



Short: Cardtronics, Inc. (CATM)

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We Are Short Shares of Cardtronics, Inc. (CATM)

- ▶ Cardtronics is the world's largest non-bank owner of ATMs with operations based primarily in US/UK
- ▶ \$1.5B market cap, \$2.0B EV, \$1B revenues¹, \$113mm reported EBIT¹
- ▶ Weak organic growth is masked by M&A, and return on capital is diminishing
 - Same-store transaction growth now ~0%; guidance repeatedly missed
 - Return on assets down 52% since 2010 (8.9% in 2010 to 4.3% in 2013)
 - Gross profit per unit on new and acquired ATMs is 41% lower than legacy ATMs²
- ▶ Earnings appear inflated by shifting accounting standards
 - CATM's 8-to-9-year assumed useful ATM life is well below peers of ~5 years
 - Policy has gotten more aggressive over time
 - Technological (e.g. Windows XP, EMV) and mechanical obsolescence is a real cash cost
- ▶ ATMs are in secular decline globally, as evidenced by Fed and other third-party data
- ▶ CATM's largest customer, 7-Eleven, is a non-renewal risk in 2017 (~40% of earnings)
- ▶ **Kerrisdale estimates an equity fair value of \$9 to \$19, 40-70% downside**

1. Based on 2014 guidance.

2. Kerrisdale estimate.

A Rich Valuation for a Secularly Declining Business

- ▶ High-growth valuation of 37x 2013 GAAP EPS¹ and 26x 2014 GAAP guidance
 - 27x and 19x on adjusted EPS (excluding intangible amortization)²
- ▶ 64% EV/EBITA premium to Canadian comparable DirectCash (TSX:DCI)

(\$mm)

Share price (5/23/14)	\$32.08
Diluted shares (mm)	45.6
Market capitalization	\$1,462
Net debt at face value	502
Enterprise value	\$1,964

Trading multiples

EV/EBITA

2013	\$110	17.9x
2014 guidance	147	13.4x

P/E

2013 ¹	\$0.86	37.4x
2014 guidance	\$1.22	26.3x

CATM stock price, 2009-2014



1. Excludes non-recurring tax charge. Reported EPS was \$0.52.

2. Excludes non-recurring tax charge in 2013 and after-tax impact of amortization expense in both years. Does not exclude stock-based compensation and other CATM adjustments.

Investors liken CATM to a secular growth company...

Business Model at a Glance

- ▶ Owns 45k machines, operates 22k on behalf of merchants, and performs smaller subset of services for another 14k
 - CATM services 80,600 ATM machines in total
- ▶ ATMs are typically located inside large retailers like 7-Eleven, CVS, and Walgreens
 - Revenue shared with merchants with terms defined in multi-year contracts
- ▶ Main revenue sources: surcharge (46%, paid by user), interchange (34%, paid by user's bank), branding and surcharge-free access fees (16%, paid by banks)¹
 - Average revenue per withdrawal: \$1.66 (many transactions surcharge-free)
 - CATM reports average withdrawals/ATM/month of ~724, while the typical domestic ATM generates 30-70% less volume²
 - ⇒ We believe there are a finite number of high-traffic locations, and CATM already owns many of them
 - ⇒ As CATM moves further away from prime locations to achieve growth, returns on capital have fallen

1. Based on 1Q14 ATM operating revenue.

2. Source: FreeATM.

...but CATM is a levered bet on *paper currency* and *retail foot traffic*

Despite its Secular Challenges, CATM Trades at a Premium

- ▶ The best public comparable, Canadian competitor DirectCash, trades at ~8x EBITA. This multiple would imply a \$15 share price for CATM (versus \$32 current price)
- ▶ Other companies with business models tied to paper-based payments also trade much lower:

	CATM	Peers	DCI ¹	BCO	DLX	NCR
(\$B)						
Market cap	\$1,462	\$2,415	\$274	\$1,245	\$2,765	\$5,374
Net debt	493	1,107	191	279	513	3,443
Enterprise value	\$1,954	\$3,521	\$465	\$1,524	\$3,278	\$8,817
2014 EBITA (\$mm) ^{2, 3}	146	380	57	137	387	937
EV / EBITA	13.4x	9.3x	8.2x	11.1x	8.5x	9.4x
<i>CATM implied stock price</i>		\$18.86	\$15.29	\$24.68	\$16.24	\$19.24
CATM equity downside		(41%)	(52%)	(23%)	(49%)	(40%)
<i>Memo: P/E 2014</i>	26.3x	15.7x	NM	22.9x	13.6x	10.6x

1. Canadian dollars.

2. CATM EBITA based on company guidance net of stock-based compensation.

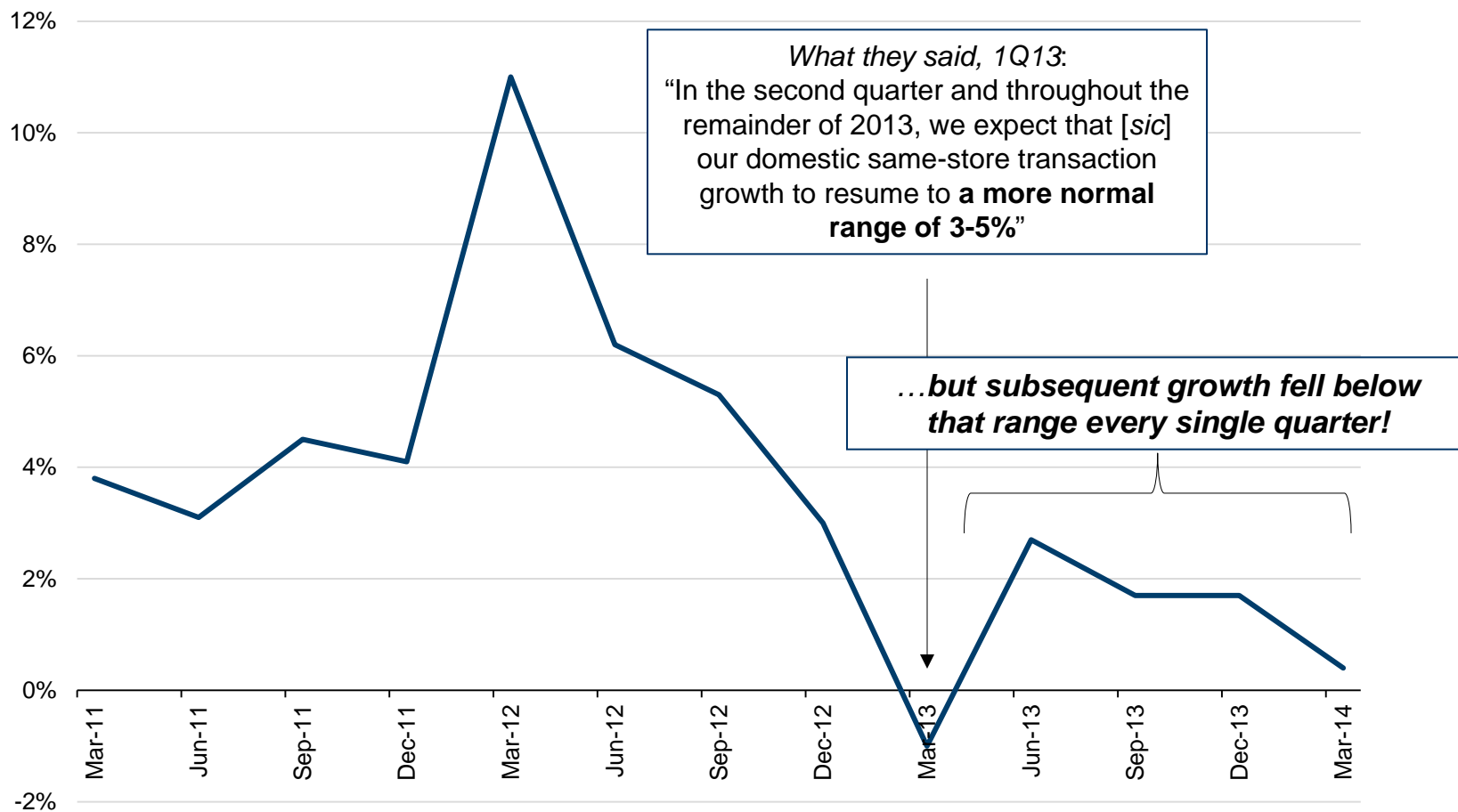
3. Peer EBITA based on consensus EBIT plus company-projected amortization or, when unavailable, 2013 actual amortization.

