

Cardtronics, Inc. (CATM)

Aggressive Accounting and Secular Decline Drive 40-70% Downside

We are short shares of Cardtronics (CATM), the largest non-bank owner and operator of ATMs, primarily in the US and UK. CATM's core business is installing ATMs inside brick-and-mortar retailers like 7-Eleven and CVS, where high foot traffic generates withdrawals that in turn generate surcharge fees (paid by consumers) and interchange fees (paid by card-issuing banks). In addition, banks sometimes pay CATM to put their brands on its devices or to offer surcharge-free withdrawals to their customers.

Despite its exclusive focus on the secularly declining ATM market, CATM trades at the rich valuation of a high-growth firm, with trailing and forward P/E ratios of 37x and 26x, respectively, 53% higher than the S&P 500 median. Moreover, we believe that CATM has inflated its earnings via aggressive accounting. It depreciates its ATMs over much longer periods than its competitors do – more than eight years rather than five years – thereby understating expenses. Applying a five-year average life to CATM's assets would have reduced EPS in 2013 from \$0.86 to just \$0.19.

While CATM's press releases paint an optimistic picture of organic growth, its SEC filings show that domestic same-store transaction growth has slowed markedly, from 3.8% in Q1 2012 to just 0.4% in Q1 2014. A recently released [Federal Reserve study](#) confirms that total ATM withdrawals in the US are already declining. *Essentially, CATM is a concentrated bet on paper currency and retail foot traffic* – stunningly at odds with the direction in which the world is moving. CATM management has distracted investors from these relentless secular trends through an aggressive roll-up strategy that has consumed more than 100% of its free cash flow over the past three years. But diminishing returns have pushed RoA from 8.9% in 2010 to 4.3% in 2013, and new ATMs have come on at 41% lower per-unit gross profitability than legacy ATMs.

Making matters worse, CATM also faces an existential threat as its largest merchant relationship, 7-Eleven – which we estimate accounts for ~40% of its earnings – comes up for renewal in 2017. A sister company of 7-Eleven's that operates all of the chain's ATMs in Japan is rapidly expanding in the US and openly pursuing the contract. If it succeeds, it would be catastrophic for CATM.

In light of its numerous risks, and based on comparable firms' far lower valuations along with our DCF analysis, we believe that CATM's fair value is only \$9-\$19 per share, or 40-70% below the current stock price.

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I. Investment Highlights

- **Roll-up strategy yields declining returns on capital while organic growth deteriorates.** After a three-year hiatus, CATM has re-embarked on an acquisition spree, gobbling up 13 companies in the last three years. From 2011 to 2013, CATM spent more than 100% of its free cash flow on acquisitions. Meanwhile, “same-store” transaction volume at its US ATMs has slowed drastically to 0.4%, net growth in ATMs (excluding acquired units) turned negative in 2013, and average revenue per withdrawal fell three years in a row. In its [2013 Q1 10-Q](#), management guided to a “more normal range of 3-5%” same-store transaction growth. In reality, growth was -1.0%, 2.7%, 1.7%, 1.7%, and 0.4% over the past five quarters, never even reaching the low end of the range. CATM has deflected investors away from these weak organic numbers by promoting its aggressive roll-up strategy. However, this strategy has generated diminishing returns: CATM’s return on invested capital dropped from 14.5% in 2010 to 9.1% in 2013, and its return on assets fell from 8.9% to 4.3%, representing declines of 37% and 52%.
- **Aggressive accounting overstates true earnings power.** Despite the simplicity of its business, CATM management and sell-side analysts focus on “adjusted” earnings rather than GAAP. But the spread between GAAP and “adjusted” has grown wider with every passing year: while adjusted EPS grew 93% from 2010 to 2013, GAAP EPS *fell* 10%, from \$0.96 to \$0.86, even after adding back a UK tax charge. “Adjusted” numbers that exclude transaction expenses, stock-based compensation, and amortization costs let management off the hook for the real costs of its M&A-driven strategy. Furthermore, we believe that CATM’s capital expenditures are dominated by maintenance and replacement costs, not growth investments. Yet CATM appears to be exaggerating its earnings by aggressively assuming long average lives for its ATMs. If CATM assumed a five-year life, in line with its peers’ accounting, then depreciation in 2013 would be \$44 million higher, cutting GAAP EPS from \$0.86 to just \$0.19. Reinforcing the case against CATM’s inadequate depreciation are the facts that (1) it consistently sells used machines for less than their carrying values, and (2) it repeatedly underestimates near-term capital-expenditure requirements.
- **ATM usage is declining at an accelerating pace – a secular trend that is only getting started.** Though CATM management and sell-side analysts pour scorn on the straw-man argument that cash will vanish overnight, the utility of ATMs need not go to zero for CATM’s value to be dramatically impaired. In the US, Federal Reserve data confirm that declining ATM usage is already a reality, not some far-off forecast: cash withdrawals grew at a 0.3% CAGR from 2003 to 2009 but *fell* at a 1.1% CAGR from 2009 to 2012. Given population growth, this implies that per-capita withdrawals have been declining since at least 2003, and the decline is now accelerating. It’s no wonder, then, that independent ATM deployers, CATM’s competitors, [rate](#) “declining transactions” and “ATM saturation” as their top two concerns. Overseas trends are similar: ATM withdrawals are declining in the eurozone, countries like Sweden and

Australia are increasingly becoming cashless, and groups like the Gates Foundation are pushing for the rapid adoption of electronic payments in developing nations. Despite CATM's valiant attempts to use M&A to paper over these trends, *CATM is a concentrated bet on paper currency and retail foot traffic*. We view CATM's aggressive shift toward M&A as a tacit admission that it faces secular decline in its existing operations and hopes to escape the inevitable by paying up for growth.

- **Upcoming contract expiration puts largest customer – and 24% of revenue – at risk.** In 2007, CATM acquired 7-Eleven's US ATM fleet in a transformational deal that made the convenience-store chain CATM's largest customer. Since then, however, the Japanese ATM operator Seven Bank – almost 50% owned by 7-Eleven's Japanese parent company, Seven & i Holdings – has entered the US market by outbidding CATM on two acquisitions, with a clear long-term goal of replacing CATM as 7-Eleven's ATM partner. Seven Bank already serves in this role in Japan. Given CATM's outsized exposure to this single merchant, constituting 24% of its 2013 pro forma revenue and, by our estimates, 40% of earnings, the loss of 7-Eleven would be devastating. Even if CATM manages to extend the contract in 2017, the genie is out of the bottle: over the long term, Seven & i wants to bring the ATM business back into the fold, and CATM is at its mercy.
- **Premium valuation unwarranted given enormous near-term and long-term risk.** Adjusted for capital structure, CATM trades at a massive premium to DirectCash, its leading Canadian competitor, as well as to firms like NCR and Deluxe that are similarly exposed to the secular decline in paper-based payments (but are seeking to diversify instead of doubling down like CATM). DirectCash trades at 8.2x EV/EBITA, while CATM trades at a lofty 13.4x – 64% higher. Averaging together a wider peer group suggests that CATM should be valued at 9.3x EV/EBITA, implying a share price of \$19, 41% lower than the current price. From a longer-term perspective, our bottoms-up DCF, which extrapolates CATM's profit drivers in a world with modestly declining per-ATM transaction volumes, produces a fair value of just \$9 per share, 72% below the current stock price. Thus CATM's stock appears to price in many years of rapid growth while completely neglecting the risks of deteriorating profitability, client attrition, overstated earnings, and long-term obsolescence.

Historical Financial & Operational Overview

	2009	2010	2011	2012	2013
Revenues	493	532	625	780	876
Cost of revenues	344	360	420	536	595
Gross profit	149	172	204	244	281
Operating expenses	106	105	127	154	199
EBIT	43	66	77	91	83
EPS	\$0.13	\$0.96	\$1.58	\$0.96	\$0.52
EPS ex. tax items	\$0.13	\$0.96	\$0.75	\$0.96	\$0.86

Profitability

Gross margin	30.2%	32.3%	32.7%	31.3%	32.1%
EBIT margin	8.7%	12.5%	12.4%	11.6%	9.4%
Return on assets ex. tax items	1.1%	8.9%	5.7%	5.9%	4.3%

ATM statistics

Ending machine count ¹	32,413	33,116	48,105	56,395	66,984
% growth	1.1%	2.2%	45.3%	17.2%	18.8%
% organic growth	1.1%	1.9%	3.5%	4.2%	-0.6%
Revenue per withdrawal	\$1.99	\$2.04	\$1.84	\$1.64	\$1.59
% growth	-4.6%	2.8%	-10.0%	-10.8%	-3.0%
Same-store withdrawals % Δ ²	not discl.	2.0%	3.8%	6.3%	1.1%

1. ATM operations only (excludes managed services).

2. Domestic ATMs only.

Source: CATM [2009 10-K](#), [2010 10-K](#), [2011 10-K](#), [2012 10-K](#), [2013 10-K](#), Kerrisdale analysis

Relative to other firms with large exposures to paper-based payment media, CATM is a clear outlier on valuation. On an EV/EBITA basis – even without adjusting for CATM's understated depreciation expense – it trades at a 64% premium to its closest comparable, a Canada-based multinational ATM operator called DirectCash. Compared to other firms like Brink's (an armored courier), Deluxe (a check printer), and NCR (an ATM manufacturer), the results are similar, implying 41% downside to CATM's stock price.

