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PMTS - Q3 2016 CPI Card Group Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Q3 2016 CPI Card Group, Inc. earnings conference.

(Operator Instructions)

As a reminder, this conference is being recorded.

I would now like to turn the call over to your host Ms. Molly Carol. Ms. Carol, you may begin.

Molly Carol - *CPI Card Group Inc - IR*

Thank you, operator and good afternoon, ladies and gentlemen. Welcome to the CPI Card Group's third 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 the 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 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 press release on the CPI's website for all disclosures required by the SEC including reconciliations to the most comparable GAAP numbers.

And 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, Molly. And thank you, everyone, for joining us today on our third quarter 2016 earnings conference call.

I would like to share some highlights from the third quarter with you. Net sales were $81.2 million, representing a decrease of 24.6% year-over-year predominantly driven by fewer EMV chip card sold in the third quarter of 2016 compared to the same quarter last year, partially offset by continued strong growth of value added services and better than expected EMV pricing.

On a GAAP basis, net income from continuing operations was $4 million or $0.07 per share in the third quarter of 2016 compared with $0.19 per share after preferred dividends in the third quarter of 2015. Adjusted net income from continuing operations was $6 million or $0.11 per share. Adjusted EBITDA was $17.8 million compared with $32.5 million in the prior year period; and we returned $2.5 million to stockholders through dividends in the third quarter of 2016.

Our third quarter results were below expectations primarily due to continued softness in demand for EMV chip cards, unfavorable foreign currency exchange rates which impacted the quarter by $1.4 million, and delays in the operational startup of our new Print on Demand offering for the U.S. prepaid debt segment. Despite the lower than expected sales, I was pleased with our performance in both gross margin and adjusted EBITDA margin performance in the third quarter compared to the second quarter. The sequential improvements in margins was driven by the combination of the expected seasonal increase in the prepaid debit segment, benefits from cross saving actions we initiated earlier this year and higher selling prices in the EMV cards resulting from improved customer mix.

The long term growth opportunities for CPI remain positive, driven by our broad product offering for the financial payment card markets, the ongoing conversions of magnetic stripe cards to EMV chip cards and increasing demand for our services offerings. The business is well positioned in markets that we believe will continue to enjoy good, long term growth dynamics.

The three pillars of our strategy at CPI remain the following; grow the base, innovate and introduce new products and services to the markets we serve and transform the business.

Our ability to grow our base business which is the first pillar of our strategy has been restrained by the current market environment for card production that remained challenging and soft. As we have discussed in prior calls, the weakening EMV markets are the result of a reduction in EMV card demand at the large issuers and processors due to inventory overstocking and at the small and medium size issuers due to EMV conversion delays.

When we spoke with you on our last quarterly call, we had expected buying patterns for EMV card to begin to improve for the issuers in the fourth quarter of 2016. However, based on the market activity we have seen through the end of October and ongoing discussions with our customers, the demand for card purchases by both issuers and processors continues to be soft with no uptick in buying levels. The slower than anticipated market demand will negatively impact our previous guidance estimates for 2016, which Dave will discuss in more detail later. Although the market continued to be software than we anticipated, we estimate that the overall financial credit and debit card market is only 56% converted to EMV cards at the end of the third quarter. So it goes without saying that there is a meaningful amount of initial conversion to EMV yet to occur.

Within our base business, I am very pleased with the continued growth and the opportunities that we are seeing from our value added personalization and fulfillment services, which I will discuss in more detail in a moment.

Our new innovative product offerings for the financial payment card markets, the second pillar of our strategy, will continue to add growth to the business. Our patented Card@Once instant card issuance solution continues to show strong growth as demonstrated by the continued increases in our install base and we continue to work on evolving this service to provide new capabilities and features.

Through our Print on Demand solution, we are expanding our prepaid business into higher growth verticals such as business to consumer and business to business. In addition, we recently announced several new products including a metal card offering for the credit card markets. Dual interface or tap-and-go EMV cards also remains a significant and relevant opportunity for us in the future when adoption by issuers, take hold the

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meaningful way. These innovative products and services all represent important medium to long term opportunities to add to the growth of the business and I will discuss each of them in more detail in a moment.

