

HARTE HANKS INC  
Form 10-Q  
November 10, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2008

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-7120

**HARTE-HANKS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**74-1677284**  
(I.R.S. Employer  
Identification Number)

**200 Concord Plaza Drive, San Antonio, Texas**  
(Address of principal executive offices)

**78216**  
(Zip Code)

Registrant's telephone number including area code **210/829-9000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Edgar Filing: HARTE HANKS INC - Form 10-Q

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller

Smaller reporting company

reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock: \$1 par value per share, 63,305,445 shares as of October 31, 2008.

**Table of Contents**

HARTE-HANKS, INC. AND SUBSIDIARIES

TABLE OF CONTENTS

FORM 10-Q REPORT

September 30, 2008

	<b>Page</b>
Part I. Financial Information	
Item 1. Interim Condensed Consolidated Financial Statements (Unaudited)	
<u>Condensed Consolidated Balance Sheets - September 30, 2008 and December 31, 2007</u>	3
<u>Consolidated Statements of Operations - Three months ended September 30, 2008 and 2007</u>	4
<u>Consolidated Statements of Operations - Nine months ended September 30, 2008 and 2007</u>	5
<u>Consolidated Statements of Cash Flows - Nine months ended September 30, 2008 and 2007</u>	6
<u>Consolidated Statements of Stockholders' Equity and Comprehensive Income - Nine months ended September 30, 2008 and year ended December 31, 2007</u>	7
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	8
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	27
Item 4. <u>Controls and Procedures</u>	28
Part II. Other Information	
Item 1. <u>Legal Proceedings</u>	29
Item 1A. <u>Risk Factors</u>	29
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	29
Item 6. <u>Exhibits</u>	29

**Table of Contents****Item 1. Interim Condensed Consolidated Financial Statements**

Harte-Hanks, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (in thousands, except per share and share amounts)

	September 30, 2008 (Unaudited)	December 31, 2007 (Audited)
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 22,017	\$ 22,847
Accounts receivable <i>(less allowance for doubtful accounts of \$4,990 and \$3,556 at September 30, 2008 and December 31, 2007, respectively)</i>	179,867	199,222
Inventory	7,749	6,007
Prepaid expenses	17,679	15,473
Current deferred income tax asset	12,082	12,628
Other current assets	9,271	9,503
<b>Total current assets</b>	<b>248,665</b>	<b>265,680</b>
Property, plant and equipment <i>(less accumulated depreciation of \$227,569 and \$229,190 at September 30, 2008 and December 31, 2007, respectively)</i>	103,091	112,354
Goodwill, net	552,840	543,583
Other intangible assets <i>(less accumulated amortization of \$11,503 and \$10,235 at September 30, 2008 and December 31, 2007, respectively)</i>	18,727	20,939
Other assets	10,193	9,370
<b>Total assets</b>	<b>\$ 933,516</b>	<b>\$ 951,926</b>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities		
Accounts payable	\$ 43,800	\$ 67,167
Accrued payroll and related expenses	18,216	26,443
Customer deposits and unearned revenue	69,379	61,988
Income taxes payable	8,762	12,482
Other current liabilities	12,339	12,028
<b>Total current liabilities</b>	<b>152,496</b>	<b>180,108</b>
Long-term debt	295,500	259,125
Other long-term liabilities <i>(including deferred income taxes of \$72,775 at September 30, 2008 and \$66,060 at December 31, 2007)</i>	111,411	104,181
<b>Total liabilities</b>	<b>559,407</b>	<b>543,414</b>
Stockholders' equity		
Common stock, \$1 par value per share, 250,000,000 shares authorized. 117,976,368 and 117,692,688 shares issued at September 30, 2008 and December 31, 2007, respectively	117,976	117,693
Additional paid-in capital	331,167	323,182
Retained earnings	1,179,819	1,145,736
Less treasury stock: 54,675,191 and 49,756,675 shares at cost at September 30, 2008 and December 31, 2007, respectively	(1,236,670)	(1,160,205)
Accumulated other comprehensive loss	(18,183)	(17,894)
<b>Total stockholders' equity</b>	<b>374,109</b>	<b>408,512</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 933,516</b>	<b>\$ 951,926</b>

Edgar Filing: HARTE HANKS INC - Form 10-Q

See Notes to Unaudited Condensed Consolidated Financial Statements.

**Table of Contents**

Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Operations (in thousands, except per share amounts)

(Unaudited)

	<b>Three Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Operating revenues	\$ 269,913	\$ 286,696
Operating expenses		
Labor	108,728	117,589
Production and distribution	100,665	97,743
Advertising, selling, general and administrative	20,464	22,236
Depreciation and amortization	8,073	8,334
Intangible asset amortization	737	794
Total operating expenses	238,667	246,696
Operating income	31,246	40,000
Other expenses (income)		
Interest expense	3,450	3,346
Interest income	(90)	(110)
Other, net	363	412
	3,723	3,648
Income before income taxes	27,523	36,352
Income tax expense	10,908	14,470
Net income	\$ 16,615	\$ 21,882
Basic earnings per common share	\$ 0.26	\$ 0.30
Weighted-average common shares outstanding	63,281	72,249
Diluted earnings per common share	\$ 0.26	\$ 0.30
Weighted-average common and common equivalent shares outstanding	63,393	73,491

See Notes to Unaudited Condensed Consolidated Financial Statements.

**Table of Contents**

Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Operations (in thousands, except per share amounts)

(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Operating revenues	\$ 813,178	\$ 859,869
Operating expenses		
Labor	335,894	348,381
Production and distribution	295,546	298,285
Advertising, selling, general and administrative	63,052	67,886
Depreciation and amortization	24,677	24,948
Intangible asset amortization	2,212	2,675
Total operating expenses	721,381	742,175
Operating income	91,797	117,694
Other expenses (income)		
Interest expense	10,788	9,603
Interest income	(316)	(414)
Other, net	2,001	766
	12,473	9,955
Income before income taxes	79,324	107,739
Income tax expense	30,909	42,635
Net income	\$ 48,415	\$ 65,104
Basic earnings per common share	\$ 0.76	\$ 0.89
Weighted-average common shares outstanding	64,118	73,454
Diluted earnings per common share	\$ 0.75	\$ 0.87
Weighted-average common and common equivalent shares outstanding	64,278	74,850

See Notes to Unaudited Condensed Consolidated Financial Statements.

**Table of Contents**

Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Cash Flows (in thousands)

(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 48,415	\$ 65,104
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	24,677	24,948
Intangible asset amortization	2,212	2,675
Stock-based compensation	4,530	5,530
Excess tax benefits from stock-based compensation	(120)	(2,292)
Deferred income taxes	6,493	4,977
Other, net	83	323
Changes in operating assets and liabilities, net of acquisitions:		
Decrease in accounts receivable, net	21,028	5,173
(Increase) decrease in inventory	(1,742)	1,142
Increase in prepaid expenses and other current assets	(1,744)	(1,819)
(Decrease) increase in accounts payable	(24,730)	13,855
Decrease in other accrued expenses and other current liabilities	(5,494)	(1,491)
Other, net	1,700	(4,014)
<b>Net cash provided by operating activities</b>	<b>75,308</b>	<b>114,111</b>
<b>Cash Flows from Investing Activities</b>		
Acquisitions, net of cash acquired	(8,655)	
Purchases of property, plant and equipment	(16,141)	(20,570)
Proceeds from sale of property, plant and equipment	202	117
<b>Net cash used in investing activities</b>	<b>(24,594)</b>	<b>(20,453)</b>
<b>Cash Flows from Financing Activities</b>		
Long-term borrowings	197,000	74,000
Repayment of long-term borrowings	(160,625)	(59,000)
Issuance of common stock	3,593	14,407
Purchase of treasury stock	(76,649)	(121,589)
Excess tax benefits from stock-based compensation	120	2,292
Dividends paid	(14,332)	(15,372)
<b>Net cash used in financing activities</b>	<b>(50,893)</b>	<b>(105,262)</b>
Effect of exchange rate changes on cash and cash equivalents	(651)	371
Net decrease in cash and cash equivalents	(830)	(11,233)
Cash and cash equivalents at beginning of year	22,847	38,270
<b>Cash and cash equivalents at end of period</b>	<b>\$ 22,017</b>	<b>\$ 27,037</b>

See Notes to Unaudited Condensed Consolidated Financial Statements.