CATM Trades at an Unjustified Premium Relative to Peers

	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
CATM implied stock price		\$18.86	\$15.29	\$24.68	\$16.24	\$19.24
CATM equity downside		(41%)	(52%)	(23%)	(49%)	(40%)
Memo: P/E 2014	26.3x	15.7x	NM	22.9x	13.6x	10.6x

1. Canadian dollars.

2. CATMEBITA 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, [CATM 2014 Q1 earnings release](#), [DCI 2013 financial statements](#), [BCO 2013 10-K](#), [DLX 2013 10-K](#), [NCR 2013 10-K](#), Kerrisdale analysis

Our DCF analysis, which assumes a modest 1% annual decline in same-store transaction volumes, suggests even more downside, with a fair-value stock price of just \$9.

Kerrisdale Illustrative DCF Analysis: Summary

	2013	2014	2015	2016	2017	2018	2019	2020	2021
Key drivers									
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%
Outputs									
(\$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%								

1. Cost of revenues and SG&A include stock-based compensation.

Source: CATM filings, Kerrisdale analysis

While the comparable and DCF analyses above take CATM's current level of earnings as their starting point, the company's heavy reliance on 7-Eleven renders that assumption optimistic. The convenience-store chain generates 24% of CATM's revenue, and based on information on ATM counts from 7-Eleven we estimate that its ATMs generate twice as much revenue per unit as CATM's overall average. As a result of ATM-level fixed costs, this means that 7-Eleven must generate a disproportionate amount of earnings relative to revenue – approximately 40% of CATM's total, according to our calculations. Even if CATM doesn't lose the contract entirely to 7-Eleven's sister firm Seven Bank (or another competitor), the existence of a serious challenger gives 7-Eleven an excellent opportunity to renegotiate the agreement on terms more adverse to CATM.

Another factor distorting CATM's current reported earnings is its aggressive approach to accounting for depreciation. While other large ATM operators almost uniformly depreciate their assets over a five-year average useful life, CATM appears to assume a much more aggressive eight-to-nine-year schedule, giving an enormous boost to stated earnings. The company's assumptions weren't always so aggressive: in [2006](#) it depreciated property and equipment over "three to seven years," but by [2013](#) the time frame had quietly extended to "three to ten years." With a host of technology and regulatory changes (along with normal wear and tear) forcing ATM upgrades, replacement costs are very large and very real, yet CATM is implying that its current fleet will last for a decade.

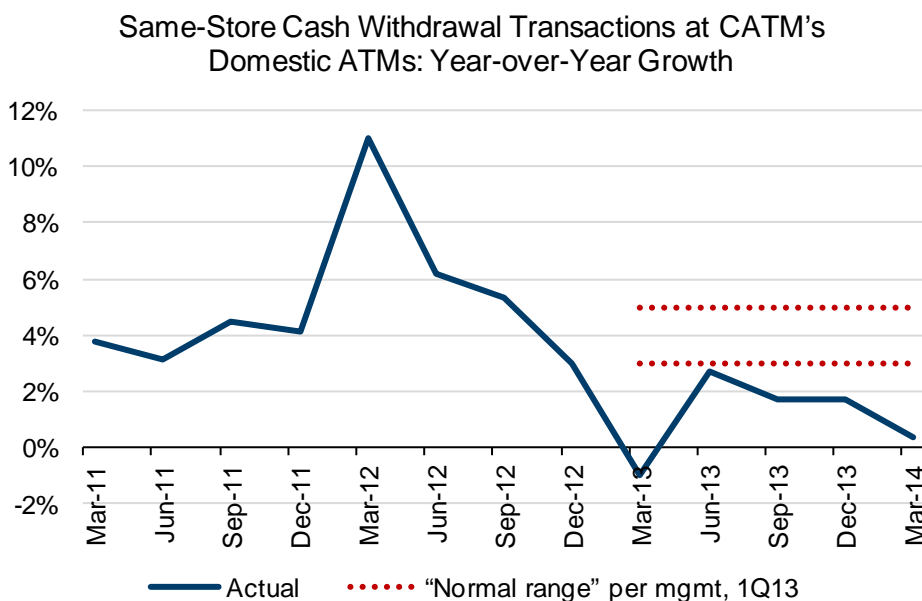
When analyzing CATM, we are reminded of the pay-phone industry. In the mid-1990s, pay phones generated \$7 [billion](#) in annual revenue, and premier operators like Davel Communications were busy buying up smaller competitors. Even after it was clear that mobile phones posed a major threat to the industry, management insisted that pay phones were as important as ever. But all of Davel's major rivals went out of business, and Davel itself saw its stock price decline from ~\$30 in early 1998 to ~\$0 by 2000. Even if the ATM sector somehow avoids its fate, CATM is still overvalued; if it doesn't, investors will look back with wonder at the price they were willing to pay for a firm like this.

III. Same-Store Transaction Growth Has Slowed Sharply and Surprised Management

Tucked away in its 10-Qs and 10-Ks – though not discussed in its earnings releases – CATM discloses same-store year-over-year growth in transaction volumes at its domestic ATMs. For CATM, same-store transaction growth is the highest-margin source of incremental volume because, unlike installing new ATMs or buying competitors, it doesn't require additional capital.

Unfortunately for CATM, same-store transaction growth has fallen sharply in recent quarters, apparently taking management by surprise. Though the data points may not be perfectly commensurable over time since CATM has altered its definition of “same store,” the trend is clear: growth has slowed.

In early 2012, CATM enjoyed very strong year-over-year same-store growth as a result of unusually warm weather along with cash withdrawals funded by tax refunds loaded onto H&R Block prepaid cards. (H&R Block had not used CATM's surcharge-free Allpoint network in the prior year.) Furthermore, the leap day lengthened the first quarter. All of this set up a difficult comparison for CATM in 1Q13, and, sure enough, same-store growth was negative. Initially, in its [10-Q commentary](#), management attributed the decline in growth to these temporary factors and stated confidently that “[i]n the second quarter and throughout the remainder of 2013, we expect that [sic] our domestic same-store transaction growth to resume to a **more normal range of 3-5%**” (emphasis added).



Note: missing quarterly values (2011 Q4, 2012 Q2, 2012 Q4, 2013 Q4) are interpolated based on stated year-to-date figures.

Source: CATM 2010 Q1 – 2014 Q1 10-Qs, 2010-13 10-Ks, Kerrisdale analysis

Over the next three quarters, however, growth never reached even the low end of this “more normal range,” and for the year it averaged just 1.1%, by far the lowest full-year result since CATM began disclosing the metric in 2010. In its [second-quarter 10-Q commentary](#), management quietly dropped any reference to a “more normal range,” saying instead (emphasis added):

We expect that [*sic*] our domestic same-store transaction growth rate to remain **relatively consistent with our second quarter rate** throughout the remainder of 2013.

But this forecast too was wrong. Growth in the second quarter was 2.7%, but in the third quarter and the second half it averaged just 1.7%. By the [third quarter](#), management had again silently moved the goalposts, projecting (accurately this time) that growth would “remain relatively consistent with our third quarter rate during the fourth quarter of 2013” without acknowledging that growth had repeatedly underperformed prior expectations. Finally, in the [2013 10-K](#), management replaced its original talk of a “normal range of 3-5%” growth – set forth just a few months earlier – with something vaguer and less ambitious:

We expect to continue to see **a moderate rate of increase** in the number of cash withdrawal transactions being conducted on our domestic ATMs.

Not only did management fail to acknowledge these serial disappointments but it also provided no clear explanation for them. In all of the Qs and the 10-K, the company blames, in part, “decreased consumer spending,” but it’s difficult to understand what this could mean. In the aggregate, US consumer spending has *increased*, not decreased: real personal consumption expenditures [grew 2.0% in 2013](#). This excuse doesn’t hold up to scrutiny.

In the recently reported first quarter of 2014, same-store transaction growth slowed even further to just 0.4%, which CATM blamed on “adverse weather conditions” (notwithstanding what should have been an easy comp) and characterized as “still slightly below where we believe the rate will be for the remainder of 2014.” Gone is any reference to lower consumer spending, but, whatever the rationalization, the trend remains weak.

Overall, CATM’s surprise declines in same-store transaction growth, coupled with its weakening organic unit growth and falling per-ATM gross profits, paint a picture of deteriorating core fundamentals. Management has attempted to mask this deterioration by engaging in an acquisition spree, eating up all of its free cash flow in the process, yet this has in turn led to lower returns on capital. With these sorts of underlying trends, CATM does not deserve its optimistic premium valuation.

