

HARTE HANKS INC  
Form 10-Q  
November 01, 2011  
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**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, 2011

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 001-7120

**HARTE-HANKS, INC.**

(Exact name of registrant as specified in its charter)

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

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

**9601 McAllister Freeway, Suite 610, San Antonio, Texas 78216**

(Address of principal executive offices) (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 the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

The number of shares outstanding of each of the registrant's classes of common stock as of October 15, 2011 was 62,816,443 shares of common stock, all of one class.

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**HARTE-HANKS, INC. AND SUBSIDIARIES**

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**FORM 10-Q REPORT**

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**Item 1. Interim Condensed Consolidated Financial Statements**  
**Harte-Hanks, Inc. and Subsidiaries**

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

|  | September 30,<br>2011<br>(Unaudited) | December 31,<br>2010<br>(Audited) |
|--|--------------------------------------|-----------------------------------|
| <b>Assets</b>  |                                      |                                   |
| <b>Current assets</b>  |                                      |                                   |
| Cash and cash equivalents  | \$ 71,794                            | \$ 85,996                         |
| Accounts receivable ( <i>less allowance for doubtful accounts of \$3,169 at September 30, 2011 and \$3,103 at December 31, 2010</i> )                                    | 147,632                              | 151,006                           |
| Inventory  | 6,957                                | 7,324                             |
| Prepaid expenses   | 9,038                                | 8,943                             |
| Current deferred income tax asset  | 6,769                                | 8,911                             |
| Other current assets   | 6,258                                | 6,283                             |
| <b>Total current assets</b>  | <b>248,448</b>                       | <b>268,463</b>                    |
| Property, plant and equipment ( <i>less accumulated depreciation of \$251,793 at September 30, 2011 and \$253,730 at December 31, 2010</i> )                             | 73,105                               | 72,659                            |
| Goodwill, net  | 565,651                              | 565,651                           |
| Other intangible assets ( <i>less accumulated amortization of \$15,531 at September 30, 2011 and \$14,942 at December 31, 2010</i> )                                     | 15,199                               | 15,788                            |
| Other assets   | 4,630                                | 4,319                             |
| <b>Total assets</b>  | <b>\$ 907,033</b>                    | <b>\$ 926,880</b>                 |
| <b>Liabilities and Stockholders' Equity</b>  |                                      |                                   |
| <b>Current liabilities</b>   |                                      |                                   |
| Current maturities of long-term debt   | \$ 71,656                            | \$ 133,000                        |
| Accounts payable   | 42,827                               | 56,085                            |
| Accrued payroll and related expenses   | 18,847                               | 24,780                            |
| Customer advances and deferred revenue   | 35,952                               | 36,834                            |
| Income taxes payable   | 828                                  | 2,247                             |
| Other current liabilities  | 21,113                               | 28,017                            |
| <b>Total current liabilities</b>   | <b>191,223</b>                       | <b>280,963</b>                    |
| Long-term debt   | 113,312                              | 60,000                            |
| Other long-term liabilities ( <i>including deferred income taxes of \$96,102 at September 30, 2011 and \$85,655 at December 31, 2010</i> )                               | 154,098                              | 148,094                           |
| <b>Total liabilities</b>   | <b>458,633</b>                       | <b>489,057</b>                    |
| <b>Stockholders' equity</b>  |                                      |                                   |
| Common stock, \$1 par value per share, 250,000,000 shares authorized. 118,484,579 shares issued at September 30, 2011 and 118,296,334 shares issued at December 31, 2010 | 118,485                              | 118,296                           |
| Additional paid-in capital   | 340,124                              | 336,795                           |
| Retained earnings  | 1,266,596                            | 1,252,438                         |
| Less treasury stock: 55,672,766 shares at cost at September 30, 2011 and 54,664,293 shares at cost at December 31, 2010  | (1,244,327)                          | (1,236,024)                       |
| Accumulated other comprehensive loss   | (32,478)                             | (33,682)                          |

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|  |            |            |
|--|------------|------------|
| Total stockholders' equity                 | 448,400    | 437,823    |
| Total liabilities and stockholders' equity | \$ 907,033 | \$ 926,880 |

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>2011</b>                             | <b>2010</b> |
| Operating revenues   | \$ 212,788                              | \$ 216,745  |
| Operating expenses   |   |             |
| Labor  | 88,214                                  | 88,038      |
| Production and distribution                                      | 81,295                                  | 81,019      |
| Advertising, selling, general and administrative                 | 17,439                                  | 16,854      |
| Depreciation and software amortization                           | 4,957                                   | 5,578       |
| Intangible asset amortization                                    | 168                                     | 201         |
| Total operating expenses   | 192,073                                 | 191,690     |
| Operating income   | 20,715                                  | 25,055      |
| Other expenses (income)  |   |             |
| Interest expense   | 889                                     | 705         |
| Interest income  | (52)                                    | (69)        |
| Other, net   | (540)                                   | 1,865       |
|  | 297                                     | 2,501       |
| Income before income taxes                                       | 20,418                                  | 22,554      |
| Income tax expense   | 8,290                                   | 8,739       |
| Net income   | \$ 12,128                               | \$ 13,815   |
| Basic earnings per common share                                  | \$ 0.19                                 | \$ 0.22     |
| Weighted-average common shares outstanding                       | 62,798                                  | 63,622      |
| Diluted earnings per common share                                | \$ 0.19                                 | \$ 0.22     |
| Weighted-average common and common equivalent shares outstanding | 63,059                                  | 64,076      |

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>2011</b>                            | <b>2010</b> |
| Operating revenues   | \$ 626,141                             | \$ 624,533  |
| Operating expenses   |  |             |
| Labor  | 268,497                                | 258,573     |
| Production and distribution                                      | 240,087                                | 232,519     |
| Advertising, selling, general and administrative                 | 50,120                                 | 49,941      |
| Depreciation and software amortization                           | 15,270                                 | 16,823      |
| Intangible asset amortization                                    | 587                                    | 733         |
| Total operating expenses   | 574,561                                | 558,589     |
| Operating income   | 51,580                                 | 65,944      |
| Other expenses (income)  |  |             |
| Interest expense   | 2,151                                  | 2,102       |
| Interest income  | (188)                                  | (136)       |
| Other, net   | 575                                    | 1,506       |
|  | 2,538                                  | 3,472       |
| Income before income taxes                                       | 49,042                                 | 62,472      |
| Income tax expense   | 19,572                                 | 24,472      |
| Net income   | \$ 29,470                              | \$ 38,000   |
| Basic earnings per common share                                  | \$ 0.47                                | \$ 0.60     |
| Weighted-average common shares outstanding                       | 63,291                                 | 63,612      |
| Diluted earnings per common share                                | \$ 0.46                                | \$ 0.59     |
| Weighted-average common and common equivalent shares outstanding | 63,669                                 | 64,119      |

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>2011</b>                            | <b>2010</b> |
| <b>Cash Flows from Operating Activities</b>                                       |  |             |
| Net income  | \$ 29,470                              | \$ 38,000   |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |             |
| Depreciation and software amortization  | 15,270                                 | 16,823      |
| Intangible asset amortization   | 587                                    | 733         |
| Stock-based compensation  | 3,810                                  | 2,954       |
| Excess tax benefits from stock-based compensation                                 | (214)                                  | 0           |
| Net pension (payments) cost   | (358)                                  | 4,722       |
| Deferred income taxes   | 10,272                                 | 5,763       |
| Other, net  | 123                                    | 123         |
| Changes in operating assets and liabilities, net of acquisitions:                 |  |             |
| Decrease (increase) in accounts receivable, net                                   | 3,374                                  | (7,548)     |
| Decrease (increase) in inventory  | 367                                    | (1,008)     |
| Increase in prepaid expenses and other current assets                             | (70)                                   | (1,533)     |
| (Decrease) increase in accounts payable   | (13,258)                               | 13,912      |
| Decrease in other accrued expenses and other current liabilities                  | (15,312)                               | (757)       |
| Other, net  | (223)                                  | (9,467)     |
| Net cash provided by operating activities   | 33,838                                 | 62,717      |
| <b>Cash Flows from Investing Activities</b>                                       |  |             |
| Acquisitions, net of cash acquired  | 0                                      | (12,904)    |
| Purchases of property, plant and equipment  | (16,444)                               | (12,631)    |
| Proceeds from sale of property, plant and equipment                               | 59                                     | 143         |
| Net cash used in investing activities   | (16,385)                               | (25,392)    |
| <b>Cash Flows from Financing Activities</b>                                       |  |             |
| Net repayment of borrowings   | (8,032)                                | (33,188)    |
| Debt refinancing costs  | (782)                                  | 0           |
| Issuance of common stock  | 697                                    | 63          |
| Excess tax benefits from stock-based compensation                                 | 214                                    | 0           |
| Purchase of treasury stock  | (8,363)                                | 0           |
| Dividends paid  | (15,312)                               | (14,356)    |
| Net cash used in financing activities   | (31,578)                               | (47,481)    |
| Effect of exchange rate changes on cash and cash equivalents                      | (77)                                   | (137)       |
| Net decrease in cash and cash equivalents   | (14,202)                               | (10,293)    |
| Cash and cash equivalents at beginning of year                                    | 85,996                                 | 86,598      |
| Cash and cash equivalents at end of period  | \$ 71,794                              | \$ 76,305   |

