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# EDITED TRANSCRIPT

PMTS - Q1 2016 CPI Card Group Inc Earnings Call

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## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the CPI Card Group Inc. Quarter One 2016 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will be given at that time.

(Operator Instructions)

As a reminder, this conference is being recorded. I would now like to introduce your host for today, Mr. William Mania, Investor Relations. Please go ahead.

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**William Mania** - *CPI Card Group Inc. - ICR*

Thank you, Andrew, and good afternoon, ladies and gentlemen. Welcome to the CPI Card Group First Quarter 2016 Earnings Conference Call. Participating on today's call from CPI Card Group are Steve Montross, President and Chief Executive Officer, and David Brush, Chief Financial Officer.

Before we begin, I'd like to remind everyone that this call may contain forward-looking statements as they are defined under the Private Securities Litigation Reform Act of 1995. Please refer to disclosures at the end of the Company's earnings press release for information about forward-looking statements that may be made or discussed on this call. Please review the information along with our filings with the SEC and SEDAR for disclosure of the factors that may impact subjects discussed on this call. All forward-looking statements made today reflect our current expectations only and we undertake no obligation to update any statements that reflect the events that occur after this call.

Also during the course of today's call, the Company will be discussing one or more non-GAAP financial measures, including EBITDA, adjusted EBITDA, adjusted EBITDA margin, adjusted net income from continuing operations, adjusted diluted earnings per share from continue operations, free cash flow, and constant currency. Please see the earnings press release on the CPI website for all the disclosures required by the SEC, including reconciliations to the most comparable GAAP numbers.

And now I would like to turn the call over to Mr. Steve Montross, President and Chief Executive Officer.

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Thanks, Will. Good afternoon, everyone, and thank you for joining us today for our first quarter 2016 earnings conference call. I'll start with some operating and financial highlights from the quarter.

Our US shipments of EMV chip cards increased to approximately 6.6% from the fourth quarter of 2015; an increase 66.1% over the prior year period. Our net sales were $86.4 million, up 11.7% over the prior year period. Adjusted EBITDA was $18.8 million, a 13.1% increase over the prior year period. Adjusted net income from continuing operations was $7.1 million, or $0.13 per share. And free cash flow was $13 million, up $7 million in the prior year period.

On a segment basis, while our EMV card sales grew on a sequential basis from the fourth quarter of 2015 and were up strongly year-over-year, our US debit and credit results were slightly below expectation due to lower than projected EMV card purchases by our large issuer customers, which is something we'll discuss further during the call. Our value-added service business line in our UK Limited segment were essentially in line with our expectations in the first quarter, as was our US Prepaid Debit segment as we recognize the significant product redesigns by a major customer in the first quarter of 2015 would not be replicated in 2016.

Dave will discuss our segment results in more detail later. I'm going to focus my comments on key trends in the US EMV market and what they mean for our revised 2016 outlook. Through recent discussions with our customers and other important market participants, there are three adverse market trends that had become evident. Two of which concern the timing of EMV card sales and which will have a significant impact on the EMV card production market in 2016, and the third impacts market pricing.

First, the overstocking of EMV cards by the large issuers and processors in 2015, which we discussed in the previous earnings call as the reason for our outlook of a relatively soft first half of 2016 for EMV sales, is now known to be much greater than previously understood. The carryover of unissued EMV card inventories into 2016 by the large issuers and processors, which is now estimated to have been an additional 50 million to 100 million units or about 8% to 16% of total EMV card production demand in 2016, has left many large issuers and processors with at least three-month supply of excess inventory, and in some cases, more.

The issuers and processors are now working through their excess card inventory position and have been curtailing their purchases of additional EMV cards. We expect this trend to continue until the large issuers and processors right-size their RMV card inventories. We estimate that the negative revenue impact to CPI in 2016 from this reduction in current card demand will be approximately $35 million to $40 million compared to our original guidance for 2016. We believe that the impact will be highest in the second quarter, with less impact in the third quarter, and then sequentially less impact in the fourth quarter.

I think it's important to note a couple of things. One, this issue is affecting the entire card production industry not just CPI. And two, this issue impacts card producers and not the issuers or processors. Many of you cover the processors so you probably appreciate that the processors' business, similar to our own personalization and fulfillment business, is driven by card issuance and is not impacted by the excess inventory of unissued cards. And as their EMV card issuance to consumers continues to grow, the processors are noting in their earnings calls the current tailwind from increased EMV issuances, which we are also experiencing in our own personalization business.

