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CPI Card Group, Inc. (PMTS)

Q3 2021 Earnings Call

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CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Hello, everyone, and welcome to the CPI Card Group Third Quarter 2021 Earnings Conference Call. My name is Sven, and I'll be coordinating your call today.

I'll now hand over to your host, [ph] Mike Salop (00:00:16), Head of Investor Relations to begin. Please, [ph] Mike (00:00:19), go ahead.

Unverified Participant

Thanks and good morning, everyone. Welcome to the CPI Card Group third quarter 2021 earnings webcast and conference call. Today's date is November 5, 2021; and on the call today from CPI Card Group are Scott Scheirman, President and Chief Executive Officer; and Amintore Schenkel, Chief Financial Officer.

Before we begin, I'd like to remind everyone that this call may contain forward-looking statements as they are defined under the Private Securities Litigation Reform Act of 1995. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. For a discussion of such risks and uncertainties, please see CPI Card Group's most recent filings with the SEC. All forward-looking statements made today reflect our current expectations only and we undertake no obligation to update any statement to reflect the events that occur after this call.

Also during the course of today's call, the company will be discussing one or more non-GAAP financial measures including, but not limited to, EBITDA, adjusted EBITDA, adjusted EBITDA margin, net leverage ratio and free cash flow. Reconciliations of these non-GAAP financial measures to the most directly comparable GAAP measures are included in the press release and slide presentation we issued this morning. Copies of today's press release as well as the presentation that accompanies this conference call are accessible on CPI's Investor Relations website investor.cpicardgroup.com. In addition, CPI's Form 10-Q for the quarter and nine months ended September 30, 2021 will also be available on CPI's Investor Relations website.

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

Scott T. Scheirman

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

Thanks, [ph] Mike, (00:02:01) and good morning, everyone. Thank you for joining us today for our third quarter conference call. During today's call, I will provide an overview of CPI's performance and review our vision and

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strategic priorities. Amintore will then discuss the financial results in more detail, and then we will conclude the call.

Before I discuss our performance, I would like to welcome Amintore to the CPI team. Amintore joined us as CFO in October and brings a wealth of experience and knowledge to the company. Prior to leading his own consulting firm, he served as Chief Accounting Officer and Controller of Western Union from 2006 to 2020. He also previously held a variety of financial roles at First Data Corporation. and spent 12 years with Ernst & Young.

Our previous CFO, John Lowe, has been promoted to become General Manager of our Secure Card business. John has been a key contributor to our business success and financial improvement since joining the company in 2018. In combination with the rest of our management team, I am pleased with the strong group we have assembled to lead our business and serve our customers moving forward.

Turning to our third quarter results, we continued our strong performance as we remain focused on providing high-quality products and services that meet the needs of our diverse and growing customer base. We delivered a 20% increase in net sales in the quarter with growth across our portfolio, including contributions from the ongoing conversion to contactless cards and related card personalization, our Card@Once instant issuance and CPI-On-Demand solutions and our prepaid business.

From a profit standpoint, net income of $6.6 million in the quarter increased 14% from last year, and adjusted EBITDA increased 23% to $21.5 million, while diluted earnings per share of $0.56 compared to $0.53 in the third quarter of 2020. Strong year-to-date cash flow also helped us further strengthen our balance sheet and financial position, as we ended the quarter with approximately $21 million of cash and no borrowings under our revolving credit facility.

Turning to slide 5. The strong business and financial performance since 2018 through the first nine months of 2021 reflects continued execution of our vision and strategic priorities which we established nearly four years ago. At that time, we implemented a vision of being the partner of choice in payment solutions by providing market-leading quality products and customer service, while operating a market competitive business model.

We made deep customer focus and continuous innovation, key strategic priorities, increasing our capabilities to offer tailored products and services and comprehensive end-to-end solutions. Implementation of our strategies has helped establish our position as a top secure card provider for small- and medium-sized financial institutions and large issuers in the US, a market which we estimate had approximately 2 billion active credit and debit cards at the end of 2020.