IV. The ATM Sector Is in Secular Decline

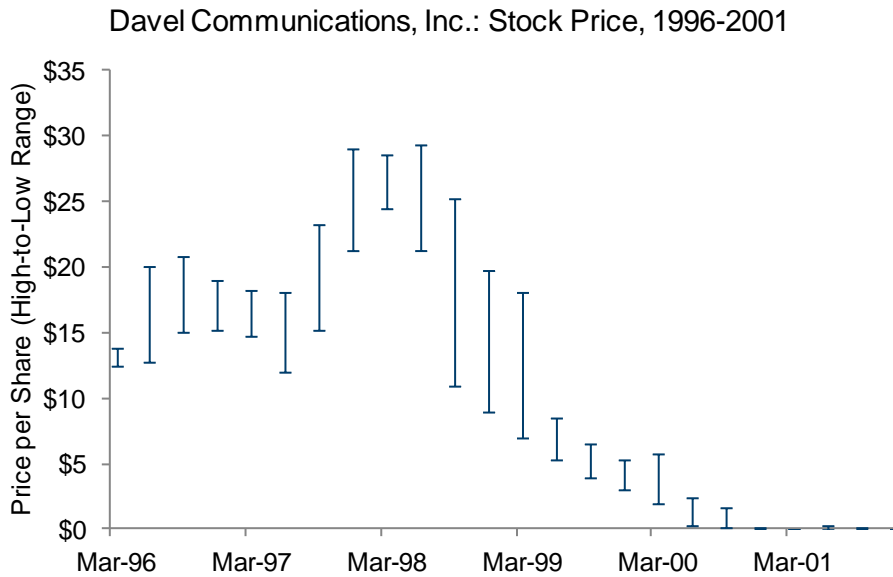
Given investor enthusiasm for the mega-trend of growth in non-cash payment methods – as expressed in the valuation of companies like Square, Visa, and MasterCard – as well as the ever rising importance of online commerce, it's surprising that analysts have expressed so little skepticism about CATM's long-term prospects. After all, CATM's entire raison d'être is supplying paper currency at brick-and-mortar merchant locations. But management has successfully convinced investors that, in the words of a company [white paper](#), "its naysayers notwithstanding, cash remains as relevant today as it was half a century ago." On its [1Q14 earnings call](#), CATM's CEO declared that "the prognosis for cash is that it remains a dominant and very healthy player in the payment infrastructure for many years to come."

This sunny outlook is wholly inconsistent with the facts, which depict an industry in the early stages of a massive secular decline. Defiant, "common sense" claims about the perennial appeal of paper currency remind us of another sector: independent pay-phone operators. Like ATM operators, these companies aimed to install their devices in a wide range of high-traffic retail locations, and some engaged in large-scale M&A to consolidate the market. In 1996, US payphone calls generated [\\$7 billion](#) in annual revenue. By the late '90s, doubts had cropped up about the long-term viability of the sector in a world of mobile phones, but many experts dismissed such talk as scare-mongering (emphasis added):

...the increasing use of cellular phone has prompted speculation over whether pay phones will become obsolete. Robert D. Hill, chief executive of Davel [the leading independent operator], pours water over that suggestion, **noting that the growth of pagers has actually spurred pay-phone use.** ([MarketWatch](#), 10/7/1999)

"There will always be the need for pay phones," said Fred Volt, an analyst with the Yankee Group consulting firm. "If you don't believe me, go to an airport or a mall and see how many people are on them." ([Dow Jones](#), 11/2/1999)

Volt was right: pay phones haven't gone away, and many people still rely on them. But that didn't stop the number of phones in the country from [declining by 74%](#) from its 1999 peak to 2009, and it didn't stop Davel's stock price from going to zero:



Source: Davel [1998](#), [1999](#), [2000](#), and [2001](#) 10-Ks

Operators in the ATM industry are equally as optimistic, and the secular trends are similarly foreboding.

US ATM Transactions Are Falling, and Operators Fear Worse to Come

According to the recently released 2013 [Federal Reserve Payments Study](#), US ATM withdrawal transactions **decreased** at a 1.1% CAGR over the three-year period from 2009 to 2012. (Although withdrawal volume in *dollars* increased at a modest 1.2% pace – far below the 4% growth rate of nominal GDP and nominal personal consumption expenditures – what matters most for CATM is the *number* of transactions: surcharge and interchange fees are primarily based on counts and not values.) Over the same period, the U.S. population grew 0.8%, implying a 2%-per-year decline in per capita withdrawals. Meanwhile, noncash payments, consisting of primarily credit- and debit-card transactions that are the primary alternatives to cash increased at an almost 8% CAGR.

US ATM Withdrawals Have Already Begun to Decline

	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

Notably, while withdrawals were already in decline on a per-capita basis from 2003 to 2009, the drop has accelerated over the past several years to the point where *aggregate* withdrawal counts have now begun to decline. The ongoing weakness in CATM’s same-store transaction volumes indicates that, even with its high-traffic retailer relationships, it is not immune from this broad industry trend.

To be sure, CATM’s competitors are well-attuned to this ominously accelerating decline. In a 2013 [study](#) conducted by the Government Accountability Office, the ATM operators surveyed said that, over the past five years, ATM revenues have decreased, while costs have risen. “The most frequently cited reason the operators gave for the decreased revenues was **declining transaction volumes**,” including both surcharged and non-surcharged transactions (emphasis added). “Similarly,” the study goes on, “of the ten financial operators that addressed future revenue trends in our survey, seven indicated they anticipate **a decline, due primarily to fewer transactions**” (emphasis added).

Similar sentiments are expressed in the [2014 U.S. Independent ATM Deployer Survey](#) sponsored by the industry association ATMIA and the consultancy Kahuna ATM Solutions. When 92 deployers were asked the question, “What are your biggest non-legislative/compliance/network fears, worries and concerns regarding the health of the ATM industry?” the two most popular responses, and the two most likely to rank as the number-one concern, were “**Declining Transactions**” and “**ATM Saturation**.” (“Keeping up with Changing Technology” was number three, further underscoring the ongoing upward pressure on capex.) Concerns about declining volumes actually got *worse* since the prior year’s survey:

Declining Transactions, Rising Concern

% of respondents naming as top-three fear:

	<u>2013</u>		<u>2014</u>
“Declining Transactions”	36.1%	→	44.5%
“ATM Saturation”	34.2%	→	40.2%

Source: [2013](#) and [2014](#) U.S. Independent Deployer Surveys, Kerrisdale analysis

These smaller operators are confirming that what the Fed data says is correct: transactions are falling at an accelerating rate. While CATM contends that cash is just as relevant today as it was fifty years ago, consumer behavior is pointing in the opposite direction, which will subject organic growth to severe and continuing pressure.

The Declining Relevance of Cash and ATMs Is a Global Phenomenon

Some CATM boosters might argue that the company’s international expansion opportunities will overshadow weakness in the domestic market. With the US contributing 87% of “adjusted” EBIT in 1Q14, however, it’s clear that local trends will loom large. Moreover, ATMs are becoming less important all across the world, not just in the US:

- *United Kingdom:* According to the [UK ATM network LINK](#), the total number of cash withdrawals grew at a 0.2% CAGR over the past five years and declined by 0.5% in 2013.
- *Canada:* According to the [Canadian Bankers Association](#), the number of cash withdrawals has declined every year since at least 2005, shrinking at a 3% CAGR.
- *Eurozone:* According to the [European Central Bank](#), while ATM cash withdrawals grew almost 2% per year from 2008 to 2010, they have since declined at 0.4% per year through 2012.
- *Sweden:* With its efficient and technologically advanced retail payment system, Sweden is among the most “cashless” nations in the world. A 2013 [study](#) by the Swedish central bank notes that this shift has been relatively rapid. After rising every year from 1950 to 2007, total cash in circulation has fallen every year since. Meanwhile, “[t]he number of ATM withdrawals and the total value of withdrawals rose until the start of the 2000s, but has declined over the past ten years. ... The total value of withdrawals fell by almost 30 percent between 2004 and 2011.” Nor is this decline slowing: the president of Bankomat AB, Sweden’s leading ATM operator, [said](#) in September 2013 that “the number of withdrawals at ATMs decreases by 6-8 percent every year.”
- *Japan:* For [Seven Bank](#), daily average transactions per ATM in its Japanese operations were down 2% year-over-year for the nine months ended 12/31/13, the latest in a string of weak numbers. Indeed, one motivation for the company’s US expansion may be the onset of weak same-store trends in its home market.

- *Australia:* According to the [Australian Payments Clearing Association](#), ATM withdrawals declined by 5% in 2013 alone and were down 7% from their 2008 peak. Meanwhile, credit- and debit-card transactions continue to grow steadily.
- Even in emerging markets where data is scarcer and banking systems less developed, cash is coming under fire from both the public and private sectors. For example, the Better than Cash Alliance – [funded](#) by the Gates Foundation, the U.S. Agency for International Development, Citigroup, Visa, and MasterCard, among others – is pushing to accelerate the shift from paper and coins toward digital payments, arguing that it will increase efficiency, transparency, and security.

