07-Nov-2017

CPI Card Group, Inc. (PMTS)

Q3 2017 Earnings Call

Copyright © 2001-2017 FactSet CallStreet, LLC

CORPORATE PARTICIPANTS

William Maina
Senior Vice President, ICR, LLC

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

OTHER PARTICIPANTS

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)

David J. Koning
Analyst, Robert W. Baird & Co., Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the Q3 2017 CPI Card Group Inc. Earnings Conference Call.

At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will follow at that time. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to introduce your host for today's conference, Will Maina. You may begin.

William Maina
Senior Vice President, ICR, LLC

Thank you and good afternoon, everyone. Welcome to the CPI Card Group third quarter 2017 earnings conference call.

Participating on today's call from CPI Card Group are Scott Scheirman, 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 disclosures at the end of the company's earnings press release for information about forward-looking statements that may be made or discussed on this call.

The earnings press release is posted on CPI's website. Please note there is also a presentation that accompanies this conference call and is also available on the IR section of our website. Please refer to the information along with our filings with the SEC and on SEDAR for a disclosure of factors that may impact subjects discussed on this

Copyright © 2001-2017 FactSet CallStreet, LLC

call. All forward-looking statements made today reflect our current expectations only and we undertake no obligation to update any statement 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, adjusted diluted earnings per share, free cash flow and [ph] currency (01:48). Please see the earnings press release on CPI's website for all disclosures required by the SEC, including reconciliations to the most comparable GAAP measures.

And now, I'd like to turn the call over to Scott Scheirman, President and Chief Executive Officer.

Scott T. Scheirman

President, Chief Executive Officer & Director, CPI Card Group, Inc.

Thanks, Will, and good afternoon, everyone. Thank you for joining us on our third quarter 2017 conference call.

Beginning on slide 4, I'd like to start the call by sharing with you how excited I am to be CPI's President and Chief Executive Officer. I am impressed by CPI's position in the market as one of the leading providers of financial payment card products and value-added solutions. The CPI team is both talented and energetic, and since joining the company, I have seen a culture of collaboration and steadfast focus on delivering superior solutions and customer service.

We remain confident in the long-term opportunities ahead of us. CPI is a leader in a large addressable market with solid long-term secular tailwinds. Our market position, diverse suite of products and differentiated solutions, passionate employees and a commitment to providing the highest levels of customer service position us well to capitalize on this opportunity. And while we are confident that we can achieve long-term success, we believe there are areas where we need to improve in order to realize our full potential.

Similar to other market leading organizations, we need to be working towards continuous improvement. For example, we believe we have opportunities to improve our business to ensure that our level of execution, quality, product delivery and cost structure are optimized. We also believe that we need to sharpen our focus on changing market trends to more quickly maneuver and capitalize on new opportunities and provide our customers with new and innovative solutions.

As a result, we recently commenced a comprehensive review of our business to assess our strategies and market opportunities, both from a short-term perspective as we continue to navigate a challenging U.S. card market, and from a longer-term perspective. The objective of this review is to enhance our strategies and execute key initiatives to further capitalize on our addressable market, better serve the needs of our customers, and deliver shareholder value.

We are in the early stages of this review. Consequently, we believe that it is prudent to discontinue our current guidance practices, while we take the time to enhance our strategies and execute the appropriate actions to achieve our objectives.

To be clear, this decision in no way reflects lack of confidence in CPI's long-term opportunities. We do believe that it is appropriate to take the time to review and assess the current situation. We plan to provide you with an update on our strategies, initiatives and guidance policies on our fourth quarter 2017 earnings call.

Copyright © 2001-2017 FactSet CallStreet, LLC

Now, turning to slide 5; I will provide a brief overview of our third quarter results. We reported total net sales of $68 million, adjusted diluted EPS of $0.02, adjusted EBITDA of $9.6 million, and positive operating cash flow of $1.3 million. Lillian will take you through our third quarter results in more detail in a few moments.

Turning to slide 6; as discussed on our last call, the market for U.S. Debit and Credit card manufacturing remains challenging in 2017. More specifically, we continue to see the impacts of the pull forward by large banks into prior years of card reissuance than normally would have occurred this year, the extension of card expiration dates for a portion of the market, as well as the negative impact on average selling prices driven by the competitive environment.

