



## **A Strategy for Savings: Postal Optimization and the Future of Direct Mail**

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## Introduction & Executive Summary

Today's direct marketers stand at the crossroads of a two-pronged assault.

From one side, the attack comes from postage rates and raw material costs, which are **rising** at a brisk pace, reflecting broader economic and geopolitical issues largely out of the marketer's control. From the opposing side, a barrage of **falling** consumer response rates has raised the economic stakes for all, intensifying pressure on the direct mail channel and demanding a departure from the "traditional" promotional approach in deference to targeted campaigns orchestrated only to those consumers most likely to buy.

No matter how you interpret these issues, there's no doubt they present significant threats, forcing marketers to re-examine their investment in direct mail and the approach by which they plan, execute and measure the impact of such campaigns. Increasingly, though, a solution is emerging that offers a means to both reduce costs and optimize overall marketing return on investment—even given the daunting economic challenges otherwise dictating "efficient" direct mail execution.

**Postal optimization**—referring to the coordination of technologies, processes and physical formats for the purposes of reducing postage costs—provides just such a solution. Often associated with one of several discreet tactical processes used to enable postal savings (including commingling, co-palletization and consolidation), the effective practice of postal optimization is actually much more strategic in nature, representing a key opportunity for both mailers and service providers to enhance the economic value of direct mail.

This white paper—sponsored by Direct Group—explores the current economic opportunity presented by postal optimization and attempts to illustrate how marketers are making use of such strategies to both reduce top-line execution costs and enhance the return on investment of their direct mail campaigns. Developed through an intensive primary research process (involving interviews with dozens of major mailers, service providers and equipment manufacturers throughout the United States), it will demonstrate that:

- Driven by both rising rates and several years of severe price compression among marketing service providers, postage costs are growing to assume a more significant proportion of direct mail budgets
- General maturity of the direct mail channel and heightened competitive intensity in several mail-dependent vertical markets have conspired to depress typical direct mail response rates, forcing marketers to re-evaluate the approach by which they derive value from the channel
- Mounting pressure to adopt environmentally-friendly business practices has focused attention on the reduction of direct mail *waste*—including both undeliverable packages and those that ultimately fail to achieve a specified marketing objective
- Though widespread understanding of postal optimization and its high-level benefits finally reached an industry-wide "tipping point" about 18 months ago, many marketers—including several of the nation's largest direct mailers—have yet to fully integrate a comprehensive postal optimization execution plan into their long-term direct mail strategy

- Effective postal optimization execution requires the integration of multiple tactical tools, potentially including data hygiene, commingling and various logistics solutions depending on the marketer and the specific needs of its direct mail program
- The critical importance of *scale* in driving optimization efficiency (especially in relation to volume-oriented commingling production) has served to bifurcate the direct mail production industry into a small corps of “mega-players” that have the tools and the capacity to drive such value, and a large general community of smaller providers that have little choice but to outsource such work or offer less comprehensive optimization solutions.
- Reduced postage rates may provide the initial motivation for investment in postal optimization, but a wide range of ancillary benefits—including improved targeting capability, enhanced flexibility with regard to mail timing and significant potential reduction in “waste mail” expense—may ultimately emerge as more significant long-term benefits.

## What Is Postal Optimization?

Just as television, print and online marketers pay fees to the networks, publishers and online content owners that provide a venue for their campaign execution, postage represents the “price of admission” for direct mail marketing—a media expense compensating the channel provider (in this case, the United States Postal Service) for carrying advertising alongside its base of other general-interest content.

