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PMTS - Q2 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's second quarter 2016 conference call.

(Operator Instructions)

As a reminder, this conference is being recorded.

I would now like to introduce your host for today's conference, William Maina. Sir, you may begin.

William Maina - *CPI Card Group, Inc. - IR*

Thank you, Operator, and good afternoon, everyone. Welcome to the CPI Card Group's second 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.

The earnings press release is posted on CPI's website. Please review the information along with our filings with the SEC and on SEDAR for a 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 to 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, adjust EBITDA on margin, adjusted net income from continuing operations, adjusted diluted earnings per share from continuing operations, free cash flow and constant currency. Please see the earnings release on the CPI's web site for all disclosures required by the SEC including reconciliations to the most comparable GAAP numbers.

Now I'd like to turn the call over to Steve Montross, President and Chief Executive Officer.

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

Thanks, Will, and thank you, everyone, for joining us today on our second quarter 2016 earnings conference call. Before beginning my discussion of our second quarter results, I want to address our announcement today that Dave Brush will be stepping down as CFO at the end of this year.

After a successful career spanning more than 25 years, Dave decided it's time to spend more time with his family. Dave has been a strong partner during this time with us, and his contributions to CPI have been very valuable. Especially the leadership during our IPO process last year. On behalf of the entire CPI family and the Board of Directors, I wish Dave the very best. I'm happy to say that Dave will stay engaged with CPI after he officially steps down on December 31 and make himself available as a consultant to help with the transition of his responsibilities through June 30, 2017. We will begin immediately the search for a permanent CFO and will update the market as soon as we have something further to announce.

Now onto the second quarter. The second quarter played out right along the lines that we discussed in our prior earnings call. The market experienced a meaningful drop in EMV card demand due to the inventory overstocking by the large issuers and processors. And while EMV activity was increasing with the small to mid-sized issuers, the EMV conversion delays at the processor level caused delays and dampened the growth in the EMV conversions and issuances by these small to mid-sized issuers.

As we anticipated and foreshadowed in our prior earnings call, our second quarter results reflect these temporary, unfavorable industry-wide factors. I am pleased, though, with the consistent, strong execution and the focus on service excellence by the entire CPI team as we work through this challenging operating environment. I want to thank everyone at CPI for their continued dedication to our customers and our company. I believe CPI is in a strong position to both deal successfully with the recent market factors and continue expanding our leadership position in the financial payment card production and services market for years to come.

Here are some highlights from the second quarter. Net sales were $73.7 million, which was above our guidance range of $68 million to $72 million, primarily due to slightly higher than expected EMV chip card production volumes and strong growth in our value-added service offerings, where we saw a 21.1%, or a $5.9 million increase year-over-year.

On a GAAP basis, the net loss from continuing operations was $328,000 or $0.01 per share in the second quarter of 2016, compared with net income from continuing operations of $12.2 million and a loss of $0.02 per share after preferred dividends in the second quarter of 2015. Adjust EBITDA was $12 million compared to $25.3 million in the prior period, which was within our guidance range. And adjusted net income from continuing operations was $2.6 million or $0.05 a share, which was within our guidance range.

And cash provided by operating activities was $16.4 million during the quarter and free cash flow was $13.2 million. Our continued solid free cash flow generation enabled us to return $8.6 million to stockholders in the form of dividends and share buybacks during the second quarter.

Now, I'll turn to a review of our segments as well as a discussion of current market conditions. Net sales on our US debit and credit business were down 30.7% year-over-year to $50.8 million in the second quarter. Our results reflect the anticipated decline in EMV chip card sales in the quarter, due primarily to reduce purchase activity by large issuers and processors, as they work through overstocked inventories of EMV cards.

In the second quarter, our shipments of EMV chip cards were down 54.9% versus the prior year period, to 22.5 million units. On a positive note, as I mentioned earlier, our EMV card volumes were modestly above our expectations in the second quarter. Since we last spoke in May, we have continued to intensify our efforts to obtain more data from our large issuer and processor customers regarding their current EMV card inventories, as well as their expected purchase activity for the rest of 2016.

What we have learned from these efforts confirms much of what we communicated to you on our first quarter earnings call. Our large issuers and processors are currently working through their excess EMV card inventory positions filled up last year, causing a temporary reduction in demand for new card production. At the same time, however, EMV card issuance by financial institutions continues to progress with an estimated 59% of total branded debit and credit cards in the market converted to EMV cards at the end of the second quarter compared to an estimated 52% at the end of the first quarter of 2016.