Lastly, we continue to transform the business which is the third pillar of our strategy through our ongoing efforts to improve our quality and service levels, improve our cost position and profitability by adding to our previously announced cost savings programs, and adding talent to the organization. Specifically, and as we discussed on our last quarterly call, we have taken a number of actions which were aimed at reducing our cost with the focus on direct manufacturing cost, indirect labor, third party services and administrative headcount reductions. We estimate that these actions are resulting in approximately $2 million of cost savings in the second half of 2016 and approximately $6 million of savings on an annualized basis going forward.

During the third quarter, we identified additional cost reduction measures specifically in the areas of direct and indirect labor, procurement and scrap reduction. We expect that these new measures will produce an additional $4 million bottom line improvement in 2017. Cost reduction measures will remain a focus for us and we will continue to look for additional areas of opportunity.

I am also pleased to point out that we have strengthened significantly our management team over the last few months with the addition of Jason Bohrer, our SVP of Operations, Lane Dubin, our SVP of Sales and Marketing, and Jay Arbabha, our Chief Technology Officer, all of whom are accomplished executives with distinguished records of accomplishments. The leadership, depth of experience and relevant market knowledge which each of them brings will be invaluable as we execute on our plans.

Now, I will turn to a review of our segments as well as a more detailed discussion of current market conditions. Net sales in our U.S. debit and credit business were down 32.5% year-over-year to $49.2 million in the third quarter. Our results reflect a decline in EMV chip card sales in the quarter due to reduced purchase activity by the large issuers and processors. In the third quarter, our shipments of EMV chip cards decreased 45.1% compared to the prior year period to 22.6 million units, and were essentially flat with our second quarter 2016 EMV sales.

As I mentioned earlier, we estimate that approximately 56% of total branded debit and credit cards in the market were converted to EMV cards at the end of the third quarter up from 50% at the end of the second quarter of 2016 and 43% at the end of the first quarter of 2016. I will point out that the conversion percentages for the first and second quarters have been adjusted from those we previously announced to reflect a more accurate view of the U.S. financial debt card market size. Given this level of EMV penetration, there still remains growth opportunity from the continued market conversion to EMV over the next two to three years.

Turning to pricing, the average selling price of $0.96 on EMV cards in the U.S. exceeded our expectations for the third quarter and was up slightly from $0.94 in the second quarter of 2016. Our average selling prices in the third quarter reflect a combination of better than expected pricing with large issuers and a higher than forecasted mix of EMV card volumes coming from small and midsize issuers where we realize higher average selling prices.

Notwithstanding the ASP outperformance in the third quarter, we continue to anticipate some pressure in our average selling prices driven by declining EMV card prices within the large issuer segment offset partially by the growth in EMV volumes with the small ended size issuers. Our value added services continues to be an area of strength for us. We reported approximately 3.8% services revenue growth in the third quarter with our personalization and fulfillment services increasing approximately $4.3 million or 35.3% year-over-year. Approximately 59% of our debit and credit personalization of fulfillment volumes consisted of EMV work in the third quarter of 2016 compared to only 9.3% in the prior year period.

We also ended the third quarter with 5,150 instant issuance, or Card@Once installations, versus 4,775 installations at the end of the second quarter of 2016. We continue to view our instant issuance products and services as a strong growth area. On the new product front, we continue to have more and more discussions with issuers about dual interface EMV cards and are currently supplying a small number of contactless cards to a handful of U.S. issuers. In addition, during the third quarter, a large regional bank began providing dual interface cards to their customers through our Card@Once instant issuance system.

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While the overall customer demand for dual interface cards continues to be small, and we don't expect meaningful adoption until 2018, we are very 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 and the growing acceptance network for contactless payments at the retail terminal level.

Turning to our U.S. prepaid debit business, segment revenue decreased 2.4% year-over-year to $23.1 million. The decline in year-over-year net sales reflects lower prices partially offset by increased sales activity. We have experienced pricing pressure in our retail prepaid activities which we have largely offset through increased retail prepaid sales volumes.

During the third quarter, we launched our new Print on Demand solution that deliver significant flexibility to prepaid program managers and financial institutions. CPI customers can now produce all image, personalized payment cards and related collateral on a one-by-one on demand basis enabling individualized offerings and eliminating waste. The Print on Demand solution enables us to penetrate new, fast growing business to business and business to consumer verticals of the prepaid market including payroll, corporate incentives and benefits. While the operational startup of the new offering has been slower than we expected, I am pleased that we have begun our first shipments in the last few weeks.