**Table of Contents**

Harte-Hanks, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity and Comprehensive Income (in thousands, except per share amounts)

(2008 Unaudited)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at December 31, 2006	\$ 116,497	\$ 295,555	\$ 1,073,395	\$ (974,625)	\$ (17,346)	\$ 493,476
Common stock issued-employee benefit plans	213	3,851				4,064
Exercise of stock options	983	13,163		(1,892)		12,254
Tax benefit of options exercised		3,554				3,554
Stock-based compensation		7,057				7,057
Dividends paid (\$0.28 per share)			(20,299)			(20,299)
Treasury stock repurchased				(183,867)		(183,867)
Treasury stock issued		2		179		181
Comprehensive income:						
Net income			92,640			92,640
Adjustment to pension liability (net of tax benefit of \$595)					(484)	(484)
Change in value of derivative instrument accounted for as a cash flow hedge (net of tax benefit of \$1,038)					(1,557)	(1,557)
Foreign currency translation adjustment					1,493	1,493
Total comprehensive income						92,092
Balance at December 31, 2007	117,693	323,182	1,145,736	(1,160,205)	(17,894)	408,512
Common stock issued-employee benefit plans	194	2,143				2,337
Exercise of stock options	89	1,262		(42)		1,309
Tax benefit of options exercised		136				136
Stock-based compensation		4,530				4,530
Dividends paid (\$0.23 per share)			(14,332)			(14,332)
Treasury stock repurchased				(76,649)		(76,649)
Treasury stock issued		(86)		226		140
Comprehensive income:						
Net income			48,415			48,415
Adjustment to pension liability (net of tax expense of \$648)					975	975
Change in value of derivative instrument accounted for as a cash flow hedge (net of tax expense of \$151)					222	222
Foreign currency translation adjustment					(1,486)	(1,486)
Total comprehensive income						48,126
Balance at September 30, 2008	\$ 117,976	\$ 331,167	\$ 1,179,819	\$ (1,236,670)	\$ (18,183)	\$ 374,109

See Notes to Unaudited Condensed Consolidated Financial Statements.

---

**Table of Contents**

Harte-Hanks, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

**Note A Basis of Presentation**

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of Harte-Hanks, Inc. and its subsidiaries (the Company ). Intercompany transactions and balances have been eliminated.

The statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The preparation of financial statements in accordance with U.S. generally accepted accounting principles for interim financial information requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2007.

As used in this report, the terms Harte-Hanks, we, us, or our may refer to Harte-Hanks, one or more of its consolidated subsidiaries, or all of them taken as a whole.

**Note B Recent Accounting Pronouncements**

We adopted SFAS No. 157, *Fair Value Measurements*, (SFAS 157) on January 1, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The adoption of SFAS 157 did not have a significant impact on our consolidated financial statements. New disclosures required by SFAS 157 are included in Note F, *Interest Rate Risk*.

We adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an Amendment of FASB Statement No. 115* (SFAS 159) on January 1, 2008. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. We have not made any fair value elections as permitted under the provisions of SFAS 159; therefore, the adoption of this standard did not have an impact on our consolidated financial statements.

In December 2007, the FASB revised SFAS No. 141, *Business Combinations* (SFAS 141). The revised SFAS No. 141 (SFAS 141R) establishes principles and requirements for how an acquiring company:

Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree;

Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and

Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

---

**Table of Contents**

SFAS 141R requires an acquiring company to recognize the assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at fair value as of the acquisition date. Under SFAS 141, acquisition-related costs were included in the total costs of the acquisition that were allocated to the assets acquired and the liabilities assumed. Under SFAS 141R, these acquisition-related costs will be expensed in the period in which they occur. SFAS 141R requires an acquiring company to recognize contractual contingencies as assets or liabilities at fair value as of the acquisition date. SFAS 141 permitted deferred recognition of preacquisition contingencies until certain recognition criteria were met. Under SFAS 141, contingent consideration usually was not recognized until the contingency was resolved, in which case an adjustment was made to goodwill. SFAS 141R requires an acquiring company to recognize contingent consideration at fair value as of the acquisition date. SFAS 141R is effective for us beginning January 1, 2009. Our adoption of SFAS 141R will affect the way we account for acquisitions, including acquisition-related costs, contractual contingencies and contingent consideration. Our adoption of SFAS 141R may also impact the amount of information we disclose about acquisitions.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161). SFAS 161 establishes, among other things, the disclosure requirements for derivative instruments and for hedging activities. This statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair values and amounts of and gains and losses on derivative instruments, and disclosures about contingent features related to credit risk in derivative agreements. SFAS 161 is effective for us beginning January 1, 2009. As SFAS 161 only affects disclosure requirements, our adoption of SFAS 161 will not affect our consolidated financial statements.

**Note C Income Taxes**

Our third quarter 2008 income tax provision of \$10.9 million was calculated using an effective income tax rate of approximately 39.6%. Our income tax provision for the first nine months of 2008 of \$30.9 million was calculated using an effective income tax rate of approximately 39.0%. Our effective income tax rate is derived by estimating pretax income and income tax expense for the year ending December 31, 2008. The effective income tax rate calculated is higher than the federal statutory rate of 35%, primarily due to the addition of state income taxes.

At January 1, 2008, unrecognized tax benefits for uncertain tax positions totaled \$11.8 million, of which \$2.0 million represents accruals for interest and penalties that were recorded as additional tax expense in accordance with our accounting policy. If recognized, the entire unrecognized tax benefit amount, net of tax, would impact the effective tax rate. There have been no significant changes to these amounts during the nine months ended September 30, 2008.

Harte-Hanks or one of our subsidiaries files income tax returns in the U.S. federal, U.S. state and foreign jurisdictions. For U.S. state and foreign returns, we are no longer subject to tax examinations for years prior to 2003. For U.S. federal returns, we are no longer subject to tax examinations for the years prior to 2005. We believe that it is reasonably possible that a reduction in our unrecognized tax liabilities in the range of \$1.7 million to \$1.9 million, net of tax, will occur in the next twelve months related to the statute expiring on various tax returns. If this reduction were to occur, it would decrease the tax expense and effective tax rate for the full year 2008.

**Note D Stock-Based Compensation**

We recognized \$1.6 million and \$2.0 million of stock-based compensation during the three months ended September 30, 2008 and 2007, respectively. We recognized \$4.5 million and \$5.5 million of stock-based compensation during the nine months ended September, 2008 and 2007, respectively.

## **Table of Contents**

Our annual grant of stock-based awards occurred in the first quarter, which is consistent with the timing of previous annual grants. We did not have any significant stock-based compensation activity in the third quarter of 2008.

### **Note E New Credit Facility**

On March 7, 2008, we entered into a new four-year \$100 million term loan facility (2008 Term Loan Facility) with Wells Fargo Bank, N.A., as Administrative Agent. The 2008 Term Loan Facility is in addition to, and does not replace, our existing Revolving Credit Facility and our existing 2006 Term Loan Facility. We utilized the funds from the 2008 Term Loan Facility primarily to repurchase shares of our common stock and for other general corporate purposes.

### **Note F Interest Rate Risk**

We use derivative instruments to manage the risk of changes in prevailing interest rates adversely affecting future cash flows associated with our credit facilities. The derivative instrument used to manage such risk is the interest rate swap. We account for interest rate swaps in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

As with any financial instrument, derivative instruments have inherent risks, primarily market and credit risk. Market risk associated with changes in interest rates is managed as part of our overall market risk monitoring process by establishing and monitoring limits as to the degree of risk that may be undertaken. Credit risk occurs when a counterparty to a derivative contract in which we have an unrealized gain fails to perform according to the terms of the agreement. We minimize our credit risk by entering into transactions with counterparties that maintain high credit ratings.

We have designated our interest rate swap as a cash flow hedge. For a derivative instrument designated as a cash flow hedge, the effective portion of changes in the fair value of the derivative instrument is recorded in other comprehensive income (loss) and is recognized as a component of interest expense in the statement of operations when the hedged item affects results of operations. We discontinue hedge accounting prospectively if it is determined that (i) an interest rate swap is not highly effective in offsetting changes in the cash flows of a hedged item, (ii) the derivative expires or is sold, terminated or exercised, or (iii) the derivative is undesignated as a hedge instrument.