We have become a leader in card personalization services for small and medium issuers and produced innovative solutions such as CPI-On-Demand and Card@Once, which is the leading software-as-a-service instant issuance solution for small and medium financial institutions in the US. Our end-to-end solutions have also helped us acquire new customers, including the emerging fintech space.

We responded to increasing focus on the environment by consumers, issuers and the payment network brands by producing innovative eco-focused solutions, and we're now offering three different cards designed to reduce first-use plastic. We have achieved leadership in this fast-growing portion of the US market with over 40 million eco-focused cards sold since launch in 2019. We also continued to lead in the US prepaid debit open loop market by providing high-quality, tamper-evident packaging with innovative, robust designs.

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We believe CPI gained overall market share each year from 2018 through 2020, and we increased company net sales at a compounded annual growth rate of more than 10% over that time. We achieved this growth while implementing a market competitive business model. We have streamlined our business, including selling foreign operations and consolidating US facilities, and we remain focused on driving increased productivity and efficiency.

Since 2018, we have significantly increased profitability and cash flow, and we have improved our net leverage ratio driving it down from nearly 11 times at the end of 2018 to under 4 times as of September 30 of this year. Our 2021 results reflect continued progress. We have achieved strong net sales growth across our portfolio, including secure card, personalization, instant issuance and prepaid. We have posted year-on-year increases in profitability, margins and operating cash flow. In addition, in March we refinanced our debt; and in August, we were relisted on Nasdaq.

Like other companies, we are facing increasing costs and challenges from global supply chain constraints and labor shortages as well as from changes in our operations to help ensure a safe work environment for our employees in the face of COVID-19. Our business though has proved resilient throughout the pandemic, and our teams have demonstrated an ability to quickly adjust and respond to the changing conditions. We're also making investments to further optimize our operations. Our objective is to continue to profitably gain overall market share over the long term, and we believe we remain well positioned to capitalize on market opportunities in our growing industry.

Overall, I am very pleased with our 2021 performance, and will now turn the call over to Amintore to review our third quarter and nine-month financial and operating results in more detail. Amintore?

Amintore T. X. Schenkel

Chief Financial Officer, CPI Card Group, Inc.

Thank you, Scott; and good morning, everyone. I'm very pleased to be able to join CPI, and I look forward to meeting many of you in the future. I will begin my overview of our results from the third quarter and first nine months of 2021 on slide 7.

Third quarter net sales increased 20% compared with the third quarter of 2020 to $99.6 million. Net sales growth was driven by a 21% increase from our Debit and Credit segment and a 14% increase from our Prepaid Debit segment. The Debit and Credit segment increase was primarily due to the ongoing transition to higher-priced contactless cards, including the related personalization and new customer growth. Based on the latest market data, we now expect contactless conversion penetration in the US to be approximately 40% by the end of 2021 and still expect it to grow to 80% by the end of 2025.

So we continue to expect incremental benefits from the ongoing transition over the next few years. Prepaid Debit segment growth in the third quarter was driven by higher volumes with existing customers. As a reminder, prior year results for both segments were negatively impacted by lower customer demand than expected which we believe was primarily attributable to the COVID-19 pandemic. Third quarter gross profit was $37.7 million, up 23% over the prior year. Gross margins for the third quarter increased 80 basis points year-over-year to 37.8% primarily due to operating leverage from higher net sales, partially offset by increased labor costs.

SG&A expenses increased by $3.9 million in the quarter compared to the prior year, primarily due to increased compensation-related costs. The increased compensation costs reflect higher year-on-year performance incentive compensation, new compliance-related labor costs including for stock and severance expense incurred in this year's third quarter.

