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CPI Card Group, Inc. (PMTS)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to CPI Card Group's Second Quarter 2022 Earnings Conference Call. My name is Alex, and I'll be coordinating the call today. [Operator Instructions]

I would like to hand over to your host Mike Salop, Head of Investor Relations. Mike, over to you.

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

Thanks, operator, and good morning, everyone. Welcome to the CPI Card Group's second quarter 2022 earnings webcast and conference call. Today's date is August 8, 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. In addition, CPI's Form 10-Q for the quarter ended June 30, 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.

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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 second 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 up the call for questions.

We will start on slide 4. We continued our strong start to the year with second quarter sales increasing 22% to $113 million, another record quarterly sales level driven by strong customer demand across our business.

Second quarter sales growth was led by our Debit and Credit segment, which increased 29% and included strong contributions from contactless cards, including eco-focused cards and our Software-as-a-Service based Card@Once instant issuance solutions.

We sold more than 18 million eco-focused cards in the quarter, led by our recovered ocean-bound plastic offering, increasing our total to nearly 80 million cards sold since launch in late 2019.

Although the higher average selling prices of contactless cards benefit our revenue and continue to be an increased part of the mix, the majority of our card sales growth in the quarter was due to unit volume increases.

Our SaaS-based instant issuance solution Card@Once was also a major growth driver for the Debit and Credit segment in the second quarter as small and medium-sized financial institutions continue to desire our plug-and-play solution.

Prepaid segment sales declined 6% compared to the exceptionally strong performance in 2021, which benefited from a significant new portfolio addition and retail inventory replenishment related to COVID impacts.

Based on first half results and anticipated orders, we now expect 2022 full year Prepaid sales to be similar to the 2021 record level.

Adjusted EBITDA increased 2% to $20 million in the quarter as the strong sales growth offset continued inflation impacts on costs. Our objective is to pass on inflationary cost increases when possible, while maintaining strong customer relationships for the long term.

Based on our strong first half performance, driven by the exceptional sales growth and our visibility for orders for the rest of the year, we are again increasing our full year outlook.

We have increased our net sales growth outlook for the full year to high teens, which is up from our previous outlook of low-double digits, as customer demand remains strong and we expect to have inventory supply and production capacity to reach this level.

We're also increasing our adjusted EBITDA expectations to low-double digits, up from mid-to-high single digits in the previous outlook, while we continue to expect our full year adjusted EBITDA margin to be slightly below 20%.

Current inflationary pressures are affecting margins for us, as well as other companies, but we believe in more normalized times, sales growth should lead to further operating leverage and we remain focused on having a market competitive business model and driving efficiencies over the long term.

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So, we anticipate 2022 to be another very good year for CPI as the combination of market demand and our high-quality innovative solutions is leading to healthy double-digit growth expectations for both sales and adjusted EBITDA.

Turning to slide 5. Before Amintore goes into more detail on financial results, I would like to review the strategic priorities we have in place that are critical to our success. As noted on slide 5, these strategic priorities include deep customer focus, market-leading quality products and customer service, continuous innovation, and a market competitive business model.

The implementation and execution of these strategic priorities has led to significant gains in market share, and we believe we have become a US market leader for eco-focused cards, personalization, and instant issuance solutions for small and medium-sized financial institution and prepaid debit card solutions.

We've built deep and long-standing customer relationships with financial institution issuers of all sizes, bank platforms and retailers, prepaid program managers, and fintechs. A particular area of strength that we have developed is our solutions for small and medium-sized financial institutions.

About two-thirds of our Debit and Credit segment sales are to those customers, as they typically need a full suite of end-to-end solutions and often want a provider that can bring program expertise and marketing and technology support.

Small and medium-sized financial institutions typically work with one provider, and services are often heavily integrated, so relationships tend to be very sticky. One example is CPI solutions that appeal to small and medium-sized financial institutions is our Card@Once instant issuance service.

Our solution is easy to implement, easy to manage, and integrates with major card management platforms in the US.

Providing a Software-as-a-Service based offering rather than a hosted solution has enhanced our appeal to small and medium-sized financial institutions, and our innovative solutions has helped us broaden and strengthen customer relationships.