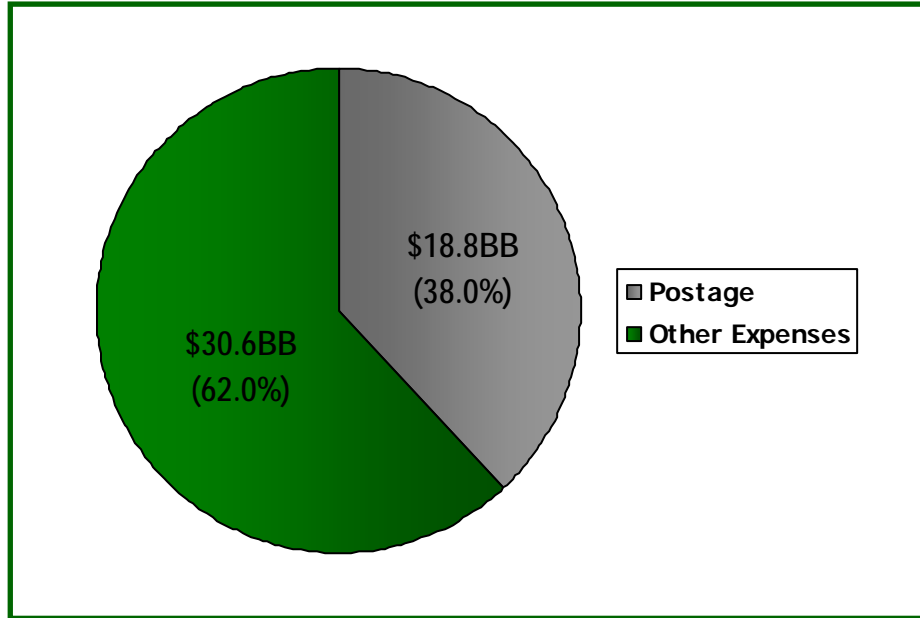
At approximately \$22.8 billion—or just under 40 percent of total direct mail spending in 2007—that price tag is significant, representing nearly one-third of the USPS’ \$75 billion in revenue last year. But such a significant financial contribution doesn’t come without reward. Just as television networks and publishers provide volume discounts to high-revenue customers (a practice that has supported the dramatic growth of a cottage industry of media agencies that aggregate purchasing so as to drive savings to their clients), the USPS effectively compensates direct mailers for their contribution to the nation’s postal channel. Those cost incentives, which form the foundation of postal optimization strategy, broadly fit into two categories:

- **Volume discounts**, which take effect once specified mail quantities are earmarked for particular geographic areas, and;
- **Worksharing discounts**, which the USPS provides to reward mailers for managing sortation and/or delivery processes that it would otherwise be forced to handle. In general, these discounts grow progressively more significant as the mailer (or its respective service provider) delivers packages geographically closer to their intended recipients.

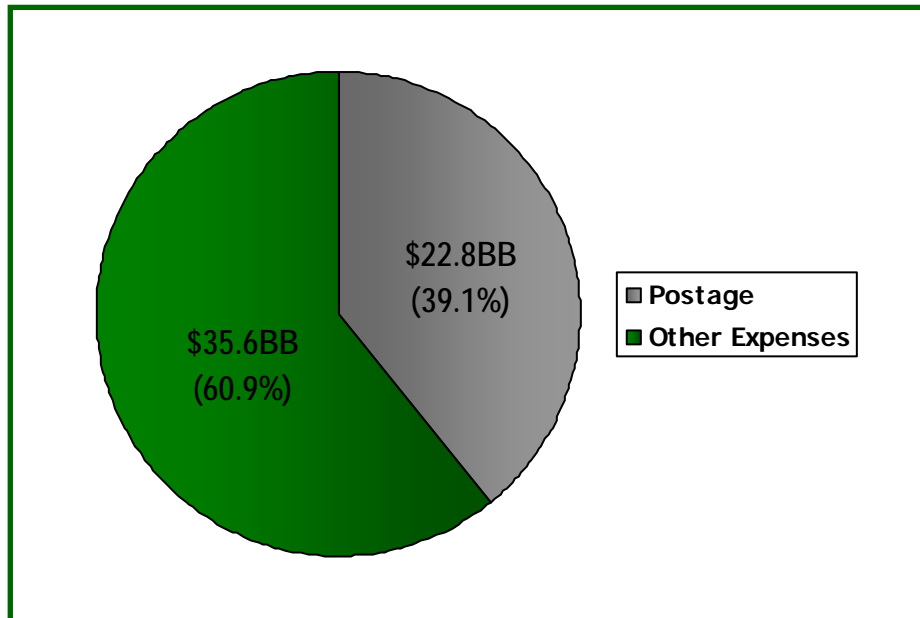
*Postal optimization, then, is any coordinated, strategic approach intended to maximize the above savings opportunities while maintaining the marketing impact of a given direct mail campaign.* Too often, though, the term is used interchangeably with the names of various tactical processes that help mailers improve their postage savings. It’s easy to understand why the misunderstanding exists, given the relatively recent advent of optimization

techniques among mailers both large and small. *But postal optimization is about more than just tactics.* No matter who develops or executes such an initiative—mailer or service provider, Fortune 500 enterprise or small business—a marketer is only optimizing its direct mail investment when it considers its postal investment as a primary driver, rather than inhibitor, of direct mail value.

