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PMTS - Q1 2017 CPI Card Group Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q1 2017 CPI Card Group 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 Investor Relations. Sir, you may begin.

William Maina *- ICR, LLC - SVP*

Thank you, Ashley, and good afternoon, everyone. Welcome to the CPI Card Group First Quarter 2017 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 may be made or discussed on this call. The earnings press release is posted on CPI's website.

Please note there is also a presentation that accompanies this conference call and is also accessible in the IR section of our 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 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 loss or income, adjusted diluted loss or earnings per share, free cash flow and constant currency. Please see the earnings release on CPI's website for all the disclosures required by the SEC, including reconciliations to the most comparable GAAP measures.

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

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Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Thanks, Will, and good afternoon, everyone. Thank you for joining us on today's call. I will begin by covering some highlights from the first quarter and then provide you with an update on market conditions and recent developments.

Beginning on Slide 4. We have a summary of our first quarter 2017 results. Total net sales were $56 million, a decrease of 35.2% from the prior year period. Adjusted net loss was $3 million or a negative $0.05 per share. We generated adjusted EBITDA of $3.9 million. Free cash flow was a negative $8.3 million, and we returned $2.5 million to shareholders through our quarterly dividend. Overall, our first quarter results were in line with our expectations, and we are reiterating our 2017 financial guidance, which Lillian will discuss later in the call.

Turning to Slide 5. I'd like to provide you with some more detail on our first quarter results. Product net sales for the first quarter were $29.8 million, down approximately 46% year-over-year. Our first quarter results compared to the prior year were predominantly driven by a decrease in our EMV card production volume, which was in line with our prior expectations and reflected a continuation of the trend of reduced volume demand in the U.S. EMV card market that began in 2016. More specifically, we produced 18.3 million EMV cards in the first quarter of 2017, which was down from 41.4 million cards in the prior year period, with the decrease driven primarily by reduced demand from large issuers. Despite this decrease, we believe our market share has remained fairly stable year-over-year. Based upon our first quarter results and ongoing conversations with our customers regarding their EMV card demand for the remainder of 2017, we continue to expect to produce about the same number of EMV cards in 2017 as we did in 2016.

From a pricing perspective, the average selling prices or ASPs for our EMV cards declined to $0.84 per unit in the first quarter from $0.97 in the fourth quarter of 2016. On a sequential basis, our first quarter ASPs were primarily impacted by customer mix with a higher percentage of our first quarter EMV card sales coming from large issuers. We anticipate large issuer pricing will continue to be under pressure for the remainder of 2017, which is in line with our prior expectations.

We will continue to pursue cost reductions, including supply chain cost reductions and efficiencies to help mitigate pricing pressure and drive the quality of our earnings. Our services net sales decreased 16.5% year-over-year to $26.2 million in the first quarter of 2017. Services revenue was impacted by the delayed rollout of a product refresh by a large prepaid customer. We expect this rollout to occur later this year.

Our leading financial card instant issuance solution, Card@Once, continued to be an area of strength for us in the first quarter as we continued to achieve record months for cards produced and for revenue. We ended the quarter with approximately 6,050 installations, up from 5,600 installations at the end of 2016, and our pipeline and backlog for Card@Once continues to grow. During 2017, we expect to add new reseller partners to help extend our sales reach and market penetration of Card@Once.

Lastly, before moving on, I will highlight that we are pleased with the progress we are making on our ongoing cost savings and efficiency initiatives. We are on track to deliver the previously announced $10 million of cost savings in 2017. In addition, in line with our long-term objectives, we will continue to look for areas of opportunity to realize additional cost efficiencies and increased productivity in order to drive earnings growth.

Turning to Slide 6. I'll provide a brief update on current market conditions. Overall, we are seeing industry trends that are consistent with what we discussed with you during our year-end earnings call in March. Based on our ongoing conversations with our customers as well as third-party information, we continue to expect EMV card production in the U.S. in 2017 to be fairly consistent with 2016 levels. The continuing conversion of mag stripe cards to EMV cards will be primarily concentrated with a small and mid-sized issuers and the increase in EMV cards from the continuing market conversion in 2017 is expected to be offset by a lower-level of card replacement activity by large issuers, who had previously converted most of their cards to EMV.