If hedge accounting is discontinued, the derivative instrument will continue to be carried at fair value, with changes in the fair value of the derivative instrument recognized in the current period's results of operations. When hedge accounting is discontinued because it is probable that a forecasted transaction will not occur, the accumulated gains and losses included in accumulated other comprehensive income (loss) will be recognized immediately in results of operations. When hedge accounting is discontinued because the derivative instrument has not been or will not continue to be highly effective as a hedge, the remaining amount in accumulated other comprehensive income (loss) is amortized into earnings over the period that cash flows that were being hedged affect earnings.

In September 2007, we entered into a two-year interest rate swap agreement with a notional amount of \$150.0 million and a fixed rate of 4.655%. The two-year term began on September 28, 2007. This interest rate swap changes the variable-rate cash flow exposure on the \$150.0 million notional amount to fixed-rate cash flows by entering into receive-variable, pay-fixed interest rate swap transactions. Under this swap transaction, we receive London Interbank Offered Rate (LIBOR) based variable interest rate payments

**Table of Contents**

and make fixed-interest rate payments, thereby creating fixed-rate debt. We designated this hedging relationship as hedging the risk of changes in cash flows (a cash flow hedge) attributable to changes in the LIBOR rate applicable to our 2005 five-year revolving credit facility (Revolving Credit Facility) and 2006 five-year term loan facility (2006 Term Loan Facility). As such, we report the fair value of the swap as an asset or liability on our balance sheet, any ineffectiveness as interest expense, and effective changes to the fair value of the swap in other comprehensive income (loss). Fair value is determined using projected discounted future cash flows calculated using readily available market information (future LIBOR rates). At September 30, 2008, this swap is recorded at fair value as a \$2.2 million liability. We reclassified into earnings losses of \$0.8 million and \$1.9 million for the three months and nine months ended September 30, 2008, respectively, that were related to the swap and previously reported in other comprehensive loss. We expect losses of \$2.2 million to be reclassified into earnings over the next twelve months related to the swap and currently reported in other comprehensive loss. The amount ultimately realized, however, could differ as interest rates change.

SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 also establishes a fair value hierarchy that prioritizes the inputs used in valuation methodologies into three levels. Fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs are based on quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The following table provides additional detail of the fair value of our swap liability at September 30, 2008 by level within the SFAS 157 fair value measurement hierarchy, as required by SFAS 157:

In thousands	September 30, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest rate swap liability	\$ 2,222	\$	\$ 2,222	\$
Total	\$ 2,222	\$	\$ 2,222	\$

On a quarterly basis, we assess the ineffectiveness of the hedging relationship, and any gains or losses related to the ineffectiveness are recorded as interest expense in our statement of operations. We do not expect the ineffectiveness related to our current hedging activity to be material to our financial results in the future. There were no components of the derivative instruments that were excluded from the assessment of hedge effectiveness.

We do not enter into derivative instruments for any purpose other than cash flow hedging. We do not speculate using derivative instruments.

We assess interest rate risk by regularly identifying and monitoring changes in interest rate exposure that may adversely impact expected future cash flows and by evaluating hedging opportunities.

**Table of Contents****Note G Earnings Per Share**

Basic earnings per share is computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is computed on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and nonvested shares.

A reconciliation of basic and diluted earnings per share (EPS) is as follows:

<b>In thousands, except per share amounts</b>	<b>Three Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>BASIC EPS</b>		
Net Income	\$ 16,615	\$ 21,882
Weighted-average common shares outstanding used in earnings per share computations	63,281	72,249
Earnings per common share	\$ 0.26	\$ 0.30
<b>DILUTED EPS</b>		
Net Income	\$ 16,615	\$ 21,882
Shares used in diluted earnings per share computations	63,393	73,491
Earnings per common share	\$ 0.26	\$ 0.30
<b>Computation of shares used in earnings per share computations:</b>		
Weighted-average outstanding common shares	63,281	72,249
Weighted-average common equivalent shares - dilutive effect of stock options and awards	112	1,242
Shares used in diluted earnings per share computations	63,393	73,491

7.3 million and 2.6 million anti-dilutive market price options have been excluded from the calculation of shares used in the diluted EPS calculation for the three months ended September 30, 2008 and 2007, respectively.

**Table of Contents**

In thousands, except per share amounts	Nine Months Ended September 30,	
	2008	2007
<b>BASIC EPS</b>		
Net Income	\$ 48,415	\$ 65,104
Weighted-average common shares outstanding used in earnings per share computations	64,118	73,454
Earnings per common share	\$ 0.76	\$ 0.89
<b>DILUTED EPS</b>		
Net Income	\$ 48,415	\$ 65,104
Shares used in diluted earnings per share computations	64,278	74,850
Earnings per common share	\$ 0.75	\$ 0.87
<b>Computation of shares used in earnings per share computations:</b>		
Weighted-average outstanding common shares	64,118	73,454
Weighted-average common equivalent shares - dilutive effect of stock options and awards	160	1,396
Shares used in diluted earnings per share computations	64,278	74,850

7.0 million and 2.3 million anti-dilutive market price options have been excluded from the calculation of shares used in the diluted EPS calculation for the nine months ended September 30, 2008 and 2007, respectively.



**Table of Contents****Note H Business Segments**

Harte-Hanks is a worldwide, direct and targeted marketing company with operations in two segments Direct Marketing and Shoppers.

Information about the operations of our two business segments follows:

<b>In thousands</b>	<b>Three Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Operating revenues		
Direct Marketing	\$ 182,567	\$ 181,313
Shoppers	87,346	105,383
Total operating revenues	\$ 269,913	\$ 286,696
Operating Income		
Direct Marketing	\$ 26,521	\$ 27,606
Shoppers	7,427	17,926
Corporate Activities	(2,702)	(5,532)
Total operating income	\$ 31,246	\$ 40,000
Income before income taxes		
Operating income	\$ 31,246	\$ 40,000
Interest expense	(3,450)	(3,346)
Interest income	90	110
Other, net	(363)	(412)
Total income before income taxes	\$ 27,523	\$ 36,352

<b>In thousands</b>	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Operating revenues		
Direct Marketing	\$ 543,880	\$ 526,958
Shoppers	269,298	332,911
Total operating revenues	\$ 813,178	\$ 859,869
Operating Income		
Direct Marketing	\$ 73,699	\$ 72,368
Shoppers	26,859	57,015
Corporate Activities	(8,761)	(11,689)
Total operating income	\$ 91,797	\$ 117,694
Income before income taxes		
Operating income	\$ 91,797	\$ 117,694
Interest expense	(10,788)	(9,603)
Interest income	316	414
Other, net	(2,001)	(766)
Total income before income taxes	\$ 79,324	\$ 107,739



**Table of Contents****Note I Components of Net Periodic Pension Benefit Cost**

Prior to January 1, 1999, we maintained a defined benefit pension plan for which most of our employees were eligible. In conjunction with significant enhancements to our 401(k) plan, we elected to freeze benefits under this defined benefit pension plan as of December 31, 1998.

In 1994, we adopted a non-qualified, supplemental pension plan covering certain employees, which provides for incremental pension payments so that total pension payments equal those amounts that would have been payable from our principal pension plan if it were not for limitations imposed by income tax regulations. The benefits under this supplemental pension plan will continue to accrue as if the principal pension plan had not been frozen.

Net pension cost for both plans included the following components:

<b>In thousands</b>	<b>Three Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Service cost	\$ 168	\$ 191
Interest cost	1,992	1,945
Expected return on plan assets	(2,244)	(2,262)
Amortization of prior service cost	15	15
Transition obligation	24	24
Recognized actuarial loss	501	612
<b>Net periodic benefit cost</b>	<b>\$ 456</b>	<b>\$ 525</b>

<b>In thousands</b>	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Service cost	\$ 504	\$ 579
Interest cost	5,975	5,475
Expected return on plan assets	(6,732)	(6,131)
Amortization of prior service cost	45	46
Transition obligation	72	72
Recognized actuarial loss	1,505	1,966
<b>Net periodic benefit cost</b>	<b>\$ 1,369</b>	<b>\$ 2,007</b>

We will not have to make a contribution in 2008 in order to obtain the Pension Protection Act of 2006 full funding limit exemption. We do not plan to make a contribution to either pension plan in 2008 other than to the extent needed to cover benefit payments related to the unfunded plan.