Given this weak global backdrop, it's easy to sympathize with the owners of foreign ATM operators who have sold their businesses to CATM in recent years: they get to cash out before the secular woes facing the sector become too obvious. CATM, on the other hand, has levered up to fund these purchases, effectively doubling down on a shrinking market. The stark contrast between the story told by the data and the one set forth by CATM management casts doubt on investors' rosy long-term outlook and the company's premium valuation.

V. CATM's Roll-Up Strategy Has Consumed All of Its Cash Flow and Generated Falling Returns

CATM has long been a serial acquirer: from 2001 to 2008, for example, it completed 16 acquisitions and increased the size of its ATM portfolio from 3,339 units to 33,755. For almost three years, though, coinciding with the financial crisis, CATM halted its M&A and focused on optimizing its existing business. But starting in 2011, it resumed its acquisition spree, gobbling up another 13 firms. Since 2011, CATM has spent more than 100% of its free cash flow on acquisitions and took on high-cost convertible and subordinated leverage to fund the remainder.

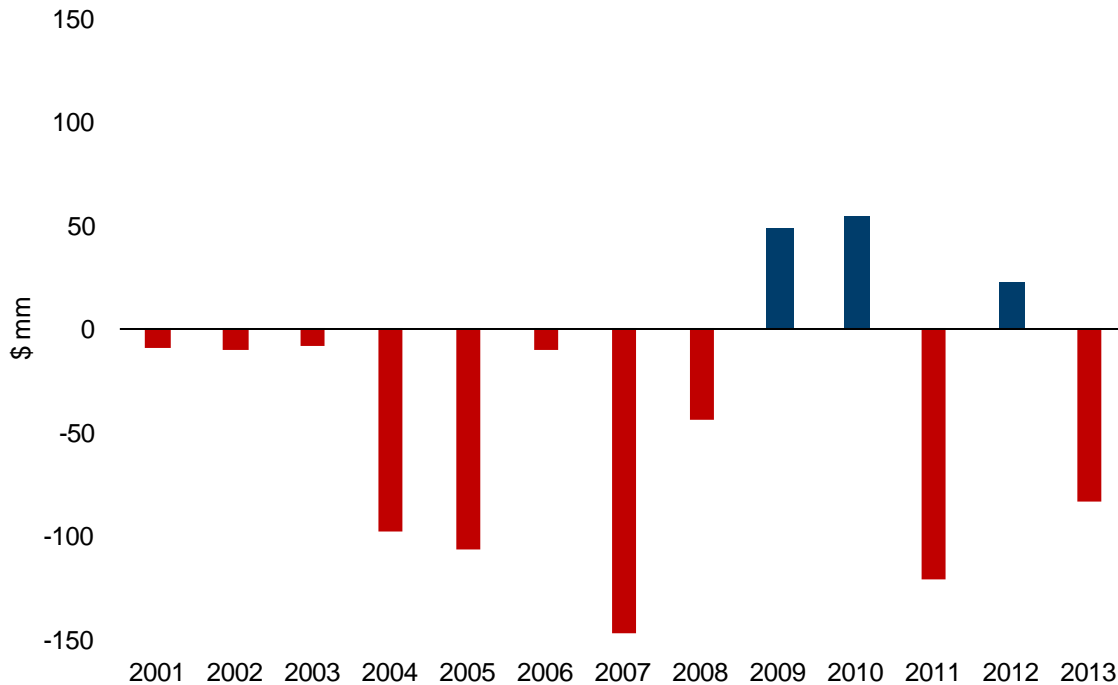
CATM Has Spent All of Its Free Cash Flow on Acquisitions

	2009	2010 ¹	2011	2012	2013	2011-13
(\$mm)						
Cash from operations	75	105	113	136	184	433
Less: capex ¹	26	51	67	93	77	237
Free cash flow	49	55	46	44	106	196
Acquisitions	-	-	168	21	190	378
FCF net of acquisitions	49	55	-121	23	-83	-182

1. Includes payments for intangible assets (exclusive license agreements, etc.).

In fact, analyzing as far as public data permits, CATM has almost never generated more cash flow from operations than it has spent on capex and acquisitions. 2009 and 2010 (and, to a far lesser extent, 2012) were the exceptions; in every other year, CATM has posted negative FCF net of acquisitions and has thus required an influx of external capital.

CATM: Free Cash Flow Net of Acquisitions, 2001-13



Source: CATM 2006-13 10-Ks, [S-1 filed 3/10/04](#), Kerrisdale analysis

In principle, there is nothing inherently wrong with a business that, for a time, spends more on acquisitions than it generates in free cash flow. Examining CATM's results, though, it's clear that the resumption of M&A has led to steadily declining returns on capital, as shown in the table below. CATM's return on assets, for example, has fallen from 9% in 2010 to just 2% in 2013. While the low level in 2013 was partially driven by the impact of a tax-related restructuring in the company's UK operations, ROA fell dramatically even when adjusting for this item, from 9% to 4%. Looking at EBIT relative to average assets – a measure of return on invested capital that abstracts from the business's changing mix of debt and equity – confirms the sizable decline in profitability.

CATM's Profitability Has Declined Sharply as Acquisitions Have Ramped Up

	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%

Source: CATM 2012-13 10-Ks, Kerrisdale analysis

While CATM management and sell-side analysts prefer to focus on "adjusted" earnings measures that exclude expenses like intangible-asset amortization, these metrics treat

acquisitions as if they are free and thus fail to address the crucial question of how much earnings power the company has been able to generate per dollar invested, whether in organic opportunities or in M&A. To get at this issue, we compute gross assets by adding back accumulated depreciation, amortization, and goodwill impairment, thereby estimating the total cumulative cash invested in the business. This permits an apples-to-apples calculation using EBITDA, since depreciation and amortization are excluded consistently from both numerator and denominator. But returns on capital computed in this fashion follow a trend similar to that of the other measures, deteriorating year after year. Even if we give CATM full credit for its “adjusted” EBITDA figure, the fact remains that the post-2010 roll-up strategy has yielded diminishing marginal returns that are becoming ever-less attractive on an absolute basis.

M&A Accounts for Almost 100% of Unit Growth, and Organic Growth Has Turned Negative

To increase the size of its ATM fleet, CATM has two basic options:

- *Organic growth*: sign up new merchant partners or install ATMs at new stores opened up by existing partners
- *M&A*: buy competing ATM operators

M&A is likely to be a less profitable source of growth: CATM must pay a control premium, incur sizable acquisition-related expenses (over \$15mm in 2013), and often compete with other buyers. By contrast, putting an ATM in, say, a new Walgreens does cost money but entails fewer frictions and should generate higher returns. Since 2011, we estimate that 93% of CATM’s rapid increase in ATM units has come from acquisitions, not organic growth:

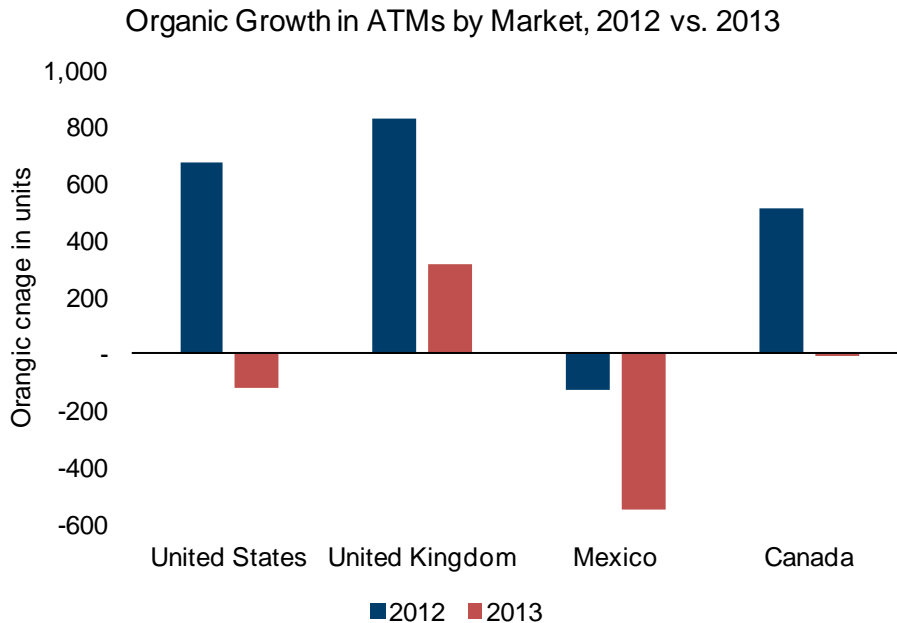
CATM Depends on M&A to Grow Its ATM Fleet

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

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

Source: CATM [2010 Q4/2011 Q4/2012 Q4/2013 Q4](#) earnings releases, Kerrisdale analysis

We believe investors now face an especially precarious situation since organic ATM growth turned slightly *negative* in 2013. While this was partially driven by the removal of unprofitable machines in Mexico, organic growth was weak across the board, slowing year-over-year in every geographic market:



Note: 2013 organic growth in Canada was -2 units.
 Source: CATM [2013 Q4](#) earnings release, Kerrisdale analysis

CATM has clearly become more reliant on acquisitions to increase the size of its ATM fleet. Yet this strategy has come at the price of weaker returns on capital. Management may have judged that, given the gloomy outlook for organic growth, M&A is the only way left to expand, but there is no reason for shareholders to reward this desperate strategy with a premium valuation.