**2004 U.S. Direct Mail Spending: \$49.4 Billion**



**2007 U.S. Direct Mail Spending: \$58.4 Billion**



Source: Winterberry Group analysis of data from multiple sources

That said, no strategy delivers results without a strong foundation of tools and processes. The following represent common tactics mailers are using to put postal optimization strategy into practice:

- **Commingling:** the physical combination of direct mail from various marketers into a single “mailstream” to guarantee the absolute highest volume and worksharing discounts for all contributors. Typically, this process strives to enable “five-digit ZIP” discounts, whereby at least 150 mail pieces are bundled to each respective area (smaller discounts are available for bundling to broader areas, including “three-digit ZIP” zones)
- **Copalletization:** the compilation of various versions (or “cells”) of the same mail campaign—or various campaigns of the same mailer—into destination-specific mail pallets designed to provide the greatest possible volume discounts for a specific mailer. This approach does not generally require mailers to count on contributions from other mailers in order to achieve savings, though it likewise tends to deliver smaller savings than those made possible through commingling
- **Consolidation:** the bundling of direct mail packages from various mailers into trucks destined for the same geographic regions, with the intent of enabling “drop-ship” worksharing discounts based on deeper mailstream penetration and reducing logistics costs associated with shipping mail from single marketers independently. The most optimal delivery points are typically the USPS’ 450-plus highly-concentrated sectional center facilities (SCFs) serving each “three-digit ZIP” zone, though reduced discounts are also available for distribution to each of 28 bulk mail centers (BMCs) and auxiliary service facilities (ASFs) designed to process high-volume Standard Class mail
- **Data Hygiene/“Enhanced” Data Hygiene:** the application of data cleansing processes—including merge/purge and de-duplication of mailing list entries, updating of addresses based upon the National Change of Address (NCOA) registry and usage of the USPS’ Coding Accuracy Support System (CASS), which ensures proper address formatting—to improve the chances of package deliverability and reduce production waste. In “enhanced” data hygiene, lists are typically updated and enhanced through one of several manual or analytical processes (including telephone address validation or modeling of addresses to ensure maximum marketing impact) to ensure even greater performance
- **Strategic Format Selection:** the consideration of various postage-related opportunities (including potential discounts made available for use of certain physical dimensions and other package formats) when developing direct mail campaigns so as to minimize postage expense.

## What's Driving Postal Optimization Adoption?

Though significant volume- and worksharing-based postage discounts have been available to marketers for decades, those opportunities have commanded critical attention from marketers only in recent years, given a number of systemic developments in the economy and in the way that marketing campaigns are planned and executed.