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)****(2011 Unaudited)**

|   | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Treasury<br/>Stock</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> | <b>Total<br/>Stockholders<br/>Equity</b> |
|---|-------------------------|---|------------------------------|---------------------------|--|--|
| Balance at December 31, 2009  | \$ 118,243              | \$ 333,612                                | \$ 1,217,975                 | \$ (1,236,217)            | \$ (31,970)  | \$ 401,643                               |
| Exercise of stock options and release of nonvested shares           | 53                      | 22  | 0                            | (124)                     | 0  | (49)                                     |
| Net tax effect of options exercised and release of nonvested shares | 0                       | (588)                                     | 0                            | 0                         | 0  | (588)                                    |
| Stock-based compensation  | 0                       | 3,907                                     | 0                            | 0                         | 0  | 3,907                                    |
| Dividends paid (\$0.30 per share)                                   | 0                       | 0   | (19,141)                     | 0                         | 0  | (19,141)                                 |
| Treasury stock issued   | 0                       | (158)                                     | 0                            | 317                       | 0  | 159                                      |
| Comprehensive income:   |                         |   |                              |                           |  |  |
| Net income  | 0                       | 0   | 53,604                       | 0                         | 0  | 53,604                                   |
| Adjustment to pension liability (net of tax benefit of \$1,051)     | 0                       | 0   | 0                            | 0                         | (1,576)  | (1,576)                                  |
| Foreign currency translation adjustment                             | 0                       | 0   | 0                            | 0                         | (136)  | (136)                                    |
| <b>Total comprehensive income</b>                                   |                         |   |                              |                           |  | <b>51,892</b>                            |
| Balance at December 31, 2010  | 118,296                 | 336,795                                   | 1,252,438                    | (1,236,024)               | (33,682)   | 437,823                                  |
| Exercise of stock options and release of nonvested shares           | 189                     | 508                                       | 0                            | (193)                     | 0  | 504                                      |
| Net tax effect of options exercised and release of nonvested shares | 0                       | (857)                                     | 0                            | 0                         | 0  | (857)                                    |
| Stock-based compensation  | 0                       | 3,810                                     | 0                            | 0                         | 0  | 3,810                                    |
| Dividends paid (\$0.24 per share)                                   | 0                       | 0   | (15,312)                     | 0                         | 0  | (15,312)                                 |
| Treasury stock issued   | 0                       | (132)                                     | 0                            | 253                       | 0  | 121                                      |
| Purchase of treasury stock  | 0                       | 0   | 0                            | (8,363)                   | 0  | (8,363)                                  |
| Comprehensive income:   |                         |   |                              |                           |  |  |
| Net income  | 0                       | 0   | 29,470                       | 0                         | 0  | 29,470                                   |
| Adjustment to pension liability (net of tax expense of \$1,370)     | 0                       | 0   | 0                            | 0                         | 2,055  | 2,055                                    |
| Foreign currency translation adjustment                             | 0                       | 0   | 0                            | 0                         | (851)  | (851)                                    |
| <b>Total comprehensive income</b>                                   |                         |   |                              |                           |  | <b>30,674</b>                            |
| Balance at September 30, 2011                                       | \$ 118,485              | \$ 340,124                                | \$ 1,266,596                 | \$ (1,244,327)            | \$ (32,478)  | \$ 448,400                               |

See Notes to Unaudited Condensed Consolidated Financial Statements.

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**Harte-Hanks, Inc. and Subsidiaries**

**Notes to Unaudited Condensed Consolidated Financial Statements**

**Note A Basis of Presentation**

**Consolidation**

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of Harte-Hanks, Inc. and its subsidiaries (the Company). All intercompany accounts and transactions have been eliminated in consolidation. Certain prior year amounts have been reclassified for comparative purposes.

In the Condensed Consolidated Balance Sheets, amounts related to postage deposits in our Direct Marketing business have been reclassified from the line item Prepaid expenses to the line item Other current assets, and amounts related to postage advances from our Direct Marketing customers have been reclassified from the line item Customer advances and deferred revenue to the line item Other current liabilities. We believe the new classification more accurately reflects each of these postage items as the cost of mailings in our Direct Marketing business is borne by our clients and is not directly reflected in our revenues or expenses.

In the Consolidated Statements of Cash Flows, contributions to our pension plans have been reclassified from the line item Other, net within the Changes in operating assets and liabilities, to the line item Net pension cost within the Adjustments to reconcile net income to net cash provided by operations. We believe the new classification more appropriately presents the net cash flow impact of activity related to our pension plans.

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.

**Interim Financial Information**

The financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) 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. GAAP for complete financial statements. 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, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. 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, 2010.

**Use of Estimates**

The preparation of financial statements in conformity with U.S. GAAP 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. Actual results and outcomes could differ from those estimates and assumptions. On an ongoing basis management reviews its estimates based on currently available information. Changes in facts and circumstances could result in revised estimates and assumptions.

**Operating Expense Presentation in Consolidated Statement of Operations**

Labor in the Consolidated Statements of Operations includes all employee payroll and benefits, including stock-based compensation, along with temporary labor costs. Production and distribution and Advertising, selling, general and administrative do not include labor, depreciation or amortization.

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**Note B Recent Accounting Pronouncements**

In the first quarter of 2011, we adopted Accounting Standards Codification (ASC) Subtopic 605-25, *Revenue Recognition - Multiple-Element Arrangements* (ASC Subtopic 605-25). ASC Subtopic 605-25 provides principles for allocation of consideration among multiple-elements in an arrangement, allowing more flexibility in identifying and accounting for revenue from separate deliverables under an arrangement. ASC Subtopic 605-25 introduces an estimated selling price method for allocating revenue to the elements of a bundled arrangement if vendor-specific objective evidence or third-party evidence of selling price is not available, and significantly expands related disclosure requirements. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The adoption of ASC Subtopic 605-25 did not have a material effect on our consolidated financial statements.

In the first quarter of 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Updates (ASU) 2010-06, *Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 amends FASB ASC Topic 820, *Fair Value Measurements and Disclosures*, and requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements, including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information about purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. ASU 2010-06 also clarifies existing fair-value measurement disclosure guidance about the level of disaggregation, inputs and valuation techniques. Except for the detailed Level 3 roll forward disclosures, we adopted the provisions of ASU 2010-06 in the first quarter of 2010. This adoption did not affect our consolidated financial statements. We adopted the provisions of ASU 2010-06 related to the new Level 3 roll forward disclosures in the first quarter of 2011. This adoption did not affect our consolidated financial statements.

In the first quarter of 2011, we adopted ASU 2010-29, *Disclosure of Supplementary Pro Forma Information for Business Combinations*. ASU 2010-29 requires public entities to disclose certain pro forma information about the revenue and earnings of the combined entity within the notes to the financial statements when a business combination occurs. The pro forma revenue and earnings of the combined entity must be presented as though the business combination had occurred as of the beginning of the comparable prior annual reporting period only. ASU 2010-29 also requires that this disclosure include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the pro forma revenue and earnings. This adoption did not affect our consolidated financial statements.

In the third quarter of 2011, we adopted ASU 2011-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. ASU 2011-08 permits an entity to make a qualitative assessment of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before applying the two-step goodwill impairment test. If an entity concludes it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it need not perform the two-step impairment test. Our adoption of ASU 2011-08 did not affect our consolidated financial statements.

In the second quarter of 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. ASU 2011-05 eliminates the option to present other comprehensive income in the statement of changes in equity and provides the option to present the components of net income and comprehensive income in either one combined financial statement or two consecutive financial statements. We currently present the components of comprehensive income in our Consolidated Statements of Stockholders' Equity and Comprehensive Income. We will adopt ASU 2011-05 in the first quarter of 2012, at which point we plan to include one combined financial statement presenting the components of net income and comprehensive income. The adoption of ASU 2011-05 will not affect our operating results, cash flows or financial position.