For the first quarter of 2017, we estimate EMV card penetration in the U.S. debit and credit market was approximately 65%, consistent with the end of 2016. We continue to expect EMV market penetration will increase to approximately 80% by year-end 2017. While EMV card migrations are progressing at a slower rate than in the past few years, with approximately 35% of the U.S. debit and credit markets still mag stripe, there continues to be significant runway for EMV-driven growth in the industry.

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In the U.S. prepaid market, we continue to expect growth in this market in 2017. And within the prepaid market, we continue to expect that the enterprise B2B and B2C verticals represent significant areas of growth in 2017 and beyond. We estimate these enterprise prepaid verticals will grow twice as fast on average as retail prepaid over the next several years.

Our recently launched Print on Demand solution, which I will discuss in more detail shortly, is enabling us to capitalize on this growth in enterprise prepaid. On the retail prepaid side, we expect our retail prepaid card volumes will grow in line with the market in 2017. However, price compression is expected to largely offset increased volumes, leading to our outlook for flattish retail prepaid revenue in 2017. This view is unchanged from our prior outlook.

We remain focused on capitalizing on the ongoing long-term secular growth trends driving the U.S. financial payment card market, and believe that we are well positioned in the industry given our strong market position, attractive broad customer base and suite of end-to-end products and solutions. We will continue to focus on what we call growing the base through our actions to deliver sales and service excellence and superior execution to our customers.

Moving to Slide 7. I will highlight a few developments that underscore the progress we are making in delivering new and innovative products and solutions to the market, which increase the value that we deliver to our customers and drive our growth. For our Print on Demand solution, we have several new customer implementations launching this quarter, including implementations with several of our largest prepaid program manager customers. We have built a solid line of business since introducing Print on Demand late last year, and the pipeline continues to grow as we gain traction in the market. The early success that we're seeing continues to support our high level of confidence in the opportunity for Print on Demand growth in the second half of 2017.

Turning to metal cards. I'm pleased to say that we have made strong progress in terms of our market readiness for this product. We have received Visa, MasterCard and Discover approval for our edge-to-edge stainless steel card and Visa has also approved a second metal card product, our encapsulated metal card.

In terms of market activity, we are still at the beginning stages of growth in this market, but we believe we are well positioned to capitalize on the future metal card market opportunity. As I mentioned earlier, we continue to see strong growth with our Card@Once solution. We plan to bring to market this year new printer technology that improves print quality and increases print capacity. Our upcoming new printer release is named precision by Card@Once. And we have been beta testing the printer since early April and are receiving positive customer feedback.

And turning to Slide 8. In closing, our first quarter results were in line with our expectations, and the financial payment card market is showing signs of stabilizing. I'm pleased with our initiatives to grow our base of business with a focus on sales and service excellence. I'm also pleased with the progress we are making with our new and innovative products and solutions and remain optimistic about their long-term growth potential.

Finally, our progress and our cost savings and efficiency actions is on track and positive. We remain focused on driving quality and superior execution for our customers and profitable long-term growth for our shareholders.

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 and Company Secretary*

Thanks, Steven. Good afternoon, everyone. I'll now provide a review of our first quarter 2017 results.

Turning to Slide 10. You will see the highlights of our first quarter results. First quarter net sales were $56 million, down 35.2% from $86.4 million in the first quarter of 2016. Product net sales decreased $25.2 million from the prior year, primarily driven by a 55.8% year-over-year decrease in the number of U.S. Debit and Credit EMV chip cards sold. Services net sales decreased $5.2 million or 16.5% year-over-year to $26.2 million, primarily driven by declines in the U.S. Prepaid Debit segment sales and lower card personalization and fulfillment services revenue, which I will discuss in more detail shortly.

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Gross profit for the first quarter was $16.1 million, a decrease of 45.8% year-over-year and representing a gross margin of 28.7% compared with a gross margin of 34.4% in the first quarter of 2016. The decrease in our gross margin from the prior year primarily reflects both the revenue decline and absorption of fixed cost, partially offset by our cost reduction actions, which we initiated during the second quarter of 2016.