Source: Capital IQ, company filings, Kerrisdale analysis

CATM equity has 41% downside to peer average

Same-store Transaction Growth Slowing to a Crawl

Same-Store Cash Withdrawal Transactions at CATM's Domestic ATMs:
Year-over-Year Growth



Source: CATM filings, Kerrisdale analysis

Illustrative DCF Shows Devastating Impact of Secular Decline

- ▶ We've modeled same-store transactions declining at a modest 1%/year
 - Likely *very optimistic* long-term, as Swedish precedent demonstrates¹
- ▶ Other assumptions:
 - Depreciation/maintenance capex based on 5.5-year average ATM life
 - Continued growth in organic ATM counts (3%/year)
 - Modest operating leverage (fixed ATM-level costs) drives slight margin compression
 - 8% WACC (note: high-yield debt issuer)
- ▶ Results?
 - Fair value of ~\$9 per share – 72% below the current stock price

1. See e.g. Sveriges Riksbank, "The Swedish Retail-Payment Market," June 2013.

Even very mild assumptions about long-term ATM usage
point to a far lower stock price

Illustrative DCF Valuation

	2013	2014	2015	2016	2017	2018	2019	2020	2021
<u>Key drivers</u>									
Revenue per withdrawal	\$1.59	\$1.61	\$1.61	\$1.61	\$1.61	\$1.61	\$1.61	\$1.61	\$1.61
Per ATM per month:									
Withdrawals (#)	708	705	698	691	684	677	670	664	657
Revenue	\$1,127	\$1,138	\$1,127	\$1,115	\$1,104	\$1,093	\$1,082	\$1,071	\$1,061
Cost of revenues	744	760	752	747	741	736	731	726	721
Gross profit	\$383	\$378	\$375	\$369	\$363	\$357	\$351	\$345	\$339
Organic ATM unit growth		3%	3%	3%	3%	3%	3%	3%	3%
Average ATM life (years)		5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
SG&A as a % of revenue	10%	10%	10%	10%	10%	10%	10%	10%	10%
<u>Outputs</u>									
(\$mm)									
Revenues	876	993	1,017	1,039	1,061	1,085	1,109	1,134	1,159
Cost of revenues ¹	595	669	686	703	720	738	757	776	796
Gross profit	281	324	331	336	341	347	352	358	364
Gross margin	32%	33%	33%	32%	32%	32%	32%	32%	31%
SG&A ¹	87	99	101	104	106	108	111	113	116
EBITDA	194	224	229	232	235	238	242	245	248
EBITDA margin	22%	23%	23%	22%	22%	22%	22%	22%	21%
Adjusted depreciation		94	103	106	109	112	116	119	123
Operating profit		131	127	127	126	126	126	126	125
Income tax		36	41	40	40	40	40	40	40
NOPAT		94	86	86	86	86	86	85	85
Less: growth capex		12	17	17	18	19	19	20	20
Unlevered free cash flow		82	69	69	68	67	67	66	65
Note: total capex	77	106	120	123	127	131	135	139	143
Note: ATMs (end of period)	66,984	70,305	72,415	74,587	76,825	79,129	81,503	83,948	86,467