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Net income in the quarter was $6.6 million or $0.56 diluted earnings per share which compared to $5.8 million of net income and $0.52 diluted earnings per share in the third quarter of 2020. Net income and EPS benefit from net sales growth and operating leverage, partially offset by increased labor and SG&A expenses, higher interest expense and a higher effective tax rate. Adjusted EBITDA was $21.5 million, an increase of 23% year-over-year compared to $17.5 million in the third quarter of 2020. Our adjusted EBITDA margin increased 50 basis points to 21.6%.

Turning to the year-to-date results on slide 8. Net sales increased 24% for the first nine months to $281.9 million, driven by a 21% increase in net sales from our Debit and Credit segment and 30% net sales growth from our Prepaid Debit segment. The primary drivers of the sales increase included growth from new and existing customers and the ongoing transition to contactless payment cards in our Debit and Credit segment, and higher overall volumes from existing customers including the addition of a large national chain portfolio by one of our customers in our Prepaid Debit segment.

Our prior year net sales in the first nine months were also impacted by lower customer demand than expected in both segments which, as mentioned, we believe was primarily pandemic related. Year-to-date we generated gross profit of $110.5 million, up 39% from the first nine months of 2020 due to strong net sales growth and operating leverage. The year-to-date gross margin of 39.2% is an increase of 440 basis points compared to prior year.

SG&A expenses increased in the first nine months primarily due to higher compensation-related expenses, including performance incentive compensation and executive severance and higher compliance costs which were primarily related to Sarbanes-Oxley. The higher compliance costs reflect both additional labor needs and third-party services and will be ongoing costs for the business. Year-to-date, our net income was $15.3 million or $1.30 diluted earnings per share.

This is inclusive of pre-tax debt extinguishment costs of $5 million and a $2.6 million make-whole premium and interest expense incurred in the first quarter of the year, which resulted from the termination of our senior credit facility and first lien term loan. This compares to $8.8 million of net income or $0.79 earnings per diluted share in the first nine months of 2020. Year-to-date, adjusted EBITDA which excludes the pre-tax debt extinguishment loss and make-whole premium and the $1.1 million of executive severance charges, was $62.9 million, up 57% over last year.

CPI has delivered substantial growth in the first three quarters of 2021. As mentioned, net sales increased 24% over that period, net income 73% and adjusted EBITDA 57%. And customer demand for our products and services remained strong. As we look to the remainder of the year, there are a few factors that may cause fourth quarter trends to vary from the first nine months. On the sales side, as we previously discussed, net sales growth in the first nine months benefited from significant new customer onboarding and our prepaid business benefited from significant retail inventory replenishment coming off a COVID-impacted year-end 2020.

On the cost side, we expect increased labor, materials and certain other costs to begin to be more impactful in the fourth quarter. We're responding to the strong customer demand by hiring additional labor and investing in state-of-the-art equipment to increase future capacity and add new capabilities. We are also implementing selective price increases while continuing to carefully manage our supply chain and inventory. We expect the benefits from the price increases and equipment investments to have limited impact in the 2021 fourth quarter. As a result, we expect fourth quarter sales growth and profit margins will not be as strong as the first nine months. We do, however, continue to expect to deliver strong growth in net sales, profit margins and overall profitability for the full year.

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Turning now to the segments on slide 9. Third quarter Debit and Credit segment net sales were up 21% year-over-year to $76.1 million. During the quarter, we benefited from new and existing customer growth, year-over-year volume increases in contactless card product sales and related personalization and strong contributions from our Card@Once instant issuance solution, CPI-On-Demand and our eco-focused cards. Income from operations for the Debit and Credit segment increased 39% in the quarter to $20.5 million. Higher net sales and gross profit drove the strong performance in the quarter.

For the first nine months of the year, Debit and Credit segment net sales were up 21% to $218.8 million, and income from operations was up 61% to $60.9 million. Net sales from our Prepaid Debit segment increased 14% to $23.5 million in the third quarter, driven by greater sales volumes with existing customers, including the previously mentioned acquisition of a large national chain portfolio by one of our customers and the replenishment of retail inventories. Prepaid Debit segment income from operations was $8.5 million in the third quarter, up over 8% from the prior year. The increase was a result of higher net sales and gross profit. Segment gross margins declined year-over-year primarily due to increased labor costs.