While these factors are impacting the market currently and also may have a longer-term influence on the frequency of reissuance, annual card demand and average selling prices, we also continue to see several positive long-term drivers to the U.S. card manufacturing market that we believe will benefit us in the years ahead.

First, the number of payment cards in circulation is expected to grow in the U.S. Given the replacement nature of cards through factors such as expiration, portfolio churn and lost cards or fraudulent activity, we believe the long-term outlook for future reissuance demand remains positive. Second, the U.S. card market continues its migration to EMV cards. We anticipate much of the migration of activity going forward will come from small and medium-sized banks, where we have a solid market position. Third, the premium portion of the card market, including metal cards, continues to grow. I'll expand upon this in just a moment. And finally, while it's still a longer-term opportunity, we continue to view the potential migration of the U.S. market to dual-interface cards as an attractive long-term opportunity.

Moving to slide 7; equally as important as these products and where I am very excited for CPI's prospects is a level of demand and building momentum in our newer products and solution areas. Our Card@Once instant issuance solution continues to show solid traction in the market, as we ended the third quarter with approximately 6,700 installations, up from approximately 6,400 installations at the end of the second quarter.

Our long-term outlook for Card@Once growth is positive, as small and medium-sized banks continue to look for innovative services to differentiate themselves in the market, and newer technology in this area is closing the gap between the look and feel of an instant issuance card compared to a card printed at a central facility. With approximately 6,700 Card@One (sic) [Card@Once] (07:50) installations and other potential markets available beyond the traditional financial services space, we believe there is room for growth.

For CPI Metal, we continue to see high levels of interest across the market for this premium product. We believe most large issuers today are exploring moving some portion of their card portfolio to metal, as we are also seeing traction in the small and medium-sized issuer segment. We began shipping our first metal cards in October, including our patented tungsten card. Opportunities in our metal card pipeline continue to build, and while it's early days, we are encouraged by the level of activity we are seeing, as we approach the end of 2017. We believe we are in a good position to capture share in this market, where average prices per card are materially higher than EMV cards.

For our CPI on Demand solutions, or what we previously referred to as Print on Demand, we are also seeing good customer demand and a solid pipeline of business opportunities. In the third quarter, we continued to onboard new customers, revenue growth in our CPI on Demand business is progressing, and we're encouraged by the momentum we are building with this solution.

Copyright © 2001-2017 FactSet CallStreet, LLC

And finally, we believe that expanding our payment solutions through digital services represents a long-term opportunity for CPI. At Money20/20 this year, we showcased our new suite of next-generation digital solutions, including CPI Digital Express, a customizable, white label solution that provides online ordering of digital and physical cards; and our CPI Digital Card, a solution that enables quick and secure delivery of prepaid cards through multiple channels. We'll continue to work closely with our customers to support their demand for digital services.

Turning to our other major business line, U.S. Prepaid, we continue to see long-term potential in the retail prepaid and the enterprise B2B and B2C verticals of Prepaid. We believe we are well positioned in Prepaid segment and expect the market to grow in the high single digits long term.

So, as I hope you can see, I'm excited about the opportunities CPI has in the future, and I'm encouraged about the forward progress we are making in many areas. However, as I mentioned earlier, I also believe that we need to take the appropriate time to review our strategies and market opportunities to better serve our customers and sharpen our execution in order to build a stronger foundation and deliver shareholder value.

Turning to slide 8; in closing, I would like to reiterate how excited and honored I am to be CPI's CEO. I am committed to working with the CPI team, our customers and our partners to build on our strengths and our market position to maximize our potential on this compelling space. I believe that CPI has many long-term opportunities. We remain completely focused on capitalizing on our large market opportunity with a goal to drive growth by improving and leveraging our entire suite of products and solutions, provide exceptional customer service, and focus on seamless execution.

I would also like to mention some of the key focus areas for me as a CEO, as I work with this talented team of CPI employees towards achieving our goals. First and foremost, a customer-first mentality in everything that we do at CPI. Our customers are a top priority and I am committed to actively working with them and providing them with the highest quality products, solutions and service. Second, I want to make sure that we have a clear strategy and an action plan in place, and that we are executing against this plan.

Third, ensuring that we continue to provide innovative products and solutions in the market, so that we're helping our customers to succeed, enabling CPI to grow. Fourth, focusing on increasing efficiencies and improving the cost structure of the business. Fifth is empowering and developing CPI's employees and as needed, hiring the most talented people. Our people are our most valuable asset, and I want to foster a culture of innovation and excellence. And finally, our guiding principles as an organization are integrity, accountability, teamwork and setting a high bar of excellence.

