an opportunity to refinance that with traditional PBI debt, but we're in the midst of finalizing our plans for that now as we speak.

Chapin Mechem - *NE Investors - Analyst*

Okay. So and just to follow-up with that. So if, with the step up, the [50%] step up every six months, by rough math, if you keep them out, is about $0.07 a share in the next year. Does that sound right?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

I don't have the number off the top of my head. I would say, it's probably in the ballpark. Our expectation is we have an opportunity to refinance this.

Chapin Mechem - *NE Investors - Analyst*

Great. And just one more thing on that sorry. Just to clarify after 10/30, you could still take them out any time at par, is that right, if it's not done by the end of October?

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

That's correct.

Chapin Mechem - *NE Investors - Analyst*

Great. Thank you.

Michael Monahan - *Pitney Bowes Inc - EVP, COO & CFO*

Thank you.

Operator

And Mr. Lautenbach, do you have any closing remarks?

Marc Lautenbach - *Pitney Bowes Inc - President & CEO*

I do, thank you. I'd like to build off of Allen's question, because I think that it's an opportune segue. To a degree, for the last several years, I feel like we've been slogging uphill between market exits, channel shifts, the deployment of new systems, and you're all very familiar with the list. With the deployment of our business platform in the United States, I feel like we've got some clear water in front of us and we're anxious to take advantage of that. So from my perspective we'll make a judgment about when we roll out the rest of the business platform. But my priority is moving towards having some clear water, so we can begin to yield on the investments that we've made. So I'm not particularly pleased with our results financially in the first half.

That being said, if you look at this transformation in the context that I always have, and that is what we're doing to improve the long-term ability of this business to create value, I couldn't be more pleased. So that's kind of where we are as we move into the second half, I believe we're poised to begin to yield on some of the investments that we've made over the last quarters, the last several years, whether it be the investments in the brand, investments in our systems, investments in our channels. And we're anxious to take advantage of that. So we'll certainly update you more as the year goes on, but I think that's kind of a synopsis of where we are right now. So I look forward to speaking to you again in 90 days.

Operator

Ladies and gentlemen, this concludes our conference for today. A replay of today's second quarter earnings call will be made available later today at www.pb.com. Thank you for your participation, and for using AT&T executive teleconference service. You may now disconnect.
