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EDITED TRANSCRIPT

PMTS - Q4 2016 CPI Card Group Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the CPI Card Group fourth quarter and full year 2016 earnings conference call.

(Operator Instructions)

As a reminder, this conference call is being recorded.

I would now like to turn the conference over to Will Maina of the ICR. Mr. Maina, you may begin.

William Maina - *ICR - SVP*

Thank you, Operator, and good afternoon. Welcome to the CPI Card Group fourth quarter and full year 2016 earnings conference call. Participating on today's call from CPI Card Group are Steve Montross, President and Chief Executive Officer; and Lillian Etzkorn, 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 disclosure 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 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, adjusted 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 CPI's Web-site for all the 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.

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

Thanks, Will. Thank you, everyone, for joining us today for our fourth quarter and full year 2016 earnings conference call. Before we begin, I would like to introduce and welcome Lillian Etzkorn, who joined CPI Card Group as our Chief Financial Officer about eight weeks ago.

Lillian joins us from Dana Incorporated where she was Vice President and head of global treasury operations and previously led their global investor relations strategy. I couldn't be more excited to have Lillian as part of the CPI team, and she has already made a very positive impact on our organization during her brief time with us. It's great to have you with us, Lillian.

Now turning to a summary of our full year results; we are pleased with our modest improvement to prior expectations. In 2016, we generated net sales of $308.7 million, a decrease of 17.5% from the prior year, which was primarily driven by a reduction in EMV card sales volumes, and partially offset by continued growth of our services business lines.

Adjusted net income from continuing operations was $15.7 million, or $0.28 per share. Adjusted EBITDA was $57.2 million. And we generated $45.7 million in free cash flow in 2016, up from $39.1 million in the prior year. While our 2016 results reflect the challenging market environment for financial card manufacturing that we faced last year, I am pleased with our accomplishments which served to strengthen our business.

During the year, we continued to grow our services business and we expanded our end-to-end product and solution set through the introduction of new offerings such as the Print on Demand solution for the prepaid debit market. We implemented significant cost reduction and efficiency improvement initiatives, driving improved profitability and cash flow generation, which had a modest impact in 2016 and which will have a more significant continuing positive impact going forward.

We strengthened our management team with the addition of key experienced senior executives in our operations, sales, technology and finance functions, all of whom came to us with distinguished records of accomplishment. And, we continued to generate strong levels of operating and free cash flow, enabling us to invest in our business for growth while at the same time reducing our debt and returning cash to our shareholders.

Looking forward, I believe we've entered 2017 stronger and well-positioned to capitalize on the significant long-term growth opportunities in the markets we serve. I'd like to now share with you an update on current market conditions and how we will grow our business in 2017.

In the US Debit and Credit markets, the conversion of magnetic stripe cards to EMV chip cards, what we refer to as the EMV card migration, is expected to continue in 2017, albeit at a slower pace, with the conversion activity concentrated in the small and mid-sized issuers. Overall, we believe that EMV card penetration in the Debit and Credit markets will increase to about 80% by year-end 2017, which is up from about 65% at the end of 2016.

We also anticipate that the continuing EMV migration will be balanced by a lower level of card replacement activity by some of the large issuers who had previously converted most of their cards to EMV. Based upon our discussions with issuers and other third-party data sources, we expect overall industry EMV card volumes to be stable and generally consistent in 2017, with 2016 levels.

From a pricing perspective, we have experienced greater stabilization in our overall EMV prices, but expect continued pressure on prices going forward. To mitigate the impact of any pricing pressure, we continue to work on cost reductions, including supply chain cost reductions and efficiencies, to ensure that the quality of earnings can be maintained and improved going forward.

With respect to the growth drivers for the business in 2017, I will highlight three areas. The first is our services business. We expect that our services business will continue to be an area of growth, driven by solid demand from small and mid-sized institutions for our personalization and fulfillment solutions, ongoing penetration of our Card@Once offering, and growth of our new Print on Demand solution which I will discuss in a moment.

Our Card@Once instant issuance solution continues to show good growth, with 5,600 installations for over 1,200 banks and credit unions at the end of 2016, which was up from 5,150 installations at the end of the third quarter of 2016. Our pipeline and backlog for Card@Once continues to grow, which we believe bodes well for 2017.

