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CPI Card Group, Inc. (PMTS)

Q1 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to CPI Card Group's First Quarter 2022 Earnings Call. My name is Charlotte and I will be your operator today. The call will be open for questions after the company's remarks. [Operator Instructions]

Now, I would like to turn the call over to Mike Salop, CPI's Head of Investor Relations.

Mike Salop

Head-Investor Relations, CPI Card Group, Inc.

Thanks, operator, and good morning, everyone. Welcome to the CPI Card Group's first quarter 2022 earnings webcast and conference call. Today's date is May 5, 2022. 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 statements 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 with conference call are accessible on CPI's Investor Relations website, investor.cpicardgroup.com.

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In addition, CPI's Form 10-Q for the quarter ended March 31, 2022 will 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, Mike, and good morning, everyone. During today's call, I will provide an overview of CPI's performance in the first quarter, update our 2022 expectations and review our long-term strategy. Amintore will review the quarterly financial results in more detail, and then we will open the call for questions.

We are pleased with our start to the year as we increased sales 25% to $111 million, which is record quarterly sales level since we became public in 2015, and significantly improved our margins from the fourth quarter levels. First quarter growth was driven by our Debit and Credit segments with particular strength from contactless cards, including the related personalization services, and our Software-as-a-Service based Card@Once instant issuance solutions. Our contactless card growth was driven by sales of eco-focused cards as we sold over 10 million of these cards in the quarter.

Our selection of innovative eco-focused card solutions presents us opportunities to gain market share as industry adoption continues to grow and provide us the incremental revenue benefit of selling higher average priced contactless cards. Card@Once also once again grew faster than the company overall. This SaaS-based instant issuance solution not only provides us initial product sales upon installation, but also offers us ongoing annuity model of service and consumable revenue. Our prepaid segment sales were flat compared to the prior year, which is good performance given the exceptionally strong first quarter in 2021, which benefited from a significant new portfolio addition. As a result of the strong sales growth overall, we were able to deliver increased adjusted EBITDA in the quarter compared to the prior year, despite cost pressures and comparisons with a very strong margin in the first quarter of 2021.

Thanks to the strong first quarter sales performance, additional inventory purchases and improvements in our production capacity, we have increased our sales outlook for the full year to low-double digit growth, which is up from our previous outlook of mid-single digit increase.

The overall macro environment remains challenging, with ongoing labor shortages, supply chain issues and uncertainty of the potential impacts from the Russia-Ukraine war, China lockdown and interest rate increases among other factors. However, customer demand remains strong and production capacity has improved and we believe we are well-positioned to serve our customers. We're also increasing the top of the range for our adjusted EBITDA expectations moving from mid-single digits in our original outlook to mid to high-single digit growth.

The increased range is a result of the improved sales outlook and we now expect our full-year adjusted EBITDA margin to be slightly below 20%, reflecting expectations for continued and accelerating inflationary impacts on costs. We did have some offsets from price increases in the first quarter and we expect more price increases to go into effect as we move through the year. So overall for 2022, we expect sales performance above our original expectation with continued strong customer demand, partially held back by anticipated supply and capacity constraints, and a higher top-end of the range and adjusted EBITDA growth with benefits of higher sales partially offset by cost pressure that we expect to continue to rise.

Turning to slide 5, Amintore will go into more detail on the financial results shortly. But first, let me spend a few minutes reiterating our long-term opportunities and strategy. As I mentioned last quarter, the strategies we have

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implemented are working. We believe we have gained significant overall market share over the last four years in growing markets and the first quarter results demonstrate further advances. Our four strategic priorities of deep customer focus, market-leading quality products and customer service, continuous innovation and a market-competitive business model have driven our strong performance in several US payment market segments. We believe we are US market leader for eco-focused card, personalization and instant issuance solutions for small and medium-sized financial institutions and prepaid debit card solutions. And we are a key player facilitating the ongoing convergence to contactless cards.