New and Acquired ATMs Are 41% Less Profitable than CATM’s Legacy ATMs

Because CATM has acquired so many different companies over the last three years, parsing its results is challenging. The company does provide operating metrics that exclude the impact of recent acquisitions, but as time goes on, the chain breaks: investors can observe the impact of 2013’s acquisitions on 2013’s results but not the impact of, say, 2011’s acquisitions, which blend in with pre-existing assets. To assess the quality of CATM’s growth strategy, however, it is important to know how the profitability of its new ATMs, added primarily via M&A, compares to the profitability of its “legacy” ATMs.

It’s clear that *overall* unit profitability has declined significantly. In 2011, excluding the impact of acquisitions, gross profit per ATM (excluding depreciation and amortization) was \$472 per month; by 2013 Q4, it had fallen 20% to \$376 per month. Cash withdrawals per ATM, a key driver of revenue and profits, had also declined by 5%. But if we make the simplifying assumption that the legacy ATMs’ operating metrics remained constant during the period, thereby attributing all of the change to the added ATMs, the comparison is even starker: new and acquired ATMs are on average 41% less profitable than CATM’s legacy ATMs.

CATM's New ATMs Are Substantially Less Profitable

Average number of transacting ATMs:		
A	2014 Q1 average	67,818
B	Less: legacy ATMs (= 2011 total excl. M&A)	<u>33,556</u>
C = A-B	Implied new & acquired ATMs	34,262
Gross profit per ATM per month:		
D	2014 Q1 average (stated)	\$375
E	Legacy (stated)	\$472
Implied gross profit per year:		
F = A x D x 12	2014 Q1 total (\$mm)	305
G = B x E x 12	Less: legacy total (\$mm)	<u>190</u>
H = F-G	Implied gross profit from new & acquired (\$mm)	115
I = (H/C)/12	Gross profit per ATM per month, new & acquired ATMs	\$280
I/E-1	% change vs. legacy level	-41%

Source: CATM [2011 Q4](#) and [2013 Q4](#) releases, Kerrisdale analysis

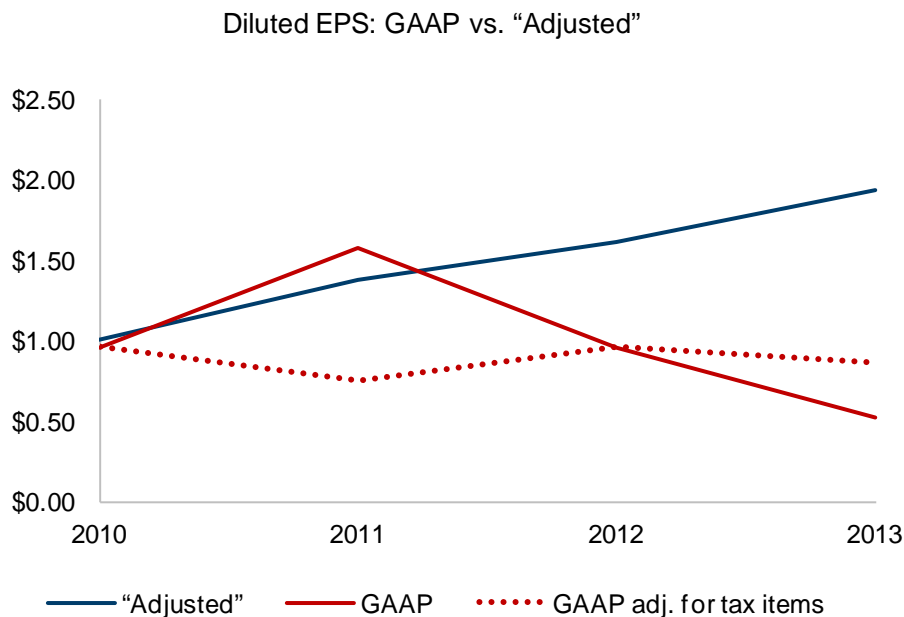
Of course, it's possible that the new and acquired ATMs are somewhat more profitable than this analysis suggests, but since the aggregate numbers still have to tie out, that would in turn imply that CATM's legacy ATMs are themselves becoming less profitable. Either way, the implications for CATM's future earnings are ominous.

This result is not surprising given the realities of CATM's ATM footprint. CATM already has relationships with many of the largest retailers in the US and UK and generates incremental revenue from branding relationships with many of the largest banks. As a result, it will be difficult to replicate the economics of its existing model since new units will tend to be far less attractive than existing ones: rather than signing an account like Costco or Target, it is stuck with marginal franchises like [Tedeschi Food Shops](#) (for which competition from smaller ATM operators will also be fiercer). The figures above indicate that this diminishing-returns effect has already begun to set in, and it should only get worse as the company adds more and more low-profitability units.

VI. Aggressive Accounting Drives Overstated Earnings

Focus on “Adjusted” EPS Obscures Flatlining GAAP Earnings

Like many other highly acquisitive firms, CATM prefers to discuss “adjusted” earnings rather than acknowledge recurring costs like intangible-asset amortization and acquisition-related expenses. The discrepancy between GAAP and adjusted earnings has only gotten wider over time: while adjusted earnings smoothly and steadily rise, actual GAAP earnings oscillate around what is at best a flat trend. Though successive tax-related restructurings in the UK are responsible for some of the volatility, the same pattern is clear even when adjusting for these items.



Source: CATM 2012-13 10-Ks, Kerrisdale analysis

As GAAP and adjusted earnings have diverged – 2013 adjusted EPS of \$1.93 was more than double tax-adjusted GAAP EPS of \$0.86, let alone actual reported GAAP EPS of \$0.52 – the sell side has been forced to zero in on the adjusted figures alone. Otherwise, the valuation metrics would become too lofty to justify: on an adjusted basis, CATM trades at a rich but plausible 16.6x trailing (2013) earnings, while on a GAAP basis (again adjusting for the unusual tax charge) it trades at a staggering 37.4x. This is a shockingly expensive price especially when considering that reported earnings, as documented below, are themselves suspect.

We recognize that excluding amortization is a sensible practice if one is trying to approximate current actual cash flow at the company. Free cash flow per share, for instance, more closely approximates adjusted EPS than GAAP EPS. However, given that we believe that ATMs are in secular decline, analysts ought to assign a low multiple to the adjusted EPS or EBIT figures. If

using GAAP EPS and EBIT, a higher valuation multiple can be justified since amortization expense helps incorporate the real costs of a growth-through-acquisition business model. What we disagree with is the practice of applying market or above-market valuation multiples to adjusted EPS or EBIT figures that conveniently exclude acquisition-related expenses such as amortization of intangible assets.

Sadly for CATM shareholders, these “adjusted” numbers are not purely for external consumption: according to the latest [proxy statement](#), CATM’s executive bonuses are based primarily on growth in revenue, “adjusted” operating income, and “adjusted” earnings per share. All of these measures can be increased simply by buying enough companies, whether or not the underlying transactions are economically sound, since management faces no penalty for tying up investor capital but gets to claim full credit for all of the added revenues – as if they cost nothing. In effect, this compensation structure incents empire-building rather than true economic profitability.

CATM Is Depreciating Its Assets Too Slowly, Inflating Earnings by 50-70%

In some businesses, depreciation is more of an accounting entry than an economic reality, and analysts rightly disregard it. But in the ATM industry, depreciation is quite real: moving parts wear out, receipt printers jam, computing hardware becomes obsolete, and, on occasion, [thieves](#) tie ATMs to their SUVs and try to yank them off their moorings. Furthermore, while ATM technology may seem simple, a host of regulatory and operational rule changes have compelled upgrades in recent years. As [an industry journal](#) put it in a recent piece entitled “ATM Deployers Face ‘Perfect Storm’ of Obsolescence”:

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.

But that “perfect storm” of adversity’s nothing new for America’s independent ATM deployers.

...“If we go back to the last decade, we had Y2K, and then back to stasis. We had triple DES [security] migration. Stasis. Then it was ADA upgrades. Stasis,” [Rob] Evans [director of industry marketing for an ATM manufacturer] says. “Now we’re looking at EMV and the double whammy of being able to support chip cards along with, oh, by the way, if you are on a Windows XP platform, you might want to get off of that because Microsoft is discontinuing the operating system.”

But despite this long history of ATM obsolescence, CATM has adopted an unusually – and increasingly – aggressive policy for depreciation accounting. While large peers, including companies that CATM ultimately purchased, tend to depreciate their ATM equipment over five years, CATM appears to assume useful lives that are *40-80% longer*, leading to overstated earnings. Meanwhile, actual capital expenditures have continually exceeded both GAAP depreciation and the company’s own initial guidance, and asset disposals have consistently generated losses, further calling into question CATM’s optimistic accounting.