**Table of Contents****Note C New Credit Facility**

On August 16, 2011, we entered into a new five-year \$122.5 million term loan facility (2011 Term Loan Facility) with Bank of America, N.A., as Administrative Agent. The 2011 Term Loan Facility replaced our \$200 million 2006 Term Loan Facility, which was scheduled to mature September 6, 2011. The 2011 Term Loan Facility did not replace, and is in addition to, our existing \$100 million 2008 Term Loan Facility and our existing \$70 million 2010 Revolving Credit Facility. A portion of the proceeds from the 2011 Term Loan Facility were used to pay off the remaining \$97.5 million obligation related to the 2006 Term Loan Facility. We plan to use the remaining proceeds for general corporate purposes. As of September 30, 2011 we had \$185.0 million of debt outstanding under our credit facilities, as follows:

| <b>In thousands</b>  | <b>September 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--|-------------------------------|------------------------------|
| 2006 Term Loan Facility, various interest rates based on LIBOR, due September 6, 2011  | \$ 0                          | \$ 117,000                   |
| 2008 Term Loan Facility, various interest rates based on LIBOR (effective rate of 0.74% at September 30, 2011), due March 7, 2012          | 64,000                        | 76,000                       |
| 2010 Revolving Credit Facility, various interest rates based on LIBOR, due August 12, 2013 (\$59.2 million capacity at September 30, 2011) | 0                             | 0                            |
| 2011 Term Loan Facility, various interest rates based on LIBOR (effective rate of 2.24% at September 30, 2011), due August 16, 2016        | 120,968                       | 0                            |
| <b>Total debt</b>  | <b>184,968</b>                | <b>193,000</b>               |
| Less current maturities  | 71,656                        | 133,000                      |
| <b>Total long-term debt</b>  | <b>\$ 113,312</b>             | <b>\$ 60,000</b>             |

The covenants related to the new 2011 Term Loan Facility are consistent with the covenants of our other credit facilities. As of September 30, 2011, we were in compliance with all of the covenants of our credit facilities.

**Note D Income Taxes**

Our third quarter 2011 income tax provision of \$8.3 million resulted in an effective income tax rate of 40.6%. Our income tax provision of \$19.6 million for the first nine months of 2011 resulted in an effective income tax rate of 39.9%. Our effective income tax rate is derived by estimating pretax income and income tax expense for the year ending December 31, 2011. The effective income tax rate calculated for the third quarter and first nine months of 2011 is higher than the federal statutory rate of 35.0%, primarily due to the addition of state income taxes.

Harte-Hanks, or one of our subsidiaries, files income tax returns at the federal level in the U.S., as well as in various U.S. state and foreign jurisdictions. For U.S. state and foreign returns, we are no longer subject to tax examinations for tax years prior to 2006. For U.S. federal returns, we are no longer subject to tax examinations for tax years prior to 2008.

We have elected to classify any interest expense and penalties related to income taxes within income tax expense in our Consolidated Statements of Operations. We did not have a significant amount of interest or penalties accrued at September 30, 2011. We had approximately \$0.1 million of interest and penalties accrued at December 31, 2010.

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**Note E Stock-Based Compensation**

We recognized \$1.0 million of stock-based compensation during the three month periods ended September 30, 2011 and 2010. We recognized \$3.8 million and \$3.0 million of stock-based compensation during the nine months ended September 30, 2011 and 2010, respectively.

Our annual grant of stock-based awards occurred in the first quarter of 2011, which is consistent with the timing of previous annual grants.

\$0.5 million of stock-based compensation related to the retirement of the President of Harte-Hanks Shoppers was recorded in the second quarter of 2011. In connection with his retirement on August 31, 2011, all of his unvested stock-based awards vested. We did not have any additional significant stock-based compensation activity in the third quarter of 2011.

**Note F Fair Value of Financial Instruments**

FASB ASC 820, *Fair Value Measurements and Disclosures*, (ASC 820) 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. ASC 820 also establishes a fair value hierarchy that prioritizes the inputs used in valuation methodologies into three levels:

- Level 1** Quoted prices in active markets for identical assets or liabilities.
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Because of their maturities and/or variable interest rates, certain financial instruments have fair values approximating their carrying values. These instruments include cash and cash equivalents, accounts receivable and trade payables.

The carrying values and estimated fair values of our outstanding debt were as follows:

| In thousands | September 30,<br>2011 |               | December 31,<br>2010 |               |
|--------------|-----------------------|---------------|----------------------|---------------|
|              | Carrying<br>Value     | Fair<br>Value | Carrying<br>Value    | Fair<br>Value |
| Total debt   | \$ 184,968            | \$ 184,601    | \$ 193,000           | \$ 190,583    |

The estimated fair values were calculated using current rates proposed to us by our bankers for debt with similar characteristics.

**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 non-vested 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>2011</b>                             | <b>2010</b> |
| <b>BASIC EPS</b>  |   |             |
| Net Income  | \$ 12,128                               | \$ 13,815   |
| Weighted-average common shares outstanding used in earnings per share computations    | 62,798                                  | 63,622      |
| Earnings per common share   | \$ 0.19                                 | \$ 0.22     |
| <b>DILUTED EPS</b>  |   |             |
| Net Income  | \$ 12,128                               | \$ 13,815   |
| Shares used in diluted earnings per share computations                                | 63,059                                  | 64,076      |
| Earnings per common share   | \$ 0.19                                 | \$ 0.22     |
| <b>Computation of shares used in earnings per share computations:</b>                 |   |             |
| Weighted-average outstanding common shares  | 62,798                                  | 63,622      |
| Weighted-average common equivalent shares dilutive effect of stock options and awards | 261                                     | 454         |
| Shares used in diluted earnings per share computations                                | 63,059                                  | 64,076      |

5.4 million and 6.1 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, 2011 and 2010, respectively. 0.3 million anti-dilutive non-vested shares have been excluded from the calculation of shares used in the diluted EPS calculation for the three months ended September 30, 2011.

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| In thousands, except per share amounts  | Nine Months Ended September 30, |           |
|---|---------------------------------|-----------|
|   | 2011                            | 2010      |
| <b>BASIC EPS</b>  |                                 |           |
| Net Income  | \$ 29,470                       | \$ 38,000 |
| Weighted-average common shares outstanding used in earnings per share computations    | 63,291                          | 63,612    |
| Earnings per common share   | \$ 0.47                         | \$ 0.60   |
| <b>DILUTED EPS</b>  |                                 |           |
| Net Income  | \$ 29,470                       | \$ 38,000 |
| Shares used in diluted earnings per share computations                                | 63,669                          | 64,119    |
| Earnings per common share   | \$ 0.46                         | \$ 0.59   |
| Computation of shares used in earnings per share computations:                        |                                 |           |
| Weighted-average outstanding common shares  | 63,291                          | 63,612    |
| Weighted-average common equivalent shares dilutive effect of stock options and awards | 378                             | 507       |
| Shares used in diluted earnings per share computations                                | 63,669                          | 64,119    |

5.4 million and 6.1 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, 2011 and 2010, respectively. 0.3 million anti-dilutive non-vested shares have been excluded from the calculation of shares used in the diluted EPS calculation for the nine months ended September 30, 2011.

**Note H Business Segments**

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

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Information about the operations of our two business segments follows:

| <b>In thousands</b>                     | <b>Three Months Ended September 30,</b> |                   |
|---|---|-------------------|
|   | <b>2011</b>                             | <b>2010</b>       |
| Operating revenues                      |   |                   |
| Direct Marketing                        | \$ 151,974                              | \$ 151,104        |
| Shoppers                                | 60,814                                  | 65,641            |
| <b>Total operating revenues</b>         | <b>\$ 212,788</b>                       | <b>\$ 216,745</b> |
| Operating income                        |   |                   |
| Direct Marketing                        | \$ 20,514                               | \$ 22,993         |
| Shoppers                                | 3,085                                   | 5,272             |
| Corporate Activities                    | (2,884)                                 | (3,210)           |
| <b>Total operating income</b>           | <b>\$ 20,715</b>                        | <b>\$ 25,055</b>  |
| Income before income taxes              |   |                   |
| Operating income                        | \$ 20,715                               | \$ 25,055         |
| Interest expense                        | (889)                                   | (705)             |
| Interest income                         | 52                                      | 69                |
| Other, net                              | 540                                     | (1,865)           |
| <b>Total income before income taxes</b> | <b>\$ 20,418</b>                        | <b>\$ 22,554</b>  |
|   |   |                   |
|   |   |                   |
| <b>In thousands</b>                     | <b>Nine Months Ended September 30,</b>  |                   |
|   | <b>2011</b>                             | <b>2010</b>       |
| Operating revenues                      |   |                   |
| Direct Marketing                        | \$ 445,776                              | \$ 426,525        |
| Shoppers                                | 180,365                                 | 198,008           |
| <b>Total operating revenues</b>         | <b>\$ 626,141</b>                       | <b>\$ 624,533</b> |
| Operating income                        |   |                   |
| Direct Marketing                        | \$ 56,850                               | \$ 59,845         |
| Shoppers                                | 3,214                                   | 14,715            |
| Corporate Activities                    | (8,484)                                 | (8,616)           |
| <b>Total operating income</b>           | <b>\$ 51,580</b>                        | <b>\$ 65,944</b>  |
| Income before income taxes              |   |                   |
| Operating income                        | \$ 51,580                               | \$ 65,944         |
| Interest expense                        | (2,151)                                 | (2,102)           |
| Interest income                         | 188                                     | 136               |
| Other, net                              | (575)                                   | (1,506)           |
| <b>Total income before income taxes</b> | <b>\$ 49,042</b>                        | <b>\$ 62,472</b>  |

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

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Prior to January 1, 1999, we maintained a defined benefit pension plan for which most of our employees were eligible. We elected to freeze benefits under this defined benefit pension plan as of December 31, 1998.