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We are also continuing to develop new digital services which we expect will enhance our product offerings through their automation, broaden our EMV-related services, and provide new payment forms such as digital payments for certain prepaid applications.

Secondly, we anticipate that our Prepaid business will be another area of growth in 2017, with volume growth in the retail prepaid vertical, and stronger growth in the B2B and B2C verticals of the prepaid market including payroll, corporate incentives and benefits.

Our recently launched Print on Demand solution, which provides our customers with a highly customizable solution for on-demand production and fulfillment of personalized Payment Cards and related collateral, positions us well to penetrate further the fast-growing B2B and B2C prepaid markets. We have been taking orders for this bundled product and service and have built a solid pipeline of new business.

Based on our current pipeline of business and the level of activity with prospective customers, we continue to be very confident in the opportunity for Print on Demand growth in 2017. And finally, in the financial card manufacturing area, as I discussed earlier, we expect the overall industry to be fairly stable in 2017 in comparison to 2016 levels, and as a result we expect modest growth in our EMV card manufacturing in 2017.

While not expected to be a driver of growth for 2017, I do want to provide an update on the more advanced contactless or Dual-Interface EMV product. While we continue to supply dual-interface cards to a handful of issuers, the demand for dual-interface cards in the US remains modest and we currently do not expect it to contribute meaningfully to our top line in 2017.

Nevertheless, we remain encouraged by our discussions with prospects regarding dual-interface technology and the overall level of activity by issuers in setting up their dual-interface product roadmaps. We continue to view dual-interface as an opportunity for us in the future, when adoption by issuers takes hold in a meaningful way.

Lastly, I'd like to touch on our ongoing cost savings and efficiency initiatives. As we've discussed, we have taken a number of actions over the past six months to reduce costs, with the focus on direct manufacturing cost, indirect labor, third-party services, and administrative costs. We are on track to deliver an expected $10 million of cost savings in 2017 and we will continue to look for additional areas of opportunity for cost efficiencies.

Overall, we entered 2017 well-positioned and are confident in our ability to grow both our existing and new products and services, and to continue to drive efficiencies and operating improvements.

With that, let me turn the call over to Lillian to review the detailed financial results and 2017 guidance.

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

Thanks Steve. Before taking you through our results, I would like to first say how excited I am to be part of the CPI (inaudible) team. I've been here for two months and I couldn't be more enthusiastic about the business and the opportunities in front of us. My time at the Company so far has served to further solidify the reasons why I decided to join CPI.

From a business perspective, I was attracted to CPI's profile, leading position in the large and attractive Financial Payment Card market, high levels of recurring demand for our products and services, strong customer satisfaction, constant product innovation, and strong free cash flow capabilities. These elements made CPI an incredibly attractive opportunity.

When arriving at CPI, it was encouraging to learn that management and the Board welcomed looking at ways to drive continuous and sustainable business process improvement. To that end, I am excited and fortunate to be partnered with Steve and the rest of the management team to build on our leadership position in the market and advance our Company's long-term vision for growth and profitability.

Now turning to our financial results, I'll first provide you with a review of our fourth quarter and full-year 2016 results, and then I will provide our guidance for full year 2017 before opening the call for questions.

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Fourth quarter net sales were $67.4 million and full year 2016 net sales were $308.7 million. On a full-year basis, this is a decrease of 17.5% compared with the prior year and up modestly from previous expectations. Product net sales of $36 million in the fourth quarter reflects a 53.7% year-over-year decrease in the number of US Debit and Credit segment EMV chip cards sold. Services net sales grew 3.7% year-over-year to $31.4 million in the fourth quarter, primarily driven by growth in our Prepaid business and card personalization and fulfillment services. For full year 2016, product net sales decreased by 30.3% and services net sales increased by 5.8%.

Moving down the income statement, gross profit for the fourth quarter was $20.4 million, representing a gross margin of 30.3%, compared with a gross margin of 33.6% in Q4 of 2051. The decrease in our gross margin from the prior year primarily reflects both the revenue decline and absorption of fixed costs, partially offset by an increase in our average selling prices and the cost reduction programs we initiated during the second quarter of 2016. For the full year 2016, gross profit was $101.9 million or 33% of net sales, compared with $135.8 million and 36.3% in 2015.