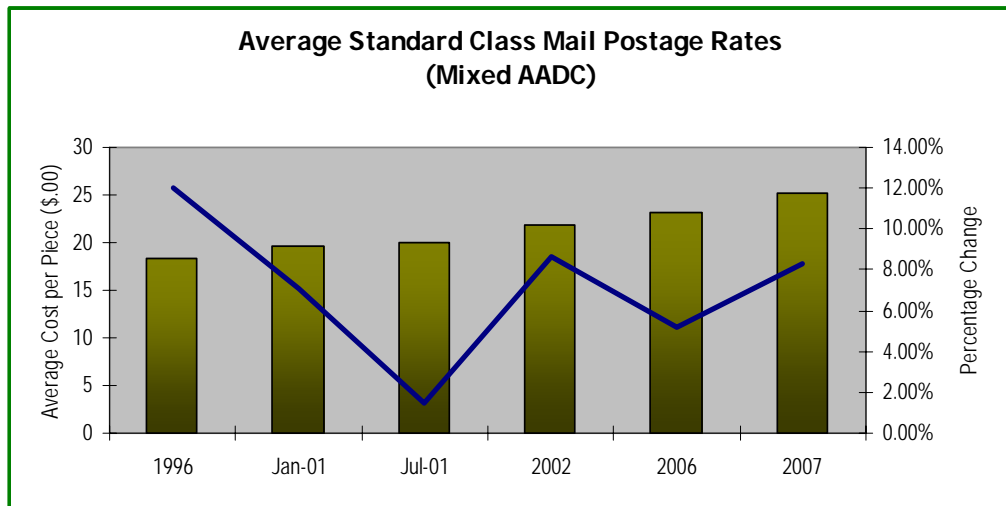
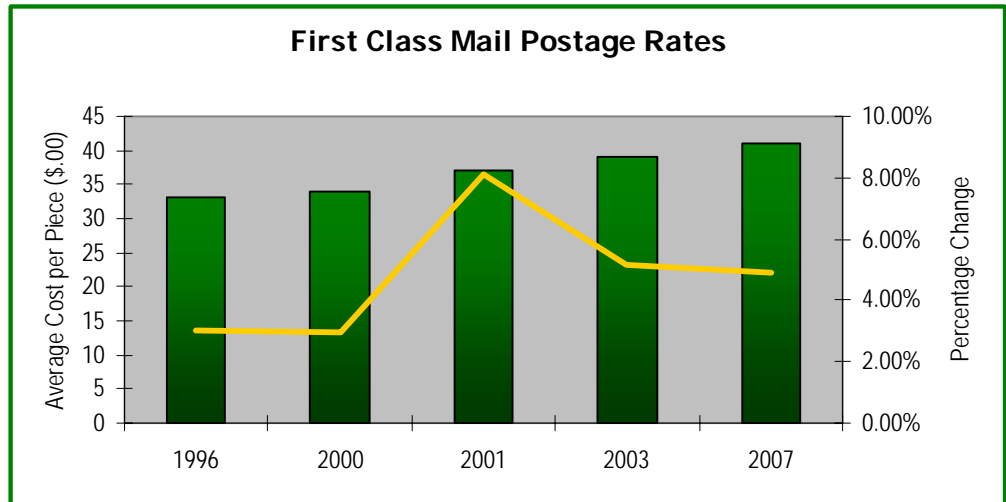
**Driven by both rising rates and several years of severe price compression among marketing service providers, postage costs are growing to assume a more significant proportion of direct mail budgets.**

The use of the mail for marketing and promotional purposes is a practice as old as the mail itself, with the first catalogs and promotional pamphlets in this country burgeoning just as the United States came to be (Benjamin Franklin, in fact, is credited with launching the first “colonial catalog” in 1744). Over those centuries, one mail truism has become abundantly clear:

*Postage rates never go down.*

And so, in one sense, recent rate increases—including a May 2007 hike that saw postage jump anywhere from 7 to 150 percent, depending on the type of package—should have caught nobody by surprise. But a unique combination of factors have conspired to concentrate the impact of rate movements, intensifying the negative impact of even slight increases and challenging the ability of marketers to derive value from their direct mail expenditures.

The first factor is linked to the nature of the rate increases themselves. Under pressure to achieve (Congressionally-mandated) breakeven profitability and finance its own overdue modernization, recent USPS rate cases have featured an incredibly complex array of new regulations and rate guidelines, shifting the requirements to achieve postage discounts and “raising the (postal compliance) bar” for marketers in virtually all industries. (Notably, package size and shape is now a key driver of certain discounts, impacting the mailers of “flats”—such as catalogs and some periodicals—disproportionately compared to other mailers.)



Source: WG analysis of data from USPS and other sources

In historical terms, the May 2007 rate hike (averaging about 4.9 percent for First Class and 8.3 percent for Standard Class mail) may likewise be considered among the highest in recent years. And that significant rise in cost, coming (for Standard Class mailers) on the heels of another hike in 2006, hit many marketers hard.

“We were simply not prepared for the increase,” said one high-volume mailer. “While we did have some time to prepare [for the rate hike], there was a great deal of uncertainty as to when and how it would happen.”

Compounding the impact of higher postage rates has been increasing pressure on direct mail service providers to reduce printing, insertion and other production costs. According to the estimates of some mailers and providers, costs over the last five years have degraded by anywhere from 1 to 2 percent per year on average, with the lion’s share of that pressure coming from high-volume mailers in mail-dependent verticals (such as financial services) that have suffered from reduced response in a more cluttered, competitive direct mail environment.