In 1994, we adopted a non-qualified, unfunded, supplemental pension plan covering certain employees, which

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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 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>2011</b>                             | <b>2010</b> |
| Service cost                       | \$ 114                                  | \$ 85       |
| Interest cost                      | 2,030                                   | 1,996       |
| Expected return on plan assets     | (1,756)                                 | (1,541)     |
| Amortization of prior service cost | 12                                      | 14          |
| Recognized actuarial loss          | 1,130                                   | 1,020       |
| Net periodic benefit cost          | \$ 1,530                                | \$ 1,574    |

| <b>In thousands</b>                | <b>Nine Months Ended September 30,</b> |             |
|------------------------------------|--|-------------|
|                                    | <b>2011</b>                            | <b>2010</b> |
| Service cost                       | \$ 343                                 | \$ 256      |
| Interest cost                      | 6,089                                  | 5,987       |
| Expected return on plan assets     | (5,267)                                | (4,623)     |
| Amortization of prior service cost | 36                                     | 41          |
| Recognized actuarial loss          | 3,389                                  | 3,061       |
| Net periodic benefit cost          | \$ 4,590                               | \$ 4,722    |

We plan to make total contributions of approximately \$5.2 million to our funded, frozen pension plan in 2011 in order to obtain the Pension Protection Act of 2006 full funding limit exemption. We made contributions of \$4.2 million in the first nine months of 2011. We plan to make a contribution of \$1.1 million in the fourth quarter of 2011.

We are not required to make and do not intend to make any contributions to our unfunded, supplemental pension plan in 2011 other than to the extent needed to cover benefit payments. We expect benefit payments under this supplemental pension plan to total \$1.0 million in 2011.

**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, |                  |
|---|----------------------------------|------------------|
|   | 2011                             | 2010             |
| Net income  | \$ 12,128                        | \$ 13,815        |
| Other comprehensive income:   |                                  |                  |
| Adjustment to pension liability (net of tax expense of \$457 in 2011 and \$414 in 2010) | 685                              | 620              |
| Foreign currency translation adjustment   | (1,875)                          | 2,860            |
| <b>Total comprehensive income</b>   | <b>\$ 10,938</b>                 | <b>\$ 17,295</b> |

| In thousands  | Nine Months Ended September 30, |                  |
|---|---------------------------------|------------------|
|   | 2011                            | 2010             |
| Net income  | \$ 29,470                       | \$ 38,000        |
| Other comprehensive income:   |                                 |                  |
| Adjustment to pension liability (net of tax expense of \$1,370 in 2011 and \$1,242 in 2010) | 2,055                           | 1,860            |
| Foreign currency translation adjustment   | (851)                           | (179)            |
| <b>Total comprehensive income</b>   | <b>\$ 30,674</b>                | <b>\$ 39,681</b> |

**Note K Goodwill**

As of September 30, 2011 and December 31, 2010, we had goodwill of \$565.7 million. Under the provisions of FASB ASC 350, *Intangibles Goodwill and Other*, goodwill is tested for impairment at least annually, or more frequently if events or circumstances indicate that it is more likely than not that goodwill might be impaired. Such events could include a significant change in business conditions, a significant negative regulatory outcome or other events that could negatively affect our business and financial performance. We perform our annual goodwill impairment assessment as of November 30th of each year.

Due to the continued difficult economic climates in California and Florida, the continued decline in Shoppers' revenues and the significant charges incurred during the first six months of 2011, management concluded that this environment could impact the valuation of the Shoppers reporting segment during the three months ended June 30, 2011. Accordingly, at the end of the second quarter management performed a review for impairment focusing on current expectations of future cash flows and concluded that no impairment existed as the recent actions taken are expected to result in significant annualized savings going forward. During the third quarter, we performed a qualitative assessment of whether it is more likely than not that the Shoppers reporting segment's fair value is less than its carrying amount and determined we did not need to perform a goodwill assessment at September 30, 2011.

**Note L Litigation Contingencies**

On January 25, 2010, Harte-Hanks Shoppers, Inc. (Shoppers), a California corporation and a subsidiary of Harte-Hanks, Inc. (Harte-Hanks), reached an agreement in principle with Shoppers employee Frank Gattuso and former

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employee Ernest Sigala, individually and on behalf of a certified class, to settle and resolve a previously disclosed class action lawsuit filed in 2001 (*Frank Gattuso et al. v. Harte-Hanks Inc. et al.*, as further described below). This agreement in principle was reduced to a class settlement agreement executed by the parties, and received final approval from the court on May 26, 2011. Pursuant to the settlement agreement, Shoppers established a class settlement fund of \$7.0 million. In return, each member of the class, including Gattuso and Sigala, have released all claims against Shoppers and its affiliates that in any way arose from or related to the matters which were the subject of, or could have been the subject of, the claims alleged in the class action lawsuit. Payments under the class settlement agreement from the class settlement fund concluded in August 2011, and the unclaimed portion reverted back to Shoppers in August of 2011.

On March 23, 2001, Shoppers employee Frank Gattuso and former employee Ernest Sigala filed a class action against Shoppers in Los Angeles County Superior Court, claiming, among other related allegations, that Shoppers failed to comply with California Labor Code Section 2802 ( CLC 2802 ), which requires an employer to indemnify employees for expenses incurred on behalf of the employer. The plaintiffs alleged that 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 class, as certified by the trial court, was limited to 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 sought indemnification and compensatory damages, statutory damages, exemplary damages, penalties, interest, costs of suit, and attorneys' fees. Shoppers filed a cross-complaint seeking a declaratory judgment that the plaintiffs were indemnified for their automobile expenses by the higher salaries and commissions paid to them as outside sales representatives. On January 30, 2002, the trial court ruled that CLC 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 CLC 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 CLC 2802 permits lump sum reimbursement and that an employer may satisfy its obligations to indemnify employees for reasonable and necessary business expenses under CLC 2802 by paying enhanced taxable compensation. The Supreme Court remanded the matter back to the trial court for further proceedings related to class certification and directed the trial court to consider whether the following issues could properly be resolved on a class-wide basis: (1) did 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 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 May 19, 2009, the trial court issued a partial class certification order certifying a class action with respect to the first two foregoing questions and denying class certification on the third foregoing question.

During the fourth quarter of 2009 we accrued the full \$7.0 million associated with this agreement. In June of 2011 we paid \$7.0 million to establish the class settlement fund. Based upon the claims received from the class members, we reduced the accrual by \$1.3 million in the first half of 2011. In August of 2011 we received unclaimed funds of \$1.3 million from the settlement fund.

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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, none of these matters is currently considered to be reasonably possible of resulting in 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 forward-looking and may be identified by words such as may, will, expects, believes, anticipates, plans, estimates, seeks, could, intends, or 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 continuing economic uncertainty 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, disposition of assets 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, 2010 (2010 Form 10-K) and in the Cautionary Note Regarding Forward-Looking Statements in our third quarter 2011 earnings release issued on October 27, 2011. 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.

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### 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 2010 Form 10-K. Our 2010 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 multichannel direct and digital marketing services and shopper advertising opportunities to a wide range of local, regional, national and international consumer and business-to-business marketers. We manage our operations through two operating segments: Direct Marketing and Shoppers.