Second, the small to mid-size issuer segment of the market, which represents over 35% of the financial payment card market and where we have our highest market share, is experiencing delays in the conversion to EMV. As a first step in EMV issuance, the processor for the issuer must set up the issuer's accounts to process EMV transactions and must do extensive testing of the processors. Also, the process to configure and test the EMV cards to be issued by the bank is an additional technical and time-consuming process. The slower-than-anticipated case of the EMV conversions for the small to mid-size issuers is expected to delay to 2017 a significant portion of EMV card demand from this market segment. We currently estimate that the impact to CPI from this deferral of EMV demand of future periods by the small to mid-size issuers will be to reduce our 2016 revenues by approximately $35 million to $40 million compared to original guidance.

Along with this temporary softness in the market for EMV cards, we are seeing increased competitive intensity for the EMV card orders, which is leading to greater than expected pressure on EMV card prices in the large issuer market. Importantly, despite the pricing pressure, we have been able to maintain stable margins through reductions in our chip cost, although the reduction of product prices does have the effect of lowering our



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revenues. When we combine the impact of the anticipated reduction in 2016 EMV card volumes and the revenue impact for the pricing dynamics that I just discussed, we will not achieve our prior growth targets for 2016 and we have to reduce our 2016 guidance to match this expectation. Dave will provide more detail with respect to our guidance for the second quarter and revised outlook for the full year later in the call.

Overall, I want to emphasize that we believe that this temporary slowdown of EMV chip card orders, which we would characterize as a result of timing, overstocking on one period resulting in a reduction in demand in the subsequent period and the delay in EMV issuance by a portion of small to mid-size issuer market, does not reflect reduced long-term market demand for EMV cards as the current estimate of market conversion to EMV is only approximately 50%. Estimates from independent industry analysts as well as our own estimates, conversations with our customers and information from the card brands indicate that the size of the market in terms of the number of cards in circulation continues to grow and the conversion from magnetic stripe cards to EMV cards continues to progress.

However, with the excess inventories sitting with the large banks and core processors, card procurements will be weaker than expected this year as issuers work through these inventories, and we currently believe a return to more normal EMV buying activity will not occur until late 2016 or early 2017.

On a positive note, we do expect the delayed EMV conversions by the mid-and small-sized banks will begin to update in late 2016, and we expect orders from this market segment to accelerate in 2017 to meet the demands of those institutions. This market segment is heavily weighted to debit issuance, and with debit estimated to be approximately 28% converted to EMV by the end of the first quarter of 2016, we believe that there is significant EMV conversion, card demand and issuance ahead for this market segment.

Before moving on, I would like to reiterate that our longer-term growth opportunity, driven by the ongoing conversion of magnetic stripe cards to EMV chip card is unchanged. Based on our analysis and recent market data, including announcements by the major card brands on a percentage of their branded cards in circulation that are EMVs, we estimate that only about 28% of debit cards and 58% of credit cards in the US were converted to EMV at the end of the first quarter of 2016, which was up from an estimate of approximately 20% and 50%, respectively, at yearend 2015. Given this level of penetration, there is clearly significant future growth for EMV as the market continues its conversion to EMV, which other leading market participants, including the core processors are noting when they're remarking that we are still in the early stages of the EMV migration. With our leading market position and longstanding trusted relationships with over 4,000 customers, we expect to continue to benefit from the ongoing migration to EMV.

Now I would like to provide you with an update on some of the other important growth areas of our business. As we discussed with you on our last call, we are experiencing increasing activity with respect to Dual-Interface or Contact with EMV cards, and although we are supplying dual-interface cards to just a couple of US issuers, the overall market customer demand remains relatively low at this time. As we previously discussed, we recently won a pilot with a major issuer to manufacture and personalized dual interface, or tap-and-go cards, and we are on the process in delivering our net project. We also discussing dual-interface EMV pilots with other issuers and now working with a number of additional issuers to get dual-interface products into their product roadmaps.

At this time, many large issuers are including a new request for proposal dual-interface products. We continue to expect to see increasing dual-interface card issuance over the next few years, starting from a low level this year and growing to a more meaningful portion of the market over the next few years, particularly as the portfolios for priority bank customers which were first converted to EMV in 2014 and 2015 come up for reissuance beginning next year and proceeding over the next couple of years. This is a particularly exciting growth opportunity for us given our significant preparation to lever this product to the market and the revenue impact to this higher-priced product.