**Table of Contents****Note J Comprehensive Income**

Comprehensive income for a period encompasses net income and all other changes in equity other than from transactions with our stockholders. Our comprehensive income was as follows:

In thousands	Three Months Ended September 30,	
	2008	2007
Net income	\$ 16,615	\$ 21,882
Other comprehensive income:		
Adjustment to pension liability (net of tax expense of \$216 and \$258 in 2008 and 2007, respectively)	325	393
Change in value of derivative instrument accounted for as a cash flow hedge (net of tax expense of \$330)	494	
Foreign currency translation adjustment	(2,518)	619
Total comprehensive income	\$ 14,916	\$ 22,894

In thousands	Nine Months Ended September 30,	
	2008	2007
Net income	\$ 48,415	\$ 65,104
Other comprehensive income:		
Adjustment to pension liability (net of tax expense of \$648 and \$771 in 2008 and 2007, respectively)	975	1,179
Change in value of derivative instrument accounted for as a cash flow hedge (net of tax expense of \$151)	222	
Foreign currency translation adjustment	(1,486)	1,006
Total comprehensive income	\$ 48,126	\$ 67,289

**Note K Litigation Contingencies**

On March 23, 2001, inactive Harte-Hanks Shoppers employees Frank Gattuso and Ernest Sigala filed a putative class action against Harte-Hanks Shoppers, Inc., claiming that Harte-Hanks Shoppers failed to comply with a California statutory provision requiring an employer to indemnify employees for expenses incurred on behalf of the employer. The plaintiffs allege that Harte-Hanks Shoppers failed to reimburse them for expenses of using their automobiles as outside sales representatives and failed to accurately itemize these expenses on plaintiffs' wage statements. The suit was filed in Los Angeles County Superior Court. The putative class that plaintiffs seek to represent has been limited to all California Harte-Hanks outside sales representatives who were not separately reimbursed apart from their base salary and commissions for the expenses they incurred in using their own automobiles after early 1998. The plaintiffs seek indemnification and compensatory damages, statutory damages, exemplary damages, penalties, interest, costs of suit, and attorneys' fees. Harte-Hanks Shoppers filed a cross-complaint seeking a declaratory judgment that the plaintiffs have been indemnified for their automobile expenses by the higher salaries and commissions paid to them as outside sales representatives. The

---

**Table of Contents**

cross-complaint also alleges conversion, unjust enrichment, constructive trust and rescission and restitution based on mutual mistake. On January 30, 2002, the trial court ruled that California Labor Code Section 2802 requires employers to reimburse employees for mileage and other expenses incurred in the course of employment, but that an employer is permitted to pay increased wages or commissions instead of indemnifying actual expenses. On May 28, 2003, the trial court denied the plaintiffs' motion for class certification. On October 27, 2005, the California Court of Appeal issued a unanimous opinion affirming the trial court's rulings, including the interpretation of Labor Code Section 2802 and denial of class certification. On November 23, 2005, the Court of Appeal denied the plaintiffs' petition for rehearing. On November 5, 2007, the California Supreme Court affirmed the trial court's ruling that Labor Code Section 2802 permits lump sum reimbursement and that an employer may satisfy its obligations to indemnify employees for reasonable and necessary business expenses under Labor Code Section 2802 by paying enhanced taxable compensation. The Supreme Court remanded the matter back to the trial court for further proceedings related to the class certification issue and directed the trial court to consider whether the following issues could properly be resolved on a class-wide basis: (1) did Harte-Hanks Shoppers adopt a practice or policy of reimbursing outside sales representatives for automobile expenses by paying them higher commission rates and base salaries than it paid to inside sales representatives, (2) did Harte-Hanks Shoppers establish a method to apportion the enhanced compensation payments between compensation for labor performed and expense reimbursement and (3) was the amount paid for expense reimbursement sufficient to fully reimburse the employees for the automobile expenses they reasonably and necessarily incurred. On July 29, 2008, the trial court stated its intention to issue a split class action certification ruling, certifying a class action with respect to the first two questions listed immediately above (adoption of a policy or practice, and establishment of an apportionment method) and denying class certification on the third question listed immediately above (sufficiency of reimbursement). Based upon its belief that the conditions for a loss accrual described in SFAS No. 5, *Accounting for Contingencies*, have not been met, Harte-Hanks has made no accrual for this loss contingency. An estimate of the possible loss or range of loss from any adverse result on this case cannot reasonably be made. We believe that we have substantial meritorious defenses to these claims and we intend to vigorously defend the lawsuit. Nevertheless, we cannot predict the impact of future developments in this lawsuit, and any resolution of this lawsuit within a particular fiscal quarter may adversely impact our results of operations for that quarter.

We are also currently subject to various other legal proceedings in the course of conducting our businesses and, from time to time, we may become involved in additional claims and lawsuits incidental to our businesses. In the opinion of management, after consultation with counsel, any ultimate liability arising out of these pending claims and lawsuits is not currently expected to have a material adverse effect on our consolidated financial position or results of operations. Nevertheless, we cannot predict the impact of future developments affecting our pending or future claims and lawsuits and any resolution of a claim or lawsuit within a particular fiscal quarter may adversely impact our results of operations for that quarter. We expense legal costs as incurred, and all recorded legal liabilities are adjusted as required as better information becomes available to us. The factors we consider when recording an accrual for contingencies include, among others: (i) the opinions and views of our legal counsel; (ii) our previous experience; and (iii) the decision of our management as to how we intend to respond to the complaints.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Cautionary Note Regarding Forward-Looking Statements**

This report, including this Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), contains forward-looking statements within the meaning of the federal securities laws. All such statements are qualified by this cautionary note, which is provided pursuant to the safe harbor provisions of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may also be included in our other public filings, press releases, our website and oral and written presentations by management. Statements other than historical facts are

---

**Table of Contents**

forward-looking and may be identified by words such as may, will, expects, believes, anticipates, plans, estimates, seeks, could, words of similar meaning. Examples include statements regarding (1) our strategies and initiatives, (2) adjustments to our cost structure and other actions designed to respond to market conditions and improve our performance, and the anticipated effectiveness and expenses associated with these actions, (3) our financial outlook for revenues, earnings per share, operating income, expense related to equity-based compensation, capital resources and other financial items, (4) expectations for our businesses and for the industries in which we operate, including with regard to the negative performance trends in our Shoppers business and the adverse impact of the ongoing economic downturn in the United States and other economies on the marketing expenditures and activities of our Direct Marketing clients and prospects, (5) competitive factors, (6) acquisition and development plans, (7) our stock repurchase program, (8) expectations regarding legal proceedings and other contingent liabilities, and (9) other statements regarding future events, conditions or outcomes. These forward-looking statements are based on current information, expectations and estimates and involve risks, uncertainties, assumptions and other factors that are difficult to predict and that could cause actual results to vary materially from what is expressed in or indicated by the forward-looking statements. In that event, our business, financial condition, results of operations or liquidity could be materially adversely affected and investors in our securities could lose part or all of their investments. Some of these risks, uncertainties, assumptions and other factors can be found in our filings with the Securities and Exchange Commission, including the factors discussed under Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007 (2007 Form 10-K) and any updates thereto in our Forms 10-Q and in the Cautionary Note Regarding Forward-Looking Statements in our third quarter 2008 earnings release issued on October 23, 2008. The forward-looking statements included in this report and those included in our other public filings, press releases, our website and oral and written presentations by management are made only as of the respective dates thereof, and we undertake no obligation to update publicly any forward-looking statement in this report or in other documents, our website or oral statements for any reason, even if new information becomes available or other events occur in the future.

**Overview**

The following MD&A section is intended to help the reader understand the results of operations and financial condition of Harte-Hanks, Inc. (Harte-Hanks). This section is provided as a supplement to, and should be read in conjunction with, our financial statements and the accompanying notes to the financial statements contained elsewhere in this report and our MD&A section, financial statements and accompanying notes to financial statements in our 2007 Form 10-K. Our 2007 Form 10-K contains a discussion of other matters not included herein, such as disclosures regarding critical accounting policies and estimates, and contractual obligations.