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I'd add that while we have engaged in better dialogue with the large issuers and we are getting better information regarding their inventories, the visibility and lead time on orders still remain shorter than the historical norms and less than what we would like. With the small to mid-sized issuers, our results were largely as expected in the quarter. We are seeing increased initial EMV adoptions by the small to mid-sized issuers, while delays in the conversions at the processor level that we highlighted last quarter will still push out EMV conversions into 2017 and beyond.

The longer-term growth opportunity for CPI, driven by the ongoing conversion of magnetic stripe cards to EMV chip cards, is unchanged. Based on our analysis and recent market data, including announcements by the major card brands on the percentage of their branding cards in circulation that are EMV, we estimate that only about 33% of debit cards and 65% of credit cards in the US were converted to EMV at the end of the second quarter of 2016, which was up from an estimate of approximately 28% and 58%, respectively, at the end of the first quarter. Given this level of penetration, there still remains growth opportunity in 2016 and beyond from the continued market conversion to EMV.

From a pricing perspective, average selling prices on EMV cards in the US were in line with our expectations for the second quarter, remaining even with the first quarter of 2016 at $0.94 per card. We continue to anticipate ongoing pressure on EMV card prices with the large issuers through the remainder of 2016, as we discussed in our prior call. We expect the pricing pressure we are seeing with the large issuers will be offset somewhat by the growth in EMV volumes with the small and mid-sized issuers as we experienced in the second quarter.

As the EMV volumes in the small and mid-sized issuer space increase as a percentage of our overall EMV card sales, the overall average selling price, we realize, were EMV cards, will benefit correspondingly. As we look at the remainder of the year, we expect to see margins improving as we exit 2016, helped by a combination of increased EMV card sales volumes, expected reductions in our chip cost, and recent cost savings initiatives which Dave will discuss later.

With respect to dual interface or contactless EMV cards, we continue to believe that this product will become a meaningful part of the market. We continue to have discussions with issuers about dual interface cards, and are supplying a small number of dual interface cards to a handful of US issuers.

While the overall customer demand for dual interface cards remains relatively low at this point, we are encouraged by the increased discussions around adoption, activity by issuers and setting up dual interface product roadmaps, request by issuers for dual interface card pricing in many of the recent request for proposal, and also the growing acceptance networks for contactless payments at the retail terminal level. Additionally, as the card portfolios for bank customers first converted to EMV in 2014 and 2015, now come up for reissuance beginning next year and foreseen over the next couple of years, dual interface cards will be a relevant reissuance option for those issuers. Given the overall market dialogue and initial issuances, we continue to believe that dual interface EMV cards will be an exciting and meaningful opportunity of the US markets in 2017 and beyond.

Turning to our US prepaid debit business, segment revenue decreased 3.2% year-over-year to $12 million. The slight decline in year-over-year net sales reflects isolated reductions in volumes with certain customers, offsetting growth with other prepaid customers. As I mentioned last quarter, we are investing in a highly customizable product offering which enables prepaid program managers to go to market quickly with unique, personalized 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, which are all high growth areas of the prepaid debit market.

Our new capacity will come online in the third quarter of 2016 and the initial discussions with customers for this newly installed capability and capacity are positive. The qualification and conversion faced by these customers will take some time and I expect to see revenue impacts beginning in 2017.

Regarding our value-added services, we continue to be very pleased with our performance in these business lines. Our services revenue increased approximately $5.9 million or 21.1% year-over-year in the second quarter to $33.6 million, driven by strong demand for our personalization and fulfillment services. As we discussed with you last quarter, we continue to benefit from the ongoing industry migration to EMV, with approximately 52% of our debit and credit personalization and fulfillment volumes consisting of EMV work in the second quarter of 2016, compared to only 2% in the prior year period.

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We ended the second quarter with 4,775 instant issuance or card at once installations versus 4,230 installations at the end of the first quarter of 2016. We continue to view our instant issuance products and services as a strong growth area.

In summary, the market dynamics that caused use to reduce in May our 2016 guidance are playing out along the lines that we had discussed. While we saw some positive signs in EMV card orders late in the second quarter, the visibility into the market is still not where it has been historically with the lead times for orders and customers still relatively short. Some carryover excess inventories remain in the system among the large issuers and processors and must be consumed before more regular order patterns return.