Another example of winning business with our end-to-end solutions, which includes consultation, design, production, personalization, and fulfilment is with fintechs. Both small and scaling fintechs have turned to us to develop card programs that match their unique styles and requirements, allowing them provide their customers with cards and services consistent with their brand and business goals.

These are just two examples of how innovation, quality, and customer service have driven sales and market share growth over the last few years. As mentioned in the past, we believe we operate in healthy, growing markets, and our strategic positioning gives us strong opportunities for additional share gains in the coming years.

Now, I'll turn the call over to Amintore to review our second 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. Second quarter net sales increased 22% to $113.3 million compared to the prior year quarter, driven by a 29% increase in our Debit and Credit segment.

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Debit and Credit segment growth was primarily due to increased sales of higher priced contactless cards, including strong growth in our eco-focused cards, strong increases in Card@Once instant issuance solutions, and personalization services for contactless cards.

Prepaid Debit segment sales declined 6% compared with the prior year, as the 2021 second quarter benefited from onboarding of significant new customer portfolios and retail inventory replenishment.

Second quarter gross profit of $40.6 million increased 9% from the prior year, while gross profit margin decreased from 39.8% to 35.8%, primarily due to the inflationary impacts on materials cost and partially offset by operating leverage from sales growth.

Gross profit margin stabilized relative to the first quarter, increasing from 35.3% in Q1 to the 35.8% in Q2.

SG&A expenses increased by $4.3 million in the quarter compared to the prior year, primarily due to $2 million of increased compensation expenses, which reflects increased head count and includes $1 million of stock compensation expense that we did not have in the prior year quarter.

Approximately $1 million of incremental professional services costs and approximately $1 million related to various items, including increased IT expenses and comparisons with a sales tax benefit in the prior year quarter.

Net income in the quarter decreased 1% to $6.2 million and adjusted EBITDA increased 2% to $19.7 million.

Adjusted EBITDA margin declined from 20.7% in the prior year to 17.4% in the 2022 second quarter due to the inflationary impact on production costs, which offset operating leverage and higher SG&A expenses.

Net income in the quarter also benefited from a lower effective tax rate, which adjusted our year-to-date tax rate to 31%, consistent with the prior year.

Turning now to our first half financial results on slide 8. First half net sales increased 23% to $224.7 million compared to the prior year quarter. By segment, Debit and Credit sales increased 31% and Prepaid declined 3% in the first half, primarily driven by the same factors mentioned for the second quarter.

First half gross profit of $79.8 million increased 10% from the prior year, while gross profit margin decreased from 39.9% to 35.5% due to the inflationary impact on production costs.

SG&A expenses increased by $8 million in the first half compared to the prior year, primarily due to $4 million increased compensation expenses, including approximately $2 million of stock compensation and approximately $2 million of incremental professional services costs, including $1 million related to Sarbanes-Oxley.

Net income in the first half increased 41% to $12.2 million, primarily due to the impact of debt refinancing cost incurred in the 2021 first quarter.

Adjusted EBITDA increased 2% to $42.2 million, while adjusted EBITDA margin declined from 22.7% in the prior year to 18.8% in the 2022 first six months. The increase in adjusted EBITDA was driven by sales growth and the resulting operating leverage, partially offset by increased production and SG&A cost.

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Turning now to our segments on slide 9. 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 25% in the quarter to $25.3 million, driven by the higher net sales and operating leverage, partially offset primarily by increased material costs. For the first half, Debit and Credit segment income from operations increased 22%, driven by the same factors as the second quarter.

Prepaid Debit segment income from operations decreased 30% in the quarter to $5.3 million due to higher labor and material costs and lower sales. For the first half, Prepaid Debit segment income from operations decreased 23%, driven by the same factors.

Turning to the balance sheet, liquidity, and cash flow on slide 10. Our cash balance as of June 30, was $9.1 million and we had $25 million of borrowings outstanding on our $75 million ABL revolver, with proceeds utilized to fund our notes redemption in the first quarter and working capital needs.

We had $290 million of senior secured notes outstanding and our net leverage ratio as of June 30 was approximately 4 times.