Harte-Hanks is a worldwide direct and targeted marketing company that provides direct marketing services and shopper advertising opportunities to local, regional, national and international consumer and business-to-business marketers. We manage our operations through two operating segments: Direct Marketing and Shoppers.

Direct Marketing services are targeted to specific industries or markets with services and software products tailored to each industry or market. Currently, our Direct Marketing business services various vertical markets including retail, high-tech/telecom, financial services, pharmaceutical/healthcare, and a wide range of selected markets. We believe that we are generally able to provide services to new industries and markets by modifying our services and applications as opportunities are presented. Depending on the needs of our clients, our Direct Marketing capabilities are provided in an integrated approach through more than 30 facilities worldwide, more than 10 of which are located outside of the United States. Each of these centers possesses some specialization and is linked with others to support the needs of our clients.

---

**Table of Contents**

We use various capabilities and technologies to enable our Direct Marketing clients to identify, reach, influence and nurture their customers. Our Direct Marketing business improves the return on our clients' marketing investment by increasing their prospect and customer value through solutions and services organized around five groupings of integrated activities:

Information (data collection/management);

Opportunity (data access/utilization);

Insight (data analysis/interpretation);

Engagement (program and campaign creation and development); and

Interaction (program execution).

Revenues from the Direct Marketing segment represented approximately 68% and 67% of our total revenue for the three months and nine months ended September 30, 2008, respectively.

Harte-Hanks Shoppers is North America's largest owner, operator and distributor of shopper publications, with shoppers that are zoned into more than 1,000 separate editions and total circulation of more than 12.5 million each week in California and Florida. Shoppers are weekly advertising publications delivered free by standard mail to households and businesses in a particular geographic area. Shoppers offer advertisers a targeted, cost-effective local advertising system, with virtually 100% penetration in their area of distribution. Shoppers are particularly effective in large markets with high media fragmentation in which major metropolitan newspapers generally have low penetration. Our Shoppers segment also provides advertising and other services online through our websites, *PennySaverUSA.com* and *TheFlyer.com*. During 2008, Shoppers continued to integrate its print and online products and formally changed the names of its print publications to *PennySaverUSA.com* (California) and *TheFlyer.com* (Florida). Both *PennySaverUSA.com* and *TheFlyer.com* display the ads published in the print versions of both the *PennySaverUSA.com* and *TheFlyer.com* publications. Revenues from the Shoppers segment represented approximately 32% and 33% of our total revenue for the three months and nine months ended September 30, 2008.

We derive revenues from the sale of direct marketing services and shopper advertising services. As a worldwide business, Direct Marketing is affected by general national and international economic trends. Our Shoppers operate in regional markets in California and Florida and are largely affected by the strength of the local economies.

Our principal operating expense items are labor, postage and transportation.

During the third quarter of 2008, our businesses continued to face challenging economic environments, which negatively impacted our financial performance. Marketing budgets are often more discretionary in nature and easier to reduce in the short-term than other expenses in response to weak economic conditions. Difficult economic conditions may also result in reduced demand for our products and services due to consolidation or, in some cases, bankruptcies of customers and prospective customers in the industry verticals that we serve.

Revenues from our Shoppers business are largely dependent on local advertising expenditures in the California and Florida geographies in which we operate. Such expenditures are substantially affected by the strength of the local economies in those markets. During the third quarter of 2008, the difficult economic conditions continued in California and Florida. These conditions were initially created by weakness in the real estate and associated financing markets and have spread across virtually all categories.

Direct Marketing revenues are dependent on, among other things, national, regional and international economies and business conditions. During the third quarter of 2008, the ongoing economic downturn in the United States and other economies adversely impacted the marketing expenditures and activities of our customers, as many customers have become increasingly cautious with their spending plans in the face of extreme economic uncertainty and reduced their marketing events and volumes from previously planned and anticipated levels, and some customers have filed for bankruptcy.





**Table of Contents**

Given the external environment, we face an uncertain revenue outlook for the remainder of the year and into 2009, and believe that our financial performance will continue to be negatively impacted. As a result, we have taken actions, and plan to take further actions, designed to align our expense base and structure to the external economic environment facing our businesses. Nevertheless, we cannot predict the impact of future economic conditions or the ultimate effectiveness and expenses associated with our efforts to address those economic conditions. A lasting recession or downturn in the United States economy and the economies we operate in abroad could have material adverse effects on our business, financial position or operating results.

**Results of Operations**

Operating results were as follows:

In thousands, except per share amounts	Three months ended			Nine months ended		
	September 30, 2008	September 30, 2007	Change	September 30, 2008	September 30, 2007	Change
Revenues	\$ 269,913	\$ 286,696	-5.9%	\$ 813,178	\$ 859,869	-5.4%
Operating expenses	238,667	246,696	-3.3%	721,381	742,175	-2.8%
Operating income	\$ 31,246	\$ 40,000	-21.9%	\$ 91,797	\$ 117,694	-22.0%
Net income	\$ 16,615	\$ 21,882	-24.1%	\$ 48,415	\$ 65,104	-25.6%
Diluted earnings per share	\$ 0.26	\$ 0.30	-13.3%	\$ 0.75	\$ 0.87	-13.7%

**3<sup>rd</sup> Quarter 2008 vs. 3<sup>rd</sup> Quarter 2007***Revenues*

Consolidated revenues decreased 5.9%, to \$269.9 million, and operating income decreased 21.9% to \$31.2 million in the third quarter of 2008 compared to the third quarter of 2007. Our overall results reflect decreased revenues of 17.1% from our Shoppers segment, partially offset by increased revenues of 0.7% from our Direct Marketing segment. The revenue performance from Shoppers was the result of decreased sales in established markets, primarily attributable to the difficult economic environment in the California and Florida geographies in which we operate, and circulation reductions that we initiated in July of this year. Direct Marketing results reflect year-over-year double-digit growth in our select markets vertical, flat revenues in our retail and high tech/telecom verticals, a mid-single digit decline from our financial vertical and a double-digit decline from our pharma/healthcare vertical.

*Operating Expenses*

Overall operating expenses decreased 3.3%, to \$238.7 million, in the third quarter of 2008 compared to the third quarter of 2007. The overall decrease in operating expenses was driven by decreased operating expenses in Shoppers, attributable to cost cutting measures and the overall decline in Shoppers circulation, ad placements and insert volumes. Compared to the third quarter of 2007, Shoppers operating expenses decreased \$7.5 million, or 8.6%. Direct Marketing operating expenses increased \$2.3 million or 1.5%, primarily due to higher logistics-related transportation costs and higher bad debt expense. General corporate expense decreased \$2.8 million, or 51.2%, primarily due to \$2.5 million of compensation costs recognized during the third quarter of 2007 associated with the retirement of our former Chief Executive Officer and President.

*Net Income/Earnings Per Share*

Net income decreased 24.1%, to \$16.6 million, and diluted earnings per share decreased 13.3%, to \$0.26 per share, in the third quarter of 2008 when compared to the third quarter of 2007. The decrease in net income was a result of decreased operating income from both Shoppers and Direct Marketing, partially offset by lower general corporate expense and a lower effective tax rate in the third quarter of 2008 than in the third quarter of 2007.



**Table of Contents**First Nine Months 2008 vs. First Nine Months 2007*Revenues*

Consolidated revenues decreased 5.4%, to \$813.2 million, and operating income decreased 22.0% to \$91.8 million in the first nine months of 2008 when compared to the first nine months of 2007. Our overall results reflect decreased revenues of 19.1% from our Shoppers segment, partially offset by increased revenues of 3.2% from our Direct Marketing segment. The revenue performance from Shoppers was the result of decreased sales in established markets, primarily attributable to the difficult economic environment in the California and Florida geographies in which we operate, and circulation reductions that we initiated in June of 2007 and July of 2008. Direct Marketing results reflect year-over-year double-digit growth in our high tech/telecom and select markets verticals, flat revenues in our retail and financial verticals, and a double-digit revenue decline from our pharma/healthcare vertical.