Our Direct Marketing services offer a wide variety of integrated, multichannel, data-driven solutions for top brands around the globe. We help our customers gain insight into their customers' behaviors from their data and use that insight to create innovative multichannel marketing programs to deliver a return on marketing investment. We believe our customers' success is determined not only by how good their tools are, but how well we help them use the tools to gain insight and analyze their consumers. This results in a strong and enduring relationship between our clients and their customers. We offer a full complement of capabilities and resources to provide a broad range of marketing services and data management software, in media from direct mail to e-mail, including:

agency and creative services;

database marketing solutions;

data quality software and services with Trillium Software;

digital marketing and social networking services;

direct mail and supply chain management;

fulfillment and contact centers; and

lead generation.

Revenues from the Direct Marketing segment represented approximately 71% of our total revenue for the three months and nine months ended September 30, 2011.

Harte-Hanks Shoppers is North America's largest owner, operator and distributor of shopper publications, based on weekly circulation and revenues. Shoppers are weekly advertising publications delivered free by mail to households and businesses in a particular geographic area. Through print and digital offerings, Shoppers is a trusted local source for saving customers money and helping businesses grow. Shoppers offer advertisers a geographically 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 business also provides advertising and other services online through our websites, *PennySaverUSA.com* and *TheFlyer.com*. These sites are online advertising portals, bringing buyers and sellers together through our online offerings, such as local classifieds, business listings, coupons, special offers and PowerSites®. PowerSites are templated websites for our customers, optimized to help small and medium sized business owners establish a web presence and improve their lead generation. At September 30, 2011, we are publishing approximately 6,800 PowerSites weekly. At September 30, 2011, our Shoppers publications were zoned into approximately 950 separate editions with total circulation of approximately 11.2 million shopper packages in California and Florida each week.



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Revenues from the Shoppers segment represented approximately 29% of our total revenue for the three months and nine months ended September 30, 2011.

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. Direct Marketing revenues are also affected by economic fundamentals of each industry that we serve, various market factors, including the demand for services by our clients, and the financial condition of and budgets available to specific clients, among other factors. The third quarter of 2011 was the fifth consecutive quarter that Direct Marketing has shown good year-over-year growth (excluding the one-time project in 2010 described below). We remain committed to making the investments necessary to execute our multichannel strategy while also adjusting our cost structure to reduce costs in the parts of the business that are not growing as fast. We believe these actions will improve our profitability in future periods.

Our Shoppers operate in regional markets in California and Florida and are greatly affected by the strength of the state and local economies. Revenues from our Shoppers business are largely dependent on local advertising expenditures in the areas of California and Florida in which we operate. During the third quarter of 2011, the negative trends and poor economic conditions that we have experienced since the second half of 2007 in California and Florida continued. These conditions were initially created by weakness in the real estate and associated financing markets and have spread and persist across virtually all categories. We see no noticeable improvement in the California and Florida economies and we expect to have further challenges before performance improves. In response, during the second quarter of 2011, we incurred \$3.3 million of charges through our efforts to reduce expenses in the Shoppers business, primarily through organizational restructuring and headcount reductions. Of these charges, \$3.1 million were related to the recently announced retirement of our Shoppers President, Pete Gorman, and severance due to headcount reductions. The remaining charges were related to facilities and other miscellaneous items. We continue to invest in our digital strategy where we are seeing good revenue growth and are adding capabilities that add value for our readers and advertisers. We believe the steps we are taking to improve overall efficiency, combined with our digital strategy, will make our Shoppers business well positioned when the economies in California and Florida improve.

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

**Results of Operations**

Operating results were as follows:

| In thousands, except<br>per share amounts | Three months ended    |                       |        | Nine months ended     |                       |        |
|---|-----------------------|-----------------------|--------|-----------------------|-----------------------|--------|
|   | September 30,<br>2011 | September 30,<br>2010 | Change | September 30,<br>2011 | September 30,<br>2010 | Change |
| Revenues                                  | \$ 212,788            | \$ 216,745            | -1.8%  | \$ 626,141            | \$ 624,533            | 0.3%   |
| Operating expenses                        | 192,073               | 191,690               | 0.2%   | 574,561               | 558,589               | 2.9%   |
| Operating income                          | \$ 20,715             | \$ 25,055             | -17.3% | \$ 51,580             | \$ 65,944             | -21.8% |
| Net income                                | \$ 12,128             | \$ 13,815             | -12.2% | \$ 29,470             | \$ 38,000             | -22.4% |
| Diluted earnings per share                | \$ 0.19               | \$ 0.22               | -13.6% | \$ 0.46               | \$ 0.59               | -22.0% |

**3<sup>rd</sup> Quarter 2011 vs. 3<sup>rd</sup> Quarter 2010****Revenues**

Consolidated revenues decreased 1.8%, to \$212.8 million, and operating income decreased 17.3% to \$20.7 million in the third quarter of 2011 compared to the third quarter of 2010. Our overall results reflect increased revenues of \$0.9 million, or 0.6%, from our Direct Marketing segment and decreased revenues of \$4.8 million, or



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7.4%, from our Shoppers segment. The Direct Marketing results were affected by a large, one-time project performed for a long-time customer in our healthcare vertical during the second half of 2010. Excluding the results from this project, total Direct Marketing revenues increased \$7.1 million, or 4.9%, in the third quarter of 2011 compared to the third quarter of 2010. Direct Marketing experienced increased revenues from our select, financial and retail verticals, which were partially offset by decreased revenues from our healthcare and high-tech vertical markets. Shoppers revenue performance reflects 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 most revenue categories.

### ***Operating Expenses***

Overall operating expenses increased 0.2%, to \$192.1 million, in the third quarter of 2011 compared to the third quarter of 2010. The overall increase in operating expenses was driven by increased operating expenses in Direct Marketing of \$3.3 million, or 2.6%. Excluding the costs associated with the one-time project described above, Direct Marketing operating expenses increased \$8.4 million, or 6.8%. The increase at Direct Marketing was primarily due to increased headcount to support revenues and improve our database service capabilities, higher mail supply chain costs on higher transportation volumes, increased production service costs due to higher revenues, increased travel and increased employee recruiting. Shoppers operating expenses decreased \$2.6 million, or 4.4%, due to lower variable payroll costs resulting from headcount reductions, decreased postage (excluding the third quarter 2010 postage rebate) due to a decline in distribution volumes, the elimination of the second day edition in southern California and temporary postage rate reductions, and decreased outsourced costs resulting from decreased outsourced volumes. The overall decrease at Shoppers was partially offset by the effect of a non-recurring postal incentive rebate earned in the third quarter of 2010, an increase in newsprint expense due to higher paper rates, and higher bad debt expense.

### ***Net Income/Earnings Per Share***

Net income decreased 12.2%, to \$12.1 million, and diluted earnings per share decreased 13.6%, to \$0.19 per share, in the third quarter of 2011 when compared to the third quarter of 2010. The decrease in net income was a result of decreased operating income from both Direct Marketing and Shoppers, increased interest expense and a higher effective tax rate.

### ***First Nine Months 2011 vs. First Nine Months 2010***

#### ***Revenues***

Consolidated revenues increased 0.3%, to \$626.1 million, while operating income decreased 21.8% to \$51.6 million in the first nine months of 2011 compared to the first nine months of 2010. Our overall results reflect increased revenues of \$19.3 million, or 4.5%, from our Direct Marketing segment and decreased revenues of \$17.6 million, or 8.9%, from our Shoppers segment. The Direct Marketing results were affected by the large, one-time pharmaceutical project described above. Excluding the results from this project, total Direct Marketing revenues increased \$25.4 million, or 6.1%, in the first nine months of 2011 compared to the first nine months of 2010. Direct Marketing experienced increased revenues from our select, financial and retail verticals, which were partially offset by decreased revenues from our healthcare and high-tech vertical markets. The August 31, 2010 acquisition of Information Arts also contributed to Direct Marketing's revenue growth. Shoppers revenue performance reflects 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 most revenue categories.

#### ***Operating Expenses***

Overall operating expenses increased 2.9%, to \$574.6 million, in the first nine months of 2011 compared to the first nine months of 2010. The overall increase in operating expenses was driven by increased operating expenses in Direct Marketing of \$22.2 million, or 6.1%. The Direct Marketing increase was primarily due to increased headcount to support revenues and improve our database service capabilities, higher mail supply chain costs on

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higher transportation volumes, increased outsourced costs resulting from increased outsourced volumes, increased travel and increased employee recruiting. The acquisition of Information Arts also contributed to the increase in Direct Marketing operating expenses. Shoppers operating expenses decreased \$6.1 million, or 3.4%, due to lower variable payroll costs, decreased postage (excluding the third quarter 2010 postage rebate) due to lower distribution volumes and the elimination of the second day edition, decreased outsourced costs on lower volumes, and a \$1.3 million reduction of a legal accrual. The overall decrease at Shoppers was partially offset by \$4.1 million of charges recognized in the first half of 2011 related to our efforts to reduce expenses in the Shoppers business. Of these charges, \$3.9 million related to the retirement of the President of our Shoppers business and severance due to headcount reductions. The remaining charges related to facilities and other miscellaneous items. The decrease at Shoppers was also partially offset by a non-recurring postal incentive rebate earned in the third quarter of 2010 and an increase in newsprint expense due to higher paper rates. Excluding the retirement, severance and other charges, and the legal accrual reduction, Shoppers operating expenses decreased \$11.6 million, or 6.3%.