Strangely, CATM does not directly disclose the average useful life it assumes for its ATM equipment. Instead, its [latest 10-K](#) provides a very wide range for property and equipment as a whole (emphasis added):

Property and equipment are stated at cost, and depreciation is calculated using the straight-line method over estimated useful lives ranging from **three to ten years**.

Going back further in time, CATM previously didn’t extend its depreciation as far out as ten years. Originally, the range was much narrower (emphasis added):

- [2006](#): “three to **seven** years”
- [2007](#): “three to seven years”
- [2008](#): “three to seven years”
- [2009](#): “three to seven years”
- [2010](#): “three to **eight** years”
- [2011](#): “three to eight years”
- [2012](#): “three to **ten** years”
- [2013](#): “three to ten years”

This quiet yet substantial protraction of the depreciation schedule is readily visible in the financial statements themselves. By comparing the *gross* carrying value of CATM’s property and equipment – i.e. the balance before accumulated depreciation – to the level of annual depreciation expense, we can estimate the effective average life of these assets. This calculation, admittedly somewhat imprecise, indicates that the change in 10-K language documented above reflects a real shift: the assumed average life has increased from ~7 years in 2010 to ~9 years based on 2014 guidance. Since “ATM equipment and related costs” constitute 85% of CATM’s property and equipment, CATM is implicitly claiming that, despite the incoming wave of technological change, its machines will last almost a decade.

CATM Is Assuming Longer and Longer Average Lives for Its ATMs

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

1. Based on CATM's 2014 guidance. Depreciation expense is assumed to be ~96% of total depreciation and accretion, consistent with 2013 results. 2014 EOP gross P&E is set equal to the 2013 EOP value plus capex at the midpoint of guidance.

Source: CATM 2011-13 10-Ks, [2014 Q1 earnings release](#), Kerrisdale analysis

The lack of a comparable publicly traded ATM operator in the US makes it difficult for investors to realize just how aggressive CATM's accounting is. Below we compile the available information on how a range of domestic and international competitors have accounted for depreciation. Large players – including those that CATM has acquired – uniformly assume a useful life of only five years for their ATMs, far shorter than what CATM assumes. While a few smaller companies also had aggressive policies, the ATM-weighted average assumed useful life is still just over five years:

CATM's Depreciation Policy Is a Clear Outlier

Company	Asset	Assumed useful life (yrs)	No. of ATMs	Period	Countries ¹
Cardtronics	all P&E	3 to 10	66,984	12/31/13	US, GB, CA, DE, MX
DirectCash Payments	ATM equip.	5	20,333	12/31/13	CA, AU, NZ, GB, MX
Seven Bank	ATMs	5	18,123	3/31/13	JP, US
E*TRADE Access Inc.	ATM equip.	5	13,000	9/30/05	US
Access to Money	ATMs	3 to 5	10,382	12/31/10	US
Cardpoint	ATMs	5 to 7	7,900	6/30/13	GB, DE
Customers	ATMs	8	5,708	6/30/11	AU, NZ
Global Access	ATMs	10	4,900	12/31/12	US
EDC	ATM equip.	5	3,600	6/30/11	US
Bank Machine	ATMs & related	5 to 7	1,000	3/31/05	GB
Global Cash Access	ATM equip.	5	n/d	12/31/13	US
<i>Total/weighted average</i>		5.5	84,946		

1. Using ISO country codes (GB = United Kingdom, CA = Canada, DE = Germany, MX = Mexico, AU = Australia, NZ = New Zealand).

Sources: [CATM 2013 10-K](#), [DirectCash 2013 financial statements](#), [Seven Bank 2013 annual report](#), [CATM S-4 filed 1/20/06 \(E*TRADE and Bank Machine\)](#), [Access to Money 2010 10-K](#), [CATM 8-K filed 10/15/13 \(Cardpoint\)](#), [Customers 2011 annual report](#), [Global Access 2012 10-K](#), [CATM 8-K filed 10/3/11 \(EDC\)](#)

What would CATM's earnings look like if it adopted a more realistic depreciation policy, in line with its peers? Even though depreciation is not one of CATM's largest expenses, the impact would still be enormous. We estimate that a five-year useful life for property and equipment, consistent with the expectations of other ATM operators, would have reduced 2013 "adjusted" EPS by 34%, while 2014 "adjusted" EPS, based on CATM's guidance, would drop by 42%. Looking at GAAP EPS instead of CATM's "adjusted" concept, earnings would fall even more dramatically (even when adding back a tax-related charge that skewed GAAP EPS last year): 75% in 2013 and 80% in 2014. Equivalently, EPS is overstated by ~50-70%.

Illustrative Impact of Normalized Depreciation

	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
%Δ to "adjusted" EPS	-34%	-42%
%Δ to GAAP EPS¹	-78%	-78%

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

Source: CATM 2013 10-K, 2013 Q4 earnings release, Kerrisdale analysis

CATM's anomalous under-depreciation is not just a matter of accounting. Since ATM depreciation is very economically meaningful, understating it makes the long-term profitability of the business look much better than it really is. The rosy asset-life expectations embedded in CATM's results are belied by the pessimism of the many large-scale ATM operators surveyed in a [recent study](#) by the US Government Accountability Office (emphasis added):

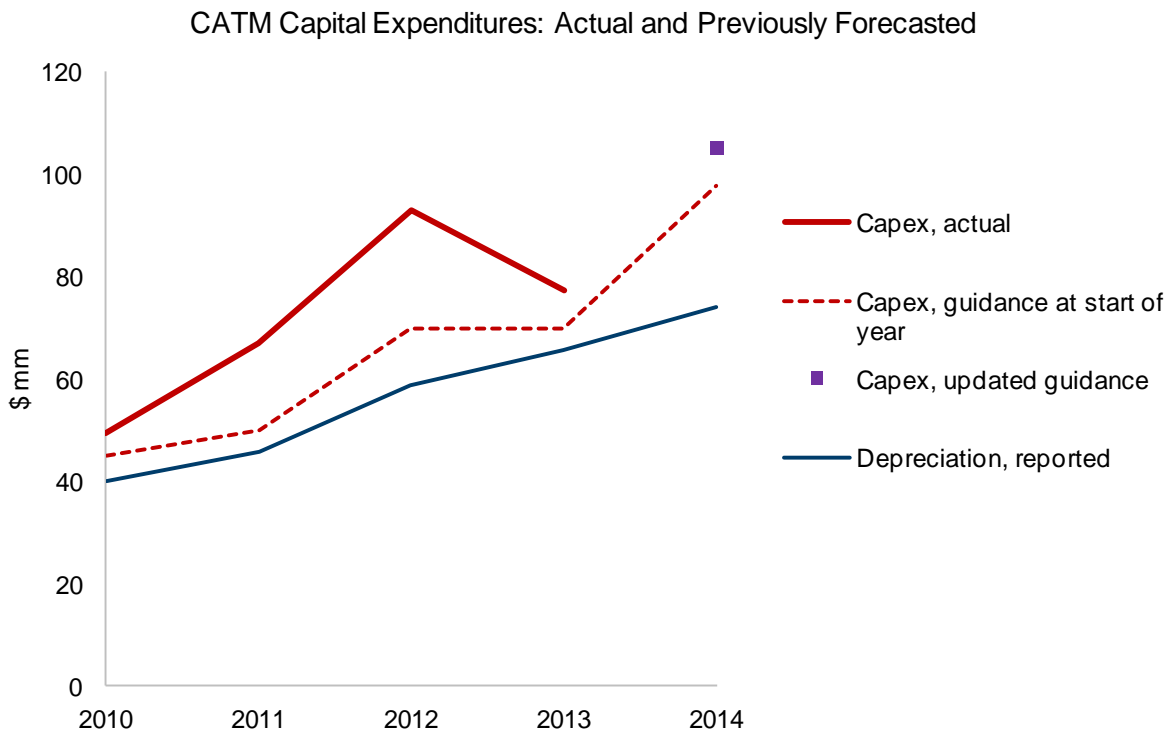
...our survey results showed that 18 out of 25 financial institution operators anticipate **ATM costs will increase in the future**. The main drivers cited for these future increases are **further investments in new and enhanced ATM terminals or upgrades** that will be needed in order to comply with new or enhanced industry wide data security standards. The community bankers and one independent firm we interviewed expressed similar views that **ATM costs will continue to rise**.

With these increased equipment costs lying ahead, CATM's accounting stands out as especially aggressive. Because its assumptions are such outliers, just moving toward peer levels would push reported earnings down dramatically.

CATM Has Consistently Underestimated Its Capital-Expenditure Requirements

Of course, it's always possible that CATM's ATM fleet really will defy the odds and outlast its competitors'; management should naturally have a more accurate view of asset lives than outside observers. However, CATM's track record for forecasting its capital expenditures is

weak, and the error is always in one direction, as shown in the graph below: capex turns out to be higher than originally estimated. But reported depreciation never rises enough to catch up.



Note: 2014 depreciation based on CATM guidance. Guidance based on mid-point of stated range.