*Operating Expenses*

Overall operating expenses decreased 2.8%, to \$721.4 million, in the first nine months of 2008 compared to the first nine months of 2007. The overall decrease in operating expenses was driven by decreased operating expenses in Shoppers, attributable to cost cutting measures and the overall decline in Shoppers circulation, ad placement and insert volumes. Compared to the first nine months of 2007, Shoppers operating expenses decreased \$33.5 million or 12.1%. Direct Marketing operating expenses increased \$15.6 million or 3.4%, primarily due to higher logistics-related transportation costs and higher bad debt expense. General corporate expense decreased \$2.9 million, or 25.0%, primarily due to \$2.5 million of compensation costs recognized during the third quarter of 2007 associated with the retirement of our former Chief Executive Officer and President.

*Net Income/Earnings Per Share*

Net income decreased 25.6%, to \$48.4 million, and diluted earnings per share decreased 13.7%, to \$0.75 per share, in the first nine months of 2008 when compared to the first nine months of 2007. The decrease in net income was a result of decreased operating income from Shoppers and increased interest and other expenses, partially offset by increased operating income from Direct Marketing, lower general corporate expense, and a lower effective tax rate in the first nine months of 2008 when compared to the first nine months of 2007.

While we continue to believe in the long-term strength and viability of our Shoppers business, the general economic conditions, initially created by weakness in the real estate and associated financing markets, in the California and Florida geographies in which we operate remain extremely challenging. We have taken steps over the past several quarters to reduce our cost base in Shoppers and we continue to look at ways to further reduce costs in both of our businesses.

**Direct Marketing**

Direct Marketing operating results were as follows:

In thousands	Three months ended			Nine months ended		
	September 30, 2008	September 30, 2007	Change	September 30, 2008	September 30, 2007	Change
Revenues	\$ 182,567	\$ 181,313	0.7%	\$ 543,880	\$ 526,958	3.2%
Operating expenses	156,046	153,707	1.5%	470,181	454,590	3.4%
Operating income	\$ 26,521	\$ 27,606	-3.9%	\$ 73,699	\$ 72,368	1.8%

---

**Table of Contents**

**3<sup>rd</sup> Quarter 2008 vs. 3<sup>rd</sup> Quarter 2007**

*Revenues*

Direct Marketing revenues increased \$1.3 million, or 0.7%, in the third quarter of 2008 compared to the third quarter of 2007. Our select markets vertical had strong year-over-year double-digit revenue growth in the quarter. Our high tech/telecom and retail verticals were essentially flat compared to the third quarter of 2007. Our financial vertical was down in the mid-single digits and our pharma/healthcare vertical recorded a double-digit revenue decline compared to the prior year quarter. Revenues from our vertical markets are impacted by, among other things, the economic fundamentals of each industry, various market factors, including the demand for services by our clients, and the financial condition of and budgets available to specific clients. Revenues for Direct Marketing are affected by a number of factors, including general national and international economic trends.

The acquisition of Mason Zimble in January 2008 also positively affected our revenues in the third quarter of 2008 compared to the third quarter of 2007.

Future revenues will depend on, among other factors, how successful we are at growing business with existing clients, acquiring new clients, meeting client demands, and the strength of the national and international economies. We believe that in the long-term we will benefit from marketing and advertising expenditures being moved from other advertising media to the targeted media space, the results of which can be more effectively tracked, enabling measurement of the return on marketing investment. Standard postage rates increased in each of the last two calendar years and increased again in May of 2008. Postage rates influence the demand for our Direct Marketing services even though the cost of mailings is borne by our clients and is not directly reflected in our revenues or expenses. While we do not expect the postal rate increases to have a significant impact on our Direct Marketing business, there is no assurance that future postal increases will not have an adverse impact on us.

*Operating Expenses*

Operating expenses increased \$2.3 million, or 1.5%, in the third quarter of 2008 compared to the third quarter of 2007. The acquisition of Mason Zimble in January 2008 contributed to this increase. Labor costs decreased \$2.9 million, or 3.6%, due to decreased incentive compensation expense, lower severance costs, and decreased payrolls due to lower headcount. Production and distribution costs increased \$4.8 million, or 9.2%, due to higher logistics-related transportation costs. General and administrative expense increased \$0.6 million, or 5.2%, due primarily to higher bad debt expense related to clients in our retail vertical. Depreciation and amortization expense decreased \$0.2 million, or 2.6%, due to certain intangible assets and software becoming fully amortized.

Direct Marketing's largest cost components are labor, outsourced costs and transportation costs. Each of these costs is somewhat variable and tends to fluctuate with revenues and the demand for our direct marketing services.

**First Nine Months 2008 vs. First Nine Months 2007**

*Revenues*

Direct Marketing revenues increased \$16.9 million, or 3.2%, in the first nine months of 2008 compared to the first nine months of 2007. Our high tech/telecom and select markets verticals had strong year-over-year double-digit revenue growth. Our retail and financial services verticals were essentially flat compared to the prior year. Our pharma/healthcare vertical recorded a double-digit revenue decline compared to the prior year.

The acquisition of Mason Zimble in January 2008 also positively affected our revenues in the first nine months of 2008 compared to the first nine months of 2007.

**Table of Contents***Operating Expenses*

Operating expenses increased \$15.6 million, or 3.4%, in the first nine months of 2008 compared to the first nine months of 2007. The acquisition of Mason Zimble in January 2008 contributed to this increase. Labor costs increased \$3.3 million, or 1.4%, in the first nine months of 2008 compared to the first nine months of 2007 due to annual salary increases and increased medical costs. Production and distribution costs increased \$12.2 million, or 8.0%, due to higher logistics-related transportation costs and outsourced costs. General and administrative expense increased \$0.6 million, or 1.4%, due primarily to increased outside sales commissions and higher bad debt expense, partially offset by decreased recruiting, training and travel expenses. Depreciation and amortization expense decreased \$0.5 million, or 2.5%, due to certain intangible assets and software becoming fully amortized.

**Shoppers**

In thousands	Three months ended			Nine months ended		
	September 30, 2008	September 30, 2007	Change	September 30, 2008	September 30, 2007	Change
Revenues	\$ 87,346	\$ 105,383	-17.1%	\$ 269,298	\$ 332,911	-19.1%
Operating expenses	79,919	87,457	-8.6%	242,439	275,896	-12.1%
Operating income	\$ 7,427	\$ 17,926	-58.6%	\$ 26,859	\$ 57,015	-52.9%

3<sup>rd</sup> Quarter 2008 vs. 3<sup>rd</sup> Quarter 2007*Revenues*

Shoppers revenues decreased \$18.0 million, or 17.1%, in the third quarter of 2008 compared to the third quarter of 2007. These results reflect the continued impact that the difficult economic environments in California and Florida are having on our Shoppers business. The decrease in revenues was the result of decreased sales in established markets, including declines in virtually every revenue category, and circulation reductions of approximately 250,000 that were initiated in July of this year. This circulation represented approximately \$0.3 million and \$1.0 million of revenue in the third quarter of 2008 and 2007, respectively. At September 30, 2008 our Shoppers circulation reached more than 12.5 million in California and Florida each week. We continue to evaluate all of our circulation performance and may make further circulation reductions in the future as part of our efforts to address the difficult economic conditions in California and Florida.

*Operating Expenses*

Operating expenses decreased \$7.5 million, or 8.6%, in the third quarter of 2008 compared to the third quarter of 2007. Total labor costs decreased \$3.5 million, or 11.1%, as a result of reductions in our Shoppers workforce due to the continuing weak market conditions. Total production costs decreased \$1.9 million, or 4.2%, due primarily to decreased paper costs resulting from circulation reductions, a decline in ad placements and lower newsprint rates, and decreased offload printing costs due to decreased print-and-deliver volumes. Total general and administrative costs decreased \$2.0 million, or 23.3%, due primarily to lower promotion-related expense. Depreciation and amortization expense decreased \$0.1 million, or 6.3%, due to decreased capital expenditures in recent periods. We are continuing to look for ways to further reduce our cost base in this business.

Shoppers largest cost components are labor, postage and paper. Shoppers labor costs are partially variable and tend to fluctuate with the number of zones, circulation, volumes and revenues. Standard postage rates increased in each of the last two calendar years. However, in 2007 we changed the manner in which we address our Shoppers publications from detached cards to direct labeling on the shopper publication. As a result of this change, our per-piece postage rates remained steady when the May 2007 rates were put into effect. Standard postage rates increased again in May of 2008, which increased Shoppers production costs. Newsprint prices have continued to decline since the third quarter of 2007, contributing to lower production costs. Paper prices are expected to increase from the current levels in the fourth quarter of 2008.