Loss from operations in the fourth quarter of 2016 was negative $900,000, compared with operating income of $10 million in the prior year period. The change in income from operations primarily reflects the same factors impacting the gross profit margin, in addition to $1 million of patent and shareholder litigation and related charges, $2.7 million of an intangible asset impairment charge related to the discontinued use of a Company trade name, and $400,000 of severance charges.

Offsetting these decreases was a $6.7 million decline in stock-based compensation. As a result, the Company incurred a $7.5 million charge in the fourth quarter excuse me, as a reminder, the Company incurred a $7.5 million charge in the fourth quarter of 2015 related to the settlement of the Phantom Stock Plan in conjunction with the IPO. For the full year 2016, operating income was $29 million.

We reported a net loss from continuing operations of $4 million or a loss of $0.07 per share in the fourth quarter of 2016, compared with a net loss from continuing operations of negative $1.6 million or $0.03 per share in the fourth quarter of 2015. We recorded a tax benefit of $2.1 million in the fourth quarter of 2016, compared to a tax expense of $1.3 million in the prior year.

Our tax rate for the full year was 36.8%, which was up from 2015 due to the impact of state income taxes. For the full year 2016, net income from continuing operations was $5.4 million, compared with $31.3 million in the prior year.

Now turning to our non-GAAP financial measures; adjusted EBITDA for the fourth quarter of 2016 was $8.6 million, compared with $21.8 million for the fourth quarter of 2015. Adjusted EBITDA margin was 12.8% versus 23.3% in the fourth quarter of 2015. On a year-over-year basis, the changes in our adjusted EBITDA and EBITDA margin primarily reflect lower net sales and some corresponding impact of absorption of overhead costs from the lower EMV chip card sales volumes.

For the full year 2016, we generated adjusted EBITDA of $57.2 million, representing an EBITDA margin of 18.5%, compared with adjusted EBITDA of $96.2 million in the prior year at a 25.7% margin. Adjusted net income from continuing operations was $100,000 for the fourth quarter of 2016, compared with $8.8 million in the prior year period. Adjusted diluted earnings per share from continuing operations in the fourth quarter of 2016 were $0.0 compared with $0.16 in the prior year period. For full year 2016, adjusted net income from continuing operations was $15.7 million, down from $47.3 million in 2015.

Full year 2016 adjusted diluted earnings per share from continuing operations were $0.28. This is compared with $0.83 in the prior year, after making the pro forma adjustment to our 2015 shares outstanding for the 15 million shares issued in our IPO.

Now turning to a review of our segments in Q4 of 2016; US Debit and Credit segment net sales were $43.7 million for the fourth quarter, a 35.2% decrease from the prior year period. Segment EBITDA was $8.8 million, down from $19 million in the prior year period.

The decline in our US Debit and Credit segment results were predominantly driven by the year-over-year decrease in EMV card shipments. Average selling price of $0.97 in the fourth quarter were up slightly compared with the $0.96 in the third quarter of 2016. This increase is primarily due to customer mix. In our card personalization and fulfillment business, we generated a $2.6 million year-over-year increase in net sales during the fourth quarter, partially offsetting the decline in product net sales.

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US Prepaid Debit segment net sales were $12.6 million in Q4, up 2% on a year-over-year basis. Revenue growth in our US Prepaid Debit business reflected higher volume from sales activity, partially offset by lower prices. US Prepaid Debit segment EBITDA was $3.2 million, down slightly on a year-over-year basis.

Finally, our UK Limited segment net sales were $7.8 million in the fourth quarter, representing a decrease of 27.7% from the prior year period. Our UK Limited segment revenues were impacted by approximately $1.7 million due to the unfavorable foreign currency exchange rate fluctuations from a weaker British pound.

On a constant currency basis, sales for the fourth quarter decreased 11.7% from the fourth quarter of 2015, reflecting softened volumes and card sales. UK Limited segment EBITDA was $1 million, compared with $1.5 million in the prior year.