For the first nine months of 2021, Prepaid Debit net sales increased 30% to $63.3 million, and we are on track for an exceptionally record sales year. As a reminder, the prepaid business is usually seasonally strongest in the third quarter, as retailers stock up for the holidays. Volumes typically dropped to lower levels in the fourth quarter, and we anticipate that pattern again this year. Prepaid income from operations for the first 9 months of 2021 was $23.1 million, a 50% increase over the prior year, driven by strong net sales growth and favorable cost absorption.

Turning to the balance sheet, liquidity and cash flow on slide 10. Our cash balance as of September 30 was $20.9 million, and we had no borrowings outstanding on our $50 million ABL revolver which gave us total liquidity of more than $70 million at the end of the third quarter. We ended September with total debt principal outstanding of $310 million, down from more than $340 million at year-end 2020. And our net leverage ratio as of September 30 was less than 4 times. In the first nine months of the year, we generated $14.5 million in cash from operating activities and utilized $4.8 million on capital expenditures.

This resulted in free cash flow for the first nine months of $9.7 million, an improvement of $2.8 million compared to the prior year. During the first nine months of 2021, we invested nearly $22 million in incremental inventory to support the business and help mitigate supply chain constraints. Cash flow from operations in the first nine months benefited from $9.8 million and income tax refunds related to the CARES Act. Our capital priorities continue to be maintaining ample liquidity, investing in the business and deleveraging the balance sheet.

Finally, I would like to mention two items. First, there is an item in our 10-Q regarding evaluation of disclosure controls and procedures. As we disclosed last quarter, the increase in our market capitalization triggered the company's status as an accelerated filer effective December 31, 2021. As a result, our independent registered public accounting firm will be required to attest to the effectiveness of our internal controls over financial reporting as of December 31, 2021.

In connection with our evaluation and testing of these controls during the third quarter, we identified efficiencies related to our general information technology user access privileges and related to the review and authorization of certain transactions within portions of our purchasing and revenue processes. Management determine these efficiencies resulted in material weaknesses in internal controls over financial reporting. To date, we have not identified any financial statement misstatements as a result of these controlled deficiencies. We are in the process of enhancing internal controls in these areas to remediate the material weaknesses.

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The second I wanted to highlight is the effective S-3 shelf registration the company filed with the SEC at the end of the third quarter. This is a primary and secondary common stock registration statement that will be effective for three years. Having the shelf on file provides the company the ability to opportunistically access growth capital and broaden its shareholder base over that timeframe. To summarize the quarter's financial results, we delivered strong net sales growth and profitability despite pressures from labor and supply chain constraints.

We expect these pressures to persist and associated costs and operational impact to increase through the fourth quarter and into next year, but have multiple initiatives in place to try to mitigate impact as much as possible. These initiatives include pricing, proactive buffer stock inventory purchases and incremental capital spending in 2022, to increase production capacity, gain efficiencies and expand capabilities to meet the emerging needs of our customers. Despite some fourth quarter challenges, we expect to deliver strong growth in net sales, margins and overall profitability for the full year.

I will now pass the call back to Scott for some closing remarks. Scott?

Scott T. Scheirman

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

Thanks, Amintore. We are pleased with the third quarter results, highlighted by strong net sales growth across our portfolio and with our overall performance year-to-date in 2021. Our business has proved resilient with strong demand for our products and services throughout the pandemic, and our employees are working hard and adapting to meet the current challenges.

In wrapping up, we remain committed to being the partner of choice in payment solutions by providing market-leading quality of products and customer service through a market competitive business model. And we believe we remain well positioned to capitalize on long-term opportunities in our growing industry. Thank you for joining our call today, and we look forward to speaking to you again soon.

Operator: This concludes today's call. Thank you so much for joining. You may now disconnect your lines and enjoy the rest of your day.

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