---

**Table of Contents**

**First Nine Months 2008 vs. First Nine Months 2007**

*Revenues*

Shoppers revenues decreased \$63.6 million, or 19.1%, in the first nine months of 2008 compared to the first nine months of 2007. These results reflect the continued impact that the difficult economic environments in California and Florida are having on our Shoppers business. The decrease in revenues was the result of decreased sales in established markets, including declines in virtually every revenue category, and reductions of unprofitable circulation of approximately 600,000 that were initiated in June of 2007 and 250,000 that were initiated in July of 2008. The circulation that was shut down in June 2007 represented approximately \$3.0 million of revenue in the first nine months of 2007. The circulation that was shut down in July of 2008 represented approximately \$1.9 million and \$3.1 million of revenue in the first nine months of 2008 and 2007, respectively.

*Operating Expenses*

Operating expenses decreased \$33.5 million, or 12.1%, in the first nine months of 2008 compared to the first nine months of 2007. Total labor costs decreased \$13.4 million, or 13.4%, as a result of reductions in our Shoppers workforce due to the continuing weak market conditions. Total production costs decreased \$14.9 million, or 10.3%, due primarily to decreased paper costs resulting from circulation reductions, a decline in ad placements and lower newsprint rates, decreased postage due to circulation reductions and distribution volumes, and decreased offload printing costs due to decreased print-and-deliver volume. Total general and administrative costs decreased \$4.9 million, or 19.8%, due primarily to lower promotion-related expense. Depreciation and amortization expense decreased \$0.2 million, or 3.1%, due to decreased capital expenditures in recent periods.

**General Corporate Expense**

General corporate expense decreased \$2.8 million, or 51.2%, in the third quarter of 2008 and \$2.9 million, or 25.0%, in the first nine months of 2008 compared to the same periods in 2007. These decreases were primarily due to \$2.5 million of compensation costs recognized during the third quarter of 2007 associated with the retirement of our former Chief Executive Officer and President.

**Interest Expense**

Interest expense was up \$0.1 million, or 3.1%, in the third quarter of 2008 and \$1.2 million, or 12.3%, in the first nine months of 2008 compared to the same periods in 2007. This increase is due to higher outstanding debt levels in 2008 than in 2007, primarily due to share repurchases and the acquisition of Mason Zimble, and additional expense related to credit agreements entered into in the first quarter of 2008. The increase was partially offset by lower interest rates on borrowings in 2008 than in 2007.

**Interest Income**

Interest income was down slightly in the third quarter of 2008 and down \$0.1 million or 23.7% in the first nine months of 2008 compared to the same periods in 2007 due to normal variances in cash levels and lower interest rates on investments.

**Other Income and Expense**

Other net expense decreased slightly in the third quarter of 2008 and \$1.2 million, or 161.2%, in the first nine months of 2008 compared to the same periods in 2007, primarily due to an increase in foreign currency transaction losses.

---

**Table of Contents**

**Income Taxes**

Income tax expense decreased \$3.6 million in the third quarter of 2008 and \$11.7 million in the first nine months of 2008 compared to the same periods in 2007. The effective tax rate was 39.6% for the third quarter of 2008, down from 39.8% for the third quarter of 2007. The effective tax rate was 39.0% for the first nine months of 2008, down from 39.6% for the first nine months of 2007. This decrease was primarily the result of the recognition of certain tax benefits in the first quarter of 2008.

**Liquidity and Capital Resources**

*Sources and Uses of Cash*

As of September 30, 2008, cash and cash equivalents were \$22.0 million, decreasing \$0.8 million from December 31, 2007. This net decrease was a result of net cash provided by operating activities of \$75.3 million, offset by cash used in investing activities of \$24.6 million and net cash used in financing activities of \$50.9 million.

*Operating Activities*

Net cash provided by operating activities for the nine months ended September 30, 2008 was \$75.3 million, compared to \$114.1 million for the first nine months of 2007. The \$38.8 million year-over-year decrease was attributable to lower net income and changes within working capital assets and liabilities.

For the nine months ended September 30, 2008, our principal working capital changes, which directly affected net cash provided by operating activities, were as follows:

A decrease in accounts receivable attributable to lower revenues in the third quarter of 2008 than in the fourth quarter of 2007. Days sales outstanding of approximately 61 days at September 30, 2008 increased from 60 days at December 31, 2007 and increased from 59 days at September 30, 2007;

An increase in inventory due to timing and increasing prices in the third quarter of 2008;

An increase in prepaid expenses and other current assets due to timing of payments;

A decrease in accounts payable due to overall lower operating expenses in the third quarter of 2008 than in the fourth quarter of 2007;

A decrease in accrued payroll and related expenses due to payment of 2007 bonuses and lower accrued commissions at September 30, 2008 than at December 31, 2007 due to 2008 revenue performance; and

An increase in customer deposits and unearned revenue due to timing of receipts.

*Investing Activities*

Net cash used in investing activities was \$24.6 million for the first nine months of 2008, compared to \$20.5 million for the first nine months of 2007. The difference is primarily the result of the January 2008 acquisition of Mason Zimble.

*Financing Activities*

## Edgar Filing: HARTE HANKS INC - Form 10-Q

Net cash outflows from financing activities were \$50.9 million for the nine months ended September 30, 2008 compared to net cash outflows of \$105.3 million for the nine months ended September 30, 2007. The difference is attributable primarily to \$44.9 million less spent on the repurchase of our common stock, and \$10.7 million less proceeds related to the issuance of common stock in the first nine months of 2008 than in the first nine months of 2007.



---

## **Table of Contents**

### *Credit Facilities*

Our five-year Revolving Credit Facility has a maturity date of August 12, 2010. At September 30, 2008, our debt balance related to the Revolving Credit Facility was \$20.0 million. The five-year 2006 Term Loan Facility has a maturity date of September 6, 2011. At September 30, 2008, our debt balance related to the 2006 Term Loan Facility was \$175.5 million. The four-year 2008 Term Loan Facility has a maturity date of March 7, 2012. At September 30, 2008, our debt balance related to the 2008 Term Loan Facility was \$100.0 million.

Under all of our credit facilities we are required to maintain an interest coverage ratio of not less than 2.75 to 1 and a total debt-to-EBITDA ratio of not more than 3.0 to 1. The credit facilities also contain covenants restricting our and our subsidiaries' ability to grant liens and enter into certain transactions and limit the total amount of indebtedness of our subsidiaries to \$20 million.

The credit facilities each also include customary covenants regarding reporting obligations, delivery of notices regarding certain events, maintaining our corporate existence, payment of obligations, maintenance of our properties and insurance thereon at customary levels with financially sound and reputable insurance companies, maintaining books and records and compliance with applicable laws. The credit facilities each also provide for customary events of default including nonpayment of principal or interest, breach of representations and warranties, violations of covenants, failure to pay certain other indebtedness, bankruptcy and material judgments and liabilities, certain violations of environmental laws or ERISA or the occurrence of a change of control. As of September 30, 2008, we were in compliance with all of the covenants of our credit facilities.

As we have capacity under our Revolving Credit Facility and the intent to use the Revolving Credit Facility to fund the required quarterly principal payments under the 2006 Term Loan Facility and the 2008 Term Loan Facility through the September 30, 2009, we have classified our entire debt balance at September 30, 2008 as long-term.

In September 2007, we entered into a two-year interest rate swap with a notional amount of \$150 million and a fixed rate of 4.655% in order to limit a portion of our interest rate exposure by converting a portion of our variable-rate debt to fixed-rate debt. Please refer to Note F of the Notes to Unaudited Condensed Consolidated Financial Statements, *Interest Rate Risk*, and Item 3. to this Form 10-Q, *Quantitative and Qualitative Disclosures About Market Risk*, for a description of our interest rate risk.

### *Outlook*

We consider such factors as current assets, current liabilities, total debt, revenues, operating income and cash flows from operations, investing activities and financing activities when assessing our liquidity. Our primary sources of liquidity have been cash and cash equivalents on hand and cash generated from operating activities. Our management of cash is designed to optimize returns on cash balances and to ensure that it is readily available to meet our operating, investing and financing requirements as they arise. Capital resources are also available from and provided through our unsecured credit facilities, subject to the terms and conditions of those facilities.