Loss from operations in the first quarter of 2017 was a negative $1.8 million compared with operating income of $13.7 million in the prior year period. The change in income from operation primarily reflects the same factors impacting the gross profit margin in addition to $580,000 of patent and shareholder litigation and related charges in the first quarter of 2017. We reported a net loss of $4.5 million or negative $0.08 per share in the first quarter of 2017 compared with the net income of $5.7 million or $0.10 per share in the prior year period.

We recorded a tax benefit of $2.3 million in the first quarter compared to a tax expense of $2.8 million in the prior year period. Our effective tax rate was 33.7% in the first quarter 2017.

Regarding our non-GAAP metrics. Adjusted EBITDA for the first quarter of 2017 was $3.9 million compared to $18.8 million for the first quarter of 2016. Adjusted EBITDA margin was 6.9% versus 21.7% in the year ago period. 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 cost from lower volumes. Adjusted net loss was $3 million or a negative $0.05 per diluted share compared with adjusted net income of $7.1 million or $0.13 per diluted share in the first quarter of 2016.

Now turning to Slide 11 and a review of our segments. U.S. Debit and Credit segment net sales were $39.5 million for the first quarter, a 39.3% decrease from the prior year period. The corresponding segment EBITDA was $7.6 million, down from $18.9 million in the prior year period. The decline in our U.S. Debit and Credit segment results were predominantly driven by a year-over-year decrease in EMV cards sold as well as lower average selling prices. 18.3 million EMV cards were sold in the first quarter of 2017 compared with $41.4 million cards in the first quarter of 2016.

On a weight average basis, average selling prices were $0.84 in the quarter, down from $0.97 in the fourth quarter of 2016. Average selling prices decreased sequentially in the first quarter, primarily due to customer mix, which Steve discussed earlier. In our card personalization and fulfillment business, net sales decreased $2.7 million year-over-year, predominantly due to reduced EMV card production.

U.S. Prepaid Debit segment net sales were $9.8 million in the first quarter, down 20.7% year-over-year. The decrease was driven primarily by a delay in the rollout of a packaging design refresh related to one of our larger customers. U.S. Prepaid Debit segment EBITDA was $1.8 million, down from $3.3 million in the prior year.

Finally, our U.K. Limited segment net sales were $5.6 million in the first quarter, representing a decrease of 10.3% from the prior year period. Revenues were impacted by approximately $900,000 from an unfavorable foreign currency exchange rate fluctuation due to a weaker British pound. On a constant-currency basis, sales for the first quarter grew 3.6% year-over-year, driven by increased sales activity related to card manufacturing, personalization and fulfillment. U.K. Limited segment EBITDA was $325,000, up from $219,000 in the prior year period.

Turning to our cash flow overview on Slide 12. Cash used in operations for the first quarter was a negative $5 million, compared with cash flow from operations of $16.8 million in the prior year period. The year-over-year decline in cash from operations primarily reflects lower net income and increased use of working capital. Capital expenditures in the first quarter of 2017 were $3.3 million, down slightly from $3.8 million in the prior year period. We paid cash dividends to stockholders of approximately $2.5 million in the first quarter. Our ending cash balance as of March 31 was $25.9 million, down from our 2016 year-end balance of $37 million. We ended the quarter with total debt principal outstanding of $312.5 million and a net debt balance of $286.6 million. Netting the deferred financing costs and discounts, our recorded total debt balance was $302.4 million. At March 31, our net debt leverage ratio was at 6.8x. As of March 31, 2017, we had [$25.9] million of cash and cash equivalents on hand and an undrawn $40 million revolving credit facility, of which $20 million was available for borrowing. In our press release issued this afternoon, we also announced that our Board of Directors approved a dividend of $0.045 payable July 7, 2017, to stockholders of record at the close of business on June 16, 2017.