Moving on to some cash flow and balance sheet items, cash flow from operations for the fourth quarter was $20.2 million and $60 million for the full year. Capital expenditures in the fourth quarter were $1.9 million and $14.3 million for the full year. 2016 full-year free cash flow was $45.7 million, up from $39.1 million in the prior year when excluding a $13.9 million payment related to the settlement of the Company's Phantom Stock Plan in 2015.

We ended the quarter with a cash balance of $37 million and a net debt balance of $275.5 million. The total debt principal outstanding was $312.5 million. Netting the deferred financing costs and discounts, the recorded debt balance was $301.9 million. At December 31, 2016, our net debt leverage ratio was at 4.8x. As of December 31, 2016, we had approximately $77 million of available liquidity, comprised of a $40 million undrawn revolver and $37 million of cash on the balance sheet.

In our press release issued this afternoon, we also announced that our Board of Directors approved a dividend of $0.045, payable on April 7, 2017 to stockholders of record at the close of business on March 17, 2017. We made no share repurchases during the fourth quarter, and for the full year we repurchased approximately 1.4 million shares of common stock for $6 million under the present share buyback authorization.

Now turning to our 2017 guidance; we came out of a challenging market in 2016 in a strong position and feel very confident as we move into 2017. As Steve reviewed, we see three key areas of growth for our business in 2017. As it relates to our services business, we anticipate this will continue to be an area of growth, driven by solid demand from small and mid-sized institutions for our personalization and fulfillment solutions, ongoing penetration of our Card@Once offering, and growth of our new Print on Demand solution.

Additionally, in the Prepaid market, we anticipate growth in 2017 with volume growth in the retail prepaid vertical and stronger growth in the B2B and B2C verticals of the prepaid market, including payroll, corporate incentives and benefits. As Steve reviewed, our recently launched Print on Demand solution positions us well to further penetrate the fast-growing B2B and B2C prepaid markets. As we continue to ramp up, the majority of the revenue for Print on Demand will occur in the second half of 2017.

And finally, for the financial card manufacturing area, we expect to see overall industry to be fairly stable in 2017 in comparison to 2016 levels. As Steve discussed, we believe that EMV card penetration in the Debit and Credit markets will increase to about 80% by year-end 2017. We also anticipate that the continuing EMV migration will be balanced by a lower level of card replacement activity by several large issuers who have previously converted most of their cards to EMV. We expect modest growth in our EMV card manufacturing sales in 2017.

Overall, we see the market to be stable this year. However, as we have begun the year, Q1 has ramped up slower than anticipated. Historically, Q1 revenue is on average 20% of the full year. Calendarization of the sales volume in both 2015 and 2016 were impacted by EMV card migration patterns, so they are not good comparisons for expected cadence.

For 2017, specifically, we expect Q1 revenue to be about 17% to 18% of the full-year results, reflecting both the more typical calendarization and also the slower ramp-up that we have seen in volume. Adjusted EBITDA will also be more heavily weighted Q2 through Q4.

In terms of the full year, we expect 2017 net sales to be between $315 million and $340 million, which reflects the growth rate of 2% to 10% over 2016 results. The tempering in growth rate reflects both a higher-level sales of 2016 performance than we previously anticipated and also the

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slower ramp-up in the first quarter volumes. GAAP earnings per share is expected to be between $0.22 and $0.32 and adjusted diluted earnings per share of $0.35 to $0.46 in 2017.

Our GAAP earnings per share range do not take into account any impact to interest expense for debt repayments, including acceleration of amortization of debt issuance costs and discount. We expect to generate adjusted EBITDA in 2017 between $64 million and $73 million, which is a strong improvement over 2016 results by about 10% to 27%.

The 2017 adjusted EBITDA margin is projected to be between 20.3% to 21.5%. In summary, we believe we are well-positioned to grow the business in 2017 and deliver shareholder value.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jim Schneider with Goldman Sachs.

James Schneider - *Goldman Sachs - Analyst*

I was wondering if you could maybe talk about the near-term outlook first. Can you give us a sense about why you have confidence that the slower ramp in Q1 is going to come back in Q2? Is it that you pulled some business from Q1 of this year into Q4 and that was driving outperformance? And can you maybe comment on the overall inventory situation in that both large and small issuers?