Discount rate	8.0%
Terminal growth rate	-1.0%
Terminal value	938
Implied EV/EBITA	7.5
PV of terminal value	522
PV of interim FCF	385
Total PV	907
Less: net debt at FV	502
FV of equity	405
Diluted shares	45
FV of equity per share	\$9.04
Downside	-72%

Source: company filings, Kerrisdale analysis

CATM Quietly Changed Its Tune on Same-Store Growth

What CATM said	What happened
1Q13: growth will rebound to 3-5%	2Q13-1Q14 growth averaged 1.6%
2Q13: for remainder of year, growth “relatively consistent” with 2Q (2.7%)	2H13 growth averaged 1.7% (37% lower than guidance)
4Q13: “normal range of 3-5%” → “ moderate rate of increase”	1Q14: 0.4% growth
1Q14: “moderate rate of increase” → growth “still slightly below where we believe the rate will be for the remainder of 2014”	?

- ▶ Same-store growth disclosures are buried within the 10-Qs and 10-Ks but rarely discussed in press releases or analyst reports

Organic growth continues to surprise management to the downside

The Secular Decline in ATM Usage Has Already Begun

- ▶ As non-cash payments (credit/debit card) and online commerce gain more and more share, paper currency becomes less useful
 - Logically, ATM withdrawals should eventually decline
- ▶ Recent Federal Reserve data illustrates this trend:

	Values			CAGR	
	2003	2009	2012	2003-09	2009-12
<i>(Numbers in billions)</i>					
Noncash payments ex. checks	44.1	83.6	104.5	11.2%	7.7%
ATM cash withdrawals	5.9	6.0	5.8	0.3%	-1.1%
Checks paid	37.3	24.5	18.3	-6.8%	-9.3%
Population (millions)	290.1	306.8	313.9	0.9%	0.8%
ATM withdrawals per capita	20.3	19.6	18.5	-0.7%	-1.9%

Source: 2013 Federal Reserve Payments Study, Kerrisdale analysis

Declining ATM usage is a reality, not some far-off forecast

Long-term Viability Is a Major Concern for the Industry

- ▶ 2013 GAO survey of ATM operators: revenues falling primarily because of **“declining transaction volumes”**
 - 70% of respondents expect further revenue declines for same reason
- ▶ 2014 U.S. Independent ATM Deployer Survey (conducted by industry association and consultancy): biggest fear/worry/concern regarding health of industry?
 - #1 answer: **“Declining Transactions”**
 - ⇒ 45% of respondents, up from 36% in 2013
 - #2 answer: **“ATM Saturation”**
 - ⇒ 40% of respondents, up from 34% in 2013
- ▶ CATM’s spin claims that “cash remains as relevant today as it was half a century ago” – but competitors’ attitudes tell a different story

Other industry players are pessimistic about the future

ATMs Are Losing Value across the World

- ▶ Piecing together the available international data:
 - Canada: withdrawals down since 2005, -3% CAGR
 - United Kingdom: withdrawals down 0.5% in 2013
 - Australia: withdrawals down 5% in 2013
 - Eurozone: withdrawals down since 2010, -0.4% CAGR
 - Sweden: approaching cashlessness
 - ⇒ Cash in circulation has fallen every year since 2007
 - ⇒ Withdrawals down 30% from 2004 to 2011
 - ⇒ Withdrawals expected to decline an additional 6-8%/yr going forward
- ▶ Will the United States and other developed countries really have less sophisticated payment systems than Sweden forever?

The ATM decline is global – and just getting started

Organic Growth in ATM Fleet Size Has Stopped

	2010	2011	2012	2013
Total ATMs (Q4 average)	33,807	44,633	55,988	67,002
Less: total excl. units acquired LTM	33,807	33,958	46,518	55,630
Implied ATMs acquired LTM	-	10,675	9,470	11,372
ATMs excl. LTM acquired	33,807	33,958	46,518	55,630
Less: prior-year total ATMs ¹	33,165	32,798	44,633	55,988
Implied ATMs added organically	642	1,160	1,885	-358
ATMs added:				
Via M&A	-	10,675	9,470	11,372
Organically	642	1,160	1,885	-358
Total	642	11,835	11,355	11,014
% growth in ATMs:				
Via M&A	0.0%	32.5%	21.2%	20.3%
Organically	1.9%	3.5%	4.2%	-0.6%
Total	1.9%	36.1%	25.4%	19.7%