Now turning to our guidance, which is summarized on Slide 13. As Steve noted, our first quarter 2017 results were in line with our expectations and overall market conditions remain consistent with our prior outlook. As such, we are reaffirming our 2017 guidance ranges on revenue, adjusted

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EBITDA and GAAP and non-GAAP earnings per share. In our prior earnings call, we discussed that the calendarization of sales volumes in 2015 and 2016 were impacted by EMV card migration patterns. So they're not good comparisons for expected cadence going forward. For 2017, we expect second quarter revenue to be about 21% to 22% of the full year results, which is reflective of a more typical calendarization of revenue based on our historical experience. For full year guidance, we continue to expect 2017 net sales to be between $315 million and $340 million, which reflects a growth rate of 2% to 10% over 2016 results. GAAP earnings per share is expected to be between $0.22 and $0.32, and adjusted diluted earnings per share is expected to be between $0.35 and $0.46. We expect to generate adjusted EBITDA in 2017 between $64 million and $73 million, resulting in an adjusted EBITDA margin of 20.3% to 21.5%.

And with that, Ashley, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Brad Berning of Craig-Hallum.

Bradley Allen Berning - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

I thought maybe you could start with a little bit more for the outlook for 2Q, specifically across the business lines and help us understand the trajectory through the year. I know you guys said 1Q met your expectations, but I think analyst estimates were a little different than yours. So what's -- maybe you guys can help us get in the right direction on those? And then secondly, just obviously, a broader question. Can you talk about visibility that you have so far into 2Q visibility into second half and then help understand from a guidance process how you are thinking about guidance versus what you have visibility on? And lastly, if you can just talk about the services margins a little bit this quarter and how those -- what you need to see to help get those recover in the second half as well?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Okay. Lillian, you want to talk about Q2 guidance?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Yes, so for the second quarter, Brad, thanks for the question. Thanks for being on the call with us today. So really we are continuing to see the revenue pick up and really get into more of what I characterize a normal historical cadence. And historically, the cadence for the company was probably 17%, 18% in the first quarter, 20% to 22% in the second quarter depending. So what we're seeing really is a return to more of those historical patterns. And as we look towards the second half of the year, we continue to see the buildup of the EMV card manufacturing volume, and we also have a lot of the initiatives that Steve was talking about during his section in terms of our initiatives, such as Print on Demand and some of the services and products that we're offering will continue to be ramping up as we progress through this year.

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

And then Brad, you had also asked about visibility. So talk a little bit about visibility. And the -- our visibility is consistent with what we have been discussing in our prior call couple of months ago, where we've got pretty good visibility out 4 to 8 weeks, and then we have good visibility in terms of where we think we will be for the year, and that's really based on bottoms-up analysis with the customers, and we continue to go through that exercise fairly regularly going through that bottoms-up analysis on our customers. And so through that process and through the discussions with them, we get a good understanding of where they expect to be for the year and then therefore where we expect to be for the year. So overall, for the year, we believe good expectations or a good level of expectations in understanding of where our customers are going to be and then, therefore,

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where we're going to be in terms of visibility, hard visibility, have a good line of sight over the next 4 to 8 weeks. I'd say it's more in the medium term, where not clear line of sight to exact business, but overall we've got expectations around business volumes based upon those discussions with the customers. And then in terms of services and with the expectations around services revenue or margins, I'll ask Lillian to comment on that.

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Sure. So really what drove those lower margins on a year-over-year basis, Brad, is that we had lower sales in our prepaid business, and that was related to a delay in the rollout of a packaging design refresh that one of our large customers had. And as a result, with lower volume, we had lower absorption and efficiency levels at the facility. Additionally, we are incurring incremental cost as we are ramping up some of our Print on Demand -- getting ready for our Print on Demand and ramping up for that. So as we look forward, the customer that had the delay, we expect to see that business as we progress through the year, and then we'll also be having incremental volumes coming on with the prepaid and Print on Demand will continue to ramp up. So the margins there will return to more what we would normally expect.

Bradley Allen Berning - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

And just a real quick follow-up on the services. The design package refresh was part of that delay due to the CFPB delay and so some uncertainty for packaging for this year?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Not really. It was more just the design considerations that they had, it was more internal to them.

Bradley Allen Berning - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

And it wasn't really caught up in those regulations.

Operator

Our next question comes from Dave Koning of Baird.

David John Koning - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

Yes. I guess first of all, just on you kind of mentioned the -- a shift a little bit towards the bigger banks and which was pretty evident in the ASP going down and in the card personalization also being weak in the quarter. But I guess, I'm wondering I know in the back half it sounds like you expect those smaller banks to spend more. But I'm just wondering why those would be down year-over-year. I think those were expected to be later like towards now years ago more of a big -- the big banks were going to really ramp the EMV cards, but what would be in growth mode for those smaller banks by now. Maybe you can talk a little bit about why they're down in Q1 and then why you kind of really think they're going to accelerate the rest of the year?