The Prepaid Debit segment remains a growth area for us. Our retail prepaid debit business continues to enjoy a strong market position due to our longstanding trusted relationships, expertise, product innovation and design, and our quality processes and data management capabilities. The heightened concerns by the prepaid program managers about fraud in the retail channels and the greater need for product security placed particular demand on our product innovation and design capabilities.

As we have discussed previously, we also see strong growth opportunity in the B2B and B2C segments of the prepaid debit market. As a result, we are investing in a highly customizable product offering, which enables prepaid program managers to go to market quickly with unique personalized



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offerings for each individual in a program. This product offering is ideally suited to address the growing demand in the prepaid debit market to utilize data analytics and drive targeted offers for gifts, rewards and incentives, payroll, tax and healthcare programs; all high growth areas in a prepaid debit market.

Finally, with respect to our service business lines, we continue to see strong demand from our customers for our industry-leading solutions. Our personalization and fulfillment services continue to achieve strong growth with our revenues and earnings up significantly in the first quarter of 2016 from the prior year period. And our services are benefiting from the EMV migration with approximately 52% of our worth represented by EMV personalization and fulfillment compared to less than 1% in the prior year period. We ended the first quarter of 2016 with over 4,230 instant issuance or card-at-once installations, versus 4,000 at the end of 2015. We continue to view our instant issuance product and services as a strong growth area.

In summary, the current market dynamics have led us to significantly reduce our 2016 outlook and we are currently disappointed with that. But our long-term growth opportunity in this market is undiminished. I want to emphasize that the strengths in the long-term fundamental growth drivers of our business remain sound and are unchanged from what we have discussed in prior quarters and during our IPO. We are a leader in the large and growing addressable financial payment card market and enjoy strong relationships as a trusted provider with over 4,000 customers. We will continue to grow as our customers in our markets grow, driven by powerful and secular tailwind including the ongoing conversion of the US financial card market to EMV as well as dual-interface cards.

We will also benefit from increasing demand in the market for value-added services and we will expand our share of our customers' wallets by continuing to cross sell our products and services to our customer-base. And we will grow by broadening our market reach into new attractive market verticals particularly in prepaid, and we will continue to pursue a highly selected acquisition strategy through which we have achieved success and generated significant growth.

I will now turn the call over to Dave.

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**David Brush** - *CPI Card Group Inc. - CFO*

Thank you, Steve, and good afternoon, everyone. I will begin by summarizing the results of our first quarter 2016. I will then provide our current guidance for full year 2016 before opening the call for questions.

First quarter net sales were $86.4 million, up 11.7% from $77.3 million in the first quarter of 2015. Our net sales this quarter continued to benefit from the ongoing conversion in the US financial payment card market from magnetic stripe cards to EMV chip cards as well as continued demand from our customers for value-added services. First quarter product net revenue grew 22.1% year-over-year to $55 million.

Services net revenue declined 2.7% year-over-year to $31.4 million in the first quarter. The decline in our service revenue primarily reflects the year-over-year impact of the significant prepaid debit card refresh program that occurred in Q1 of 2015 upsetting solid growth in other areas of the segment. When you remove the $4.4 million year-over-year of the program refresh and as well as $1 million of revenue related to the closed Petersfield facility, services net revenue increased by 17% in Q1 2016.

Now turning to the review of our segments, US Debit and Credit segment net sales were $65.1 million for the first quarter, a 30% increase over the prior year period. And segment EBITDA was $18.9 million or a 50.4% increase. The increase in revenue and EBITDA were predominantly driven by 66.1% year-over-year growth in EMV card shipments, partially outset by declines in average selling prices. Our EMV card shipment through the first quarter increased 6.6% sequentially from the fourth quarter 2015 to 41.4 million cards in the quarter. This was modestly below our original forecast driven by the market factors Steve discussed earlier.

US Prepaid Debit segment, net sales were $12.3 million in Q1, down 29.2% year-over-year, and segment EBITDA decreased 45.4% year-over-year to $3.3 million. The year-over-year decline of US prepaid debit segment revenues and EBITDA primarily reflect the timing of the large customers to refresh its packaging designs in the first quarter of 2015, which was not replicated this past quarter. Consistent with what we said on our last



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earnings call, we expect the prepaid debit business to show increasing revenue growth in the second half of 2016 driven by ongoing growth per customer-base and entry in the new vertical markets with a new investment Steve mentioned earlier.