Ironically, this *reduction* in package costs may have actually served to *intensify* the negative impact of rising postage rates, given the higher proportion of direct mail budgets devoted to postage. Many observers added that service providers—having been forced to optimize their internal production efficiencies in the face of these revenue pressures—have begun to actively resist the pressure to cut prices any further, leaving mailers searching for other avenues to save money (“You’re not going to save much more in package [production] costs going forward,” said one marketer. “The printers and lettershops have gotten pretty good at what they do.”)

Furthermore, some mailers say that postal reform efforts designed to minimize future rate hikes—including a much-publicized provision capping forthcoming rate increases to the pace of inflation—may ultimately provide little relief, given embedded regulatory flexibility that allows the USPS Board of Governors to spread out rate increases disproportionately across mail classes.

“One misconception in the industry is the cap [of future rate increases to increases in the consumer price index] will solve the shock of future rate cases, but that is not true,” said one catalog mailer. “The way that the CPI is averaged over Standard Class mail, flats could receive another substantial increase. The same rate shock that Standard flats experienced in the last rate case could happen again.”

**General maturity of the direct mail channel and heightened competitive intensity in several mail-dependent vertical markets have conspired to depress typical direct mail response rates, forcing marketers to re-evaluate the approach by which they derive value from the channel.**

The tremendous growth of the direct mail channel over the past decade (a period that saw total mail investment grow by approximately 50 percent in the U.S.) has had at least one unintended consequence for mailers both old and new: On a per-piece basis, direct mail just doesn’t generate the same response it once did.

The impact of the degradation in response rates—estimated at about two-tenths of a percentage point between 2004 and 2006—has hit mailers particularly hard in those verticals where high competitive intensity and a relatively sophisticated approach to mail execution have traditionally fueled the highest volumes (and, consequently, the most reliance on the channel). Credit card mailers, in particular, now struggle with response rates that often fail to crack one-half of 1 percent—a stark decline from not-so-long-ago times five or six years ago, when comparable campaigns drew four or five times the response.

Notably, the proliferation of mail isn’t all to blame for the changing response equation. General product saturation in certain verticals (credit card once again presenting the clearest example) and economic stagnation, for example, have presented comparably high hurdles to continued strong marketing performance.

No matter what its origin, however, the decline in response rates has forced many marketers to revisit their strategic direct mail approach in search of untapped execution opportunities. On the “revenue” side, this often relates to experimentation with new creative concepts, product bundling, customer

targeting methodologies and integration of mail with other channels (especially online). On the “cost” side, process enhancements and the pairing-down of expenses (including aforementioned pressures on service providers to cut costs) traditionally provided the sole opportunities to drive value in this respect.

Postage, by comparison, was considered comparably off-limits—mostly because of widespread unawareness of postal optimization alternatives and the benefits they could offer to both large and small mailers. But as postage costs continue to creep higher (and as mailers find they are able to wring fewer and fewer costs out of their production processes), this understanding has changed markedly, bringing with it a new awareness of how direct mail campaigns generate value and what steps marketers can take to protect that investment.

**Mounting pressure to adopt environmentally-friendly business practices has focused attention on the reduction of direct mail *waste*—including both undeliverable packages and those that ultimately fail to achieve a specified marketing objective.**

Over the last two years, the war on “junk mail” has become fierce.

Consumers, having grown tired of seeing their mailboxes filled with advertisements that don’t address their basic wants or needs, are turning a deaf ear to the many offers that come to their doors. Environmental advocates, citing the 3.6 million tons of unwanted mail that the Environmental Protection Agency estimates wind up in our nation’s landfills every year, are organizing opt-out campaigns and leading the charge against catalogers and other marketers that they perceive as “eco-unfriendly.” And certain politicians, anxious to latch on to populist notions in an election year, are using input from both causes as justification for their sponsorship of “do-not-mail” proposals—potentially setting strict limits on unsolicited mail marketing—in 16 different states.

Curiously, the one constituency absent from the fight (until now) has the most to lose from the continued proliferation of “junk.” That group is, of course, mailers themselves.

No matter how you assess the challenge, there’s no question that direct mail execution today is fraught with inefficiencies. Besides the high-level issues (environmental waste, low consumer response), actual direct mail execution waste goes much deeper, reflecting the huge volume of mail that essentially fails in its marketing objective—either because it reaches a target consumer that has little or no need for a given offering, or because it never reaches a target in the first place.