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Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Yes. So overall, what we're seeing, Dave, is that the migration continues with the small and mid-sized issuers as they convert. What we're seeing is that, that it's now with the small and mid-sized issuers some of the larger of those players were converting in 2016. Now we're seeing the smaller players convert, but there continues to be conversion activity in that small- to mid-sized issuer market. So that progresses. But overall, for the market, that growth, if you will, around the small and mid-sized issuers is being offset by reduced demand from the large issuers. The large issuers really went through their conversions in a very significant way back in 2015. And so what we're seeing is that those conversions from the large issuers are pretty much done. And so the demand from the large issuers have really slowed quite a bit. So that slowing demand is really offsetting some of the growth that we're seeing from the small and mid-sized issuer market.

David John Koning - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

Okay, okay. Well, that's good on that one. And then I guess 2 real small questions, one being if the ASP bottomed in Q1 and the rest of the year gets better. And the other is how far into the $10 million cost save plan are you? Because Q1 seemed a little elevated. I'm wondering if you just really haven't started the plan and Q2 starts to be the benefactor of that?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Yes. So ASPs in the first quarter were pulled down a bit by just the concentration or predominance of some large issuer activity. Also, we had -- with the volumes at the levels they were had a couple of large orders that also skewed a bit the ASPs. So we think that, that impact is mitigated as we look forward. But we still expect -- with the large issuer market, we still expect we're going to see pricing pressure in the large issuer market. So don't want to lead you to believe that suddenly ASPs and that -- with the large issuers that are going to pop up, therefore, you ought to start seeing rising ASPs from us. I think the mix will change a bit, and that will cause our ASP to move around a bit. And we saw that impact in the first quarter, where it was really down from the fourth quarter. So we think that, that will cause it to move around a little bit. But it's -- we still believe that we're going to see some pricing pressure from the large issuers as we go throughout the year. And then the second half of your question, sorry, Dave.

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

So as it related to the cost savings, right?

David John Koning - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

Yes.

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Yes. So we definitely have been implementing and have been receiving the benefit of the cost efficiencies and reductions in the first quarter. Just as we did in the fourth quarter of last year, a lot of the activity that we began, we began in 2016. So on an ongoing basis, we're continuing to work to drive those cost improvements and efficiencies. We have full visibility to the $10 million commitment that we have for this year, and quite candidly will continue to look for incremental opportunities as we progress in the business, because as Steve just mentioned, as customers continue and the market continues to pressurize the prices, we need to ensure that we're maintaining and quite frankly trying to improve our margin so that we deliver appropriate returns.

Operator

Our next question comes from Paulo Ribeiro of BMO Capital Marketing (sic) [Markets].

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Paulo E. Ribeiro - *BMO Capital Markets Equity Research - Associate*

Well, a lot of questions. But I'll repeat some of the points that have been discussed so far. I still want to get more granularity and understanding of those. In particular, let's start with the smaller issuer market. You've talked in the past 2 things about a year ago when you first revised downward your EMV expectation for '16 pretty dramatically. You mentioned 2 things: One was the inventory at the large issuers, and second was the delay at the smaller issuers due to bottlenecks in getting their processing ready. How much visibility do you have in both issuers? Where are inventories now? Gemalto mentioned 3 to 6 months. Is that the normal level? And on the smaller issuers, have they solved the bottlenecks? Are they about to solve the bottlenecks? How well do you understand or have visibility into that issue?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Sure. So with the large issuers and the inventory issue, we think the inventory issue is largely past. And that's based upon discussions that we've had with a large issuer. So we believe the vast majority of the large issuers have worked through excess inventories. We think the -- generally, the large issuers want to have inventories kind of in that 3- to 4-month range. And so we believe based on the discussions with those large issuers, the vast majority of them have worked through that inventory issue. So that's largely past. In terms of the bottlenecks, that was -- a year ago at this time, that was a real issue for the small and mid-size issuers where there was a real backlog of conversions at the processor level for the small and mid-size issuers. That was really worked through over the course of 2016. So that isn't an issue impeding the conversions for the small and mid-size issuers at this point. Again, we think that in terms of numbers of institutions we think that it's probably about 60% of the small and mid-size issuers have converted over with a lot of those being some of the larger players in that space, but there's still a lot of these small issuers still to convert. But as we've had discussions with the processors and with the issuers themselves, it doesn't appear that their bottlenecks at the processor level are impeding the conversions.