Finally, UK Limited segment, net sales were $6.2 million in the first quarter or a 0.1% decline from the prior year period, and EBITDA was 200,000, up 19.7% year-over-year. Our UK Limited segment results were impacted by unfavorable foreign currently exchange rate fluctuations. And on a constant basis, sales and EBITDA for the quarter were up 5.8% and 40.3% respectively compared to the prior year.

Moving down the income statement, gross profit for the first quarter grew 16.4%, $29.7 million, representing a gross margin of 34.4% compared with gross profit of $25.5 million in gross margin of 33% in Q1 2015. Further, the first quarter 2016 gross margin improved sequentially from the fourth quarter 2015 gross margin percentage of 33.6%. Income from operation in the first quarter was $13.7 million, up 16.8% from $11.7 million in the prior year period, driven primarily by a revenue and gross profit growth partially offset by incremental cost associated with operating as a public company.

We report net income from continuing operations of $5.7 million or $0.10 per share in the first quarter of 2016, compared with net income from continuing operations of $6 million and a loss of $0.16 per share in the first quarter of 2015. Our loss per share attributed the common shareholders in Q1 2015 reflects $12.6 million of preferred dividends paid on our series A preferred stock, all of which was redeemed with our IPO in October of 2015, and therefore had double impact to our EPS in our first quarter of 2016. The modest decline in our net income from continuing operations versus the first quarter of 2015 primarily reflects higher interest expenses owing to our higher average stat balance partially offset by a lower tax rate. Our GAAP tax rate in Q1 was 33%, down from 39.9% in the year ago period. The higher rate in the prior year period primarily relates to the impact of foreign and state income taxes.

Turning to our non-GAAP financial measures, adjusted EBITDA for the first quarter of 2016 was $18.8 million, representing a 13.1% increase over $16.6 million in the first quarter of 2015. Our adjusted EBITDA, marginal list 21.7% in the first quarter, an increase over the prior year of first quarter adjusted EBITDA margin of 21.5%. The first quarter 2016 adjusted EBITDA margin was impacted by the timing of SG&A spending and the higher expenses associated with being a public company. Adjusted net income from continuing operations was $7.1 million for the first quarter of 2016, representing a 1.6% decrease compared to $7.3 million in the prior year period driven by the factors I previously mentioned.

Our adjusted diluted earnings per share from continue operations in the first quarter of 2016 was $0.13 per share, consistent with the prior year period after making a pro forma adjustment to our Q1 2015 shares outstanding for the issuance of $15 million shares in our IPO. Our adjusted EPS from continuing operations using actual weighted average diluted shares outstanding was $0.13 and $0.18 for the first quarter of 2016 and 2015 respectively. Our Q1 2015 adjusted EPS from continue operations exclude the impact of preferred stock dividend which I mentioned earlier.

Moving to some key cash flow and balance sheet items. Cash flow from operations for the first quarter was $16.8 million, up 32.2% with $12.7 million in the prior year. Capital expenditures in the first quarter were $3.8 million yielding free cash flow of $13 million, up from $7 million in the prior year. We ended the quarter with a cash balance of $26.9 million, while total debt outstanding was $309.5 million net of deferred financing and discount.

At March 31, 2016, our net debt leverage ratio was at 3.0 times compared with 3.2 times at the end of the fourth quarter of 2015. As of March 31, 2016, we had approximately $66.8 million of available liquidity comprised of $39.9 million undrawn revolver and $26.9 million of cash in the balance sheet. We continue to be committed to maintaining strong liquidity.

As you may have read future in our press release issued this afternoon, we announced today a quarterly dividend of $0.045 per share payable on July 7, 2016 for stockholders of record at close of business on June 16, 2016. Finally, we announced today that our board of directors has approved a stock repurchase plan that authorizes a $20 million repurchase of our common stock with the maximum of 2.8 million shares over the next 12 months. The share repurchase program reflects our confidence in long-term growth prospects and our financial flexibility.

Now turning to our guidance, as Steve discussed we are seeing a reduction in EMV card purchase activity across all large issuers and processors as they work through the higher-than-expected excess in inventory. In addition, we are seeing the vast majority of small and midsize issuers delaying



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their EMV purchases due to slower than anticipated EMV conversions at the processor level. And finally, the current softness in demand for new EMV products is driving greater than expected pricing pressure for those EMV card programs that are now being executed.