***Net Income/Earnings Per Share***

Net income decreased 22.4%, to \$29.5 million, and diluted earnings per share decreased 22.0%, to \$0.46 per share, in the first nine months of 2011 when compared to the first nine months of 2010. The decrease in net income was a result of decreased operating income from Shoppers and Direct Marketing, changes in net foreign currency transactions and a higher effective tax rate.

***Direct Marketing***

Direct Marketing operating results were as follows:

| In thousands       | Three months ended |                    |        | Nine months ended  |                    |        |
|--------------------|--------------------|--------------------|--------|--------------------|--------------------|--------|
|                    | September 30, 2011 | September 30, 2010 | Change | September 30, 2011 | September 30, 2010 | Change |
| Revenues           | \$ 151,974         | \$ 151,104         | 0.6%   | \$ 445,776         | \$ 426,525         | 4.5%   |
| Operating expenses | 131,460            | 128,111            | 2.6%   | 388,926            | 366,680            | 6.1%   |
| Operating income   | \$ 20,514          | \$ 22,993          | -10.8% | \$ 56,850          | \$ 59,845          | -5.0%  |

**3rd Quarter 2011 vs. 3rd Quarter 2010*****Revenues***

Direct Marketing revenues increased \$0.9 million, or 0.6%, in the third quarter of 2011 compared to the third quarter of 2010. These results reflect an increase (as a percentage) in the high teens from our select vertical compared to the third quarter of 2010. Our financial vertical experienced revenue growth in the low teens, while our retail vertical was up slightly. Our high-tech vertical declined in the mid single digits and our healthcare vertical declined approximately 25%. The results from our healthcare vertical were affected by a large, one-time project performed for a long-time customer during the second half of 2010. Excluding the results from this project, total Direct Marketing revenues increased 4.9% in the third quarter of 2011 compared to the third quarter of 2010. 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.

Future revenue performance will depend on, among other factors, the overall strength of the national and international economies and how successful we are at maintaining and growing business with existing clients, acquiring new clients and meeting client demands. We believe that in the long-term an increasing portion of overall marketing and advertising expenditures will be moved from other advertising media to the targeted media space, and that our business will benefit as a result. Targeted media advertising results can be more effectively tracked, enabling measurement of the return on marketing investment.

***Operating Expenses***

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Operating expenses increased \$3.3 million, or 2.6%, in the third quarter of 2011 compared to the third quarter of 2010. Labor costs increased \$3.1 million, or 4.7%, due to increased headcounts to support revenues and improve our database service capabilities. Production and distribution costs increased \$0.2 million, or 0.5%, due to higher mail supply chain costs on higher transportation volumes and increased production service costs due to higher revenues. This increase was partially offset by decreased outsourced costs resulting from decreased outsourced volumes. General and administrative expense increased \$0.6 million, or 5.6%, due primarily to an increase in travel and employee recruiting. Depreciation and software amortization expense decreased \$0.5 million, or 12.9%, due to decreased capital expenditures over the last few years. Intangible asset amortization was down slightly due to certain intangible assets becoming fully amortized.

Direct Marketing's largest cost components are labor, outsourced costs and mail supply chain costs. Each of these costs is somewhat variable and tends to fluctuate with revenues and the demand for our direct marketing services. Mail supply chain costs have increased significantly over the last several quarters due to demand and supply issues within the transportation industry, contributing to the overall increase in operating expenses. Future changes in mail supply chain costs will continue to impact Direct Marketing's total production costs and total operating expenses, and may have an impact on future demand for our supply chain management. Postage costs of mailings in our Direct Marketing business are borne by our clients and are not directly reflected in our revenues or expenses.

**First Nine Months 2011 vs. First Nine Months 2010**

***Revenues***

Direct Marketing revenues increased \$19.3 million, or 4.5%, in the first nine months of 2011 compared to the first nine months of 2010. These results reflect an increase (as a percentage) in the high teens from our select vertical compared to the first nine months of 2010. Our financial vertical experienced revenue growth in the low teens, while our retail vertical was up in the high single digits. Our healthcare vertical declined in the low teens and our high-tech vertical declined in the mid single digits. The results from our healthcare vertical were affected by the large, one-time project described above. Excluding the results from this project, total Direct Marketing revenues increased \$25.4 million, or 6.1%, in the first nine months of 2011 compared to the first nine months of 2010. The August 31, 2010 acquisition of Information Arts also contributed to Direct Marketing's revenue growth.

***Operating Expenses***

Operating expenses increased \$22.2 million, or 6.1%, in the first nine months of 2011 compared to the first nine months of 2010. Labor costs increased \$11.7 million, or 6.1%, due to increased headcounts to support revenues and improve our database service capabilities. Production and distribution costs increased \$9.2 million, or 7.1%, due to higher mail supply chain costs on higher transportation volumes, and increased outsourced costs resulting from increased outsourced volumes. General and administrative expense increased \$2.6 million, or 7.9%, due primarily to an increase in travel and employee recruiting. Depreciation and software amortization expense decreased \$1.1 million, or 9.1%, due to decreased capital expenditures over the last few years. Intangible asset amortization was down slightly due to certain intangible assets becoming fully amortized.

**Table of Contents****Shoppers**

| In thousands       | Three months ended    |                       |        | Nine months ended     |                       |        |
|--------------------|-----------------------|-----------------------|--------|-----------------------|-----------------------|--------|
|                    | September<br>30, 2011 | September<br>30, 2010 | Change | September<br>30, 2011 | September<br>30, 2010 | Change |
| Revenues           | \$ 60,814             | \$ 65,641             | -7.4%  | \$ 180,365            | \$ 198,008            | -8.9%  |
| Operating expenses | 57,729                | 60,369                | -4.4%  | 177,151               | 183,293               | -3.4%  |
| Operating income   | \$ 3,085              | \$ 5,272              | -41.5% | \$ 3,214              | \$ 14,715             | -78.2% |

**3rd Quarter 2011 vs. 3rd Quarter 2010****Revenues**

Shoppers revenues decreased \$4.8 million, or 7.4%, in the third quarter of 2011 compared to the third quarter of 2010. 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 most revenue categories. At September 30, 2011, our Shoppers circulation reached approximately 11.2 million addresses each week. While we have not made any significant changes to our circulation since the first quarter of 2009, 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.

Future revenue performance will depend on, among other factors, the overall strength of the California and Florida economies, as well as how successful we are at maintaining and growing business with existing clients, and acquiring new clients.

**Operating Expenses**

Operating expenses decreased \$2.6 million, or 4.4%, in the third quarter of 2011 compared to the third quarter of 2010. Total labor costs decreased \$2.5 million, or 12.6%, due to lower variable payroll costs from lower ad sales, headcount reductions and lower incentive compensation. Total production costs increased slightly, 0.1%, due primarily to the effect of a non-recurring postal incentive rebate earned in the third quarter of 2010 and an increase in newsprint expense due to higher paper rates. These increases were partially offset by decreased postage costs (excluding the postal incentive rebate) resulting from a decline in distribution volumes, the elimination of the second day edition in southern California and temporary postage rate reductions, and decreased outsourced costs resulting from decreased outsourced volumes. Total general and administrative costs decreased slightly, 0.9%, as small decreases in a number of line items were partially offset by an increase in bad debt expense. Depreciation and software amortization expense decreased \$0.1 million, or 5.9%, due to decreased capital expenditures in the last few years. Intangible asset amortization was flat compared to the prior year quarter.

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 have increased in recent years, and increased again in April 2011. Shoppers postage rates increased by less than 1.0% as a result of the April 2011 rate increase. Based on recent U.S. Postal Service announcements, we believe the next postal rate increase will likely occur in January of 2012 and will be approximately 2.0%. This anticipated postage rate increase, and any additional future changes in postage rates will affect Shoppers production costs. The U. S. Postal Service has also proposed various changes in its services to address its financial performance, such as delivery frequency and facility access. We do not believe the proposed changes will have a material impact on our Shoppers business. Shoppers newsprint prices increased in the second half of 2010 and continued to increase in the first nine months of 2011, causing the increase in Shoppers paper costs. Newsprint prices in the fourth quarter of 2011 are expected to be consistent with third quarter 2011 prices. Any future changes in newsprint prices will affect Shoppers production costs.