I look forward to sharing our progress and the next steps in our strategy with you in early 2018. I'll now turn the call over to Lillian to review our detailed financial and operating results for the third quarter.

Lillian Etzkorn

Chief Financial Officer, CPI Card Group, Inc.

Thanks, Scott and good afternoon, everyone.

Turning to slide 10, you will see an overview of our third quarter results. As Scott referenced earlier, we continue to operate in a challenging U.S. card manufacturing market, which is impacting our performance, as well as the entire domestic card manufacturing industry.

Copyright © 2001-2017 FactSet CallStreet, LLC

Third quarter net sales were $68 million, down 16.2% from $81.2 million in the third quarter of 2016. Product net sales decreased by $6.1 million or 16.2% from the prior year, primarily driven by a 13.6% year-over-year decrease in the number of U.S. Debit and Credit EMV chip cards sold, and lower EMV card average selling prices. Services net sales decreased approximately $7.1 million or 16.2% year-over-year to $36.6 million, primarily driven by a decrease in card personalization and fulfillment sales and lower U.S. Prepaid Debit segment revenue.

Gross profit for the third quarter was $21 million, representing a gross margin of 30.8%, down from 35.8% in the third quarter of 2016 and up sequentially from 29.3% in the second quarter of 2017.

Income from operations in the third quarter of 2017 was $3.5 million, compared with operating income of $11.7 million in the prior-year period. The year-over-year change in gross profit and income from operations primarily reflects the decline in our revenue, partially offset by our previously announced cost reduction actions and efficiency initiatives.

We reported a net loss of $700,000 or $0.01 loss per diluted share in the third quarter of 2017. This compared with a net income of $4 million or $0.07 per diluted share in the prior-year period.

Now, turning to our non-GAAP metrics; adjusted EBITDA for the third quarter of 2017 was $9.6 million, compared with $17.8 million for the third quarter of 2016. Adjusted EBITDA margin was 14.1%, up from 13.2% in the second quarter of 2017, but down from 21.9% in the prior-year period. The year-over-year changes in our adjusted EBITDA and EBITDA margin primarily reflect lower net sales, with the margin reflecting some corresponding negative impact of absorption of overhead costs from lower volume, partially offset by cost efficiencies.

Adjusted net income was $1.1 million in the third quarter or $0.02 per diluted share, compared with $6 million or $0.11 per diluted share in the third quarter of 2016.

Now, turning to a review of our segments, which you will find on slide 11. U.S. Debit and Credit segment net sales was $39.3 million for the third quarter, a 20% decrease from the prior year period. The corresponding segment EBITDA was $6.5 million, down from $12.9 million in the prior-year period. The year-over-year decline in our U.S. Debit and Credit segment results was predominantly driven by a decrease in EMV cards sold, as well as lower average selling prices.

19.5 million EMV cards were sold in the third quarter of 2017, down from 22.6 million cards in the third quarter of 2016, but up from 18.8 million in the second quarter of this year. On a weighted average basis, average selling prices were $0.86 in the quarter, down from $0.96 in the third quarter of 2016, and flat sequentially with $0.86 in the second quarter of 2017. As was the case in the prior quarter this year, the annual decrease in average selling prices in the third quarter was primarily due to lower prices experienced in a large issuer market.

In our U.S. card personalization and fulfillment business, net sales decreased $3.6 million versus the third quarter of 2016. This is predominantly due to the reduced EMV card production.

U.S. Prepaid Debit segment net sales were $19.9 million in the third quarter, down $3.2 million year-over-year. The decrease in revenue was primarily driven by lower volume, partially offset by higher net sales related to our new CPI on Demand solution. U.S. Prepaid Debit segment EBITDA was $7.6 million, down from $8.6 million in the prior year. Our Prepaid EBITDA margin of 38.2% is improved by approximately 100 basis points over the third quarter of 2016. This is primarily due to product mix and cost efficiencies.

Copyright © 2001-2017 FactSet CallStreet, LLC

Finally, our U.K. Limited segment net sales were $7 million in the third quarter, representing a decrease of 8.2% from the prior-year period. The lower net sales in our U.K. Limited segment resulted from a prior-year loyalty card project, which did not reoccur during the third quarter of 2017, and this is partially offset by higher retail gift card net sales. U.K. Limited segment EBITDA was about $400,000, down from about $900,000 in the prior-year period.