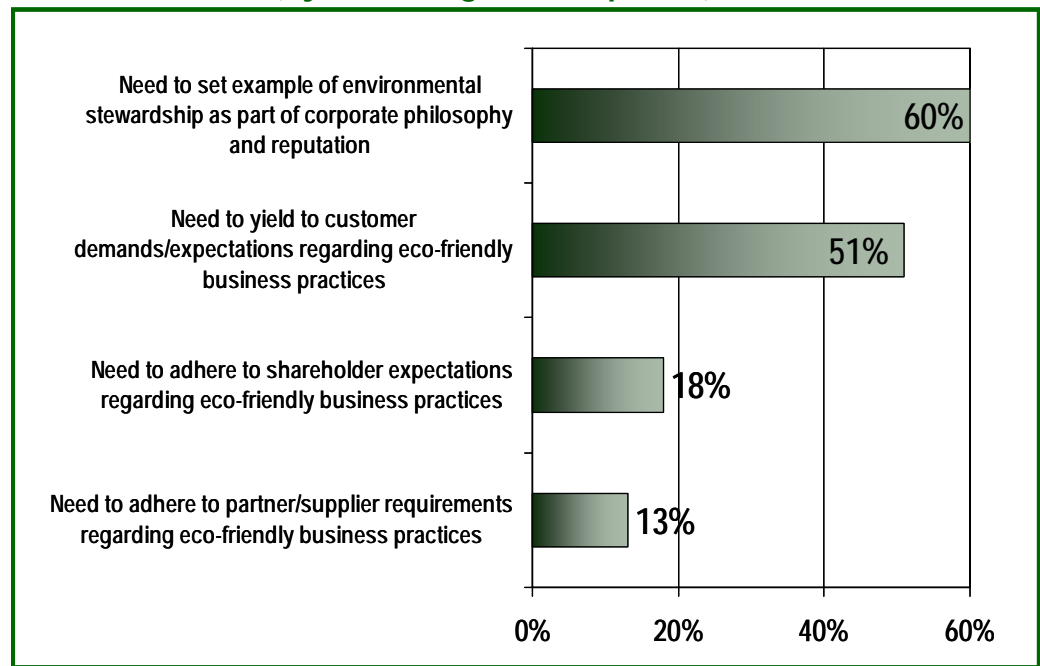
In many respects, this is the *real* “junk mail” that inspires such discontent. But given souring public perception, how do marketers defend their legitimate direct mail marketing—a practice that drove over \$700 billion in domestic economic value in 2007?

In today’s increasingly eco-conscious business environment, many industry observers say that the solution lies *not* in fighting to legitimize the role of all direct mail, but rather by addressing the key shortcomings in mail program

execution that currently promote both poor prospecting and ultimate environmental waste. Consider the following:

- Nearly 6 percent of all direct mail sent in the U.S. in 2007 was classified as “undeliverable as addressed”—meaning that an incorrect or improperly formatted address prevented the package from finding its way to *any* recipient (in 2005, by comparison, “UAA mail” represented only 4.5 percent of total volume)
- Nearly 18 billion mail pieces will be “wasted” in that respect in 2008—and that total does not include mail that is delivered to the correct address but the wrong person.

### Leading Factors Compelling Companies to Focus on Direct Mail Waste Reduction (By Percentage of Companies)



Source: Aberdeen Group

Several marketers said that while they’ve recognized these problems for years, pressure from environmental groups and rising raw materials costs—yet another “real” cost related to wastage—are finally inspiring them to take proactive remedial steps. Coordinated postal optimization strategy is fast emerging as a key tool in this effort, given its ability to improve both address deliverability (through application of better hygiene processing) and bottom-line targeting capability (by enabling better timing of mail delivery, a feature made possible through both commingling and distributed drop-shipping processes).

Given the huge value potential that marketers stand to receive by eliminating the waste already present in their mail programs—imaging how much would be saved if those 18 billion pieces to be “wasted” this year never passed through the production or postage budgets—it seems obvious that such investment will continue through the foreseeable future. The next challenge: Ensuring that frustrated consumers and environmentalists see the results of those efforts.

## What Trends Are Defining the Execution of Postal Optimization?

Though widespread understanding of postal optimization and its high-level benefits finally reached an industry-wide “tipping point” about 18 months ago, many marketers—including several of the nation’s largest direct mailers—have yet to fully integrate a comprehensive postal optimization execution plan into their long-term direct mail strategy.