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**First Nine Months 2011 vs. First Nine Months 2010**

***Revenues***

Shoppers revenues decreased \$17.6 million, or 8.9%, in the first nine months of 2011 compared to the first nine months of 2010. 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 most revenue categories.

***Operating Expenses***

Operating expenses decreased \$6.1 million, or 3.4%, in the first nine months of 2011 compared to the first nine months of 2010. During the first half of 2011, we incurred \$4.1 million of charges through our efforts to reduce expenses in the Shoppers business primarily through organizational restructuring and headcount reductions. Of these charges, \$3.9 million related to the retirement of the President of our Shoppers business and severance due to headcount reductions. The remaining charges related to facilities and other miscellaneous items. Total labor costs decreased \$1.8 million, or 3.0%, due to lower variable payroll costs from lower ad sales, headcount reductions and lower incentive compensation. Excluding the severance and retirement charges described above, total labor costs decreased \$5.9 million, or 9.8%. Total production costs decreased \$1.6 million, or 1.5%, due primarily to decreased postage costs as a result of a decline in distribution volumes and the elimination of the second day edition in southern California, and decreased outsourced costs resulting from decreased outsourced volumes. These decreases were partially offset by a non-recurring postal incentive rebate received in the third quarter of 2010 and an increase in newsprint expense due to higher paper rates. Total general and administrative costs decreased \$2.2 million, or 15.1%, due primarily to a \$1.3 million reduction of a legal accrual. Depreciation and software amortization expense decreased \$0.4 million, or 9.7%, due to decreased capital expenditures in the last few years. Intangible asset amortization decreased \$0.1 million, or 23.3%, as certain intangible assets became fully amortized. Excluding the retirement, severance and other charges, and the legal accrual reduction, Shoppers operating expenses decreased \$11.6 million, or 6.3%.

**General Corporate Expense**

General corporate expense decreased \$0.3 million, or 10.2%, in the third quarter of 2011 compared to the third quarter of 2010. This decrease was due to lower incentive-based compensation and acquisition-related expenses.

General corporate expense decreased \$0.1 million, or 1.5%, in the first nine months of 2011 compared to the first nine months of 2010. This decrease was due to lower acquisition-related expenses.

**Interest Expense**

Interest expense increased \$0.2 million, or 26.1%, in the third quarter of 2011 and was up slightly, 2.3%, in the first nine months of 2011 compared to the same periods in 2010. These increases were due to a higher interest rate spread and an increased debt balance as a result of the 2011 Term Loan Facility, which replaced the 2006 Term Loan Facility in August 2011. See discussion of our credit facilities in the *Liquidity and Capital Resources* section below.

**Interest Income**

Interest income was down slightly in the third quarter of 2011 due to lower balances on cash and cash equivalents in the third quarter of 2011 than in the third quarter of 2010. Interest income increased \$0.1 million, or 38.2%, in the first nine months of 2011 compared to the first nine months of 2010 due to higher returns on invested cash and cash equivalents in 2011.

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### **Other Income and Expense**

Other income, net, increased \$2.4 million in the third quarter of 2011 compared to the third quarter of 2010. Other expense, net, decreased \$0.9 million in the first nine months of 2011 compared to the first nine months of 2010. These changes were primarily due to changes in net foreign currency transaction gains and losses.

### **Income Taxes**

Income tax expense decreased \$0.4 million in the third quarter of 2011 and \$4.9 million in the first nine months of 2011 compared to the same periods in 2010. Our effective tax rate was 40.6% for the third quarter of 2011, increasing from 38.7% for the third quarter of 2010. Our effective tax rate was 39.9% for the first nine months of 2011, increasing from 39.2% for the first nine months of 2010. The increase in the effective tax rate is primarily due to an increase in state income tax.

### **Economic Climate and Impact on our Financial Statements**

The current economic climate in California and Florida has had a negative impact on our Shoppers' operations and cash flows for the three months and nine months ended September 30, 2011, and our financial position at September 30, 2011. We cannot predict the timing, strength or duration of the current difficult economic environment in California and Florida or any subsequent improvement. If the economic climate and markets we serve continue to deteriorate, we may record charges related to restructuring costs and the impairment of goodwill, other intangibles and long-lived assets, and our operations, cash flows and financial position may be materially and adversely affected.

### **Liquidity and Capital Resources**

#### *Sources and Uses of Cash*

As of September 30, 2011, cash and cash equivalents were \$71.8 million, decreasing \$14.2 million from cash and cash equivalents at December 31, 2010. This net decrease was a result of net cash provided by operating activities of \$33.8 million, net cash used in investing activities of \$16.4 million and net cash used in financing activities of \$31.6 million.

#### *Operating Activities*

Net cash provided by operating activities for the nine months ended September 30, 2011 was \$33.8 million, compared to net cash provided by operating activities of \$62.7 million for the nine months ended September 30, 2010. The \$28.9 million year-over-year decrease was primarily attributable to changes within working capital assets and liabilities and a decrease in net income.

For the nine months ended September 30, 2011, our principal working capital changes, which directly affected net cash provided by operating activities, were as follows:

A decrease in accounts receivable attributable to higher revenues in the fourth quarter of 2010 than in the third quarter of 2011. Days sales outstanding of approximately 64 days at September 30, 2011 increased from 63 days at September 30, 2010 and 59 days at December 31, 2010;

A decrease in inventory due to purchasing and holding higher levels of newsprint inventory in the fourth quarter of 2010 and first quarter of 2011 in advance of increases in newsprint prices;

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

A decrease in accounts payable due to higher overall operating expenses in the fourth quarter of 2010 than in the third quarter of 2011;



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A decrease in accrued payroll and related expenses due to the payment of 2010 incentive compensation;

A decrease in customer deposits, unearned revenue and other current liabilities due to timing of receipts; and

A decrease in income taxes payable due to the timing of payments.

*Investing Activities*

Net cash used in investing activities was \$16.4 million for the nine months ended September 30, 2011, compared to \$25.4 million for the nine months ended September 30, 2010. The \$9.0 million decrease is the result of the August 31, 2010 acquisition of Information Arts, and was partially offset by a \$3.8 million increase in capital spending in the first nine months of 2011 compared to the first nine months of 2010.

*Financing Activities*

Net cash used in financing activities was \$31.6 million for the nine months ended September 30, 2011 compared to \$47.5 million for the nine months ended September 30, 2010. The \$15.9 million decrease is attributable primarily to a \$25.2 million decrease in net debt repayments in the first nine months of 2011 compared to the first nine months of 2010, as a result of refinancing a term loan in August 2011. This decrease was partially offset by the repurchase of \$8.4 million of treasury stock in the second quarter of 2011 and \$1.0 million more dividends paid in the first nine months of 2011 than in the first nine months of 2010.

*Credit Facilities*

On March 7, 2008, we entered into a 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 matures on March 7, 2012. For each borrowing under the 2008 Term Loan Facility, we can generally choose to have the interest rate for that borrowing calculated based on either (i) the LIBOR rate (as defined in the 2008 Term Loan Facility), plus a spread which is determined based on our total debt-to-EBITDA ratio (as defined in the 2008 Term Loan Facility) then in effect, and ranges from 0.40% to 0.75% per annum, or (ii) the higher of Wells Fargo Bank's prime rate in effect on such date or the Federal Funds rate in effect on such date plus 0.50%. There is a facility fee that we are also required to pay under the 2008 Term Loan Facility that is based on a rate applied to the outstanding principal balance owed under the 2008 Term Loan Facility. The facility fee rate ranges from 0.10% to 0.25% per annum, depending on our total debt-to-EBITDA ratio then in effect. We may elect to prepay the 2008 Term Loan Facility at any time without incurring any prepayment penalties. At September 30, 2011, we had \$64.0 million outstanding under the 2008 Term Loan Facility.