On the small to midsized issuer front, we are seeing increased EMV conversions in card volumes, which are reflected in both our card and services businesses. So, this part of the market continues to experience delays in the EMV conversions at the processors as we discussed in the previous quarter, which will push EMV conversions into 2017 and beyond.

On the pricing front, we continue to see pressure with the large issuers, consistent with our expectations. With the increasing EMV volumes with the small to midsized issuers, our average selling prices held constant in the second quarter from the first quarter and we expect this missed improvement will help mitigate pricing pressures with the large issuers.

I would sum up our view of the market right now as consistent with how we described it to you in May -- order patterns not yet back to historical levels and predictability less than we would like. Overall, we believe the near-term unfavorable market factors will be offset eventually by the strong industry dynamics of the financial payment card market.

As we left the second quarter, there are still approximately 41% of branded US credit and debit cards remaining to be converted to EMV. There is increasing demand for prepaid debit cards in new vertical markets that we are positioned to take advantage of and the value-added service segments of our business are growing nicely. Our balance sheet and liquidity remains solid, generating $13.2 million of free cash flow in the quarter and returning $8.6 million to shareholders through dividends and share repurchases.

I'll now turn the call over to Dave.

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

Thank you, and good afternoon, everyone. First, I wanted to say that I have been -- enjoyed the last year and a half working with Steve and the entire CPI team as we've gotten a lot of things accomplished. Further, as Steve mentioned, I will continue my role as CFO through December 31, 2016 when I will officially step down. I will then serve as a consultant through June 30, 2017 to help with the transition of my responsibilities.

Now, I will begin by summarizing the results of our second quarter 2016. I will then provide our guidance for full-year '16 before opening the call for questions.

Second quarter net sales were $73.7 million, down 22.8% from $95.5 million in the second quarter of 2015. Our net sales primarily reflect a 54.9% year-over-year decrease in the number of EMV chip cards sold this quarter partially offset by continued demand for our customers for value-added services.

Product net revenue decreased 40.8% year-over-year to $40.1 million in the second quarter while services net revenues grew 21.1% year-over-year to $33.6 million in the second quarter. When you remove the approximately $1 million of revenue related to the closed Petersfield facility, services net revenue actually increased by 25.7% in the second quarter of 2016.

Now, turning to a review of our segments. US debit and credit segment net sales were $50.8 million for the second quarter, a 30.7% decrease over the prior-year period. Segment income from operations was $9.2 million representing a 58.6% decrease and segment EBITDA was $11.4 million, a 52.5% decrease.

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As we discussed, the decline in revenue, operating income and EBITDA were predominantly driven by the year-over-year decrease in EMV card shipments. Average selling prices were in line with our expectations during the second quarter, and on a weighted average basis, stayed flat with the first quarter of 2016 at $0.94. In our card personalization and fulfillment business, we had a $5.7 million year-over-year increase in net sales during the second quarter, which partially offset the decline in product net sales.

US prepaid debit segment net sales were $12 million in the second quarter, down 3.2% year-over-year. Segment income from operations was $3 million, a decrease of 7.2% and segment EBITDA decreased 5.8% year-over-year to $3.6 million. The year-over-year decline of US prepaid debit segment net sales primarily reflect isolated reductions in volume with certain customers offset by growth with our other prepaid customers.

Finally, UK, limited segment net sales were $8 million in the second quarter representing 4% growth from the prior-year period. Segment income from operations was $600,000, representing a 16.3% increase and EBITDA was $700,000 consistent with the prior-year period. Our UK limited segment results were impacted by unfavorable foreign currency exchange rate fluctuations, and on a constant currency basis, sales for the second quarter were up 11.2% over the prior-year period.

Moving down the income statement, gross profit for the second quarter decreased 36.6% to $22.7 million, representing a gross margin of 30.8% compared with gross profit of $35.8 million and a gross margin of 37.5% in Q2 2015. Our gross profit margin this quarter primarily reflects the impact of lower EMV chip card sales volumes and related overhead cost absorptions, and to a lesser extent, some other low-margin work delivered in the quarter. We believe that our gross margins will improve as card shipments return to more normal purchasing patterns.