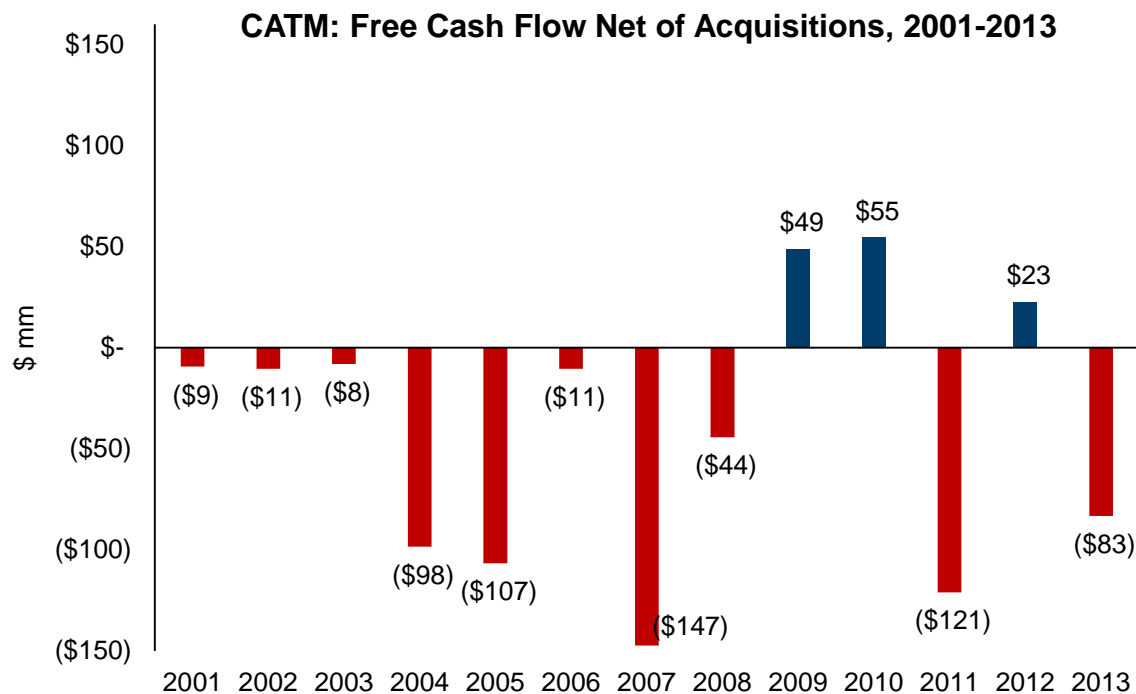
All of CATM's net fleet growth now coming from acquisitions, not organic growth (e.g. new clients)

1. Because of a change in CATM's ATM classifications, the 2011 prior-year total does not equal the total as reported in 2010.

Source: CATM filings, Kerrisdale analysis

CATM Has Reinvested Much of its Earnings into M&A

- ▶ After a pause during the financial crisis, CATM has reinvested >100% of its free cash flow into acquisitions:



Source: CATM filings, Kerrisdale analysis

Other players in the ATM value chain (e.g. NCR) are diversifying, but CATM is doubling down

The Returns on M&A are Diminishing

- ▶ As CATM has resumed its acquisitions spree, its return on capital has declined by any measure:

	2010	2011	2012	2013	'10-13 Δ
Return on assets	9.0%	12.0%	5.8%	2.3%	-75%
Return on assets, adj. for UK tax items	8.9%	5.7%	5.9%	4.3%	-52%
EBIT to average assets	14.5%	13.2%	12.2%	9.1%	-37%
EBITDA to average gross assets	17.2%	15.9%	15.5%	12.6%	-27%
“Adjusted” EBITDA to average gross assets	18.0%	17.4%	16.9%	15.5%	-14%