Turning to our cash flow overview on slide 12. Cash flow from operations for the third quarter was $1.3 million, down from $6.6 million in the prior-year period, but up sequentially from a negative $3.3 million in the second quarter of 2017 into positive territory, which is in line with our expectations. Capital expenditures in the third quarter of 2017 were $2 million, down from $5.4 million in the prior-year period. We expect positive operating cash flow for the balance of 2017.

Moving to slide 13; our ending cash balance as of September 30 was $14.8 million. We ended the quarter with a total debt principal outstanding of $312.5 million and a net debt balance of $297.7 million. Netting the deferred financing costs and discounts, our recorded total debt balance was $303.4 million. At September 30, 2017, our net debt leverage ratio was at 9.7 times. As of September 30, 2017, we had an undrawn $40 million revolving credit facility, of which $20 million was available for borrowing. Our Term Loan has no financial leverage covenants and does not mature until 2022.

Total available liquidity for the company is $34.8 million as of September 30 this year. In conclusion, I'm pleased with the improvement in an operating cash flow trend in the third quarter. Our ongoing cost reduction and efficiency actions are on-track to achieve greater than $10 million in savings this year. I look forward to working with Scott and the rest of the management team, as we implement our initiatives aimed at sharpening our execution and driving shareholder value. Our priorities continue to include, making the investments necessary to position CPI for growth, while also seeking additional cost efficiencies in the business, returning to consistent positive cash flow generation, and improving our overall liquidity position.

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

Copyright © 2001-2017 FactSet CallStreet, LLC

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question is from [indiscernible] (21:19) from BMO Capital Markets. Your line is now open.

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)

Q

Hi. This is Paulo Ribeiro from BMO.

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Hi, Paulo.

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)

Q

Hey, how are you? Oh, well, so much to say, Scott, welcome. I mean, you have a challenge ahead of you. So, let me ask right off the bat, do you think this is a turnaround situation? Do you think it's – CPI has – I don't know. I used to think that, with the market problem, challenging position in the market, I start to think it's a CPI-specific problem. Are you guys – again, is it turnaround situation, are you guys losing market share? Is your product not up to par? Anything you can comment? Sorry to put you in this spot, but it's just very frustrating.

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

No, no. Thank you for your question. I'm sure your question is on the mind of others too. So, Paulo, thank you for the question. First, I'm very excited to be here. Are there things that we need to turn around? Absolutely. But I will say – what I've been very impressed with is we have a strong foundation for growth, we're an industry later and large addressable markets that have growth opportunities, and we have breadths and depths of our products and solutions. The management team here is very strong. We have very engaged employees and so forth. To your point, Paulo, the U.S. card manufacturing environment has been challenging, not only for us, but for our competitors too from that standpoint.

But with that said, I do believe there's things we need to get better at, like most companies. We need to continuously improve around our execution and our quality and our product delivery. We need to take a hard look at our processes in our business to optimize them to get to a lower cost structure, and then just continue to sharpen our focus on changing market trends just to ensure that we quickly capitalize on new opportunities and provide customers with new solutions and innovative products from that standpoint.

But with that said, Paulo, I really see a lot of opportunity here. The EMV transition will continue. We're later in the prepaid space, I visited the Minneapolis, Minnesota facility, a couple of weeks ago. I was very impressed, what I saw there with the team and the talent. Dual-interface, maybe not a near-term opportunity in 2018, but longer-term opportunity. And then, as I mentioned on the call, Card@Once, we've got 6,700 installations. I believe we've got a lot of room to grow there. Metal cards, where we're positioned well. I don't think that's a matter of if, but when. We know our customers have long marketing cycles or lead time, but we shipped our first cards and we're doing some things in the digital area.

Copyright © 2001-2017 FactSet CallStreet, LLC

So, all-in-all, I'm optimistic about our future. I believe we've got a number of long-term growth opportunities here. Are there some near-term bumps we've got to work through? Absolutely. But I feel like we've got a really good foundation for growth, a great management team, and I believe ultimately, we're going to win in the marketplace long term.

