Stamps.com under scrutiny – will this be the end of Postage Discounting for lower volume shippers?

On July 8th, a report from The Capitol Forum[1], a provider of investigative analysis, issued a provocative piece on Stamps.com, titled: "Reliance on Negotiated Service Agreements with USPS Relationship with Intuiship Leaves Stamps.com with Significant Regulatory Risk; USPS Can Terminate with 30 Days' Notice if Agency Finds Abuse". It attempts to make the point that Stamps is profiting at the Post Office's expense by abusing specific NSA (USPS Negotiated Service Agreement) participatory agreements.

Prescience Point Research Group (PPRG) updated their report on Stamps on July 14th commending the work of the Capitol Forum report. It was a much larger in scope, titled: Stamps.com – The Software Valeant? It begins with this statement: "Shares of Stamps.com ("STMP", or "the company") are grossly overvalued" and that they have discovered "STMP's Big Secret" ~ "undisclosed business affiliates (e.g., IntuiShip) that STMP has aligned with to exploit legacy USPS postage reseller discount contracts to skim 100%-margin revenue from the USPS."

The Motley Fool[2] reported on July 18th: *Shares of Stamps.com (NASDAQ:STMP) suffered a 13% hit after a subscription service raised some regulatory concerns and another publication issued a bearish report*

These participatory Negotiated Service Agreements (NSA's) are in the background of all the discounted postage reseller programs that are typically accessed through "middleware" providers. Middleware being any provider that helps shippers process their parcels. In other words, they act as a conduit between the shipper's IT systems (ie; ERP, WMS and TMS) including shopping carts and the USPS, and in many cases there are more than one. For example, it is very common for an end user to incorporate a "Multi Carrier Shipping Solution" provider and use Endicia in the background to process the postage. Stamps.com over the last couple years has acquired ShipWorks, ShipStation, Endicia and just recently ShippingEasy. According to the PPGR report, the arbitrage is driving "Financial results that defy expectation and Logic". Arbitrage in this case is the margin between the costs of Postage paid to the USPS and the price sold to the end user.

Wall Street analysts were scratching their heads, trying to understand how Stamps were regularly outperforming all expectations. PPRG believes that if the USPS ended the ability to participate in these NSA arrangements, 65% of Stamps.com EBITDA would vanish!

What would this mean to Shippers?

We will explore some possible scenarios, but first it is important to put this "news" into context. According to Rick Munarriz[2] of The Motley Fool, "Prescience Point Research Group is a publisher of shorting recommendations". PPRG believes that Stamps.com stock may lose the majority of its value (at time of this article, it is trading between $70- $76 a share) and may fall as low as $15.

However, Mr. Munarriz reports "Stamps.com fired back, telling Bloomberg that it does not believe that its service agreements with the USPS can be simply nixed with 30 days' notice. It also suggests that the integrity of the report could be compromised since the primary source in the piece is a major

Stamps.com rival."   (Inferring that the primary source was Jeff Crouse, VP of Shipping for Pitney Bowes Global SMB, who was listed as a source in the Capitol Forum Report).

Both reports reference legal filings in the litigation between Endicia and ShipStation. This litigation began while Stamps.com and Endicia were competitors. PPRG also list the litigation between Rapid Enterprises (dba Express 1) v. Auctane (dba ShipStation) as an additional source for their report. This lawsuit was filed on August 14, 2014 and settled (after Stamps.com acquired ShipStation on Aug 6, 2015) for ten million dollars. Per The Capitol Forum Report "the closeness of the relationship suggests that Stamps.com may be receiving a greater portion of the revenues from IntuiShip than it did from Express 1". The report further explains: "Indeed, retention of a larger portion of the spread that IntuiShip receives by virtue of being a postal reseller could help explain Stamps.com's significant revenue growth since 2014, which outpaces the 15% industry growth in e-commerce. Also, Stamps.com's average monthly revenue per paid customer (ARPU) has also increased dramatically."

Both the Capitol Forum and PPRG reports explain how the majority of the profits are generated from the postage margin (arbitrage) versus the transactional service fees. PPRG reports "Stamps.com is happy because it now collects 7x the monetization it would have received had it been working directly with the USPS. IntuiShip is happy because, without doing an ounce of work, it is collecting 20% of the spread for volumes it would not have gotten without its relationship with Stamps.com and can play golf all day. "

On July 19th, Copperfield Research in a report titled: STMP – Long Case "Based on our own extensive diligence, we believe the negative arguments are factually incorrect and that USPS reseller relationships are not only stable, but integral to their market share gains. We also believe that one of the most impactful components of the recent short thesis is premised on a USPS Table that appears to have been manipulated to misleadingly add credence to the cannibalization argument." It goes on to state: "The segments the table does show, Priority Mail and Priority Mail Express, are of course USPS monopolies that are in secular decline and not particularly relevant to resellers and the high volume shipping market that has driven Stamps.com growth and ARPU."