Our quality products and services and end-to-end solutions have helped us establish robust and long-standing customer relationships with financial institutions, issuers of all sizes, bank platforms and resellers, prepaid program managers, and more recently, fintechs. We believe that the markets where we participate remain healthy and growing, as evidenced in part by the latest figures reported by Visa and Mastercard which shows US credit, debit and prepaid cards in circulation have grown at a compounded annual growth rate of 8% over the three-year period ended December 31, 2021.

We have significantly increased profitability and improved our financial position over the past four years and despite the cost pressures in the current environment, we expect to drive further profit growth in 2022. I remain confident in our strategies, our positioning, our markets and our people, and I believe we have great opportunities to continue to deliver share gains and strong performance in the coming years.

Now, I will turn the call over to Amintore to review our first quarter results in more detail. Amintore.

Amintore T. X. Schenkel

Chief Financial Officer, CPI Card Group, Inc.

Thank you, Scott, and good morning, everyone. I will begin my overview on slide 7. First quarter net sales increased 25% to $111.4 million compared to the prior year quarter, driven by a 32% increase in our Debit and Credit segment. Debit and Credit segment growth was primarily due to increased sales of higher priced contactless cards, including related personalization and strong growth in our eco-focused cards, and strong increases in Card@Once instant issuance solution.

Prepaid Debit segment sales were flat compared with the prior year, as the 2021 first quarter benefited from significant onboarding of new customer portfolios. As we have noted in the outlook we provided in March, we expected Prepaid Debit sales to be between the 2020 and 2021 levels due to the record year this segment delivered in 2021. Based on our current outlook, we now expect prepaid sales to be only slightly below 2021 levels.

First quarter gross profit of $39.3 million increased 10% from the prior year while gross profit margin decreased from 40.1% to 35.3% due to the inflationary impact on materials and labor costs. Gross margin increased 200 basis points from the fourth quarter 2021 levels due to operating leverage from higher sales. SG&A expenses increased by $3.7 million in the quarter compared to the prior year, primarily due to $2 million of increased compensation expenses and $800,000 of increased consulting and accounting costs related to Sarbanes-Oxley. SG&A was $16 million in the first quarter of last year before increasing to approximately $20 million per quarter the rest of the year as we began incurring SOX compliance costs and increased compensation expenses.

Net income in the quarter increased 149% to $6 million, primarily due to the impact of debt refinancing costs incurred in the 2021 first quarter, as well as increased sales growth and the resulting operating leverage, partially offset by the increased material, labor and SG&A costs. Adjusted EBITDA increased 2% to $22.5 million, while adjusted EBITDA margins declined from 24.8% in the prior year to 20.2% in the 2022 first quarter. Last year's first

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quarter adjusted EBITDA margins were particularly high, primarily due to lower SG&A expenses, so the comparisons will not be as challenging in the remaining quarters. While our adjusted EBITDA margin was 24.8% in the 2021 first quarter, it averaged 19% in the remaining three quarters as the higher SG&A expenses and increased labor costs impacted results. Our first quarter adjusted EBITDA margin of 20.2% this year increased substantially from the 14.6% margin recorded in the fourth quarter, as we expected.

Turning now to our segments on slide 8. I mentioned the segment sales drivers earlier, so I will just discuss segment profitability on this slide. Income from operations for the Debit and Credit segment increased 20% in the quarter to $24.1 million, driven by the higher net sales and operating leverage, partially offset by increased materials and labor costs. Prepaid Debit segment income from operations decreased 15% in the quarter to $6 million due to higher labor and materials costs on flat sales growth.

Turning to the balance sheet liquidity and cash flow on slide 9. Our cash balance as of March 31 was $12.1 million and we had $30 million of borrowings outstanding on our $75 million ABL revolver, with proceeds utilized to fund our notes redemption and temporary working capital needs.