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)

Q

So, let me follow-up, [indiscernible] (24:51). Have you had a chance to talk to some of your large clients? And did they express, to the extent you can comment, any – they complain about your product or your process or something, one? As you review the business, are you also reviewing personnel and might be able to make some change to implement your vision? And third, just getting more granular here on this quarter, Prepaid, I thought 3Q is a bit – 3Q is seasonally stronger, and there was [indiscernible] (25:42) in Prepaid is based on top of EMV and other areas that we should be worried about new problems? [indiscernible] (25:52).

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

Oh, that's okay, that's okay. Let me first start with customers, Paulo. One of my first goals as the CEO was – is and continues to be is to go listen to the voice of the employee and the voice of the customer. And I've had a number of meetings, face-to-face and over the phone, with customers and I've received a warm reception. They very much value the partnership or the relationship with CPI, and many of these have been longstanding relationships, and I believe they'll continue to be longstanding relationships on a go-forward basis, and they see the value we bring.

We have had some good candid discussions around where are opportunities to improve and it's some points I touched upon in my prepared remarks. But opportunity is around just continuous improvement with our level of execution, our quality and our product delivery, but our customers have been very warm and welcoming and in the spirit of partnership, want to continue to work with CPI.

On your second question, as far as personnel and so forth, again, I would say that we are in the early days of reviewing our strategies, our business plan. We want to do a comprehensive and robust review, and I look forward to sharing that with everybody in early 2018. I feel like overall, we've got a really strong management team. We've got passionate employees. But I'd say like, every company, you are always looking to add talent, as you can find talent, because at the end of the day, what makes almost every company work is having the best and the brightest employees and that will be our focus. But overall, I'm pleased with the talent, but there's always opportunities to improve all facets of your business.

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

And, I guess – Paulo, this is Lillian. So, in terms of your question around the Prepaid performance, you're very right in pointing out that, that has lagged on a year-over-year basis when we compare it to last year, and Q3 is typically the highest quarter, which it has been thus far this year. But really, the overhang that we've been dealing with in terms of the Prepaid has been an overhang for most of the year and it's really been around the indecision around the CFPB regulations and coming out with kind of firm guidelines that, what we've been experiencing with our clients is that they've been pushing out some of the orders that we might typically have seen this year, as they've been waiting for some of those decisions.

Copyright © 2001-2017 FactSet CallStreet, LLC

So, as we're looking forward into the coming months and into 2018, we're expecting more certainty on that front. We are starting to see more encouragement, I guess to say, from the clients to progress, as they feel that there is more conclusions there, at least, in stuff that would impact their forms, so the outside security packaging for these secured prepaid cards.

And the other thing that we're finding as well quite happily is that we're gaining new business in this area, and we're offering some very innovative solutions for our clients, and we're winning new business that we don't presently have on the books and are excited to be onboarding as we move into 2018.

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)

Q

Thank you. I will get back in the queue. Thanks.

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Thanks, Paulo.

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

Thanks, Paulo.

Operator: Thank you. Our next question is from James Schneider from Goldman Sachs. Your line is now open.

Q

Hi, this is [ph] Julie (29:24) on for Jim Schneider.

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

Hi, [ph] Julie (29:28).

Q

So, we are wondering, are you going to incur any additional cost as a part of your strategic review?

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

It's really too early to determine that. We're literally just, [ph] Julie (29:43), weeks into that process, and we're looking at a broad range of strategies, and really have not concluded on anything at this point in time. But, the goal of the review is to enhance our strategies, our business plan, develop key initiatives and action plans, all with an aim to improve the business performance in simple terms.

So, we'll have more to share with you on that in early 2018. But hope we can appreciate, we're just in the early days of that review and need to continue through that process, but we'll come back to you in early 2018 to give you our thoughts and where we're heading and what we're doing.

Copyright © 2001-2017 FactSet CallStreet, LLC

Q

Okay, great. Thanks.

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

Thanks, [ph] Julie (30:24).

Operator: Thank you. [Operator Instructions] And our next question is from Dave Koning from Baird. Your line is now open.

David J. Koning
Analyst, Robert W. Baird & Co., Inc.

Q

Oh, yeah. Hey, guys. Thank you.

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Hey, Dave.

David J. Koning
Analyst, Robert W. Baird & Co., Inc.