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

This is Steve. So, what was seen is some of the business got deferred, and that's one factor, is we were seeing business deferred out of the first quarter, and it wasn't business - - there wasn't any business that was pulled into the fourth quarter of 2016 from the first quarter of 2017, so that wasn't a factor. It was some business was being deferred, and so that's a factor.

And also as we have discussions with the issuers, we have a good sense of what their overall demand is for the year, and based on that, that's why we still feel confident that we are going to see the overall demand levels that we had indicated in our guidance, although we are starting out slowly in the first quarter.

And so, that's why we have confidence that we are going to get to the overall numbers for the year, Jim, is just through the discussions we are having with issuers about their business and what they expect to do for the year. And then again, the other factor is just having some business move out of the first quarter into subsequent quarters.

James Schneider - *Goldman Sachs - Analyst*

Okay. And then maybe belay that point a little bit, it wouldn't have been prudent to take a little bit of a haircut to that forecast, because obviously all these people are the same customers who told you that demand was going to come back in last year, so obviously it will be around the same situation and all. But can you talk about the level of conservatism around the forecast you're placing this year versus last year?

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

In terms of the forecast we have for this year, we think it's extremely balanced. We have gone through and looked at each of the areas of the business, not just card manufacturing but also the other areas as well. And so, we have taken a very, very balanced view of the business, and the result is the forecast or the guidance that we have provided. So, we feel very good about that guidance, Jim. We again feel good about putting that guidance out.

James Schneider - *Goldman Sachs - Analyst*

Just one more for me, which would be on the gross margin outlook. Can you comment directionally on whether gross margins are going to be flat, up or down in 2017, and help me know how much of that is driven by mix of the services business and Prepaid? And, do you expect any kind of improvement on the core EMV side as you get any better absorption on the fixed costs there?

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

Jim, this is Lillian. So in terms of the gross margin, I think it will be a little bit of a mixture across the various product lines. What we're seeing and what we are anticipating is that it's still a competitive market, as we're working on the business.

We're aggressively working, as Steve indicated, on cost reductions, so that as there are potentially competitive pressures in the marketplace, we are able to mitigate those pressures through material cost efficiencies, supply-chain improvements, overall efficiencies in the business, so that we can continue to maintain and ultimately grow those margins as we move forward.

James Schneider - *Goldman Sachs - Analyst*

So net-net, would you expect them to end up higher for the full year than they were in 2016 on the gross margin line?

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

From an overall adjusted EBITDA margin perspective, yes, we are looking for improvement 2017 versus 2016.

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

Jim, just to go back to your question about the overall guidance, again we feel very, very good about the overall guidance. As I said, we took a very balanced and measured view of the business, but we were, as I mentioned, we're anticipating that we're going to have very modest growth in our card manufacturing, and on our services side - - which has been a strong growth area for us - - we see there being growth in the services area, particularly as I mentioned around Card@Once and then with our Print on Demand, for Prepaid we see growth coming from there.

So, I think we've been very balanced in our view, overall, about the business and what the expectations are from card manufacturing as well as the other areas of the business.

Operator

Bob Napoli with William Blair.

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Robert Napoli - *William Blair - Analyst*

The second quarter, Steve, how much visibility do you have sitting here on March 1st into April, what you would expect to see, Lillian, in the April timeframe? Do you expect like the second quarter to be the second quarter and the third quarter to kind of be the largest quarters of the year? I mean how much visibility do you have into that type of a ramp-up?

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

It's Lillian. So as we start looking into the year, I guess first in terms of the visibility, we probably have the best visibility on four to eight-week perspective. So, we're starting to see the visibility as we are getting into the second quarter with firm orders from the customers.

When we think about the overall cadence for the year, as I mentioned, first quarter is definitely going to be the lower quarter for the year with 17% to 18% of the revenue. And then I'd say the balance of the year is probably more your typical type of historical cadence. So, as we move through the year, just expect more consistent with the past seasonality that we have seen with the business.

Robert Napoli - *William Blair - Analyst*

OK. And then, on the pricing, your average selling price was pretty steady in the quarter, which was good to see. But JPMorgan had their Investor Day yesterday and one of the things that they talked about in their card area, I mean they didn't put a lot of emphasis on it, but one of their targets was to reduce the cost of cards in metal cards and overall the purchasing cards.