It is important to note that we are seeing chip input cost to counter the pricing impacts. While this balance offset the bottom line impact, the effect on net sales is meaningful. We currently believe the negative impacts of these factors will be highest in Q1 and Q2 and then sales improvement begins in Q4. The second quarter will primarily be negatively influenced by the 2015 inventory carryover issue and the third quarter will be principally influenced by the delay in timing of the small to mid-size issuer conversions. The net sales for the fourth quarter will be influenced by the ramp up of small issuer conversions and by declines in pricing for the large issuers.

Given our current visibility into the second quarter and the magnitude of our guidance reduction, we thought it would be prudent to provide you with the guidance range for the second quarter. Please note that we don't intend to provide quarterly guidance going forward. For the second quarter, we expect our EMV card shipments to be approximately 60% lower than our prior estimate, directly influenced by the impact of excess inventory in the market. When we combine the volume impact with some pricing pressure I just discussed, the negative impact on our second quarter net sales is estimated at approximately $38 million to $40 million. As a result, we currently expect to generate revenue in the second quarter in the range of $68 million to $72 million. This translates into adjusted EBITDA in the range of $12 million to $14 million and EPS in the range of $0.4 to $0.7.

For full year 2016, giving effect to the EMV card volume, pricing impacts and based on our best estimate given visibility we have in the market today, we currency expect net sales to be between $335 million and $355 million. This revision of guidance principally relates to the US Debit and Credit segment and specifically the card manufacturing, cards for the segment. The remaining segments including the personalization and service component of US Debit and Credit are largely unchanged from our original guidance range. The Prepaid Debit segment has some pricing pressure that we have contemplated within the new guidance range.

For full year 2016, we now expect to generate adjusted EBITDA between $75 million and $82 million. Our guidance range reflects the expenses associated with being a public in the range of $6 million. Finally, expect full year 2016 pro forma adjusted diluted earnings per share of $0.50 to $0.58.

With that, operator, please open the call for questions.

## QUESTIONS AND ANSWERS

**Operator**

Certainly. (Operator Instructions) Jim Schneider with Goldman Sachs.

**Jim Schneider** - *Goldman Sachs - Analyst*

Guys, I'm wondering if you can maybe start with the sequence of events that kind of happen since the last Q4 conference call and what are the factors that you started to hear from your issuing partners and what order do they come in and can you give us a sense of how these factors came to play out in terms of your awareness of them? And I have a follow-up please.

**Steve Montross** - *CPI Card Group Inc. - President, CEO*

So just going through the timeline, we saw a slowing of orders. As we got into late first quarter, we saw a slowdown in the orders and we started having more frequent discussions with the issuers about the slowdown in orders. And we had -- as you referenced, in our earnings call back in February, we had discussed this overstocking that took place in 2015, and so we were aware of that through discussions with the customers and we knew that that was going to slow the first quarter of the year.



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Then in late March, we started seeing a slowdown in orders and we knew that the overstocking had taken place and part of it was an assumption that we're seeing the impact because the -- from other shipments that we had thus far in the first quarter and orders were fairly strong. And as you know by the numbers, we shipped about 41 million EMV cards in the first quarter was sequentially up from the fourth quarter. So the activity level is still pretty good, but as things started to slow down, we assumed that part of it was this overstocking. We started having more frequent discussions with the issuers, and the issuers frankly were -- have been reluctant all along to really give the details in terms of what their -- what their own situation is. Part of it is competitive reasons. Also, part of it, it takes a while in those organizations for the information to really funnel down.

As we started having more discussions all through April with those issuers, the picture started to emerge that the overstocking in 2015 was far more significant than what we had been led to believe and what we understood by all of the information that we had gathered. And then over the last couple of weeks, as we started to get much harder information, i.e., with -- from the issuers directly as we had discussions, then we started to get then a much better sense of the inventory levels that they had, the pace of their issuance that they had, and therefore what that excess inventory position was. And so that's the timeline as things progressed.

With the small to mid-size issuer, we -- as you know, when we discussed this in the earnings call on the first quarter, we didn't expect that we were going to see a pick-up in the small to mid-size issuer market until the second half of the year, and so we were already looking at that being a second half of that, not a first half of that. But as we got into the first quarter and saw the pace of conversions, and what we were hearing was that there was a bottleneck at the price processor level for converting the small to mid-size issuers over to EMV. And then also as we started to look at the information from our own personalization and fulfillment operation where we're doing a lot of business with processors, we started to chart exactly how much of -- how many of those financial institutions with those core group of processors that we were working with, how many of those issuers had been converted over, and so we were looking at those percentages as well and looking at that progress.