Source: CATM 2012-13 10-Ks, [2009 Q4/2010 Q4/2011 Q4/2012 Q4/2013 Q4/2014 Q1](#) earnings releases, Kerrisdale analysis

In the first quarter of this year, the pattern has already appeared again: management’s original capex guidance was \$95.0 to \$100.0 million but is now \$100.0 to \$110.0 million, [attributed](#) in part to “timing of contract renewals that may involve a hardware refresh.” In other words, merchant partners want CATM to replace outdated machines with more advanced models on CATM’s dime, implying more spending than originally projected.

This history of underestimated capex implies that CATM management has failed to anticipate the cash costs of maintaining its ATM fleet, casting doubt on the validity of its depreciation assumptions.

Routine Losses on Disposal Confirm Overmarked Assets

Another signal of CATM’s under-depreciation is its history of asset disposals. From time to time, when CATM prunes its portfolio of ATMs or ends its relationship with a merchant, it gets rid of the used devices. If it were, on average, depreciating the devices accurately, then gains and losses should roughly offset. But in reality, CATM has posted losses on disposal every year, totaling \$14mm from 2009 to 2013.

CATM Consistently Loses Money on Asset Disposals

	2009	2010	2011	2012	2013	Total
(\$mm)						
Loss on disposal of assets	6.0	2.6	1.0	1.8	2.8	14.2

Source: CATM 2011-13 10-Ks

These losses again suggest that CATM is overestimating the value of its physical assets by adopting an aggressive depreciation policy that substantially inflates its reported earnings.

VII. CATM's Largest Customer and a Third of Its Profits Face a Severe Competitive Threat

In addition to the chronic difficulties that CATM will endure from its weakening core business model, dependence on M&A, and secular decline, it also faces a significant risk over the next few years: the potential loss of its largest customer (7-Eleven) to an affiliated firm called Seven Bank. Though the 7-Eleven brand was created in the US, the company is now owned by a publicly traded Japanese firm called Seven & i Holdings Co., which in turn [owns 45.8%](#) of Seven Bank, itself a publicly traded Japanese firm. Though technically a deposit-taking bank, Seven is primarily an ATM operator, with over 90% of its revenue coming from ATM-related fees and, [as of 12/31/13](#), 93% of its 19,065 Japanese ATMs located in Seven & i group stores.

Established in 2001, Seven Bank was originally confined to Japan, but in [September 2012](#) it entered the US market by buying a small operator called FCTI, characterizing the acquisition as “an important first step for Seven Bank in effecting a full-scale entry into ATM service markets overseas.” Then, in [August 2013](#), FCTI purchased out of bankruptcy the ATM business of Global Access. (According to its court filings, Global Access’s bankruptcy came about precisely because “the contracts with [its] two largest merchants were set to expire.” The company was “able to renew the contracts but on term much less favorable” than before. Then, it lost its third largest merchant to a competitor.) Today, via FCTI, Seven Bank owns over 7,000 ATMs in the US.

Given the close relationship between 7-Eleven’s Japanese parent and Seven Bank – even the companies’ logos are almost identical – the obvious question is whether Seven Bank will seek to take over 7-Eleven’s US ATMs from CATM, which has operated them since 2007. Since the contract expires on June 1, 2017 – only three years from now – and accounted for 24% of pro forma (M&A-adjusted) 2013 revenue (source: [CATM 2013 10-K](#)) this is, for CATM, a matter of increasingly pressing importance.

Seven Bank’s management has not been particularly shy about its long-term intentions. In November 2012, it said the following in a [Q&A document](#) attached to an earnings release (emphasis added):

Q1 What possibility is there of Seven Bank installing ATMs in 7-Eleven stores in the United States?

A1 A leading ATM operator in the United States has been installing ATMs in U.S. 7-Eleven stores. **Seven Bank will work hard to ensure that 7-Eleven and its customers choose FCTI ATMs when this leading company negotiates a contract extension with 7-Eleven.** At the moment, that is all I can say about this matter. As of today, no decision has been made.

In November 2013, it [reiterated](#) its interest in the US 7-Eleven opportunity:

Q3 I believe that ATMs have already been installed at 7-Eleven stores in North America, so how are you planning to differentiate Seven Bank ATM services from your rivals'? Also, what expectations do consumers and owners of 7-Eleven stores in America have of Seven Bank ATMs?

A3 What 7-Eleven stores in the United States want to see is a contribution in terms of, for example, services which increase the number of customers coming into the stores, and they also want a better revenue environment. We believe that the key to differentiation lies in responding rigorously to such demands. We think it is also necessary to prioritize two-way communication, so as to fully understand what the other side wants. ...

Seven Bank's latest [annual report](#) also emphasizes the importance of US expansion to its strategic ambitions "over the next 10 years" (emphasis added):

First, we will study the operating methods of FCTI as our second business model, **and then we intend to roll out a wide-ranging scheme for further expansion.**

Threatening as this sort of rhetoric may seem, sell-side analysts have downplayed the importance of the Seven Bank threat, arguing that, with its much larger existing US ATM network, CATM is in a strong position to outbid Seven in 2017 or even enter into an early renewal. One analyst has argued that CATM has already put pressure on Seven's economics:

CATM will not make Seven Bank's US expansion painless. We note that Seven Bank has paid a mid-teens EBITDA multiple for both recent US ATM fleet acquisitions (FCTI in September, 2012 and Global Axxess in September, 2013), which is effectively double market rates. Our independent checks indicate that CATM may have had a hand in bidding up the prices of these assets.

While this approach may enable CATM to beat back smaller players, we would argue that, for an acquisition-driven company, causing transaction multiples to double is a dangerous long-term strategy. To be sure, CATM may well win the 7-Eleven contract and extend the relationship for another few years. Then again, given Seven Bank's avowed long-term intentions and intimate relationship with 7-Eleven's parent, it's difficult to see how the state of affairs won't impact Cardtronic's long-term profitability. If nothing else, Seven Bank's presence in the US gives 7-Eleven a huge club to wield in future negotiations to tamp down CATM's margins.

Though de-installing CATM's machines and replacing them with another provider's would be disruptive to 7-Eleven, there is certainly precedent: after a long-running [legal dispute](#) with CATM over proper revenue-sharing, Duane Reade (CATM's fifth-largest customer in in [2008](#)) terminated its contract with CATM, extracted a \$1 million settlement from the company, and spent five months replacing CATM's equipment with Chase's. Moreover, 7-Eleven is not CATM's only concentration risk: CATM's other top-five merchants account for another 17% of its pro forma revenue and also, on average, expire in three years. This recurring risk of customer loss and less lucrative contract renewals only exacerbates the fundamental problems with CATM's model.

7-Eleven ATMs Are Disproportionately Profitable, Compounding the Long-Term Threat

CATM discloses that 7-Eleven accounts for 24% of its pro forma revenues but does not estimate its contribution to *profits*. Based on the available data, we estimate that the 7-Eleven fleet is likely to be much more profitable than CATM's typical ATMs, putting CATM at risk of losing not just a quarter of its revenue but a third or more of its earnings. According to 7-Eleven's [store locator](#), there are 8,176 domestic stores with ATMs. This represents just 12% of CATM's 1Q14 ATM count (excluding managed services) yet generates approximately twice as much of CATM's total revenue, implying that 7-Eleven ATMs produce about two times as much revenue as CATM's average.

Estimated Revenue per 7-Eleven ATM

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

Source: CATM 2013 10-K, 7-Eleven store locator, Kerrisdale analysis

While we lack the information to assess precisely the profit margin achieved on this far higher revenue per ATM, we use management's own comments to estimate it. CATM has [indicated](#) that "the majority of merchant commissions, vault cash rental expense, and other costs of cash," constituting 69% of the total cost of ATM operating revenues, vary with transaction volume. These line items constitute 46% of ATM operating revenues (excluding managed services). If we apply this ratio to the revenues generated from 7-Eleven and assume that the remainder of the costs are fixed, **we estimate that 7-Eleven constitutes 41% of CATM's adjusted EBITDA.**

Illustrative Analysis of 7-Eleven ATM Profitability

	Per ATM per month	
	Overall ¹	7-Eleven
Revenues	\$1,127	\$2,297
Cost of revenues:		
Variable	516	1,052
Fixed	228	228
Total	744	1,280
Gross profit	\$383	\$1,017
Multiple of overall average		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%

Assumptions

Variable % of total costs	69%	69%
Variable cost as % of revenue	46%	46%

1. 2013 average.

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

Source: CATM 2013 10-K, [2014 Q1 earnings release](#), Kerrisdale analysis

With such an enormous fraction of CATM's earnings power tied to a single relationship that is so demonstrably at risk, it's foolhardy to pay a premium multiple on profits that could decline by almost half in just a few years. This is even more true in light of the fact that CATM's reported earnings appear to be artificially inflated by aggressive accounting.

VIII. Stretched Valuation Points to >50% Downside

Comparable-Company Multiples Are 30-40% Lower than CATM's

One factor that has enabled CATM to sustain a high valuation despite the host of concerns identified above is the absence of close comparables in the US. However, there is a similar publicly traded firm listed in Canada: DirectCash (TSX:DCI), which operates more than 20,000 ATMs in Canada, Australia, New Zealand, Mexico, and the UK. Moreover, a number of US-listed firms, while not in precisely the same industry, face similar business risks: outsized exposure to paper-based payment media, which they often aim to overcome via deal-making. This group includes Brink's Company (BCO), an armored-car operator and ATM-maintenance provider; NCR (NCR), the leading ATM manufacturer; and Deluxe Corporation (DLX), the top supplier of paper checks.