Q

And, I guess, first of all, it seems like in the core U.S. Debit and Credit business, now you've kind of been hovering right around $40 million of revenue. Some of your competitors have actually been calling out the – really the toughest comps are hitting this quarter, and that it's just tough environment. Actually, you are kind of holding pretty steady in that. Is this kind of normalized, or does it start to feel like a pretty normal cadence of business to kind of hold around $40 million, or is it too premature to kind of say that we couldn't get some pretty extreme lumpiness in the future so?

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Thanks for the question, Dave. I think, it's a little bit hard to tell quite candidly. I mean, the market is definitely soft. We're hearing that from others in the industry, and I think, we still feel that we're experiencing that. That said, I think you're pointing out something very fair that, it seems to have kind of tapered off through some consistency in terms of the EMV cards that we're producing. We're not seeing continued sequential declines, which I think was the concern that the marketplace had for some time.

So, is this where we're going to hover? I'm not sure. I mean, it definitely feels soft at this stage, and I think there's still a lot of opportunity, as Scott referenced in some of his comments during the earlier part of the call that, as the industry goes into, what I'd characterize as a more normalized reissuance cadence, once we start approaching expiration dates, which I think is longer term, we should see some recoveries and some improvements overall broadly for the marketplace.

I think it's more of the timing that the industry is still grappling with.

Copyright © 2001-2017 FactSet CallStreet, LLC

David J. Koning
Analyst, Robert W. Baird & Co., Inc.

Q

Got you. Okay. And then, I guess, the second thing, just on operating expenses, they've been very steady now, right around $17 million, $17.5 million, $18 million, very steady for a while. Is this sort of a bare bones operating expense? Like is their limited like ability to cut more from here, and you're kind of operating really lean or can that flex either way still?

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

I would say, everything is in the scope as part of our reviewing our strategies and our business plan and those initiatives to enhance our business performance. So, I'm not taking anything for granted, so to speak. One of our key goals is really to be a high quality provider, but to also be a low cost structure, if you will. So, as we go through this business review, that's something we're going to take a hard look at, and make sure that we have the right resources to serve our customers well. So, really more to come on that.

David J. Koning
Analyst, Robert W. Baird & Co., Inc.

Q

Okay, got you. And just, yeah, appreciate how transparent you're being with the tough trends and everything. But, I guess, the one thing like – how does the bank – I know you said that you have committed financing through 2022. But, yeah, how does the bank deal with such high leverage? I mean, is it just committed that you guys have that money for now, and there's not really too strict of covenants right now? How do they deal with that?

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Yeah. Well, I think that – first to start off, I think nobody wants to see the company operating at these higher net leverage levels, and really, as we look towards the long term for the company, our intention is to get back into, what I'd characterize as, more normalized leverage. I think in the past, we've talked about our objective of getting back to 3 turns net leverage. That being said, the way the term debt has been structured, there are not restrictions in terms of the financial covenants that will trigger any types of repayments. So that debt really is on the books until 2022.

In terms of our revolving credit facility, that is where we do have a restriction and it's a restriction in access. So, the facility is approved and stands at $40 million, but to the extent that our net leverage is at 7 turns or greater, what's available to us is only $20 million. But I should also point out that once the leverage returns back below 7 turns, the full $40 million is available to the company again. So, it's a limited restriction is how I would characterize it.

David J. Koning
Analyst, Robert W. Baird & Co., Inc.

Q

Got you. Great. Well, thank you, guys.

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Thanks, Dave.

Copyright © 2001-2017 FactSet CallStreet, LLC

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

Thank you.

Operator: Thank you. We have a follow-up question from Paulo from BMO Capital Markets. Your line is now open.

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)

Q

Thank you. Could you comment on the smaller financial institutions and sort of the demand, because you mentioned in your prepared remarks about the pull forward from the renewals and so forth from the larger financial institutions, and you talk about their impact on pricing? Where are the smaller FIs in terms of the issuance of EMV, and more broadly, if you could talk how you think – give us an update on the status of EMV migration broadly? Thanks.

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Sure, Paulo. Thanks for the question. So, as you know, the small and medium-sized institutions definitely lagged in the migration in comparison to the large financial institution. And, I guess, how I would characterize them at this stage is that, they're steadily progressing their conversion. We're not seeing the type of lumpiness I think that we experienced with the large institutions early in the cycle. So, it's steady progression.

I think the market is still overall trending and our expectation is that market in total is trending to about 100% conversion by the end of 2018, which will be good. We don't have a specific number in terms of measuring the third quarter levels, but things are progressing as we would expect.