And so after looking at all of that information, we came to the conclusion that the conversions to that small to mid-size issuer market were not happening as quickly as we expected, and also were not happening as quickly as what we were hearing from others as well including issuers that those conversions were happening as quickly as expected. And so we started to do more digging in terms of talking to other people and other market participants, and we started hearing similar things that there was a bottleneck of these conversions at the processors and that seems to be slowing things down, and which led up to the conclusion that the business and the ramp up that we expected we were going to see in the second half of the year is not going to be nearly as strong as what we had first expected and that there is going to be a portion of that business for the small and midsize issuer market that's going to be pushed into 2017 from 2016.

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**Jim Schneider** - *Goldman Sachs - Analyst*

Then if we come to pricing situation, can you maybe comment on what your revised guidance implies in terms of the pricing for EMV cards in both the small and larger issuer segments and maybe talk about what we should thinking about in terms of the growth margin impacts due to that pricing? Is there small impact which what you alluded to or could it be a bigger impact and how can we know that there is not further downside on the pricing side as we're heading back half of the year?

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**David Brush** - *CPI Card Group Inc. - CFO*

What I would tell is that it's in the range of $10 million to $12 million of pricing and it's substantially outweighed in the third and the fourth quarters. As we moved through the first quarter of pricing, really it's right in line with what we expected. And as we looked at much smaller volumes, we look at the pricing for the second quarter again, it's right in line with what we expected as begin the year.

I think when you look at the third and the fourth quarter expectations, we're predicting a little bit forward about where we see pricing just giving current market activity. The current market activity is obviously being driven by people searching for volume at much lower levels. But as we predicted forward, it's really all around the large issuer segment. We haven't seen any real pricing pressure at all in that small and midsize issuer segment. So I guess to specifically address the magnitude of the pricing in and around the large issuer segment, when we put together our original guidance, we were in the $0.87 range for that part of the market.



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I think as we predict forward for the -- what we could see in the latter half of the year, it's $0.15 to $0.20 reduction off of that. I think at the same time, we have -- already have discussions with chip suppliers on the -- on the chips, they go into those cards and those levels already have commitments on lower chip pricing that would maintain our margins even at those levels. So I think what I can tell you, as we stood here today, is our projection to the fourth quarter too conservative. One and two is a permanent decline in pricing or is it a more temporary situation just based on the current volume that's available into the marketplace.

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**Jim Schneider** - *Goldman Sachs - Analyst*

So then finally, just to be clear, are you saying that you don't anticipate gross margins to be down by the end of the year relative to where they are now?

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**David Brush** - *CPI Card Group Inc. - CFO*

What I would say, Jim, is that the second and third quarters, the gross margins are going to be down off of where we would historically predict then, but that's more driven by volume and absorption at the margin level. We have adjusted indirect labor and the things that are variable that we can control. But I think margins in the second and third quarter will be impacted by just the low volumes on the same overheard.

As we move into the fourth quarter, based on our current projection of volumes and our current discussions on pricing and chip pricing, we would expect to see our gross margins back in that 36% to 37% range.

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**Operator**

Bob Napoli with William Blair.

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**Bob Napoli** - *William Blair & Company - Analyst*

I guess what is your buyback you have out there? How aggressive will you be with the buyback, share buyback?

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**David Brush** - *CPI Card Group Inc. - CFO*

I think first of all, as the share prices, where they're at, it's below that. Doing the share repurchase will be an accretive transaction for the Company. We also believe that in the spirit of shareholder return, it's a good measure to have it out there. What I would tell though is as we look at the 20 million and 2.8 million shares, we're going to be measured in terms of how we spend that. I think we'll we measured partly in terms of not just being very aggressive on the front end, then secondarily, just measured from a liquidity perspective as we move through the year to make sure that we're in line with our current expectations and that we don't spend well ahead of it.

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**Bob Napoli** - *William Blair & Company - Analyst*

And then just on dual interface, I guess we've heard some rumblings that some larger banks are looking at launching dual interface in the US, I mean, though nothing definitive on that from what we've heard. But I mean, are you hearing -- what are you hearing in the market with regard to dual interface at this point?