Cash flow from operating activities in the first half of the year was a usage of $8.1 million, and we utilized $8.2 million of capital expenditures. This results in a year-to-date free cash flow being a usage of $16.3 million. In the prior year first half, we had free cash flow generation of $19 million, which included $6 million of tax cash refunds primarily related to the CARES Act.

The free cash flow usage in the first half of this year was driven by increased inventory purchases of $18 million to continue to support customer demand and a $12 million increase in cash receivable due to the 22% sales growth in the quarter. We anticipate improvement in free cash flow for the remainder of the year as we collect receivables and stabilize inventory levels.

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. 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 expectation to reflect high teens net sales growth, low-double-digit adjusted EBITDA growth, and adjusted EBITDA margin of slightly below 20%, likely in the approximately 19% to 20% range.

I will now pass the call back to Scott for some closing remarks on slide 11. Scott?

Scott T. Scheirman

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

Thanks, Amintore. The second quarter built on our strong first quarter performance, and we're pleased to be able to raise our outlook for the year. We have been able to navigate a challenging supply chain, labor, and inflationary environment, and deliver for our customers.

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Our portfolio of innovative products and end-to-end solutions continues to generate strong demand, and we have experienced very high growth from eco-focused contactless cards and our SaaS-based instant issuance solutions, among other products.

In addition, our Prepaid business is doing well relative to expectations after the record sales year in 2021. As always, I would like to thank all of our employees for working hard to deliver these results.

Execution of our strategic priorities of deep customer focus, market leading quality of products and customer service, continuous innovation, and a market-competitive business model continue to produce results and position us well to realize the long-term opportunities in our growing markets.

Thank you for joining our call today, and we will now open up the call for any questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question for today comes from Jaeson Schmidt of Lake Street. Jaeson, 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 the clearly impressive results there. Just want to start with sort of Q2. Just curious if there was any demand you were unable to ship because of the supply chain backdrop.

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

A

Jaeson, good morning. I would say yes. Clearly, customer demand is still very strong and robust. And so, we continue to work on improving our capacity, hiring talent, and making sure we've got robust supply chain.

So, I would say, yeah, we could have done more. And I think that's reflective of we've increased our full year outlook this morning just because of the strong customer demand. Our quality and our innovative products are winning in the marketplace.

Jaeson Allen Min Schmidt
Analyst, Lake Street Capital Markets LLC

Q

Okay. That's helpful. And just following up on that, I mean, with the lifted full year outlook, does that assume you guys are anticipating at least some easing in the supply chain or is this really a function of demand is so robust and even if supply chain remains tight, just given the demand profile, you guys should be able to kind of hit that new range?

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

A

Yeah. We work closely with a lot of our customers, so we've got really good visibility for the next five months. July is already on the books for us, right, Jaeson. So, we've got really good visibility with our customers. We anticipate

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having chips and other supplies we need and the labor in place. So, just given the visibility with our customers, we feel really good about our outlook for 2022.

Jaeson Allen Min Schmidt
Analyst, Lake Street Capital Markets LLC

Q

Yeah, okay. Got it. And then, just the last one for me and I'll jump back into queue. I know you outlined some of the dynamics that went into sort of that increase in operating expenses. Just curious if this kind of Q2 level is more the run rate we should expect here in the second half of this year.

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

A

Yeah. Amintore, I'll let you address that.

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

A

Yeah. No, I mean, I think as we think about the second quarter, we did have some expenses in the SG&A side that were a little bit higher than we would think they'd be on a normal run rate. But overall, I'd say, yes. I'd say the run rate that we had in the second quarter outside of some of those SG&A expenses is probably a good run rate going forward here.

Jaeson Allen Min Schmidt
Analyst, Lake Street Capital Markets LLC

Q

Okay. That's helpful. Thanks a lot, guys.

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

A

Thanks, Jaeson.

Operator: Thank you. [Operator Instructions] Okay. Currently we have no further questions, so I'll hand back to Mike Salop for any further remarks.

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

Okay. Thank you, Alex. Thanks, everyone, for joining our call today and hope everyone has a good day.

Operator: Thank you for joining in today's call. You may now disconnect your line.

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