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.

A

Yeah. The only thing I would add, Paulo, the midyear numbers we had, is we think that the market's, in round numbers, about 70% converted as of the end of the second quarter. So, still a fair amount to go in the next 12, 18, 24 months from that standpoint. So, and with the small and mid-sized issuers, as you're probably well aware, that's one place that we are well positioned and we have really good relationships there.

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)

Q

And do you have a sense of your market share? And in your prepared remarks, you kept pointing, you guys are the leader and one of the things that you guys probably still have is you have more production capacity than anyone else. You have four facilities, right, I think the closest competitors have a couple or something. Can you give any sense of where that was like – where your capacity stand versus the competition, if it's true you still have more? And in terms of market share, in last quarter's call, Steve talked about, finally, I guess, that you guys lost some market share [ph] where much of (38:11) – the overall market was down. Do you think – any comments on that?

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.

A

Copyright © 2001-2017 FactSet CallStreet, LLC

Sure, Paulo, it's Lillian. Why don't I start off? And then I think, Scott will chime in as well. So, in terms of just talking maybe a little bit about our production facilities, because I think, sometimes there can be some confusion in terms of what we actually have in our footprint here in the U.S., because what we have is very unique compared to others that participate in the card manufacturing space. And what I mean by that is, we have two facilities that I would characterize as dedicated to card manufacturing. We have a facility here in Colorado, which really focuses more so on the large production runs, supports more of your large financial institutions, is how I would characterize it. Then we have a sister facility, for lack of a better way to refer to it, in Indiana, which really specializes in the small and mid-sized issuers, provide some very customizable support and great customer service for those small and mid-sized issuers.

Our other two facilities that we have in the U.S., one is in Minnesota that really is fully geared toward supporting our Prepaid market and our CPI on Demand business. And then we have our facility in Tennessee which focuses on the personalization. That said, I think we recognize and that's part of what Scott was discussing in his remarks is we do need to look at the business, and that's part of the business review that we're looking at to make sure that we're operating as efficiently as we can as an organization. But I think it's important to clarify that while we do have more facilities than many of our peers, our business footprint and the type of business that we support out of those facilities are very unique.

In terms of the market share, quite candidly, that's a really hard number to get at in our industry, just given the lack of what I'd call system-wide, industry-wide sharing of data, in terms of actual production volume. So, while we did discuss in the last call where we did have a couple of large financial institutions that were in our portfolio in 2016 that aren't with us now, it's hard to assess what is the absolute share level as we look at the business. We have not lost other clients, as we move through 2017, I think that's an important data point. But the absolute share metric is real difficult to assess.

Scott T. Scheirman
President, Chief Executive Officer & Director, CPI Card Group, Inc.
A

One thing I'd add, Paulo, not maybe direct with your question, but I think that's one thing that I like about our business model, and that we're diverse, just beyond – call it the traditional card manufacturing, but we're in the prepaid space; dual-interface we think is a long-term opportunity; Card@Once, 6,700 installations, more room there; metal cards, we've got capacity to produce metal cards; and then CPI on Demand; and digital solutions. So, there is a number of other products and solutions that have allowed us to become, let's say, somewhat more diverse and broaden our product portfolio from that standpoint.

But also on a go-forward basis, as we think about market share, our goal is to profitably gain market share because you can't put a card in the bank, you can't put revenue in the bank, but you can put profits in the bank, so to speak, as a proxy for cash flow. So, we'll be very focused on profitably gaining share as we move forward as an objective.

Paulo E. Ribeiro
Analyst, BMO Capital Markets (United States)
Q

Great. Thank you.

Lillian Etzkorn
Chief Financial Officer, CPI Card Group, Inc.
A

Thanks, Paulo.

Copyright © 2001-2017 FactSet CallStreet, LLC

Operator: Thank you. At this time, I am showing no further questions. I would now like to turn the call back over to Scott Scheirman, CEO, for closing remarks.

Scott T. Scheirman

President, Chief Executive Officer & Director, CPI Card Group, Inc.

Thank you for participating in our earnings call today, and I look forward to speaking with you and meeting with many of you in the months to come, and I look forward to speaking with all of you again during our fourth quarter earnings call in early 2018. Operator, you may end the call. Thanks everyone for joining us.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect.

Disclaimer
The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2017 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.