We had $290 million of senior secured notes outstanding. And our net leverage ratio as of March 31 was just over four times. Cash flow from operating activities was a usage of $16 million and we utilized $3.2 million on capital expenditures. This resulted in free cash flow being a usage of $19.1 million, which compared to a $2.4 million usage in the first quarter of 2021. Increased working capital usage in the first quarter was expected, primarily driven by increased inventory purchases of $13 million to continue to support future growth and a $10 million increase in accounts receivable due to the 25% sales growth in the quarter.

We anticipate improvement in free cash flow for the remainder of the year, but we will also continue to be opportunistic with inventory purchases based on customer demand levels and availability of supply materials, as our first priority is to ensure we can meet our customers' needs. Our capital structure and allocation priorities remain focused on maintaining ample liquidity, investing in the business, including possible strategic acquisitions, deleveraging the balance sheet and potentially returning funds to stockholders through share repurchases. Consistent with these priorities, we continue to target further lowering our net leverage ratio over time.

To reiterate what Scott mentioned earlier, we have updated our full year 2022 expectations to reflect low double-digit sales growth, mid to high single-digit adjusted EBITDA growth and an adjusted EBITDA margin of slightly below 20%.

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

Scott T. Scheirman

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

Thanks, Amintore. Overall, I am pleased with the business performance to start the year. Customer demand remains strong and we were able to execute in a challenging environment to deliver a 25% sales increase in the first quarter. As always, I'd like to thank all of our employees for working hard to deliver these results.

We have updated our 2022 outlook to reflect higher sales expectations and a higher top end of the range for adjusted EBITDA, despite labor, supply chain, inflationary pressures and uncertainties. We are also pleased to have completed the redemption of $20 million of our senior secured notes in the first quarter and I expect improved cash flow for the remainder of the year. We're excited about our long-term opportunities and we look forward to updating you on our progress as we move forward.

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Thank you for joining our call today. And we will now open the call for any questions.

QUESTION AND ANSWER SECTION

Operator: We will now open the call for your questions. [Operator Instructions] Our first question comes from Jaeson Schmidt from Lake Street. Your line is now open.

Jaeson Allen Min Schmidt
Analyst, Lake Street Capital Markets LLC

Q

Hey, guys. Thanks for taking my questions and congrats on some really impressive results. Just want to start with kind of Q1, sorry if I missed it. So was there any demand that you were unable to fulfill because of the supply chain backdrop? And then, I guess, relatedly, just given how strong Q1 was, are you at all concerned about any sort of pull forward in demand?

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

A

Jaeson, good morning, this is Scott. Appreciate you joining the call. First I would like to say customer demand is very strong and very robust. Clearly in Q1 we had great results, but still had constraints around capacity, some of it labor, some materials. I feel like, yes, we could have sold more in Q1 than we did as customer demand is very strong and very robust. On the second part of your question on pull-forwards, I would say there may be some, however we broadly work very closely with our customers in planning. [Availability varies, we have some constraints on capacity. I know certain customers would like more product than we can provide today.] Broadly, we're not seeing a lot of pull-forward in the market today.

Jaeson Allen Min Schmidt
Analyst, Lake Street Capital Markets LLC

Q

Okay. That's really helpful. And then, looking at the prepaid segment, for the upward revision here, is that being more driven by just overall improving market conditions or share gains or I guess a combination of both?

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

A

I think it's a couple of things. I'd first say just the customer demand has been a bit stronger than what we anticipated call it 60 or 90 days ago. But I think more importantly, it really just speaks to our product set. Our team in Minneapolis does a great job up in Minnesota. Their quality is very high. Our prepaid solutions are very innovative with our packaging. It helps prevent fraud, but also helps drive shelf appeal. So I think just being a market leader here, customers continue to turn to us and we continue to – over time we've won new programs, we continue to win the share of wallet with our customers. So very pleased with that business.