Paulo E. Ribeiro - *BMO Capital Markets Equity Research - Associate*

Perfect, great. Another point I want to discuss is the delay in the packaging refresh. And you guys gave a lot of color already, but I'm still trying to get a better sense what was, to the extent that's a fair question, the impact this quarter, right, and that's refresh, is -- when it comes, is it a onetime big event and off to move the quarter like we've seen this quarter or is a process that happens spread over a few quarters? How should we think about, again, try to quantify as much as you can, what was the loss or delayed revenue this quarter and how we should think of it being recuperated once this client decides to go ahead?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Yes. Once that business starts moving ahead, we would expect to recoup that over a couple quarter period of time.

Operator

Our next question comes from Gary Prestopino from Barrington.

Gary F. Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

I don't want to beat a dead horse on some of these issues. But in the quarters on the progression of sales, Q3, Q4, as I'm kind of thinking about it, literally, we'll continue to see an increase. So Q3 will be more than obviously Q2. But will Q4 be more than Q3?

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Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

I guess, on that -- Gary, it's Lillian. Thanks for the question. Thanks for being on the call. We're not going to break out specific Q3 and Q4 guidance and revenue breakout. I think from the perspective that as we're looking at the second half of the year, obviously, that's where the majority of our revenue is going to be for this year, given where our first quarter came out and our expectations for the second. So we'll continue to ramp up as we discussed on the services side of the business, the products that we have coming out in addition with the EMV card manufacturing sales. So those will continue to ramp up as we move into the second half of the year. But I don't want to get into specificity between the third and the fourth quarter at this point.

Gary F. Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

Okay. That's fine. And then anything on the dual-contact cards you can share with us?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Yes, in terms of our outlook and our discussion around the dual-interface card, it really is consistent with what we discussed a couple of months ago on our year-end earnings call that we continue to supply a few or several issuers, but at low levels for dual-interface cards. And we have discussions with the issuers about it, but there's not any firm plans to launch dual interface as far as we -- as far as our discussions go with the issuers, don't see any plans to have a material launch of dual-interface cards now. We think it's -- as we look at the market, we think it's an event that happens after 2017 in terms of a meaningful issuance of dual interface. That's our outlook right now, Gary. We're not counting on dual interface in 2017.

Gary F. Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

What about the metal cards? Now that you've received certification, is that something that is way off in the future as well?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

We think that -- we're excited about it. We're excited about the opportunity, and we're excited about getting those certifications. And so we are -- we're very focused on working with our customers around that. And so we're looking forward, and we're optimistic about the long-term potential of that, and certainly we're pushing to make sure that we -- as soon as our customers are ready, we're there to deliver for them.

Gary F. Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

And then just lastly, in terms of what you said in the quarter with the average prices going down, it was a mix issue. Historically, what happens is the bigger banks come in and put their orders in or get most of their cards from you in Q1 and then it slacks off as you go through the year. And then you're looking at the small and mid-size issuers throughout the rest of the year bulking up their orders.

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

No, I wouldn't characterize the order patterns as something like that. It just happened in the first quarter. We had a preponderance of large issuer business. And there were a couple -- and a couple of those orders were fairly lumpy that came in, in the first quarter that pushed the ASPs around a little bit. But no, there is not -- that's not typical order pattern. Typically, we'd see a flow throughout the year.

Operator

Our next question comes from Stephanie Price of CIBC.

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Stephanie Price - *CIBC World Markets Inc., Research Division - Analyst*

In terms of EBITDA, are you expecting that EBITDA is going to follow the same cadence that you were kind of talking about for revenue for Q2, so kind of 20% to 22% of total for the year?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

I wouldn't necessarily characterize a specific target range on that. I didn't provide the range for the EBITDA. But how I would characterize EBITDA as we progress through the year is as the revenue is coming in and we're having better utilization, we don't have underabsorption. So for instance, we'll have much better efficiencies coming in. And as we continue to realize the cost reductions, that will also benefit the EBITDA. So really, as the business comes in and ramps up, I also expect EBITDA to be coming through and dropping through to the bottom line as well.