- ▶ Based on company disclosures, we estimate that ATMs added after 2010 are **41% less profitable** than legacy ATMs
 - Legacy ATMs: \$376 gross profit per month
 - New/acquired ATMs: \$280
 - Overall average dragged down with each new deal

M&A is diluting CATM's profitability
as it reaches for lower-quality, less lucrative merchants and locations

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ISO - INDUSTRY NEWS


ATM Deployers Face 'Perfect Storm' of Obsolescence

BY MICHAEL GIUSTI
JAN 10, 2014 10:41am ET

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Independent ATM operators will soon have to upgrade, replace or abandon their newly obsolete machines.

The nation's fleet of cash machines is becoming outmoded because of the upcoming shift to EMV-chip cards, the decision to abandon a key Windows operating system, and issues raised by the Americans with Disabilities Act and the Payment Card Industry data security standards.

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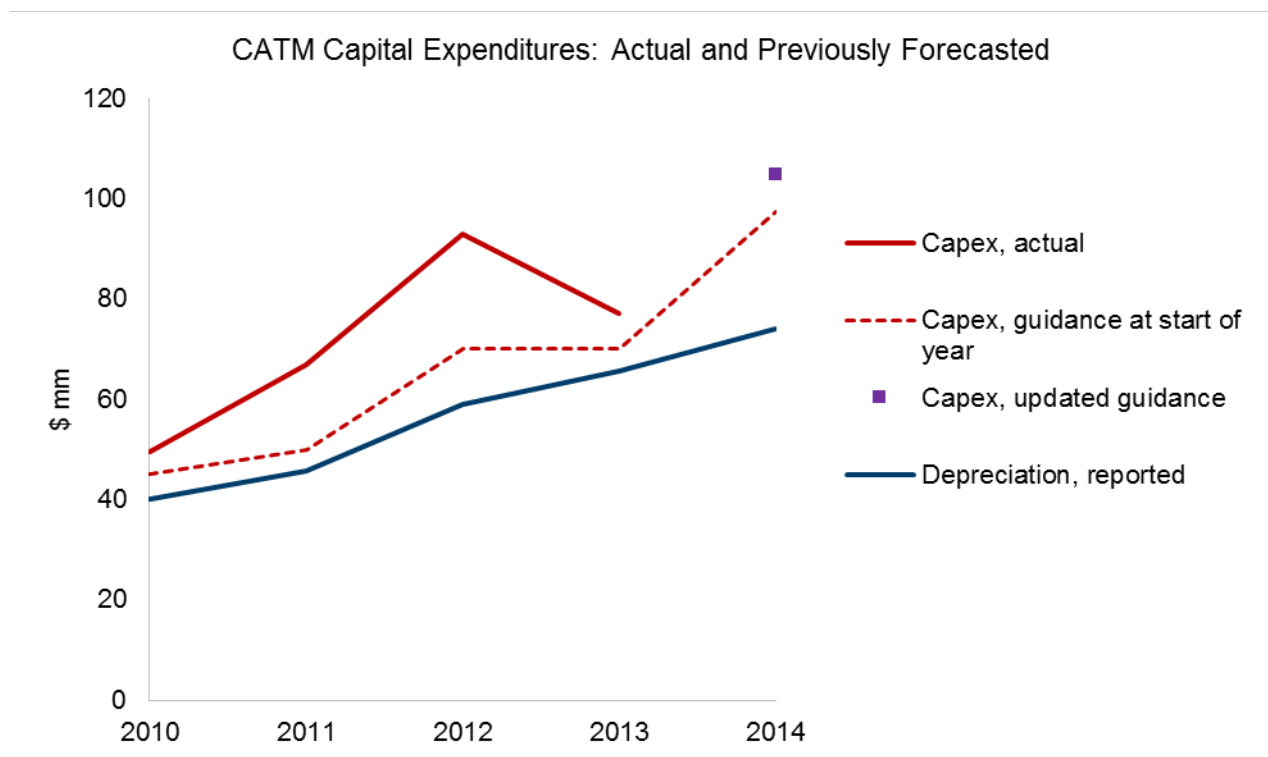
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ATMs must be replaced routinely:
wear & tear, rule changes, new technology...