Income from operations in the second quarter was $4.5 million compared with $19.7 million in the prior-year period. The change in income from operations reflects the aforementioned decline in our net sales and impact of absorption of overhead costs. We have taken a number of actions over the past three months aimed at reducing our cost with a focus on direct manufacturing cost, indirect labor, third-party services and administrative headcount reductions. While the impact of these cost reductions program was minimal in second quarter, we expect them to result in approximately $2 million of cost savings in the second half of 2016 and approximately $6 million on an annualized basis going forward.

I would point out that not all of the cost savings from these programs will fall dollar-for-dollar to the bottom line, however, particularly as it relates to direct manufacturing costs. We continue to evaluate further opportunity for cost reductions while balancing investment in supporting our core business and funding growth initiatives aimed at accelerating market expansion. In addition, during the second quarter, we incurred approximately $1.9 million of litigation and related charges associated with the Gemalto patent litigation, which appears in our SG&A expense line.

The amount of these fees related to the litigation was unusually high in the second quarter, primarily driven by the legal costs associated with a challenge to the patentability of the asserted claims. The challenge was filed with the US Patent Trial and Appeal Board on May 31, 2016. On July 11, 2016, the US District Court granted our motion to stay the litigation in the matter pending the outcome of the patent trial towards review. Accordingly, we would expect the litigation costs related to this claim to be minimal in the second half of 2016.

On May 25, 2016, we also filed the motion to dismiss a second claim filed by Gemalto, asserting that the patent claims are not patentable. A motion to stay the litigation has also been filed but is not yet decided. As we have stated in prior quarters, we believe that Gemalto claims are without merit and we will continue to vigorously defend the suits.

We reported a net loss from continuing operations of $328,000 or $0.01 per share in the second quarter of 2016 compared with net income from continuing operations of $12.2 million and a loss of $0.02 per share after preferred stock dividends in the second quarter of 2015. As a reminder, we redeemed all of our Series A preferred stock with our IPO in October of last year, so preferred dividend had no impact to our second quarter 2016 EPS. We recorded a tax benefit of 161,000 in the second quarter, reflecting a tax rate of 32.9% compared to tax expense of $6 million in the prior year reflecting a tax rate of 33.1%.

Turning to our non-GAAP financial measures. Adjusted EBITDA for the second quarter of 2016 was $12 million, compared with $25.3 million in the second quarter of 2015. Adjusted EBITDA margin was 16.3% in the second quarter versus 26.5% in the second quarter of 2015. As I discussed previously, our adjusted EBITDA margin was also impacted by lower EMV chip card sales volume and the corresponding impact on absorption of

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overhead costs. The increased expenses associated with being a public company in 2016 also had an impact on the year-over-year quarterly comparison.

Looking to the second half of this year, we would expect our adjusted EBITDA margin to improve, driven by the expected increase in EMV chip card sales, expected decreases in the cost of chips, as well as the cost reduction programs I discussed earlier.

Adjusted net income from continuing operations was $2.6 million for the second quarter of 2016 compared with $13.9 million in the prior-year period. Adjusted diluted earnings per share from continuing operations in the second quarter of 2016 were $0.05 per share versus $0.25 in the prior-year period after making a pro-forma adjustment to our Q2 2015 shares outstanding for the issuance of 15 million shares during the IPO. Our adjusted EPS from continuing operations using actual weighted average diluted shares outstanding was $0.05 and $0.34 for the second quarter of 2016 and 2015, respectively. Our second quarter 2015 adjusted EPS from continuing operations excludes the impact of preferred stock dividends.

Moving to some key cash flow and balance sheet items. Cash flow from operations for the second quarter was $16.4 million compared with $6.2 million in the prior year, with the year-over-year increase primarily reflecting changes in working capital partially offset by lower net income.

Capital expenditures in the quarter were $3.2 million, yielding free cash flow of $13.2 million. We ended the quarter with a cash balance of $31.5 million and a net debt balance of $290 million. The total debt principal outstanding was $321.5 million, and with the netting of the deferred financing costs and discounts, the recorded debt balance was $310 million.

At June 30, 2016, our net debt leverage ratio was at 3.4 times compared with 3.0 times at the end of first quarter of 2016. As of June 30, 2016, we had approximately $71.4 million of available liquidity comprised of $39.9 million undrawn revolver and $31.5 million of cash on the balance sheet. We will continue to be committed to maintaining strong liquidity. In our press release issued this afternoon, we also announced that our Board of Directors approved a dividend of $0.045 payable on October 7, 2016 to stockholders of record at the close of business on September 16, 2016.