Although the impact from our Print on Demand activities will be meaningful for the fourth quarter, we expect the opportunity for growth in 2017 will be meaningful. In our UK segment, our sales decline was caused primarily by foreign exchange fluctuations and to a lesser extent by slightly lower activity across our retail gift card base. We attribute the softening in sales to uncertainty in the UK retail market following the UK vote to exit the European Union. Absent the foreign exchange fluctuations, the UK segment maintained its profitability and profit margins.

In summary, though the recovery in market demand is taking longer than we have originally expected, I continue to believe we are in a strong position to withstand this slow EMV market environment and that we are pursuing the right strategy in terms of growing our base, innovating and introducing new product and services to our markets, and transforming the business which will position CPI Card Group to capitalize on our significant market opportunities and to generate attractive, profitable growth over the long term.

Finally, we are committed to improving our profitability and cash flow and maintain a strong liquidity position and balance sheet. I will now turn the call over to Dave.

David Brush - *CPI Card Group Inc - CFO*

Thanks, Steve. I will first provide you with a review of our third quarter results and then update you on our financial outlook for 2016 as well as providing some comments on 2017.

Third quarter net sales were $81.2 million down 24.6% from $107.7 million in the third quarter of 2015. The decline in our net sales primarily reflects a 45.1% year-over-year decrease in the number of EMV chip cards sold in Q3 of 2016. Products and net revenue decreased 42.8% year-over-year to $37.5 million in the third quarter while services net revenue grew 3.8% year-over-year to $43.7 million.

Turning to our segments; U.S. debit and credit segment net sales were $49.2 million for the third quarter, a 32.5% decrease from the prior year period. Segment income from operations was $10.8 million compared with $21.6 million in the prior year and segment EBITDA was $12.9 million, a 44.7% decrease over prior year.

The decline in our U.S. debit and credit segment results were predominantly driven by the year-over-year decrease in EMV card shipments, as Steve discussed average selling prices exceeded our expectations during the third quarter and on a weighted average basis were $0.96 compared with $0.94 in the second quarter of 2016 and $0.94 in Q1 of 2016.

In our card personalization and fulfillment business, we generated a $4.3 million year-over-year increase in net sales during the third quarter, which partially offset the decline in product net sales. U.S. debit and credit segment net sales were $23.1 million in Q3 down 2.4% year-over-year. Segment income from operations was $8 million, a decrease of 15.3% and segment EBITDA decreased 13.8% year-over-year to $8.6 million. The year-over-year decline of U.S. prepaid debit segment net sales was primarily reflecting lower prices partially offset by increased volumes from sales activity.

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Finally, our UK limited segment net sales were $7.7 million in the third quarter representing a decrease of $20.6 million from the prior-year period. Segment income from operations was $800,000 down 14.6% year-over-year and EBITDA was $900 compared with $1.2 million in the prior year period.

The decline in our UK limited segment revenue primarily reflects the impact of unfavorable foreign currency exchange rate fluctuations from a weaker British pound. On a constant currency basis, sales for the third quarter decreased 6.4% from the third quarter of 2015 and reflect softening volumes in retail gift card customer base.

Moving down in the income statement; gross profit for the third quarter decreased 32.5% year-over-year to $29.1 million representing a gross margin of 35.8% compared with gross margin of 40% in Q3 2015 and up 500 basis points from a gross margin of 30.8% in the second quarter of 2016.

The sequential improvement in our Q3 gross margin primarily reflects the increase in our average selling prices, the cost reduction programs we initiated during the second quarter of 2016 including some lower realized chip prices. Income from operations in the third quarter was $11.7 million compared with $26.4 million in the prior year period.

The change in income from operation primarily reflects the year-over-year decline in our net sales as well as higher SG&A expenses driven by $1.4 million of incremental public company cost, $600,000 of patent and shareholder litigation and related charges and $300,000 increase in stock based compensation partially offset by $500,000 reduction related to the prior year shutdown of the Petersfield UK operation.

We reported net income from operations of $4 million or $0.07 per share in the third quarter of 2016 compared with net income from continuing operations of $14.8 million or $0.19 per share after preferred stock dividends in the third quarter of 2015. We recorded tax expense of $2.5 million in the third quarter reflecting a tax rate of 38.7% compared to tax expense of $6.6 million in the prior year, reflecting a tax rate of $30.7 million. Our Q3 2016 tax rate was higher than expected primarily due to the impact of state and foreign income taxes. We currently anticipate our 2016 full year expected tax rate to be approximately 36%.