The amount of cash on hand and borrowings available under our credit facilities are influenced by a number of factors, including fluctuations in our operating results, revenue growth, accounts receivable collections, capital expenditures, tax payments, share repurchases, acquisitions and dividends.

Recent developments in the financial markets have increased our exposure to the possible liquidity and credit risks of counterparties to our Revolving Credit Facility. As of September 30, 2008, we had \$105.0 million of unused borrowing capacity under our Revolving Credit Facility and we have not experienced any limitations on our ability to access this source of liquidity. Based on our current operational plans, we believe that our credit facilities, together with cash provided by operating activities, will be sufficient to fund operations, anticipated capital expenditures, contributions to our pension plans, payments of principal and interest on our borrowings, and dividends on our common stock for at least the next twelve months. Nevertheless, we cannot predict the impact on our business performance of the ongoing economic downturn in the United States and other economies. A lasting economic downturn or recession in the United States and other economies could have a material adverse effect on our business, financial position or operating results.

## Table of Contents

Our existing credit facilities begin to expire in the third quarter of 2010. We cannot predict future economic and credit market conditions and cannot assure you whether future credit facilities will be available on acceptable terms or at all.

## Critical Accounting Policies

Our financial statements and accompanying notes are prepared in accordance with U.S generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. These estimates and assumptions are affected by management's application of accounting policies. We consider the following to be our critical accounting policies, as described in detail in our 2007 Form 10-K:

Revenue recognition;

Allowance for doubtful accounts;

Reserve for healthcare, workers' compensation, automobile and general liability;

Goodwill; and

Stock-based compensation.

There have been no material changes to the critical accounting policies described in our 2007 Form 10-K.

As discussed in Note B, *Recent Accounting Pronouncements*, of the Notes to Unaudited Condensed Consolidated Financial Statements, certain new financial accounting pronouncements have been issued which either have already been reflected in the accompanying consolidated financial statements, or will become effective for our financial statements at various dates in the future. Our adoption of SFAS 141R, *Business Combinations*, in 2009 will affect the way we account for acquisitions, including acquisition-related costs, contractual contingencies and contingent consideration, and may also impact the amount of information we disclose about acquisitions.

The adoption of the remaining new accounting pronouncements discussed in Note B of the Notes to Unaudited Condensed Consolidated Financial Statements have not and are not expected to have a material effect on our consolidated financial statements.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk includes the risk of loss arising from adverse changes in market rates and prices. We face market risks related to interest rate variations and to foreign exchange rate variations. From time to time, we may utilize derivative financial instruments as described below to manage our exposure to such risks.

We are exposed to market risk for changes in interest rates related to our credit facilities. Our earnings are affected by changes in short-term interest rates as a result of our credit facilities, which bear interest at variable rates based on Eurodollar rates (effective rate of 3.65% at September 30, 2008). The five-year Revolving Credit Facility has a maturity date of August 12, 2010. At September 30, 2008, our debt balance related to the Revolving Credit Facility was \$20.0 million. The five-year 2006 Term Loan Facility has a maturity date of September 6, 2011. At September 30, 2008, our debt balance related to the 2006 Term Loan Facility was \$175.5 million. The four-year 2008 Term Loan Facility has a maturity date of March 7, 2012. At September 30, 2008, our debt balance related to the 2008 Term Loan Facility was \$100.0 million. In September 2007, we entered into a two-year interest rate swap with a notional amount of \$150 million and a fixed rate of 4.655% in order to limit a portion of our interest rate exposure by converting a portion of our variable-rate debt to fixed-rate debt.



---

**Table of Contents**

Assuming the actual level of debt throughout the third quarter and first nine months of 2008, and assuming a one percentage point change in the period's average interest rates, it is estimated that our net income for the quarter and nine months ended September 30, 2008 would have changed by approximately \$0.2 million and \$0.7 million, respectively. Due to our interest rate swap, overall debt level at September 30, 2008, anticipated cash flows from operations, and the various financial alternatives available to management should there be an adverse change in interest rates, we do not believe that we currently have significant exposure to market risks associated with changing interest rates.

Our earnings are also affected by fluctuations in foreign currency exchange rates as a result of our operations in foreign countries. Our primary exchange rate exposure is to the Euro, British pound sterling, Australian dollar, Philippine peso and Brazilian real. We monitor these risks throughout the normal course of business. The majority of the transactions of our U.S. and foreign operations are denominated in the respective local currencies. Changes in exchange rates related to these types of transactions are reflected in the applicable line items making up operating income in our statement of operations. Due to the current level of operations conducted in foreign currencies, we do not believe that the impact of fluctuations in foreign exchange rates on these types of transactions is significant to our overall earnings. A smaller portion of our transactions are denominated in currencies other than the respective local currencies. For example, inter-company transactions that are expected to be settled in the near-term are denominated in U.S. dollars. Since the accounting records of our foreign operations are kept in the respective local currency, any transactions denominated in other currencies are accounted for in the respective local currency at the time of the transaction. Upon settlement of such a transaction, any foreign currency gain or loss results in an adjustment to income, which is recorded in other, net in our statement of operations. Transactions such as these amounted to \$0.1 million and \$1.0 million in pre-tax currency transaction losses in the quarter and nine months ended September 30, 2008, respectively. At this time we have not entered into any foreign currency forward exchange contracts or other derivative instruments to hedge the effects of adverse fluctuations in foreign currency exchange rates.

We do not enter into derivative instruments for any purpose other than cash flow hedging. We do not speculate using derivative instruments.

**Item 4. Controls and Procedures**

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, or the Exchange Act). It should be noted that, because of inherent limitations, our disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the disclosure controls and procedures are met. Based upon that evaluation, the Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer concluded that the design and operation of these disclosure controls and procedures were effective, at the reasonable assurance level, to ensure information required to be disclosed by us in the reports that we file or submit under the Exchange Act is properly recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer, of our internal control over financial reporting to determine whether any changes occurred during the third quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there were no changes in our internal control over financial reporting or in other factors that have materially affected or are reasonably likely to

**Table of Contents**

materially affect our internal control over financial reporting. We may make changes in our internal control processes from time to time in the future. It should also be noted that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements, and controls may become inadequate because of changes in conditions or in the degree of compliance with the policies or procedures.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Information regarding legal proceedings is set forth in Note K to the Notes to Unaudited Condensed Consolidated Financial Statements, *Litigation Contingencies*, in Item 1 of Part I of this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

**Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our 2007 Form 10-K, which could materially affect our business, financial condition or future results. The risks described in our 2007 Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and operating results. In our judgment, there were no material changes in the risk factors as previously disclosed in Part I, Item 1A. Risk Factors of our 2007 Form 10-K. Refer to Part I, Item 2 of this Quarterly Report on Form 10-Q, for a discussion of the ongoing economic downturn in the United States and other economies and its adverse impact on our business.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

During the third quarter of 2008, we did not purchase any shares of our stock through our stock repurchase program that was publicly announced in January 1997. Under this program, from which shares can be purchased in the open market or through privately negotiated transactions, our Board of Directors has authorized the repurchase of up to 74,400,000 shares of our outstanding common stock. As of September 30, 2008, we had repurchased a total of 63,924,509 shares at an average price of \$18.83 per share under this program. The maximum number of shares that may yet be purchased under this program was 10,475,491 at September 30, 2008.

**Item 6. Exhibits**

See Index to Exhibits on Page 31.

**Table of Contents**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

	HARTE-HANKS, INC.
November 10, 2008 Date	/s/ Dean H. Blythe Dean H. Blythe President and Chief Executive Officer
November 10, 2008 Date	/s/ Douglas C. Shepard Douglas C. Shepard Executive Vice President and Chief Financial Officer
November 10, 2008 Date	/s/ Jessica M. Huff Jessica M. Huff Vice President, Finance and Chief Accounting Officer

**Table of Contents**

**INDEX TO EXHIBITS**

**Exhibit**

<b>No.</b>	<b>Description of Exhibit</b>
*31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*32.1	Furnished Certification of Chief Executive Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
*32.2	Furnished Certification of Chief Financial Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed or furnished herewith