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

I'd say there is a range of views. There is one major issuer that as I mentioned that we're in a process of delivering on a pilot for right now, and then there is another major issuer that has taken the view that they are going to wait and see, and then there is a lot of activity in between. I can say



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that almost without exceptions, everybody is putting dual interface products on their roadmap and they are going through the process of getting those products qualify, so they are ready.

And while there is no one that has announced a major program, that being said, there are some issuers right now in the US market that are issuing dual interface and so we have that activity, but that number of issuers is limited. No other major issuers have a dual interface program or coming out with one. But there are some issuers right now, including one major issuer that is issuing dual interface cards. And so, there is activity, Bob, and increasing interest I would say based upon our work around the products and qualifying products. There seems to be much more interest in dual interface and starting that whole process of being prepared for dual interface issuance sometime in the near future.

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**Bob Napoli** - *William Blair & Company - Analyst*

And then do you have any dual interface in your guidance or how much do you have in your guidance?

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**David Brush** - *CPI Card Group Inc. - CFO*

We have a little bit, Bob, but I wouldn't categorize it as meaningful. Think about it in -

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

It's really very small. It's not -- as Dave said, it's not meaningful, Bob. So I'd say, put it this way, we're not counting on dual interface in 2016 at all. We're doing all the missionary work so to speak around that and working with the customers, but we're not counting on dual interface to any meaningful extent.

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**Bob Napoli** - *William Blair & Company - Analyst*

What is the pricing on dual-interface cards today?

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Pricing is in the - it's around $2 a unit.

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**Bob Napoli** - *William Blair & Company - Analyst*

I mean, how confident are you that you have not lost market share that this is -- there are challenges, a market challenge?

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Yes. We're pretty confident we haven't lost market shares because we've been tracking very closely the sales that have taken place, what issuers are preparing, and through those discussions, we've got a good sense of what the market is in the first quarter for instance, and we believe there our market share was close to 40% in the first quarter. Now, we're not projecting that through the whole year at all, but we're looking very, very closely at the procurement by the issuers and tracking that very closely. So we feel comfortable that this isn't -- suddenly, this revision is a big share loss by us at all.

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**Operator**

Wayne Johnson with Raymond James.

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**Wayne Johnson** - *Raymond James & Associates, Inc. - Analyst*

So if we could just summarize here again, so three challenges, inventory, SMB pricing pressure, how would you weigh that again? Let's say that revenues are essentially coming down by $100 million in this year 2016, so if I have to assign a dollar value to each one or a percentage to each one, could you just hit that one more time for me please?

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**David Brush** - *CPI Card Group Inc. - CFO*

I think the number I quoted on pricing to Jim was in the 10 to 12 range. And then the issue on the large issuer or the inventory carryover and the delay in the small issuer is about 50-50, equally divided from the dollar perspective. From the unit perspective, obviously the small issuer delay at higher pricing and a little bit larger on the volume on the inventory delay off a bit smaller pricing.

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**Wayne Johnson** - *Raymond James & Associates, Inc. - Analyst*

Could you talk at all about what else you're seeing in the prepaid market over and above general purpose cards?

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Yes. A couple of things we're seeing in the prepaid market. One is we're seeing a lot of growth in what we call the enterprise prepaid or we talked -- I talked about it earlier as the B2B and B2C segments of prepaid, and so that's rewards and incentives. It's also in healthcare for instance and so if these are in payroll, it would be another area. So we're seeing strong growth in those areas. And it's a more specialized or customized offering that's really demanded by the participants, but there's very strong growth there which is why we're investing to our ticket to make sure that we have the capabilities to really serve those markets, and so we're seeing excellent opportunity in those segments of prepaid.

In terms of retail prepaid, we see still strength in GPR, gift as you know is seasonal, but we're seeing still good strength in GPR. Also what we've seen is a real concern by the program managers around fraud in the retail channel, and so there is a lot more focus on the secure package in itself and how that can help them to combat fraud in the retail channel. But there is big concern and a big increase in the prepaid or fraud with prepaid cards. And so the program managers are concerned about that and they are taking steps to address that.

Also, we've been having conversations or discussions with the prepaid program managers about chip cards for the reloadable cards and we're continuing to work with them on that. I think you probably know we're already doing chip cards for prepaid cards up in Canada and we're actually doing some dual interface cards -- prepaid cards up in Canada one program manager. So we've already seen chip cards emerged in the prepaid space up in Canada. And again, we're working with several program managers around qualifying a chip product for their reloadable products.