Now turning to our non-GAAP financial measures, adjusted EBITDA for the third quarter of 2016 was $17.8 million compared with $32.5 million in the third quarter of 2015. Adjusted EBITDA margin was 21.9% versus 30.2% in the third quarter of 2015 up approximately 560 basis points sequentially, up approximately 560 basis point sequentially from 16.3 in the second quarter of 2016. Compared with the prior quarter, our third quarter adjusted EBITDA margins improved primarily as a result of higher average selling prices and the aforementioned cost reduction programs.

On a year-over-year basis, the change in our adjusted EBITDA and EBITDA margins primarily reflect lower net sales and some corresponding impact of absorption of overhead cost from lower EMV chip card volumes as well as increased expenses associated with being a public company which I mentioned previously.

Adjusted net income from continuing ops was $6 million for the third quarter of 2016 compared with $17.9 million in the prior-year period. Adjusted diluted earnings per share from continuing operations in the third quarter of 2016 were $0.11 compared with $0.30 in the prior year period after making a pro-forma adjustment to our Q3 2015 shares outstanding for the 15 million shares issued in our initial public offering.

Adjusted EPS from continuing operations using actual weighted average diluted shares outstanding were $0.42 for the third quarter of 2015. Our Q3 2015 adjusted EPS from continuing operations, excludes the impact of preferred stock dividends of $7.1 million.

Moving to some key cash flow and balance sheet items, cash flow from operations for the third quarter was $6.6 million compared with $25.5 million in the prior year with the year-over-year change primarily reflecting lower net income partially offset by positive changes in working capital. Capital expenditures in the third quarter $5.4 million, yielding free cash flow of $1.2 million. We ended the quarter with a cash balance of $21.3 million and a net debt balance of $291.2 million.

The total debt principal outstanding was $312. 5 million, and with the netting of the deferred financing cost and discounts, the recorded debt balance was $301.4 million. During the quarter we repaid the $9 million promissory note made in conjunction with our acquisition of EFT Source

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which matured in September of this year. At September 30, 2016, our net debt leverage ratio was 4.1 times compared with 3.4 times at the end of the second quarter of 2016. As of September 30, 2016 we had approximately $61.3 million of available liquidity comprised of a $40 million undrawn revolver and $21.3 million of cash on the balance sheet. We continue to be committed to maintaining the strong liquidity position.

In our press release issued this afternoon, we also announced that our board of directors approved a dividend of $0.045 payable on January 12, 2017 to stockholders of record at the close of business on December 16, 2016. During the quarter, we made no share repurchases. On a year-to-date basis, we have repurchased approximately 1.4 million shares of common stock for $6 million under the current share buyback authorization.

Now turning to our guidance; the market environment remains challenging and we continue to have and will continue to have an impact on our results for the remainder of 2016. Our Q3 EMV card volumes reflects -- we continue to see reduced EMV card purchase activity across the larger issuer segment. We had previously expected those buying patterns from the large issuers to improve in the third and principally in the fourth quarters. However, based on the level of activity we are seeing through the end of October, we do not see EMV card shipments materializing at the improved rates we had assumed in our prior guidance. As a result, we are reducing the 2016 full year guidance range primarily to reflect the softness.

For full year 2016, we now expect net sales between $300 million and $305 million which implies a revenue range of 59 million to 64 million in the fourth quarter. Our revenue outlook assumes a slight decline in average selling prices for EMV and lower EMV card volumes than what we saw in Q2 and Q3 of this year. The revenue guidance also reflects minimal revenue from our new Print on Demand offering and the negative impact of foreign currency exchange rates. We expect to generate adjusted EBITDA between $53 million and $55 million for the full year and adjusted diluted earnings per share of $0.24 to $0.26 per share.

Now turning to some comments on 2017; for 2017 while we expect the U.S. debt and credit card production market to stabilize, we expect that that growth will be influenced by a slower than previously anticipated rate of market conversion from magnetic strip cards to EMV cards. The prior market predictions have suggested a 90 plus percent conversion of all financial debit and credit cards to EMV by the end of 2017. At this time, our expectations for 2017 reflect a much lower level of EMV conversions, largely influenced by financial debit cards. It is our expectation that the 90 plus percent conversion level will be met by the end of 2018. Our current 2017 outlook also assumes minimal market adoptions of dual interface cards.