To normalize for differing capital structures and business models, we focus on EV relative to EBITA – i.e. EBIT plus intangible-asset amortization or, equivalently, EBITDA less depreciation. As intuition would suggest, these stocks trade at relatively modest EV/EBITA multiples, reflecting market concerns about their long-term prospects, notwithstanding current rates of growth. CATM is a clear outlier, with an EV/EBITA multiple 44% higher than its peer average and 64% higher than that of its closest comparable, DirectCash. Applying these multiples to CATM would imply ~40% downside relative to the current stock price. *Note that these figures don't penalize CATM for its aggressively protracted depreciation schedule.* Nor do they account for the risk that the 7-Eleven relationship will be lost.

CATM Trades at an Unjustified Premium Relative to Peers

	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, [CATM 2014 Q1 earnings release](#), [DCI 2013 financial statements](#), [BCO 2013 10-K](#), [DLX 2013 10-K](#), [NCR 2013 10-K](#), Kerrisdale analysis

This comparison shows that once investors begin to question long-term growth, multiples can compress dramatically even before metrics like revenue start to decline visibly. Given the underlying trends in CATM's business, including weak organic growth and declining returns on capital, there is no reason for the company to trade at such a massive premium to similarly challenged peers.

Adjusted for Normalized Depreciation, GAAP Earnings Power Indicates Sharply Lower Price

Even if we give CATM credit for the non-cash (albeit recurring) nature of its amortization expense, the company's guidance for 2014 earnings do not support its current lofty stock price, especially when considering its understated depreciation expense. At the mid-point of CATM's 2014 guidance range, diluted EPS excluding the negative impact of amortization would be \$1.71.

CATM 2014 Guidance Excluding Amortization

	Low	High	Mid
(\$mm)			
GAAP net income	53.6	55.8	54.7
Plus: amortization of intangible assets	34.0	34.0	34.0
Less: tax impact of amortization (@ 35%)	-11.9	-11.9	-11.9
GAAP net income excl. amortization	75.7	77.9	76.8
Diluted shares	44.8	44.8	44.8
Diluted EPS	\$1.20	\$1.25	\$1.22
Diluted EPS excl. amortization	\$1.69	\$1.74	\$1.71

Source: CATM 2014 Q1 earnings release, Kerrisdale analysis

Below we show the values per share that result from applying a range of P/E multiples to this level of EPS, adjusted to true up depreciation based on a range of assumed average useful lives for property and equipment.

Fair Value Based on Depreciation-Adjusted EPS

	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
<i>P/E multiple:</i>			
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: Kerrisdale analysis

For useful lives of 5-7 years and P/E multiples of 10x-16x – below or in line with the market average, as befits its weak secular outlook – CATM’s fair value per share would be \$8-\$22, 32-76% below the current stock price. This simple analysis serves to reinforce the conclusion that CATM is highly overvalued.

DCF Analysis with Modestly Declining Transaction Volumes Implies ~70% Downside

Though comparison with related firms sheds some light on CATM’s irrational overvaluation, a full DCF analysis throws into relief just how much current shareholders are implicitly relying on unachievable same-store transaction growth and stupendous amounts of value-creating M&A to justify the current stock price. To illustrate the importance of even an extremely modest but ongoing decline in per-ATM transaction volume, we construct a DCF analysis with the following simple core assumptions:

- Starting in 2015, withdrawals per ATM start declining by 1% per year.
- Variable expenses, in line recent experience, constitute 46% of ATM operating revenue (excluding managed services).
- Economic depreciation is based on an average asset life of 5.5 years.
- Organic ATM unit growth is 3% per year.
- The tax rate is CATM’s stated “long-term, cross-jurisdictional effective cash tax rate of 32%.”

With these downright mild assumptions, CATM’s equity value is massively lower than its current stock price – by a stunning 72%:

Kerrisdale Illustrative DCF Analysis: Summary

	2013	2014	2015	2016	2017	2018	2019	2020	2021
Key drivers									
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%
Outputs									
(\$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%								

1. Cost of revenues and SG&A include stock-based compensation.

Source: CATM filings, Kerrisdale analysis

This illustration reveals just how levered CATM's value is to transaction growth, along with blue-sky dreams of endless large accretive acquisitions at bargain prices. In a world where the US's payment system comes anywhere near the level of sophistication of Sweden's, CATM investors cannot justify anything close to the current stock price. The nearer-term risks surrounding the 7-Eleven contract only multiply the magnitude of the overvaluation.

Future M&A Is Unlikely to Create Material Value

Some CATM boosters point to future acquisition opportunities as a source of upside, apparently unperturbed by the trend of declining profitability that has coincided with the company's latest round of deals. Based on our DCF analysis, however, CATM has been paying more for ATMs via M&A than the long-term fundamentals would justify. For example, in CATM's last major purchase, [Cardpoint](#), it paid \$153 million for a business with 7,900 ATMs, or \$19,367 per ATM. This valuation is roughly consistent with the median of the transactions analyzed by PricewaterhouseCoopers in its "[independent expert's report](#)" on DirectCash's acquisition of an Australian firm called Customer Limited. PwC found that in past transactions the median enterprise value paid per ATM (a metric it characterized as "an industry rule of thumb") was \$20,900.

Yet if we adjust our DCF to set organic growth in ATM units to 0%, we find that the fair value EV per ATM given CATM's business model is just ~\$12,500, *35% lower than what CATM paid for Cardpoint and 40% lower than the median price in past transactions*. In other words, the more acquisitions CATM does at these sorts of prices, the more value it destroys, because it is paying more than the operations are worth. The long-term decline in transaction volumes and the need to frequently replace and upgrade obsolete units make M&A a drastically worse option economically than organic growth in units. Yet organic growth is precisely where CATM has faltered over the past several years.

Even if we ignore the prospect of secularly declining ATM transactions and take for granted CATM's inflated stock price, CATM is just not buying earnings cheaply enough to generate a huge increase in economic value. As shown below, it purchased Cardpoint at an EV/EBITA multiple of 8.5x. Even if it could draw down the rest of its \$375mm revolving credit facility to purchase additional businesses at this same multiple, and even if the market (wrongly) valued the resulting incremental earnings at CATM's higher EV/EBITA multiple of 13.4x, then it would only add about \$4 per share to CATM's equity value.

Limited Upside from M&A
(\$mm)

Precedent transaction

A	Cardpoint EBITA, 2012	18
B	Cardpoint purchase price	153
C = B/A	EV/EBITA paid	8.5x

Illustrative M&A capacity

Revolving credit facility:

	Total capacity	375
	Less: outstanding amount	<u>73</u>
D	Undrawn amount	302

C	EV/EBITA paid	8.5x
E = D/C	EBITA acquired	35
F	CATM current EV/EBITA	13.4x
G = F x E	Value of acquired EBITA @ CATM mult.	476
D	Less: amount paid	<u>302</u>
G-D	Value created by M&A	174
	Fully diluted CATM shares	46
	Value created per share	\$3.83

Source: CATM [Cardpoint presentation, 8-K/A filed 10/15/13](#) (Cardpoint financials and pro formas), [2014 Q1 10-Q](#), Kerrisdale analysis

We view this analysis as extremely generous. From a long-term perspective, these acquired earnings streams are likely to shrink, not grow, which will impair both their standalone fair value and the valuation that investors ultimately ascribe to CATM. What matters fundamentally is not this sort of financial engineering – buying in the private market for a low multiple and hoping to be valued in the public market at a high multiple – but whether the businesses acquired are actually worth more than the purchase price. If we adopt this more rational perspective, then CATM’s M&A is likely value-destructive; even if we don’t, the total “value”-creation potential given CATM’s existing financial resources is still modest.

IX. Conclusion

CATM is a pure-play operator in a sector that faces decades of decline. By engaging in serial acquisitions over the past three years, it has masked the deterioration of its underlying business and diluted both its return on capital and its profitability per ATM. Through anomalously aggressive assumptions about the useful lives of its assets, it has inflated its reported earnings by as much as 50-70%, while distracting analysts from the true costs of an M&A driven growth strategy by honing in on “adjusted” non-GAAP earnings. With domestic same-store transaction growth barely positive and industry data pointing toward declining volumes across the planet, CATM would need to create incredible value via M&A in order to come close to rationalizing the current stock price. However, CATM is acquiring other ATM operators at healthy multiples from sellers that are only too happy to unload businesses that are increasingly being made obsolete by increased credit card usage, online payment systems and multiple other secular trends. On these grounds, CATM has 40-70% downside without even considering the looming risk that it will lose its largest merchant relationship, contributing more than 40% of current earnings. Investors who believe that cash is as important now as it was 50 years ago are welcome to hang on, but those with a more realistic outlook should get out before it’s too late.

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