...but CATM Continually Underestimates Capex...

- ▶ Actual capex comes in above guidance every year
 - The 2014 guidance from 4Q13 was already revised upward in 1Q14



Source: CATM filings, Kerrisdale analysis

Year after year, CATM spends more on equipment than it expects despite slow/negative organic unit growth

...and Assumes Its Machines Last Longer & Longer

- ▶ CATM says it depreciates P&E over 3 to 10 years – a wide range!
- ▶ We estimate that the average assumed useful life has gone from ~7 years to ~9 years:

	2009	2010	2011	2012	2013 ¹	2014 ¹
(\$mm)						
Depreciation expense	37	40	46	59	66	74
Gross property & equipment:						
End-of-period carrying value	253	291	362	460	632	737
Average carrying value (est.)		272	327	411	546	685
<i>Implied average life (years)</i>		6.8	7.1	7.0	8.3	9.2

- ▶ Consistent with little-noticed language change in 10-Ks:

- 2006: “three to **seven** years”
- 2010: “three to **eight** years”
- 2012: “three to **ten** years”

1. Based on CATM guidance.
Source: CATM filings, Kerrisdale analysis

Peer Accounting Is Much More Conservative

- ▶ By compiling every known accounting comparable, we could compare CATM's depreciation standards against other ATM owners
- ▶ CATM is a major outlier, especially among large operators:

Company	Asset	Assumed useful life (yrs)	No. of ATMs	Period
Cardtronics	all P&E	3 to 10	51,873	12/31/13
DirectCash Payments	ATM equip.	5	20,333	12/31/13
Seven Bank	ATMs	5	18,123	3/31/13
E*TRADE Access Inc.	ATM equip.	5	13,000	9/30/05
Access to Money	ATMs	3 to 5	10,382	12/31/10
Cardpoint	ATMs	5 to 7	7,900	6/30/13
Customers	ATMs	8	5,708	6/30/11
Global Access	ATMs	10	4,900	12/31/12
EDC	ATM equip.	5	3,600	6/30/11
Bank Machine	ATMs & related	5 to 7	1,000	3/31/05
Global Cash Access	ATM equip.	5	n/d	12/31/13

Source: company filings, Kerrisdale analysis

Most peers assume 5-year average lives for ATMs, ~45% shorter than CATM

Five-Year Depreciation Schedule Would Slash CATM's Earnings

- ▶ Depreciating assets over 5 years, in line with peers, would have a dramatic impact on CATM's preferred, heavily "adjusted" non-GAAP earnings measure (42%), as well as reported earnings (79%)

	2013	2014
(\$mm)		
Average gross P&E	546	685
Assumed useful life (years)	5	5
Normalized depreciation expense	109	137
CATM depreciation expense	66	74
<i>Incremental depreciation required</i>	44	63
Effective tax rate	32%	32%
Diluted shares	44.6	44.8
EPS impact	-\$0.66	-\$0.95
<i>%Δ to "adjusted" EPS</i>	-34%	-42%
<i>%Δ to GAAP EPS¹</i>	-78%	-78%

1. 2013 GAAP EPS excludes negative impact of tax charge.