Stephanie Price - *CIBC World Markets Inc., Research Division - Analyst*

Okay. So I guess, you answered most of my second question just around where that EBITDA improvement is coming from and how should we be thinking about the drive in improvement in EBITDA for the rest of the year?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Yes, it really is -- as the volumes come in, it improves the efficiency for the operations. You can cover your costs better, you have better throughput, better efficiency. So that naturally improves the EBITDA. And then also as we continue with our cost initiatives throughout the year, that will also continue to improve EBITDA.

Stephanie Price - *CIBC World Markets Inc., Research Division - Analyst*

Okay. And then just finally from me on cash flow, when you think about cash flow for the full year, can you kind of talk a bit about how we should think about that rolling out through the remainder of the year?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Yes. I think we talked in the last call, in terms of cash flow, we haven't provided specific guidance for cash flow for this year. But CPI has historically been a positive free cash flow, a positive operating cash flow type of business. We fully expect that to be the case this year. One of the dynamics that is different though as we're looking at 2017 in comparison to 2016 is 2016 with the decline of our revenue, we basically threw off a lot of working capital, and that was a true benefit for the cash flow last year. As you think about the business and as we look through the year and as we're ramping up throughout 2017, working capital tends to become more of a use versus a benefit. So that is something that I would expect as we progress through the year, you are going to see working capital usage, but I do fully expect the company as it has historically been to be positive free cash flow.

Operator

(Operator Instructions) Our next question comes from the line of James Schneider of Goldman Sachs.

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Lara Arielle Fourman - *Goldman Sachs Group Inc., Research Division - Research Analyst*

This is Lara Fourman stepping in for Jim. I was just -- my first question was just on chip prices and if you could just talk a little bit about chip price trends that you're seeing. And even if you're seeing pricing pressure, if we could expect gross margin expansion over the course of the year.

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Yes. So in terms of overall prices, I think we had indicated before, and this is something that we had talked about over the last several quarters that we expect that there would be continuing pressure with the large issuers around prices, and that's certainly something that we've seen throughout that period of time, and that's something that we expect to see through the rest of the year. And that's also something that we had taken into consideration as we put our guidance together in terms of pricing pressure in the market overall and then with the large issuers. And so it's something that we look at and we track and certainly have taken into account expectations -- our expectations around that.

Lara Arielle Fourman - *Goldman Sachs Group Inc., Research Division - Research Analyst*

And then what does that mean for gross margins, expecting that cost of the cards were also -- the cost that you have for the cards were also coming down?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Yes, we were seeing chip cost come down, and that's one of the things we continue to focus on is making sure that we're really pushing to get some cost reductions on the chip cost side as well.

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

And so when it comes to the actual gross margins, we're not providing specific guidance on the gross margin and really where we're focused and where we are providing the guidance is on overall EBITDA and EBITDA margin. As Steve was indicating, pricing has been a pressure, and that'll continue. Just as we're working with the chip cost and looking for the efficiencies there, we continue to have the pricing pressure. So we do need to be very focused on our cost structure and ensure that we're driving as many efficiencies out of that as we can to ensure that we're hitting those EBITDA targets.

Lara Arielle Fourman - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Got it. And then my last question was just in terms of the EMV card pricing pressure that you're seeing on the ASP side. What are the main pricing pressure points, if you will? Is it coming from other competitors going after the same contracts more, just EMV cards being later in the cycle, getting everyone to transition, your clients pushing back more on the cost side?

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

I think it's a combination of both the competition and the customers looking for price reductions. And so we've had with the large issuers, because they've large volumes, that then would justify them going through a time-consuming process, a lot of large issuers have gone or will go through a request for proposal process where they are soliciting bids from us and others in the industry. And so as a result, you're seeing competition around the businesses there. And so that's a factor is the competition and then also the large -- especially with the large customers, but all customers are looking to make sure that they're minimizing the cost that they have to pay. And so we're seeing the customers really seeking to get some price reductions as well. So that's the source of it.