We expect our services business to grow at above market rates in 2017 benefiting form a personalization and fulfillment offering, a recently launched Print on Demand capabilities in the U.S. prepaid debit segment and continued adoption of our proprietary Card@Once instant issuance offering. We are in the process currently of preparing our annual operating plans which include taking the aforementioned factors into consideration. Our preliminary view for 2017 results in an expected revenue growth range of 10% to 15% to net sales from 2016 announced. With our strategic plans and budgets for 2017 are finalized, we will provide more detailed guidance in conjunction with our fourth quarter call in February.

With that operator, I would like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jim Schneider of Goldman Sachs.

Unidentified Participant

Good afternoon. This is Larry stepping in for Jim today. Just a couple of questions. Could you give us an update on the current inventory levels at the large issuers, I think on the last call you say that six to nine months and kind of where that's trended now and where you expect it to trend over by the end of the year and then also just in terms of your 2017 revenue outlook, could you maybe explain some of the drivers there and how it delves up to that net sales level and kind of the mix between pricing and volumes in the different sub segments of price?

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

Sure, this is Steve and I will address the first part in terms of the inventory levels and then I will ask Dave to talk about the buildup of the revenues for 2017. But overall, the revenue level or the inventory levels for the large issuers have continued to come down. There as we've talked about before there were excess inventories all through the year and we had indicated previously. We didn't expect that those that issue was going to be going away until we got into 2017 and that's still our outlook that the inventory levels continue to do be consumed and continue to decline and we expect that the large issuers are going to get to what their desired inventory levels are as we get into 2017. So our outlook around that really hasn't changed, and I will ask Dave to please comment on the build-up of revenues for 2017 with the main issues asking the main drivers.

David Brush - *CPI Card Group Inc - CFO*

As I said in my comments, you know, I think we are filling the process of finalizing the 2017 plans, but I think -- I also mentioned that the influencing factor perhaps from what the model has suggested previously is really driven by lower conversion rate of financial debt cards to EMV during 2017 and that that sort of expected 90 plus percent conversion rate that had originally been expected to take place in 2017 has now been really spread over 2017 and 2018 so that part of the you know the impact is probably the single biggest factor, I think then when we look underneath of the other components, you know, I think as I have said, you know, we see the EMV markets and overall credit card issuance markets stabilizing as we move into 2017 but more or less on a volume base slightly up from 2016 but not getting back to the 2015 levels. Then the last piece to that is really in our services business which includes both our personalization fulfillment and the prepaid businesses, you know, we see above market rate growth for those businesses in 2017.

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

And included in Dave's comments on the services businesses that we expect that Print on Demand which is the new offering that we're bringing to the market or have brought to the market, we expect that we are going to see some meaningful growth from that in 2017, so we should get a good boost from that product offering.

Operator

Dave Koning of Baird.

Dave Koning - *Baird - Analyst*

I guess a few questions. The first one, I think our models which kind of matched your guidance, had Q4 revenue previously in the kind of low 90s range and now you are saying kind of the more low 60s range. So, you know, it's pretty significant reduction like you know whatever the 35% reduction or so. I guess two questions here. One is, is it just that hard to forecast which makes 2017 also had to forecast and then B, maybe you can just give, is there a base level recurring revenue that kind of no matter what, there is kind of a level of revenue that it can go below?

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

Yes, in terms above the fourth quarter, Dave, as you look at the fourth quarter, I think we were anticipating when we gave the previous guidance back in May, we were really anticipating that in the second half of the year, but sequentially greater from the third to the fourth quarter, we were going to see an uptick in EMV buying levels. And that has not materialized; it was off a bit in the third quarter and we see that in our lower than expected results in the third quarter, but really is also manifesting itself in the fourth quarter what our expectations are for the fourth quarter.

And so that's part of it, it's just slower volume levels and part of it is also way as we mentioned FX has a small -- on the margin small impact and also we have expected that we are going to be getting in the fourth quarter about $4 million of revenues from Print on Demand, and with the

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delay in the operational start up of Print on Demand, that's not going to be there except in the small amount for the fourth quarter. So it was really the expected uptick in EMV buying just not materialize; we do not see in it, market continues to be soft and migrations while progressing are progressing more slowly than expected.