*“The mailing community hasn’t yet grasped the power of what postal optimization can do for them.”— CEO, Leading Printer/Lettershop Services Provider*

As recently as two years ago, popular sentiment in the community of high-volume direct mailers leaned heavily against the adoption of commingling and other production-oriented postal optimization tactics. “Why should we spend the money [on commingling processing] and risk missing our drop dates?” one financial services mailer said in late 2005, “Especially when our volumes help us get some of the best discounts available?”

At the time, that perspective was far from unique. Though a number of data-oriented optimization approaches, like hygiene processing, had long since established their ability to improve mail deliverability total campaign ROI, the typically more expensive production tools were often met with skepticism from mailers who considered them risky and needless, given otherwise manageable production costs, postage and comparably high consumer response. The variety of concerns voiced about commingling and similar methods was likewise wide:

- “Commingling costs are expensive”
- “The postage savings don’t outweigh the costs and risks”
- “We risk delaying the ‘drop’ of our campaigns into the mailstream if we have to wait for our provider to gather mail from other marketers for a commingling run”
- “Timing and quality of our direct mail packages are risked by adding another major step to the production process”
- “We don’t want our mail included in production runs with our competitors.”

Time, experience and a shifting economic environment—which has seen total direct mail package costs skyrocket while response rates headed in the opposite direction—have gradually neutralized most of those arguments, especially for the highest-volume mailers, who rely on strict process control to deliver their margins. Whereas a few cents of postage savings once added up to small potatoes in the eyes of even the most sophisticated mailers, years of declining response have reinforced the critical value of those 2.2 cents per package that some (First Class) mailers stand to save by adopting commingling programs. In the words of one service provider: “Many of the old objections [to commingling and other postal optimization techniques] are fading away with the inception of better and better technology.”

But still, a great many holdouts remain. Even in high-volume vertical markets like financial services, telecommunications and retail, many companies simply

have not yet integrated the prospect of the postal optimization-enabled savings into their direct mail budgeting, preferring to either assume “worst-case” costing scenarios or in continued fear of the supposed execution risks associated with postal optimization.

A number of service providers said the answer is even simpler than that: Some marketer-side production managers aren’t compensated on the total *value* of their direct mail programs (a metric that would generally be improved by the adoption of comprehensive postal optimization strategies) and instead work to meet traditional performance benchmarks usually based on either granular printing/lettershop costs or consumer response.

“Tell me how you’re going to measure me, and I’ll tell you how I’m going to act,” said an executive at one leading lettershop services provider.

That perspective should change in the coming year, several panelists said, as cost pressures continue to depress total direct mail ROI and new Postal Service delivery requirements—like delivery point validation (DPV), which requires perfect address formatting in order to qualify for the best postage discounts—take their toll on marketers who aren’t exploiting the same cost-savings opportunities as their competitors.

“Close enough is not good enough,” said Postmaster General Jack Potter, discussing the need for mailers to meet stricter addressing requirements. “When dialing the phone, if you’re one digit off, your call won’t go through. Unlike phone calls, your mail may still go through, but you’ll lose postal discounts of 2-6 cents per piece.”

**Effective postal optimization execution requires the integration of multiple tactical tools, potentially including data hygiene, commingling and various logistics solutions depending on the marketer and the specific needs of its direct mail program.**

Like any complex marketing program, proper postal optimization execution requires more than just one set of tools. In fact, many panelists argued that the most important item in the postal optimization skillset isn’t simply the presence of “big iron” commingling capabilities; rather, it’s the ability to integrate those production processes with *equally valuable* creative- and data-oriented optimization techniques that really drives meaningful value in competitive direct mail verticals.

The burden for developing and executing on those holistic strategies typically rests equally on the shoulders of both mailers (who set out the guiding campaign objectives and manage process, timing and interactions of multiple suppliers) and marketing services providers (who handle physical execution).

Given the growing complexity of the postage rate structure and heightened pressure to meet strict USPS processing requirements, it’s only reasonable to expect that efficient management of those disparate optimization functions will soon become a key driver of direct mail success. The responsibilities inherent in this central coordination role span the whole gamut of direct mail execution, from managing the selection of “postal-friendly” creative formats (folded pieces now enjoy better rates than flats, even at the same weight) to

directing day-to-day commingling operations to assigning logistics providers to handle nationwide drop-ship operations.