How confident are you or what do you expect to see in a decline, and I think is more of your growth coming from smaller banks next year going forward, but just some thoughts about pricing, JPMorgan's comments on focusing on reducing card costs?

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

As we know, the large issuers are very focused on that. But we expect overall, Bob, that as we said, we'll continue to see some pricing pressure and we'll continue to really focus on making sure that we are taking out costs.

And so, whether it's supply-chain cost or it's other efficiencies in the business, we're going to be very, very focused on reducing our costs, so that we keep the quality of earnings up. But we expect that we are going to see pricing pressure and that's just the nature of the market, and so in the past we have worked hard to counteract that and we'll continue to deal with that.

Robert Napoli - *William Blair - Analyst*

Do you expect to see growth of your what kind of growth do you expect to see out of the Prepaid business in 2017? And do you see that in the first quarter? I mean, you're adding a lot of new products.

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

We expect that we're going to see big growth in the Prepaid business year-over-year. And then as I mentioned, there was some business and we had some business in the Prepaid that moved out from the first quarter to later quarters, and the cadence of the orders can be a bit challenging, and we have talked about that before on Prepaid.

But overall, we see good growth for Prepaid. And then in terms of the acceleration of the results in Prepaid, we really see that ramping up as we get out into quarters two through four.

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Robert Napoli - *William Blair - Analyst*

Thanks. And this last question - - free cash flow utilization for this year, will you pay down debt? Will you continue to build cash? What will you do with your excess free cash flow?

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

So as we think about our capital allocation strategy, I guess for a simple way to put it, is really what we look to do with our cash first and foremost is to make sure that we are investing in the business, investing in these growth activities and products and services that Steve has talked about.

So, that has been historically and it will continue to be our focus. Additionally, we are also focused on reducing the debt. So, we'll continue as the opportunity presents to take advantage and pay down our debt to improve our net leverage ratio. And then as we continue to think about excess cash beyond that, we'll look to return excess to the shareholders.

You saw us in 2016 both have the dividend as we announced today with the press release, we declared a dividend again for this past quarter. And then we also, last year, did share buybacks. So there's different potential uses for the cash, but I'd say the top two priorities are to first and foremost invest in the business and then to continue to delever.

Operator

Brad Berning with Craig-Hallum.

Brad Berning - *Craig-Hallum - Analyst*

A few follow-ups on some of the comments already, can you just, for one housekeeping item, number of EMV cards that you sold in the quarter? Secondly, can you address a little bit more specific, Steve, on the inventory issue? Where do you guys think you are in the market? You talked about 150 million cards in the inventory issues in the past, if you can give us an update on that.

And then third, on the EMV issues, can you talk about the 2015 cards, what portion of those had three-year expirations? Just trying to get some early thoughts on the recurring revenue piece that will kick-in in 2018 of that big implementation that you had in 2015.

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

In terms of the number of EMV cards, we'll get back to you in just a moment on that, Brad. In terms of the inventory issue, and I know Jim asked this question too, we think that that inventory overhang with the large issuers and the large processors that we saw in 2016 - - we think that overhang issue is over. I think that for the most part, all of those major players have consumed or run through that excess inventory and the inventory levels.

There is a couple of exceptions in the market, but in the most part the inventory levels for the large issuers and processors have returned to what they would consider to be more normalized level. So we think that that excess inventory that was a real issue in 2016 is not going to be an issue in 2017.

Brad Berning - *Craig-Hallum - Analyst*

Good to hear. And then the three-year expiration?

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

So we have not seen any kind of third-party data. And what we have is some information from our own operations. And so, for the small and mid-sized issuer market, what we have seen recently is that the card expirations with three years or less, there's actually surprisingly a meaningful percentage of cards that have two-year expiration, but for three years or less, it's running about 70%, with the other 30% greater than three years.

And then for the large issuers, when we had looked at it last year, and we don't have any updated numbers on that, but when we had looked at it last year, the percentage were roughly the same, with that 30% longer than three years represented by, somewhat represented by Discover and American Express that have always had longer expiry dates. But we have not gotten any updated information on, say, that segment of the market.