In addition, we repurchased approximately 1.4 million shares of our common stock or about $6 million in the second quarter, which equates to an average repurchase price of $4.17 per share. As of June 30, 2016, we had approximately 1.4 million shares remaining under our current share buyback authorization.

Now, turning to our guidance, while we were pleased to see EMV orders nominally above our expectations and continued strong demand for our value-added solutions in Q2, the market environment continues to be challenging marked by reduced EMV card purchase activity across the large issuer customers, delayed EMV purchases from small and midsized issuer customers and increased pricing pressures. These factors remain unchanged from the prior earnings call.

For 2016, we expect net sales between $335 and $345 million. We expect to generate adjusted EBITDA between $75 and $78 million, and we expect full-year 2016 adjusted diluted earnings per share of $0.50 to $0.53 per share. We have tightened up our range of 2016 guidance given in May.

As you all know, we have adjusted down the top end of the range based on the continued slowness in shortened order patterns in the large issuer custom space, which still reflect some inventory in the system that is reducing orders from the producers. The upper end of our May guidance range had anticipated a stronger recovery in the buying patterns late in Q3 and into Q4 of 2016. In the small to mid-size issuer space, we are seeing the push-out of initial EMV conversions in '17 and beyond, consistent with our previous guidance. Likewise, the pricing scenarios that we articulated on the last call were generally playing out with the declines in the large issuer space during the second half of '16 materializing and the build in small to mid-size issuer EMV volumes partially offsetting those declines.

With respect to adjusted EBITDA, the lower planned volumes are having a drag on margins, resulting from lower absorption of fixed plant costs. We expect the cost reduction initiatives we have put in place will help offset some of these issues in 2016, but not fully.

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

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jim Schneider with Goldman Sachs.

Jim Schneider - *Goldman Sachs - Analyst*

I guess it was helpful commentary to hear kind of what's changed from May versus today. Is that fully 100% in terms of the guidance, the lower end of the range, the result of the large issuer push-outs? Can you give us a sense for how many months of inventory you think remain at the large issuers, and do you think -- do you have confidence now that that inventory situation is going to be fully normalized, exiting the calendar year?

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

Yes. Jim, what we're seeing right now and it varies by issuer, but generally the large issuers still have inventories in the 6 to 9-month range, and in our discussions with the large issuers, they want to get those inventories down more in the 3 to 6-month range. And so, in general, what we're -- the information we're getting from the large issuers is, there is still about three months of excess inventory or so on average that they're sitting on.

And so, they want to burn through that inventory before they get to what we would expect to be more normal buying patterns. And so, what we're expecting is that by the beginning of 2017, they will have burned through that excess inventory and start reverting to more normal buying patterns.

Jim Schneider - *Goldman Sachs - Analyst*

And then maybe, just as a follow up. One bright spot in the quarter was the services business up above 20%, I think you said it was. Can you give us a sense of like, whether that was any different from what you had planned last quarter, and whether that level of growth is sustainable in services going forward and over the next few?

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

Yes. No, we think it is sustainable, it's reflective of a couple of things. One, our personalization fulfillment business is really performing well. We continue to see growth in that business, just in volumes, but also the uplift from EMV conversions is impacting that business as well, having a positive impact on it. So we're seeing that, so both growth in volumes and then the uplift from EMV and then also we continue to see strong results from instant issuance in those services. And so, overall, we feel really good about our service offering and where it's headed. So, we believe it is sustainable, Jim.

Operator

Bob Napoli with William Blair.

Robert Napoli - *William Blair - Analyst*

Historically, Steve, you guys get a ramp-up in the prepaid business going into holidays, the third quarter in the last couple of years has been a big ramp. In order to hit your guidance, you need to have -- I think, you need to have average revenue in the back half of the year at around the $90 million per quarter level. And in order to get there, I think you need to have ramp probably in prepaid, as -- are you going to get that ramp that you've had, and how confident are you in being able to get that ramp and increase the average revenue in the back half versus the front half?

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

Yes. We are confident that our prepaid business is going to be stronger in the second half than the first half. And we also believe that our prepaid business is going to be up year-over-year, Bob, but we're confident that our prepaid business, we are going to get a ramp and it's going to be stronger in the second half than the first half.

Robert Napoli - *William Blair - Analyst*

I'm sorry, you said you are confident it will be up year-over-year in the back half?