Several panelists said that the postal optimization requirement will begin to overlap with “traditional” lettershop processing next year, when the USPS begins enforcing mandatory Intelligent Mail barcoding as a condition for receiving automation discounts. The new requirements, designed to improve workflow efficiency throughout the USPS mailstream and improve the ability of marketers to track their packages (so as to coordinate multichannel campaign delivery), call for marketers and their service providers to adopt one of two new barcoding options by May 2009.

That requirement will be challenging for some providers to meet, said panelists, though several noted that the new requirements stand to drive new value that runs much deeper than the production and postal optimization processes. “We’re just scratching the surface on what this intelligent barcoding is going to mean for the industry,” said an analyst from a leading data management and hygiene firm. “It’s not just about package tracking and tracing—it has the potential to drive real customer intimacy [as marketers are better able to time the receipt of their direct mail packages].”

**The critical importance of *scale* in driving optimization efficiency (especially in relation to volume-oriented commingling production) has served to bifurcate the direct mail production industry into a small corps of “mega-players” that have the tools and the capacity to drive such value, and a large general community of smaller providers that have little choice but to outsource such work or offer less competitive platforms.**

The widespread adoption of commingling and other production-oriented postal optimization processes over the last five years has been driven by a great many factors—heightened demand from marketers, greater awareness of available alternatives and better underlying technology being foremost among them.

One development, though, has had a particularly strong impact on the willingness of marketers to invest in commingling and similar processes. The growing corps of optimization-focused marketing service providers—as exemplified by the number of production shops offering a full suite of commingling, data processing and other optimization tools—has literally put to rest many of the concerns that marketers proffered about such practices just a few years ago.

Whereas certain gripes, for example—“The postage savings aren’t worth an extra two days of waiting time if that’s when the commingling machines are going to run”—used to predominate, virtually all such issues have been rendered moot by the development of both dedicated niche players and “integrated” production shops (offering optimization in addition to standard direct mail production) that can execute broad programs virtually any time of the day.

That widespread adoption has, however, had one consequence: The significant capital costs required to establish a fully-scaled postal optimization platform (with commingling as an anchor capability) have effectively split the direct mail production industry according to revenue. On one side of the divide reside the largest players, with the cash, real estate, supporting production volume and

in-house expertise to develop and grow comprehensive offerings, serving the needs of both enterprise mailers and middle market companies that may effectively capitalize on the volume discounts enabled by their larger counterparts.

Smaller providers, by contrast, are confronting a series of real challenges given their relative inability to make the significant investment necessary to get a commingling operation off the ground. To these providers, a stark choice has presented itself: Either develop partnerships with larger, optimization-enabled providers (threatening your margins and, potentially, the security of your client relationships), or disavow the strategic benefits offered by postal optimization, focusing on providing other ancillary services or serving smaller customers with less need for such savings.

Marketer panelists said they are increasingly coming to recognize greater value in the larger, “full-service” optimization option. “If the price is the same, I’d rather have a lettershop with a postal optimization business under the same roof, even more than one that has a partnership,” said one marketer. “You just have more control over the mail that way.”

## Conclusion

**Reduced postage rates may provide the initial motivation for investment in postal optimization, but a wide range of ancillary benefits—including improved targeting capability, enhanced flexibility with regard to mail timing and significant potential reduction in “waste mail” expense—may ultimately emerge as more significant long-term benefits.**

Postal optimization emerged and has evolved into a critical direct mail execution tool for one key reason: it reduces postage costs, helping many mailers realize important additional value from their campaigns.

In the future, though, the possibilities presented by such strategies appear far more diverse. Reduced waste (through the advance elimination of undeliverable addresses), improved targeting (through more precise timing of mail delivery and better application of available consumer data) and dramatically enhanced multichannel coordination (again through improved tracking and delivery) are all benefits made possible simply by approaching the “postage issue” as a key driver of direct mail value.

“Anybody that is doing mailings of 200 or more pieces would really be remiss in not looking at an opportunity to reduce postage and improve deliverability—enhancing the customer intimacy that comes about with that,” said an executive at one leading data processing and hygiene provider.



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