On August 12, 2010, we entered into a new three-year \$70 million revolving credit facility, which includes a \$25 million accordion feature, a \$25 million letter of credit sub-facility and a \$5 million swing line loan sub-facility (2010 Revolving Credit Facility), with Bank of America, N.A., as Administrative Agent. The 2010 Revolving Credit Facility permits us to request up to a \$25 million increase in the total amount of the facility. The 2010 Revolving Credit Facility matures on August 12, 2013. For each borrowing under the 2010 Revolving Credit Facility, we can generally choose to have the interest rate for that borrowing calculated on either (i) the LIBOR rate (as defined in the 2010 Revolving Credit Facility) for the applicable interest period, plus a spread which is determined based on our total net debt-to-EBITDA ratio (as defined in the 2010 Revolving Credit Facility) then in effect, which ranges from 2.25% to 3.00% per annum; or (ii) the highest of (a) the Federal Funds Rate plus 0.50%, (b) the Agent's prime rate, and (c) the LIBOR rate plus 1.00%, plus a spread which is determined based on our total net debt-to-EBITDA ratio then in effect, which ranges from 1.25% to 2.00% per annum. There is a facility fee that we are also required to pay under the 2010 Revolving Credit Facility. The facility fee rate ranges from 0.40% to 0.45% per annum, depending on our total net debt-to-EBITDA ratio then in effect. In addition, there is a letter of credit fee with respect to outstanding letters of credit. That fee is calculated by applying a rate equal to the spread applicable to LIBOR based loans plus a fronting fee of 0.125% per annum to the average daily undrawn amount of the outstanding letters of credit. We may elect to prepay the 2010 Revolving Credit Facility at any time. At September 30, 2011, we did not have any outstanding amounts drawn against our 2010 Revolving

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Credit Facility. At September 30, 2011 we had letters of credit totaling \$10.8 million issued under the 2010 Revolving Credit Facility, decreasing the amount available for borrowing to \$59.2 million.

On August 16, 2011, we entered into a five-year \$122.5 million term loan facility (2011 Term Loan Facility) with Bank of America, N.A., as Administrative Agent. The 2011 Term Loan Facility matures on August 16, 2016. A portion of the proceeds from the 2011 Term Loan Facility were used to pay off the remaining \$97.5 million obligation related to the 2006 Term Loan Facility. We plan to use the remaining proceeds for general corporate purposes. For each borrowing under the 2011 Term Loan Facility, we can generally choose to have the interest rate for that borrowing calculated based on either (i) the LIBOR rate (as defined in the 2011 Term Loan Facility) for the applicable interest period, plus a spread (ranging from 2.00% to 2.75% per annum) based on Harte-Hanks' total net funded debt-to-EBITDA ratio (as defined in the 2011 Term Loan Facility) then in effect; or (ii) the highest of (a) the Agent's prime rate, (b) the BBA daily floating rate LIBOR, as determined by Agent for such date, plus 1.00%, and (c) the Federal Funds Rate plus 0.50%, plus a spread (ranging from 1.00% to 1.75% per annum) based on Harte-Hanks' total net funded debt-to-EBITDA ratio then in effect. We may elect to prepay the 2011 Term Loan Facility at any time without incurring any prepayment penalties. At September 30, 2011, we had \$121.0 million outstanding under the 2011 Term Loan Facility.

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 customary covenants restricting our and our subsidiaries' ability to:

authorize distributions, dividends, stock redemptions and repurchases if a payment event of default has occurred and is continuing;

enter into certain merger or liquidation transactions;

grant liens;

enter into certain sale and leaseback transactions;

have foreign subsidiaries account for more than 20% of the consolidated revenue, assets or EBITDA of Harte-Hanks and its subsidiaries, in the aggregate;

enter into certain transactions with affiliates; and

allow the total indebtedness of Harte-Hanks' subsidiaries to exceed \$20.0 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, 2011, we were in compliance with all of the covenants of our credit facilities. Our material domestic subsidiaries have made guarantees for the performance of Harte-Hanks under our credit facilities.

*Outlook*

We consider such factors as total cash and cash equivalents, current assets, current liabilities, total debt, revenues, operating income, 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

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available from and provided through our 2010 Revolving Credit Facility, subject to the terms and conditions of that facility.

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The amount of cash on hand and borrowings available under our 2010 Revolving Credit Facility are influenced by a number of factors, including fluctuations in our operating results, revenue growth, accounts receivable collections, working capital changes, capital expenditures, tax payments, share repurchases, pension plan contributions, acquisitions and dividends.

As of September 30, 2011, we had \$59.2 million of unused borrowing capacity under our 2010 Revolving Credit Facility and a cash balance of \$71.8 million. Based on our current operational plans, we believe that our cash on hand, cash provided by operating activities, and availability under the 2010 Revolving Credit Facility will be sufficient to fund operations, anticipated capital expenditures, payments of principal and interest on our borrowings, and dividends on our common stock for the next 12 months. Nevertheless, we cannot predict the impact on our business performance of the economic climate in the United States and other economies. A lasting economic recession in the United States and other economies could have a material adverse effect on our business, financial position or operating results.

The 2008 Term Loan Facility matures in the next 6 months, and we are scheduled to make principal payments of \$71.7 million during this period. We plan to make these scheduled principal payments using cash on hand, cash provided by operating activities and availability under the 2010 Revolving Credit Facility.

**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 2010 Form 10-K:

Revenue recognition;

Allowance for doubtful accounts;

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

Goodwill; and

Stock-based compensation.

There have been no material changes to the critical accounting policies described in our 2010 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. The adoptions of these new accounting pronouncements 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 LIBOR rates (effective 30 day LIBOR rate of 0.24% at September 30, 2011). The five-year 2011 Term Loan Facility has a maturity date of August 16, 2016. At September 30, 2011, our debt

balance related to

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the 2011 Term Loan Facility was \$121.0 million. The three-year \$70 million 2010 Revolving Credit Facility has a maturity date of August 12, 2013. At September 30, 2011, we did not have any debt outstanding under the 2010 Revolving Credit Facility. The four-year 2008 Term Loan Facility has a maturity date of March 7, 2012. At September 30, 2011, our debt balance related to the 2008 Term Loan Facility was \$64.0 million.

Assuming the actual level of borrowings throughout the third quarter and first nine months of 2011, and assuming a one percentage point change in the average interest rates, we estimate that our net income for the third quarter and first nine months of 2011 would have changed by approximately \$0.3 million and \$0.8 million, respectively. Due to our overall debt level and cash balance at September 30, 2011, anticipated cash flows from operations, and the various financial alternatives available to us 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 Consolidated Statements of Operations. Due to the current level of operations conducted in foreign currencies, we do not believe that the impact of fluctuations in foreign currency exchange rates on these types of transactions is significant to our overall annual 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. Any foreign currency gain or loss from these transactions, whether realized or unrealized, results in an adjustment to income, which is recorded in Other, net in our Consolidated Statements of Operations. Transactions such as these amounted to \$0.8 million and \$0.5 million in pre-tax currency transaction gains in the third quarter and first nine months of 2011, 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.

**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 2011 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 materially

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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 L 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 2010 Form 10-K, which could materially affect our business, financial condition or future results. The risks described in our 2010 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 2010 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.

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

The following table contains information about our purchases of equity securities during the third quarter of 2011:

| Period               | Total<br>Number<br>of Shares<br>Purchased<br>(2) | Average<br>Price<br>Paid per<br>Share | Total Number<br>of Shares<br>Purchased<br>as Part of<br>a Publicly<br>Announced Plan(1) | Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased Under<br>the Plan |
|----------------------|--|---------------------------------------|---|--|
| July 1 31, 2011      | 0  | \$ 0                                  | 0   | 9,475,491  |
| August 1 31, 2011    | 0  | \$ 0                                  | 0   | 9,475,491  |
| September 1 30, 2011 | 11,738   | \$ 8.10                               | 0   | 9,475,491  |
| Total                | 11,738   | \$ 8.10                               | 0   |  |

- (1) During the third quarter of 2011, 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, 2011, we had repurchased a total of 64,924,509 shares at an average price of \$18.67 per share under this program.
- (2) Total number of shares purchased includes shares, if any, purchased as part of our publicly announced stock repurchase program, plus shares withheld to pay applicable withholding taxes and the exercise price related to stock options, and shares withheld to pay applicable withholding taxes related to the vesting of nonvested shares and performance stock units, pursuant to the Harte-Hanks, Inc. 2005 Omnibus Incentive Plan.

**Item 6. Exhibits**

See Index to Exhibits on Page 34.

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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 1, 2011<br>Date | /s/ LARRY FRANKLIN<br><b>Larry Franklin</b><br><b>President and Chief Executive Officer</b>                            |
| November 1, 2011<br>Date | /s/ DOUGLAS SHEPARD<br><b>Douglas Shepard</b><br><b>Executive Vice President and</b><br><b>Chief Financial Officer</b> |
| November 1, 2011<br>Date | /s/ JESSICA HUFF<br><b>Jessica Huff</b><br><b>Vice President, Finance and</b><br><b>Chief Accounting Officer</b>       |

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**INDEX TO EXHIBITS**

| <b>Exhibit<br/>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. |
| *101                   | XBRL Instance Document  |

\*Filed or furnished herewith