Brad Berning - *Craig-Hallum - Analyst*

And then on the supply-chain cost management that you talked about, as far as dealing with the more typical historical pricing, have you seen chip pricing keeping pace with your expectations for pricing? Or, are you able to in the small and medium side stay ahead of the chip pricing side?

Just comment on both, the chip side as far as that goes, but also all-in, do you expect gross margins to be able to be better ex the fixed cost element of the inventory overhang pressures of the last year - - can you help us think through both sides of that, the chip price and the gross margin side?

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

Yes. And so on the chip side, we have seen chip prices come down, and we had I think talked about that throughout 2016, but we have seen chip prices continuing to come down. Finished product prices were coming down a bit, as you saw.

We are seeing stabilization in our finished product prices now. Some of it is mix related, that you just referred to. But we've been able to continue to take chip costs down, and that's one of the things we're focused on, is making sure that we can continue to reduce those chip costs.

In terms of the gross margins, I'm going to have to - - I'm not sure we have a real clear number for you around that, Brad. We weren't planning on giving guidance to the gross margin.

Brad Berning - *Craig-Hallum - Analyst*

Understood. Last question, metal cards, you mentioned in the press release just vaguely, didn't talked about it. Can you give an update on where you are at on the new product offering?

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

Yes. So, we have certification for our edge-to-edge metal card from Visa, MasterCard and Discover. So, we're excited about that. We have certification from Visa on our metal-embedded card. We are having discussions with a number of issuers about that product. And so, we're very optimistic about that product for the business.

Brad Berning - *Craig-Hallum - Analyst*

Okay, thank you. I'll get back in the queue.

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Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

Brad, just as a follow-up, in terms of the overall volume for the EMV cards in 2016, we had produced 104.5 million cards, just to follow up on that question.

Brad Berning - *Craig-Hallum - Analyst*

OK. (inaudible) handy? If not, I'll back into it, don't worry.

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

Can we have our next question?

Operator

Paulo Ribeiro with BMO Capital Markets.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

Just quickly, back to that number, 18 million cards produced this quarter, right? Because you had 38.9 million a year ago and you said you had declined by 53.7%, so it comes to 18 million. So that said, you guys are guiding for a modest increase in the EMV production for next year and for continued price pressure.

I have an issue with continued because it seems that during 2016 you were able to keep price pretty stable overall. So I'm a little puzzled here, because it seems to me that what happened in 2016, and I want some comments and your color or perspective on that, is that because you traded sort of volume for price, right, you were able to keep a fairly stable good price but the volume was not there, disappointed throughout the year.

For 2017, if you're just expecting a modest increase in production numbers, where is the pricing pressure coming from? Is the change in mix that dramatically, meaning we're going to see the large issuers, that you just alluded that they kind of depleted their inventories, coming back and that will be a substantial part of the volume while the medium and smaller issuers are not back in any meaningful way yet and thus the pricing pressure?

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

Yes. Paulo, I think part of it is just the overall view that we have just seen over a period of years that prices generally drift down. And so, that's why we think we are prudent in anticipating that we are going to continue to see some pricing pressure. And we did see pricing pressure in 2016.

We have held up, the prices have stabilized. Part of it is mix, our business mix, because of the diversity of the business we have, which is a good thing. So, part of it is mix in terms of the stabilization of prices. But we think that we'll continue to see some pricing pressure. I think it would be imprudent of us not to expect that given that's just the history over a period of years in the industry.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

Right, but imagine how much pressure, given that if the volumes are not really picking up, unless you have a dramatic change in mix towards larger issuers, where is that coming from? What was the average pricing for 2016, total 2016 I guess, is a better way to maybe assess?

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

OK. Just a second, we'll get that for you.

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

So, Paulo, if we are looking at the overall, the average in the year, so we ended the year at $0.97 on average for the fourth quarter. And when we look at the full year, it was at $0.95 on average.

And I think what Steve is indicating is not so much that there is a specific event or activity that's going to cause the pressure on the pricing, it's just really the general trends that have happened over time that there continues to be pressure. So, we are focused on trying to control what we can control, and that's operating efficiencies, cost reductions, et cetera.