Source: company filings, Kerrisdale analysis

CATM's aggressive accounting is inflating reported earnings

Depreciation-Adjusted EPS Indicates Gross Overvaluation

- ▶ CATM 2014 guidance, *excluding recurring amortization*, implies ~\$1.74 of EPS – using the company’s aggressive accounting
- ▶ Adjusted for higher depreciation and applying a range of multiples, CATM has massive downside:

	Useful life (years)		
	5.0	6.0	7.0
EPS baseline	\$1.71	\$1.71	\$1.71
Depreciation adjustment	0.95	0.61	0.36
Depreciation-adj. EPS	\$0.76	\$1.11	\$1.35

P/E multiple:

10.0x	\$7.61	\$11.07	\$13.55
12.0x	\$9.13	\$13.29	\$16.26
14.0x	\$10.65	\$15.50	\$18.96
16.0x	\$12.17	\$17.71	\$21.67

Source: company filings, Kerrisdale analysis

Truing up CATM’s depreciation implies a major hit to the stock price

CATM's Largest Customer Is at Risk

- ▶ 7-Eleven accounts for 24% of CATM's revenues
- ▶ The chain is owned by a Japanese firm, Seven & i
 - Seven & i owns ~half of Seven Bank, **the company that owns and operates all the ATMs in Japanese 7-Eleven stores**
 - Seven Bank entered the US ATM market with two acquisitions: one in 2012 and another in 2013
 - Seven Bank management is openly seeking the US 7-Eleven contract:
 - ⇒ *“Seven Bank will work hard to ensure that 7-Eleven and its customers choose [our] ATMs when [Cardtronics] negotiates a contract extension”¹*
 - ⇒ *“[W]e intend to roll out a wide-ranging scheme for further expansion”²*
- ▶ CATM's current contract with 7-Eleven expires in mid-2017
 - The threat from Seven Bank gives 7-Eleven a strong bargaining position

1. Seven Bank FY 2012 Q2 Q&A.

2. Seven Bank FY 2012 annual report.

Even if CATM retains the 7-Eleven relationship, the competitive pressure could result in less favorable terms and lower earnings

7-Eleven Exposure Is Larger than the Market Appreciates

- ▶ 7-Eleven accounts for 24% of CATM's revenues – widely cited statistic
- ▶ However, we estimate that 7-Eleven ATMs generate ~2x as much revenue per unit as CATM's average ATM and thus **41% of total earnings**:

<i>Estimated Revenue per 7-Eleven ATM</i>	
Pro forma revenue, 2013 (\$mm)	939.0
Of which: 7-Eleven (%)	24.0%
Implied: 7-Eleven (\$mm)	225.4
7-Eleven US ATMs (#)	8,176
Implied revenue per ATM per month	\$2,297
Overall avg rev. per ATM per mo, 2013	\$1,127
7-Eleven revenue as mult. of avg	2.0x



	<i>Per ATM per month</i>	
	<i>Overall¹</i>	<i>7-Eleven</i>
Revenues	\$1,127	\$2,297
Cost of revenues:		
Variable	516	1,052
Fixed	228	228
Total	<u>744</u>	<u>1,280</u>
Gross profit	\$383	\$1,017
<i>Multiple of overall average</i>		2.7x
7-Eleven ATMs		8,176
7-Eleven gross profit per year (\$mm)		99.8
7-Eleven % of total gross profit		30%
7-Eleven % of total adj. EBITDA		41%
<i>Assumptions</i>		
Variable % of total costs	69%	69%
Variable cost as % of revenue	46%	46%

1. 2013 average.

2. Based on CATM 1Q14 update guidance for FY2014.

7-Eleven's high-traffic ATMs are disproportionately profitable, exacerbating CATM's concentration risk

Conclusion

- ▶ CATM faces sharply slowing same-store transaction growth
 - Management has repeatedly underestimated this trend
- ▶ Overall ATM usage faces broad declines across the world
- ▶ Aggressively drawn-out depreciation has inflated earnings
 - But cash capex keeps surprising to the upside
- ▶ Roll-up strategy papers over these issues but leads to declining returns
 - Lower gross profits per ATM, lower returns on capital
- ▶ Peer valuations and illustrative DCF point to \$9-19 fair value, 40-70% lower
- ▶ None of these concerns turn on the 7-Eleven contract...
 - But CATM also risks losing ~25% of revenue/~40% of earnings because of it
 - Long-term presence of Seven Bank in US market will put ongoing competitive pressure on CATM's margins

Kerrisdale believes that Cardtronics is a compelling short

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