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

Yes. In the second half, we believe it's going to be up year-over-year and also, we're confident it's going to be up in the second half versus the first half.

Robert Napoli - *William Blair - Analyst*

Just something that's been out in the market the last week or so, fraud on chip cards has -- the fraudsters are finding ways to trick the chip cards into being -- not being able to be used and they can still get data off the magnetic stripe, are you -- is that -- are you getting a feedback in the market on that issue and -- I mean, how well are you aware of that?

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

No, we haven't been getting any feedback on that issue in terms of some tricking of the chips. So, I don't have anything to share in that regard, Bob. The one area that we continue to hear a lot about fraud is, well, a couple of different areas. One area is just for the people that haven't -- for the merchants that haven't converted over, their chargeback, the chargebacks in the market have just skyrocketed, and so that's ongoing and while there continues to be a lot of focus on making these conversions happening and get to chip-on-chip transactions.

And then the other area of fraud is just with prepaid cards, that the fraudsters continue to attack prepaid cards, and because they are magnetic stripe and so we've seen increased desire to really look at what are some fraud prevention measures, including continued focus on tamper-evident packaging, and that's -- the fraud issues are particularly queued up in Canada with prepaid.

So, those are the two areas that we continue to have a lot of discussion about but haven't heard anything or haven't had any discussion around tricking the chip and seeing fraud as a result of that.

Robert Napoli - *William Blair - Analyst*

And last question, the services business. As you look into 2017 and '18, do you expect that to continue to be a double digit top line growth business?

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

We do, yes, we do.

Robert Napoli - *William Blair - Analyst*

And what parts of that business are you most confident in that services business?

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

I would say around personalization fulfillment, we expect that we're going to continue to see strong growth there and then also with our instant issuance business, that continues to grow well. So, we expect that we'll see good growth there. And then in the prepaid segment, as we moved into -- we talked about the new -- basically new offerings to really attack and go after and take advantage of the high-growth areas of prepaid, those niches of prepaid where we have a new offering to take advantage of those areas, we expect that we're going to see really good traction there, based on the discussions with our customers

And most of the people right now that we're engaged with are existing customers, we are expanding that with some new customers that we're talking to on our new offering, but a lot of it is our existing customer base and we think that we're going to see really good growth from that as well.

Operator

Stephanie Price with CIBC.

Stephanie Price - *CIBC World Markets - Analyst*

You mentioned visibility still isn't where you would like. Can you talk about your comforts on the full-year guidance and looking out into 2017?

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

Yes. So, the visibility is not as much as we would like, and I think we've got a better handle overall on inventory levels. I think where we are still lacking the visibility is the order cycle is still very short. And so, we're not getting forecast, for instance, out over the next six months. And so, those order cycles are short, although we have better information about inventory levels, it's still short cycles and so don't have as much specificity to the future as we'd like, and so that goes to our comments around not having as much visibility as what we'd really like. We feel good about the guidance that we gave in terms of where we are and where we see things developing.

As Dave mentioned, we tightened up the top end of the range because we just weren't seeing the large issuers coming back above really the expectations that we had that we set in the second quarter when we reestablished our guidance; we weren't seeing them or don't anticipate that they were going to come back at levels above kind of those prior expectations that would get us up to the upper end of the previous guidance range. And so we've tightened the guidance ranges as Dave talked about. But overall, we feel good about where the estimates are, that are out there in terms of the business. And so, hopefully, that is responsive to what you're looking for.

Stephanie Price - *CIBC World Markets - Analyst*

And then, can you talk about share buybacks as well? Sounds like you did a bit in the quarter and what's your thinking on share buybacks at this point?

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

I think what we did in the second quarter is we took advantage of the ability to buy a couple of blocks and really liked the pricing where we were able to buy CPI's stock at the average of $4.17. I think that being said, we have 1.4 million shares left to buy over the, I guess, the authorization is for the next year, and I would expect this to continue to use the program to buy CPI stock at the levels that it trades at today.

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Operator

Paulo Ribeiro with BMO.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

My first question is about the pace of sales for the rest of the year and then piggybacking on Bob's question about the uptick that you got in prepaid and typically in the third quarter. So, you say it's about $90 million on average for revenue per quarter for the next to meet your guidance, but that's not what's going to happen, right? Do you think that third quarter is stronger than the quarter or vice versa?