So it's not that there is something specific and imminent, it's just historically that is how it's transpired, so we are just planning prudently from that perspective.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

Right. I just think that for $0.95, the average price if I remember correctly was just around $1. So the decline doesn't seem to be as dramatic as some of us that covered kind of from the beginning were expecting.

Anyway, moving on to a different point here, if you expect the markets to be stable overall, the industry in terms of production, and you are just growing modestly, it seems to me that for 2016 you actually were below your historic market share that you had with mag stripe cards. Is that a fair assessment that you lost share in EMV and you don't expect to regain it in 2017?

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

No, that's not the assumption. That's not our view, Paulo. Our view is that our market share is relatively consistent with what it's been historically, and that's based on discussions that we are having with the issuers as well as looking at whatever data is there in the marketplace.

As you know, all of that information isn't published and there is only one other reporting entity that publishes volume and that's valid. But just through discussions with the customers and other third-party sources, we don't think that our market share has changed from what it's been historically.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

Perfect. The last question for me, and I'll get back into queue, litigation and impairment, are those truly one-off? Is the litigation the end of your Gemalto - - is that for the Gemalto lawsuit?

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

It is, it's for the Gemalto and shareholder lawsuit. And then the impairment, what that's related to is we acquired a business back in 2014 and we discontinued one of the trade names associated with that business because we unified everything under the CPI trade name and wanted to make sure that we're going to market with one trade name.

So, it wasn't impairment of any asset value that we have or a position in the market or a product or anything like that, it was just the discontinued use of a trade name so that we could unify how we go to market under one trade name, which was CPI.

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Paulo Ribeiro - *BMO Capital Markets - Analyst*

Okay. And the litigation, where does it stand? And then I'm really done.

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

So the shareholder litigation, where that stands is that there has been a motion to dismiss that we have filed. And so, that will be ruled on sometime in the coming months. In terms of the other litigation, the first lawsuit with Gemalto, that's been stayed. As you may know, we had filed what's called an Inter Partes Review with the Patent and Trademark Office, asking them to review that patent because we felt that it was invalid.

And they came back and indicated that they believe that all of the independent claims - - they upheld our petition for all the independent claims and they upheld our petition for almost all of the dependent claims. And so, we feel very good about that outcome, but the litigation is stayed until there is a final ruling by the Patent and Trademark Office.

And then for the second lawsuit, that's just proceeding in discovery, and so there hasn't been any material change to that lawsuit. That just proceeds through discovery at this stage.

Paulo Ribeiro - *BMO Capital Markets - Analyst*

Perfect. Thank you.

Operator

Eric Ciura with Baird.

Eric Ciura - *Baird - Analyst*

I guess earlier in the year, you talked about the potential for pricing from the larger issuers to be down up to about $0.15 or so by the end of the year, and I was just wondering if that played out largely as you expected. And then secondly, just on small and mid-issuer demand, how was that during Q4 and did that help bring ASP higher?

Lillian Etzkorn - *CPI Card Group, Inc. - CFO*

Eric, as we look at maybe from an end to end perspective or a year-to-year perspective, where we ended the year in Q4 of 2015 was an overall average selling price of $1.05, and then we ended this year at the $0.97 as we stated. So, there were some pricing pressures that occurred on balance during the year across the businesses.

And again, that's part of why as we look to cost reductions, the commitment that we had for 2016 and the $10 million that Steve addressed for 2017, we think it's prudent to continue to focus on that to ensure that we maintain strong margins for the business.

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

And just in general, just to your question about the large issuer, we didn't see that level of deterioration or erosion in the price going from the end of 2015 to the end of 2016.

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Eric Ciura - *Baird - Analyst*

All right, thank you. And then secondly, next year as small and mid-issuer demands gains to improve more, what impact does that have on margins overall?

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

Overall, it's a positive impact on the business. The more the mix shifts to the small and mid-sized issuers for us, it has a positive impact on our margins.

Eric Ciura - *Baird - Analyst*

All right, thanks guys.

Operator

Thank you. This concludes our question-and-answer session for today. I would like to turn the conference back over to Steve Montross, Chief Executive Officer, for closing remarks.

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

Thank you everyone for participating in our earnings call and we look forward to speaking with you next quarter.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone have a great day.

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