Dave Koning - *Baird - Analyst*

And I guess that second question; the base level, is there like a base level across your segments of like maybe some of the services work or some of the debt issuing work. Is there a base level of, like, say, $50 million of revenue that that each quarter that is very sticky and highly recurring and it's really that next level that's really hard to predict between maybe $10 million and $50 million it's just because the card revenues bounce all over the place? But, you know, could you give some confidence in like just a base level recurring business?

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

Yes. As we look -- and I think Dave expressed, we believe the market is really stabilized at a slower rate of migrations and at lower level of buying than what was previously anticipated, but we do believe that the EMV market in particular stabilized. And so as we look to 2017, we took that into consideration as we thought about what our guidance is, is what is -- where is the market now, where do we think the market is going to be based upon discussions with the issuers? And so that's what really drove the guidance that we had around the debit and credit business, and we continue to see good strength in our personalization and fulfillment business. And as Dave mentioned, we expect that to grow at higher than market rates, which is consistent with what our experience has been and then we expect our prepaid businesses going to show good growth in 2017 based upon business in hand and also discussions we are having with customers around prepaid particularly around Print on Demand.

So we really feel that the guidance that we put out there those reflect a level of activity that is consistent with the level of activity that we're experiencing now with growth coming from again the services business which is consistent with the growth that we have been achieving.

Dave Koning - *Baird - Analyst*

And then my last one, that was helpful on that. The last one is just the EBITDA margins, you know, obviously coming down this year and it's hard, I get it's hard to manage when if revenue is lower and you have a cost base somewhat fixed you know it becomes a little difficult to manage the margins, can, if you grow next year, you know, is there a good incremental margin kind of on the bounce back in revenue next year? And, you know, it's somewhere higher than 16 but less than 15 -- I think that may be what you were saying on the last question, too.

David Brush - *CPI Card Group Inc - CFO*

I think that's right, Dave. And I think if you look at, you know, where we were at in 2015 at a 26% EBITDA adjusted sort of return level and with a -- what I would say a drop in second quarter this year that was in the 16% range, but then seeing that raise back up to 21.5% in the third quarter that as we look at 2017, I think it would be, you know, looking to probably at the volume levels that we're predicting for 2017, hard to get back to the 2015 level. But in the 20s is still where our line of sights are. And so, you know, I think as volume comes back it's scalable. I think when we look at the things that we can't control and Steve talked about them, it's continuing to look at our cost base whether it's in the SG&A side of things or it's in the manufacturing cost, those are things that we've now I suppose become more focused and have undertaken as an ongoing process to try to balance those against the volumes that we're predicting.

Operator

Chris Kennedy with William Blair.

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Chris Kennedy - *William Blair - Analyst*

Can you talk about your market share and how we get confidence that CPI is maintaining its market share?

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

Yes. In terms of our market share, Chris, we believe that our market share continues to be consistent with what we've experienced in the past. And as we've talked about before, at this point in time we could see some movement on that because there are puts and takes. With business for instance, this year there was -- it was recently that there was an RFP for a customer that we lost, and so that business that was lost business to us and then we're gaining business in other areas.

So there is always ebbs and flows but overall, our market shares is consistent with what we've had in the past and what we would, what we've discussed with you. So we don't -- the market share that we're looking at is also as we determine our market share, we continue to look at what are the issuers doing? Have discussions with them about it and then look at our own production to come up with where we think we are and so our view of our market position hasn't changed and again at a point in time, it could fluctuate a bit but over the long term, our view of our market position, where we are and what our market share is hasn't changed, Chris.

Chris Kennedy - *William Blair - Analyst*

Then the Print on Demand service, I think you mentioned you were expecting $4 million of revenues in the fourth quarter, is that kind of an annualized run rate as we look into 2017, you know, $15 million to $16 million or --

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

It, I would say that, that would be annualized run rate. It just -- for clarification that business was contracted business that we had, so with business in hand it was just an operational delay that we had both on our side and the customer side that pushed that out. But in terms of a run rate that we would expecting, yes, that's neighborhood of a run rate we would be expecting as we get into 2017.