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

What I would tell you is that the third quarter will be driven by the normal seasonal build in prepaid that we've described to you and I think, this year, when you put the third quarter against the first and the second quarter, it will be even a more dramatic build when you compare it against those, but likely in line with where we have seen it historically as a percent of the overall year.

What, I think, then, tenders that a little bit in the third quarter is the softness of the EMV markets and so, I think if you use sort of Bob's on average $90 million, I would suggest that the third quarter probably is a bit below the $90 million level.

And then you get the recovery of the EMV card volumes starting to begin in the fourth quarter, which helps that piece of the revenue and I do think as Steve mentioned, I think we would expect to see a nice third quarter, nice fourth quarter also in the prepaid business as we begin to bring on some of this new volume, coupled with just other programs that we have line of sight to with existing customers.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

And there's prepaid, so this is a new revenue stream, new product, but the investments you made and you highlighted some -- are already in place, is that correct? So, this is on top of service [already provides] not substitutes to what -- on upgrades to what you provide, right?

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

No, we really like it, because as you know, we've been the dominant provider in what we would call retail prepaid in that area of prepaid. This really expands the offering that we have in the -- what we would call the enterprise or the B2B and B2C areas of prepaid, and those are also high-growth areas we talked about before where it's rewards, it's also for instance, payroll benefits, healthcare. And so, we're really excited about it because it is an expansion into that segment where we've been, we believe, under penetrated. Those are also high-growth segments.

And where we are right now is, we're bringing that online in September, that capability online, and we've had discussions with customers, discussions have gone very well, they're excited about the capability and we believe that once we bring that online, really demonstrate the execution, then we're going to see a lot more traction of sales at that point. And so we expect that we're going to see impact from that in the fourth quarter as Dave mentioned, but we think that we're really going to see bigger impact, get more traction in 2017.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

One last question before I get back on the line. But the adjusted diluted earnings per share guidance for the year, does it incorporate the repurchase? The $1.4 million that you still have left?

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

I don't think we've forecasted the guidance at that level of precision. So, I think within the range of guidance that we've given you, if we were to do the remaining 1.4 million, you'd still sit inside of that range, Paulo.

Operator

(Operator Instructions) Dave Koning with Robert W. Baird.

David Koning - *Robert W. Baird - Analyst*

So, I guess, first of all, year-to-date, the number of cards, the cards sent is down and I know you've mentioned kind of the reason and everything. Do you think for the full year that the number of cards will be down and I guess, the second part of the question is, do you think the overall market is still up? And I guess I'm just wondering if you think you're losing share this year and then how you kind of catch that back up maybe next year?

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

Yes. No, we've -- so, let's just go directly to market share and then we can talk about the overall market. So, in the first quarter, we felt our market share was actually above our long-term historical averages, and in the second quarter, we believe that our market share is right at what our long-term historical numbers have been. So, we don't see any loss of market share.

Overall, what we're seeing in the market, Dave, is that the number of cards in circulation are not changing, it's going up a little bit, but it's not changing. And the issuances are perhaps down a little bit this year from what they were last year by the financial institutions. But as we've talked about before, in the second quarter and then also today, we talked about it as well is just card purchases and I'm talking specifically about EMV card purchases are definitely down year-over-year, reflecting that carryover of excess inventories.

So, overall, card production and hard demand for EMV cards is down this year and will be down year-over-year. Card issuances, we think, are going to be, for the year, probably relatively flat, maybe down a little bit and cards in circulation, though, are remaining the same or going up a little bit.

David Koning - *Robert W. Baird - Analyst*

And then, I guess, the second thing is, in 2017, my guess is your expectation is that revenue is going to grow, and so, do you think, A, that we can get back to the 2015 level of revenue and then, B, if that's the case, are margins, do you think margins can be in a place where you would generate a similar EPS as you generated in 2015 if that was the case?

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

Yes. I think look, 2015 total revenue of $374 million, I think, when you look at where we would expect issuance next year as the market returns to what we'll call some more normalcy when you look at the continued migration of the remaining EMV cards which it's going to be driven by debit, which becomes a proxy for the small issuers where we have a nice position and then we just look at sort of any other further penetrations and things like dual interface and ongoing movements on prepaid, that, for sure, without going out on a big limb here that yes, I think she would be well above the 2015 revenue as we would predict our 2017 sitting here today, Dave.