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**Operator**

Paulo Ribeiro with BMO Capital Market.

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**Paulo Ribeiro** - *BMO Capital Markets - Analyst*

I have a couple of questions. The first is very straight forward. In your EPS guidance for revised EPS guidance for the year, do you include any of the buyback situations for your EPS?



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**David Brush** - *CPI Card Group Inc. - CFO*

No. Sorry, Paulo. I know you have some problems getting the press release. But we've laid out the guidance on schedule up and just noted at the bottom of the revised guidance, it does not reflect the accretion impact of the share repurchase.

**Paulo Ribeiro** - *BMO Capital Markets - Analyst*

Second question is in terms of what Steve said in the US dividend credit that you expect this impact from lower EMV volumes in products but not in service, did I get it right? And if I did, does it mean that you are personalizing a higher share of the existing cards, yeah, just trying to -- you producing or shipping less cards, but your service are not impacted, so just trying to understand that better.

**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Yes, we are seeing the decline or the decrease in card manufacturing, the purchases or the demand in card manufacturing and we are seeing the increase in our personalization and fulfillment business. And like we were talking about earlier with the issuers, I'm sorry, the processors in the earnings call, we're talking about the EMV tailwind and we see increasing activity, well, we're seeing the same kind of increasing activity with our personalization and fulfillment operation around EMV. And that's also helping increase the results for our personalization and fulfillment business.

We had really strong results in the first quarter year-over-year. But just to give you a sense, in the first quarter of 2015, we personalized -- of all the cards we personalized and fulfillment in the first quarter, less than 1% was EMV. And in the first quarter of 2016, approximately 52% of the cards that we personalized were EMV. So we've seen a big increase in EMV activity around the issuance if you will, but in our personalization and fulfillment business, so in services.

**Paulo Ribeiro** - *BMO Capital Markets - Analyst*

I see. So just a quick -- try to follow up that logic, so coming to 2017 and I know you are not giving guidance for that. But you're setting the stage for one, if the timing issue for -- especially for the small issuers, are they pushing this to 2017? And then personalization, it does keep -- it seems sustainable that increased degree of personalization --percentage of personalization, you set up 2017 to be stronger than you initially expected in US Debit and Credit? Hello?

**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Yes. Yes, we would. But we absolutely -- with that -- with that small midsize issuer business pushing out, we would expect that we'll have a positive impact on 2017 for us.

**Operator**

Eric Ciura with Baird.

**Eric Ciura** - *Robert W. Baird & Company, Inc. - Analyst*

Just on the personalization. You guys called a pricing pressure from the large issuers on the manufacturing side, have you seen any pricing pressure on personalization, and then do you expect to see any in the latter half of the year?



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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

No. In the personalization business, no, we haven't seen any pricing pressur4e and we wouldn't expect to see any. The personalization business that we have is heavily weighted to the small and midsize issuer and, as Dave was mentioning, even on the manufacturing side, we haven't pricing pressure in the small to mid-size issuer segment. It's been really in the large issuer segment as where we've seen the pricing pressure and where we expect to see it in the second half of the year. But we don't expect to see pricing pressure in the personalization business.

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**Eric Ciura** - *Robert W. Baird & Company, Inc. - Analyst*

Okay. And then secondly, on potential M&A opportunities, you mentioned that during the call, I guess what types of things are you guys still looking for and how big could they potentially be given you're using seriously free cash flow for potential buybacks and the dividend?

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Yes. The things that we would be looking for are -- we would really be looking to complement our services to build -- to continue to build out our service offering. And so that's -- that would be number one priority, it's something that will strengthen -- obviously strengthen our offering for our customers. If we also get into a new niche for it, that would be very attractive, but the focus has been services. We've got -- we believe we've got excellent manufacturing capacity, and therefore really looking at the service side of things and how we can continue to really build out and strengthen the service side of the business. So that would be the number one priority for us.

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**Operator**

And at this time, I'm showing no further questions or comments. So with that said, I would now like to turn the conference back over to President and CEO, Mr. Steve Montross for closing remarks.

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**Steve Montross** - *CPI Card Group Inc. - President, CEO*

Well, thank you everyone for your participation in the earnings call today. And we know that we're going to have follow-up discussion with a number of you over the next few days and we look forward to those discussions, and we also look forward to communicating with you next quarter in our earnings call. Thanks for participating. Have a good rest of the day.

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**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may now disconnect. Everyone, enjoy the rest of your day.

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