Chris Kennedy - *William Blair - Analyst*

Then just, on the penetration of EMV cards, I think initially you were looking for 90% exiting 2017. You said you reduced that expectation. What's your expectation today?

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

And it was, I would say, our expectation driven also were influenced by the expectation of a lot of people in the marketplace that whether it was the card brands or it was third party consulting firms. I think everybody was anticipating or projecting that the market was going to be 90% plus converted to EMV by 2017. We don't think we get to that until towards the end of 2018 maybe in to 2019, but we don't think we get to that level then. Based upon the current pace of migrations to EMV, we think that next year at the end of 2017, it's probably more in the range of 80% and then getting up to 90% plus as you get into the end of 2018 beginning of 2019.

David Brush - *CPI Card Group Inc - CFO*

Yes, I think, Steve, just to sort of add to that a little bit, you can dissect it and think back through the transcript, but I think you have within the 90% plus, we refer to that as the combination of both debt and credit for the financial payment space. I still think, yes, that the credit part of that is certainly well ahead of debit. And so, when we look at exiting this year, I think you see a more -- a number that's closer to the 90% for credit and the debit is still in the 30% range. And so the step up between '17 through '18 is really influenced by the debit component of debit and credit cards.

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Chris Kennedy - *William Blair - Analyst*

Any update on the CFO search?

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

Yes, we have -- as we talked about, I think we talked about the last time, we had engaged with the national search firm. We have met with some excellent candidates, and so we are very, very excited about the people that we have met with and we continue to -- we will continue to meet with a couple others. But that process is moving along as expected, but we are really encouraged by the caliber of people that we are talking to.

Operator

Stephanie Price of CIBC.

Stephanie Price - *CIBC - Analyst*

I am just working through this lower Q4 volumes versus Q3 and Q2 and trying to translate that into sort of the outlook for 2017. Can you kind of walk through where you are expecting the pickup in EMV volumes to occur; is it going to be at the beginning of 2017 or how are you kind of thinking about that year?

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

Yes. Usually, if we look at the patterns in the past, the patterns have been that Q4 is generally a lower quarter. Quarters two and three are stronger quarters and there is a -- then there is a slowdown in Q4 that then carries over into Q1 and then there is a pickup after that as we get into the year. In terms of exactly how we see that sequence out in 2017, we are still working on our operating plans, Stephanie. So, can't give you that kind of precision right now around how we see exactly that sequencing in 2017. Overall, as we talked about we think the market had stabilized, we think that the expectations around EMV for 2017 as a whole should be consistent with what we have experienced in 2016 and that's our view as we look at our guidance and as we look for 2017.

Stephanie Price - *CIBC - Analyst*

And then in terms of leverage, can you talk a bit about where you are comfortable with and how you are thinking about leverage right now?

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

We continue to -- leverage is something that we continue to be focused on making sure that we are managing and over the long-term we want to be reducing our leverage. That's always been a long-term goal of ours. Right now, we have a debt facility that is very favorable to us. We know we have interest payments on it, but we have no principal payments on that debt for a number of years. And so the capital structure that we have I think is favorable and we will continue to really monitor what our leverage levels are. And over the long-term, we are absolutely committed to getting our coverage ratios up and our leverage ratios down, but we believe that the debt facility -- well, the debt facility doesn't provide or it doesn't constrain us in anyway and we don't expect that it's going to.

Operator

Paulo Ribeiro of BMO.

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Paulo Ribeiro - *BMO - Analyst*

I have couple of questions. First, is the mix of chip to mag stripe, because you guys talked about the chip volumes are coming lower than you expected. Is it -- how about mag stripe? What's going on in that market? Is it also weaker, or are we seeing less overall replacement volumes, for issuance rather, from financial institutions or that is holding up and it's more the conversion is being slower. Can you talk a little bit about the trends in mag?

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

Yes. Paulo, in terms of the volume levels, as we look tomorrow --

Paulo Ribeiro - *BMO - Analyst*

Overall parts, yes.

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

Yes, yes. As we look at the buying levels overall from financial payment card combined levels are lower than anticipated, lower than what we have had expected when we had provided previous guidance. And so I would say overall buying levels for all of financial payment cards are lower and that specifically includes EMV which we know has larger impact given the difference in price.

Paulo Ribeiro - *BMO - Analyst*

Right.

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

Yes.