Jaeson Allen Min Schmidt
Analyst, Lake Street Capital Markets LLC

Q

Okay. Perfect. And then, just the last one from me and I'll jump back in the queue, early nice rebound in gross margin. I know the situation is fluid with the supply chain and lots of dynamics going on. But is it fair to think about sort of that 35.3% being the low watermark for the year?

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

Jaeson, what I'd probably guide you towards is the top-line outlook we've provided and the EBITDA guidance, adjusted EBITDA guidance that we've provided. You've mentioned that there still is a bit of uncertainty out there. We're in a very dynamic environment with inflation, low unemployment levels, supply chain challenges and so forth. But I would say with the outlook we've provided, we are quite confident in the top-line growth in our outlook and the adjusted EBITDA guidance that we've provided today.

Jaeson Allen Min Schmidt
Analyst, Lake Street Capital Markets LLC
Q

Okay. That makes sense. That's it for me. Thanks again, guys.

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

Thanks. Appreciate your input.

Amintore T. X. Schenkel
Chief Financial Officer, CPI Card Group, Inc.
A

Thank you.

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

Thank you.

Operator: [Operator Instructions] Our next question comes from the line of Kartik Mehta from Northcoast Research. Your line is now open.

Kartik Mehta
Analyst, Northcoast Research Partners LLC
Q

Hey, Scott, how are you? I was hoping to get your perspective upon what you think could happen in the business or if you see any pressure from the business if banks start making underwriting standards more stricter, because of what's happening in economy. And have you seen any signs of that?

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

Good morning, Kartik. Good to hear your voice. I have not seen any signs of that. In fact, if you look at the banks, who have reported in the first quarter of 2022, their underwriting has been robust. They are issuing more cards. In fact, Visa and Mastercard over the last three years have said, on an average annual basis, cards outstanding are up 8% per year, it's pretty robust. So we had not seen any pullback on that. I think, one thing that's really important in our business about 600 million cards are issued every year. 90% of that is really driven by re-occurrence issues. So it could be a lost or stolen credit card. It could be fraud. It could just be a normal reissuance cycle. So, the good news in our business, at least 90% of that 600 million cards that are issued every year are re-occurring in nature. So, any potential impact in the future, hard to predict for sure, but I don't see that having a real meaningful impact given that 90% of its reoccurring with what we see with card issuance.

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Kartik Mehta
Analyst, Northcoast Research Partners LLC

Q

And then just as a follow-up, Scott, I know that at least banks in the last couple of years have been very aggressive trying to get new card holders out there, because of – they kind of slowed down during the pandemic. I'm wondering – I don't know if you look at this on a quarterly basis, but if you do, any change in that 90-10 percentage from last quarter to this quarter in terms of renewals or expiration versus new cards?

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

A

It's hard to look at it on a quarterly basis. It's more something we do on an annual basis. But, your point is spot on and as far as issuing banks are competing card for a share of wallet. And that's where I think for example our eco-focused cards are a very innovative product you know through customer research that's over 50% of consumers would switch to an eco-focused card if it had the same benefit. So I think, one of the reasons why we're winning in the marketplace, we sold 10 million eco-focused cards. So I think we've got products with solutions that will help our customers continue to gain share of wallet.

Kartik Mehta
Analyst, Northcoast Research Partners LLC

Q

Okay. Thanks, Scott. I really appreciate it. It was good to hear your voice.

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

A

You, too. Thanks, Kartik.

Operator: [Operator Instructions] There are no further question at this time. I will now turn the call back to Mike Salop for the closing remarks.

Mike Salop
Head-Investor Relations, CPI Card Group, Inc.

Okay. Thank you, Charlotte. Thanks, everyone for joining our first quarter call today. Hope you have a good day. Thank you.

Operator: That concludes today's CPI Card Group's first quarter earnings call. Thank you.

Editor's Note: Text in [] was added after the conclusion of the call, to provide clarity on certain statements, at the request of the company.

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