On July 20th, PPRG responded: "the reason we only include Priority Mail / Priority Mail Express is that the table displayed in our analysis is that is the only product USPS resellers are allowed to resell. It is also the only product Stamps.com is able to monetize on a volume basis, as evidenced in STMP's 10-K, ~ The rest is irrelevant. ~ the only real debate is whether the USPS is cannibalizing Priority Mail volumes. And the reason this is important is Priority Mail is the only service from the USPS that competes with FDX/UPS."

Perspective: Copperfield Research missed the point, it is general knowledge that Priority Mail is highly relevant to both clients, Postage Resellers, middleware providers and Stamps. Both original reports point out that all of the NSA agreements they researched include a 30 day termination clause[3]. So could the USPS cancel them? Likely the answer is yes, but more likely the Postal Service will institute controls to ensure proper use of NSA's. Again, the purpose of these NSA reseller agreements were to help drive new volume to the USPS from competitors like UPS, FedEx and others by providing customized contract pricing.

What does the future hold?

- It is likely too early in the process to understand what is going to happen, over what time period and to whom

- We do know that the purpose of USPS discounts are to drive new volume to the USPS or to protect volume at risk from competition
- The USPS Office of Inspector General (OIG) is likely to conduct an investigation. **<u>If</u>** the OIG is able to get a hold the transactional data, then the facts will determine the merits of the alleged arbitrage.
- The USPS announced prior to the Jan 17th rate change that it would eliminate CPP discounted pricing for Priority Mail™ by 2017, and that they would depend on NSA's to attract and retain business directly. In that Rate Change, the USPS did effectively eliminate CPP pricing for all International modes, Priority Mail Express™ and FCPS (First Class Package Services).
- Generally, the largest shippers command the best discounts from the private carriers. To compete against these deeply discounted rates and accessorial concessions, the USPS needs to discount to remain competitive, especially in the higher weight ranges.

So one might conclude that the result of this could be the elimination of Reseller Postage discounts for the smaller shipper.

If the USPS substantiates the claims within these report that the reseller programs are not being used as intended and that they are being harmed financially as a result, it is likely they will take steps to mitigate their losses while retaining the business. In the spirit of retaining business, the USPS understands that larger shippers need discounted programs in order to route meaningful volume to the Postal Service as part of their carrier mix. Smaller shippers will still save money shipping with the USPS at non-discounted rates since USPS Base rates are often more competitive than street pricing from the private carriers.

This means that **<u>if</u>** there are small volume shippers enrolled in these programs, and **<u>if</u>** they are removed, it will **<u>not</u>** cause a loss of business to the USPS. However to continue the reasoning, ***if*** these smaller shippers are in fact enrolled in these reseller programs, and **<u>if</u>** they make up the majority of the volume that Stamps.com and its subsidiaries are producing, then the loss of this arbitrage will greatly impact Stamps.com's profitability. This is what the reports are trying to convey, but there are a lot of "if's".

Marketplace Reset

There are well over a hundred "middleware" solution providers and in the past they made money by providing services, solving unique interface and go-to-market needs, one client at a time. With the rise in e-Commerce however, fast growing startups can quickly and inexpensively process their shopping carts automatically with low fee cloud based provider platforms. This new revenue model has transaction based fees from FREE to about 5 cents a package with the burden to integrate and customize shifted to the client. What is often not disclosed is that these providers may be making the majority of their profit from the arbitrage share, not the service fees.

If the arbitrage were to go away for the smaller shippers, then those providers that were dependent on them would need to shift their pricing back towards a transactional service fee model. The net costs to ship for smaller shippers would increase. The NSA holders and their partners would have to shift their focus to the purpose for which these programs were developed, which is to drive new business to the Postal Service.

New Providers

Have you ever wondered why there was little to no regulatory pushback when Stamps acquired Endicia? Many in our industry did and the common rational was that there were going to be new providers and ways for industry to print postage. Pitney Bowes, who was already an approved PC Postage provider, has opened up its platform for general use. There is now a new variant on how to evidence postage, it is known as "e-Postage" and the first[4] e-Postage provider available to independent shippers is a company named "Shippo" and they are operating under the guidelines of the USPS beta test phase. (It is a process that every Postage provider must go through) Both Shippo and Pitney Bowes offer multi-carrier solutions or the ability to just print USPS Shipping labels. In addition, shippers still have the option to use metered postage and EVS Manifesting.

There is much afoot, and it would be a good idea to schedule time to step back and take a holistic look at your small parcel transportation profile to better understand how you might be affected. In addition third party consultants are available to assist those companies that need help and are often funded from the savings that they are able to help generate.

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[1]The Capitol Forum Report on Stamps.com is a subscription based 6 page report dated July 8, 2016

[2]Rick Munariz "The Motley Fool" Jul 18, 2016 at 9:19AM "Can Stamps.com Bounce Back After Last Week's 13% Drop? A pair of troublesome reports weigh on the digital postage provider".

[3]NSAs are all published and they are all accessible but with key information including the participant's name being redacted.

[4]Other e-Postage users are tied to specific market places like Amazon and Etsy who allow their participating vendors to share in their discounted rates.