Paulo Ribeiro - *BMO - Analyst*

And the second question is regarding cost. You mentioned some cost savings, if I got it right, $6 million annualized for this year from $2 million in cost savings in the second half. And then did you say some additional $4 million from cost initiatives that you started in 3Q '16? I am trying to --

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

Yes.

Paulo Ribeiro - *BMO - Analyst*

So in total, we are talking about $10 million in cost savings for '17 and what is the basis that -- how should I think about it is like -- is that based on which year and what is the cost of sales and what is OpEx?

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

Yes. Most of the $10 million is going to be in cost of sales.

Paulo Ribeiro - *BMO - Analyst*

Okay.

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

Okay. And that will be $10 million impact to the bottom line, so that will flow through.

Paulo Ribeiro - *BMO - Analyst*

So if I have, let's say, a cost of sales $200 million for '16, it's $10 million less?

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

Yes.

Paulo Ribeiro - *BMO - Analyst*

No, so you already had some savings flowing through third quarter --

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

We already had some savings, yes.

Paulo Ribeiro - *BMO - Analyst*

So, you had already some $4 million or $5 million in the second half of the year?

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

Yes. We have $2 million in the second half of the year and then we expect that, that's going to grow on an annualized basis and that's going to grow to $6 million for the full year in 2017, and then there is going to be an additional $4 million of savings that we will generate in the full year 2017.

Paulo Ribeiro - *BMO - Analyst*

So you have a little bit of that in this year, but most of it the $4 million, the full $4 million is next year?

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

Yes.

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Paulo Ribeiro - *BMO - Analyst*

And how about the buyback? Last question on buyback. How are you guys thinking about that? How much you still have left, if you can remind us?

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

Yes. In terms of the total buyback, I believe its 1.6 million shares that we have left.

David Brush - *CPI Card Group Inc - CFO*

1.4.

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

1.4. Okay, 1.4 million shares. And the way we are looking at it Paulo is we continue to evaluate that, but one of the things that we are always weighing in is, what are the other uses of capital that we have. For instance, in the third quarter as Dave mentioned, we have reduced our debt by $9 million when we paid off that promissory note. And so that was important to us for using that cash for debt reduction and managing that leverage. And also we want to make sure that we are maintaining liquidity that we are maintaining a strong balance sheet.

So, those are things that are really important to us. And so we are going to continue to balance what we do and we have the flexibility to be buying more shares in the future if that looks like the right decision for us. And so that's something that we can do, but we are constantly weighing in terms of the importance in the use of capital for us.

Operator

Carl Norberg of Craig-Hallum.

Carl Norberg - *Craig-Hallum - Analyst*

Just want to get your thoughts on sort of the longer term post EMV, how should we be thinking about like annualized car production, EMV car production runway front rates? Is that like a $200 million number or $300 million number just kind of want to get your thoughts on sort of longer term here?

David Brush - *CPI Card Group Inc - CFO*

Carl, just to make sure I heard the question right, Steve, are you asking what is for CPI or for the market in terms of --

Carl Norberg - *Craig-Hallum - Analyst*

For CPI?

David Brush - *CPI Card Group Inc - CFO*

In terms of total card units?

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Carl Norberg - *Craig-Hallum - Analyst*

Total cards units sold per year, yes.

David Brush - *CPI Card Group Inc - CFO*

And what we have -- I am sorry, Carl, you are asking what we have got in 2017.

Carl Norberg - *Craig-Hallum - Analyst*

What sort of a run-rate -- just sort of a run-rate post EMV once EMV is fully converted, how many cards you guys would be selling per year?

David Brush - *CPI Card Group Inc - CFO*

I think it's going to -- now taking out prepaid cards, so I think the question is in and around what's the normal run-rate just so that I am very clear for financial debit and credit cards and that is after you sort of get through the full mix issue between what's magnetic stripe and what's EMV.

And I think based on what we have historically done I would say a normal runway if we just based it on a no growth, but just normal run-rate would be somewhere in the range of 180 million to 200 million cards would be the normal run-rate.

Operator

Thank you. I am showing no further questions at this time. I will turn the call back over to your Mr. Montross for closing remarks.

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

Okay, thank you. Thanks, everyone, for participating in the earnings call and we look forward to speaking with all of you next quarter.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference. Thank you for your participation. You may all disconnect.

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