I mean, if you just, I think as we, if you look at what underpinned the EMV cards that we issued in 2015, it was 154 million cards, as we reported it out. I think if you look at what we've issued this year, year-to-date with the second quarter being at 22 million cards and we were at around 41 million cards, if my memory is right on the first quarter. So, sort of 63 million cards in the first half. For sure, we will see that number building, but

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I don't think our guidance has predicted getting back to even the 154 million level that we saw in '15 for card production. So again, just the ongoing conversions and the return to normalcy will be helpful for sure to that top line.

David Koning - *Robert W. Baird - Analyst*

And then do you think if you did generate a similar amount that margins can get back to a similar level, so you can drive EPS kind of around the same level as '15 or above?

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

Yes. I think what we've learned in the last quarter or two is that volume matters, and so I mean I think as we've looked at the cost-saving programs that we've been working on to try to take out some of the variable labor, but ultimately, when volumes come back with the absorption of the fixed cost, it has a meaningful impact. And so, I think, when we start to talk about the more normal volumes on the EMV side, from an EBITDA return perspective, I think in '17, we would return back to that 26% sort of average number to the bottom line. And with that, you continue then to sort of enjoy gross margins in that 35% to 37% range.

And I think as we've said right along, as we see the average pricing mix change for us, which is beneficial, meaning that as the small and midsize customers become more significant for our overall portfolio, it actually helps offset that decline that we've talked about in the large issuer space, pretty good reference point was $0.94 held flat for us as the mix improved in the second quarter of this year, coupled with the fact that we do continue to see declines in the underlying chip costs itself.

So, when we put all of those things together, with the sort of normalized volume, we would expect the metrics, both the gross margin and EBITDA margins to get back to those normal levels and then if we're able to get a bit more aggressive on some of these cost programs, then that just works in our favor.

Operator

Paulo Ribeiro with BMO.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

Just back to the instance issuance, you threw some numbers there, on the number of machines, I missed out.

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

Yes.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

But could you just repeat and also talk about on this pickup in revenues from personalization, and in terms of instance issuance, was it driven by machine sales, by service, a mix of both? The dynamic there?

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

Yes. It was a mix of both, Paulo. In terms of the numbers, it was 4,775 installations. So that's units that are installed and online versus 4,230 at the end of the first quarter. And so, we saw a good pickup, so sales have continued, installations have continued at a really healthy level and so as a

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result, we're seeing increased revenues from that, but then also, now, we're building up the install base and so we're seeing increased revenues from the sale of supply, from the quick fees that are generated through that ongoing service, if you will. And so, we're now starting to see that have an impact.

So overall, instance issuance is, it was with the increase around that it was a combination of new sales plus the install base generating higher revenues for us.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

Last question, mag stripe. What are some of the numbers that are in terms of production and average selling price in this quarter and how they compare versus last?

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

Yes, I think we would --

(Multiple Speakers)

Paulo Ribeiro - *BMO Capital Markets - Analyst*

-- how much your mix have changed already?

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

Yes. I would say that magnetic stripe volumes were definitely down, the substitution continues in debit and credit and in prepaid, mag stripe volumes are not down. We still haven't seen any kind of -- in the US versus Canada, where we've seen really an uptake now of prepaid chip cards, not seeing that in the US, so it's all mag stripes. So the mag stripe volumes for prepaid are holding steady, up a little bit.

And so, that's overall -- in terms of overall volumes, that's what we're seeing in terms of pricing, we're seeing pricing relatively stable for mag stripe cards.

Operator

Bob Napoli with William Blair.

Robert Napoli - *William Blair - Analyst*

Just quickly on the services revenue, I forget. Did you break that out by segment? How much of the services revenue was in debit and credit and prepaid?

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

Yes. Well, Bob, we don't -- just to sort of help you a little bit, but won't give you the exact answer you're looking for. The prepaid business that we show as a segment all goes to services. And then the part of US debit and credit is our personalization and fulfillment business that a good share of it goes into the services line, and then we have a rough number, it's about half of the UK business and half of the revenue that gets generated out of the other segment, which is Canada, goes between services and product.

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Robert Napoli - *William Blair - Analyst*

So all of the prepaid you said goes into --

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

Yes. All of the prepaid.

Operator

At this time, I'm showing no further questions. I would like to turn the call back over to Steve Montross for any closing remarks.

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

Okay. Well, thank you. Thanks, everyone, for participating in our earnings call and we look forward to speaking to you next quarter.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may all disconnect.

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