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Operator

And we have a follow-up question from Paulo Ribeiro from BMO Capital Marketing (sic) [Markets].

Paulo E. Ribeiro - *BMO Capital Markets Equity Research - Associate*

I want to go back to Stephanie's question on the cash flow, and Lillian it was great explanation. But we really saw a big consumption of cash this quarter. And can you just tell us a little more about as use of working capital as you're ramping up, is it you're building inventory in expectation of demand, accounting (inaudible) account receivables consuming cash? Could you just give us a little more color on that -- how should we think about the uses of cash?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Yes. So for this quarter, I mean, obviously, part of the drivers were just the earnings results. And when we look more specifically into the cash flow statement, it is really the working capital uses. So some of it was some inventory as we were producing, and it's quite frankly work-in-process inventory that we're producing for shipments that are going to happen later in the year in the second quarter, in particular, one large customer. And again, just as we're building up and getting prepared to support the revenue and the volume that we have coming in in the later parts of the year.

Paulo E. Ribeiro - *BMO Capital Markets Equity Research - Associate*

So the delay, for instance, from the prepaid side of the business, that delay from the packaging issue, that's not -- is that part of it? Meaning you are preparing to get that out -- the product out the door and now, it got -- you're stuck with it for a little bit longer?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

No, I would say it's more so as we are supporting the volume and the business that was coming in that. That itself was not a driver.

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Around that prepaid, the delay in that business, it's -- we didn't start building it because they are still redesigning it, and so we didn't have working capital tied up in that, Paulo.

Paulo E. Ribeiro - *BMO Capital Markets Equity Research - Associate*

Okay, perfect. And kind of a related question about the use of capital. You announced a while ago a buyback program. How do you think about it? And how should we think about it? Do you use part of it, but not all of it? What are the metrics that you follow to consider when -- deciding that you should pull the trigger?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

I'd say from the overall capital allocation approach and strategy, Paulo, that we've employed is really focusing on first investing in the business. And that's really where you see us spending our cash and dedicating our cash. The other areas that we're keenly focused on is on reducing leverage. Obviously that wasn't the case this quarter, just given some of the cash consumption. But on a long-term basis, that really is our focus is to reduce the net leverage. And then to the extent that we have excess cash, so to speak, we'll look to return it to shareholders. We did do that this quarter with the dividend that we just announced and will continue to look to that. But again, really the top priority for our cash and cash deployment is investing in the business to support the profitable growth, and then secondly is to ensure that we're improving our net leverage position.

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Paulo E. Ribeiro - *BMO Capital Markets Equity Research - Associate*

Perfect. One last question, if I may. In terms of the innovation, the product innovation that you showed in the slide, are their margins better on those business versus let's call the peers in their segment, meaning personalization and the Print on Demand and so those are all that we have and the metal card versus the regular chip card. Are that also a factor in the improvement in margins changing mix?

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Yes. I mean our math and quite candidly, just as we've talked about other products, we're not going to get into specific margin information and provide that. As much as I know that, even others would like us to share that, but we're not going to.

Paulo E. Ribeiro - *BMO Capital Markets Equity Research - Associate*

Just generally if they are better.

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Well -- so that said, I think maybe I'll answer the question a little bit differently. I mean part of what we're focusing on is we want to make sure that we're delivering value to our customers. We want to be the innovative partner with our customers and providing them products and services that meet the needs both today, but also in the future. So really that's where you see the excitement that we have around the innovation and the new products, and it's really focused on delivering that value for the customer and, of course, getting a fair return for ourselves as well. And that's really how we think about it.

Operator

I'm showing no further questions. I would like to turn the call back to Steve Montross for any further remarks.

Steven Montross - *CPI Card Group Inc. - CEO, President and Director*

Okay. Well, thank you, everyone, for participating in our earnings call. Also, I'd like to thank all of the CPI employees for their contributions and commitment to serving our customers, and also want to thank our valued customers who depend on and trust us to serve their businesses. So we look forward to speaking with you next quarter. Thanks, everyone.

Lillian Etzkorn - *CPI Card Group Inc. - CFO and Company Secretary*

Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a great day.

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