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CPI Card Group, Inc. (PMTS)

Q3 2022 Earnings Call

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CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Hello and welcome to CPI Card Group's Third Quarter 2022 Earnings Call. My name is Sam and I'll be your operator today. If you are viewing on the webcast, you may advance the slide by pressing the arrow buttons. This call will open for questions after the company's remarks. [Operator Instructions]

And now, I'd like to turn the call over to Mike Salop, CPI's Head of Investor Relations, to begin. Mike, please go ahead.

Mike Salop

Head-Investor Relations, CPI Card Group, Inc.

Thanks, operator, and good morning, everyone. Welcome to the CPI Card Group third quarter 2022 earnings webcast and conference call. Today's date is November 3, 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 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

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Relations website, investor.cpicardgroup.com. In addition, CPIs Form 10-Q for the quarter ended September 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.

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 third 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 had an outstanding third quarter with strong sales growth across our portfolio, which generated operating leverage and significant increases in profitability. Net sales increased 25% to $125 million, our third consecutive record quarterly sales level, led by 31% growth in our Debit and Credit segment, and 8% growth in our Prepaid Debit segment. Our Debit and Credit business was again driven by strong growth from higher priced contactless cards, but we saw good increases across our portfolio of solutions.

Card sales growth in the segment resulted primarily from unit volume increases as more than 85% of secure card growth was due to volume, with the remainder from higher average selling prices due to price increases and favorable mix. We sold 7 million eco focused cards in the quarter, increasing our total to approximately 85 million cards sold since launch in late 2019. As we mentioned last quarter, eco focused card sales will vary by quarter based on deliveries of large customer orders. But demand for our recovered ocean bound plastic card offering remains very strong.

Our sales growth generated strong operating leverage, with net income increasing 80% to $12 million and adjusted EBITDA increasing 32% to $28 million in the quarter, despite inflationary impacts on production costs. Given these results and ongoing strong customer demand for our portfolio of innovative solutions, we have again increased our full year financial outlook. We now expect net sales growth for the full year to be in the low-20 percentage range, up from high-teens in our previous outlook, and adjusted EBITDA growth in the high-teens, up from low-double digits previously. We continue to expect our full year adjusted EBITDA margin to be slightly below 20%. This is shaping up to be another strong year of double-digit top line and bottom line growth for CPI despite the global macro challenges.

Turning to slide 5. We believe the strategies we have been executing for the past several years allowed us to deliver strong results and continue to position us well for the future. Our ongoing strategic priorities include deep customer focus, market leading quality products and customer service, continuous innovation and a market competitive business model. Some of the successes we experienced in the third quarter resulting from our strategies, including leveraging innovative packaging solutions to win more business from existing prepaid customers and meeting the needs of fintech customers for print-on-demand services.

We also continue to be a leader in the US eco focused card solution, a fast growing area that is expected to have strong adoption over the coming years and Software-as-a-Service based instant issuance solutions for small and medium financial institutions. Our focus on customer service has resulted in deep and longstanding relationships with financial institutions issuers of all sizes, bank platforms and resellers, prepaid program managers and fintechs.

The strategic emphasis on operating a market competitive business model encompasses driving efficiency and productivity throughout our business, with ongoing process improvements, operational automation, and

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technology and equipment advancement. This emphasis has helped contribute to our 2022 results and we are delivering record sales levels despite supply chain challenges, a competitive labor environment and inflationary pressures.

Customer demand has been very strong, but we would not have been able to deliver against it without the improvements we have made in our business. Specifically, we have invested in equipment and technology, and made process changes that allowed us to increase our secure card capacity by nearly 50% this year. We've also worked to reduce customer lead times from the high levels prompted last year by supply chain disruptions, which has affected the entire industry.

To summarize, our strategic priorities have contributed greatly to our success driving sales growth, market share gains and operating leverage. And we will continue to focus on these areas moving forward.

Now, I'll turn the call over to Amintore to review our third 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. Third quarter net sales increased 25% to $124.6 million compared to the prior year quarter, led by volume growth as price increases provided a low-single-digit contribution to the growth percentage. The 31% increase in our Debit and Credit segment was primarily due to increased sales of higher priced contactless cards. But we saw good growth across our portfolio, including contact card, personalization services and Card@Once instant issuance solutions. Prepaid Debit segment sales increased 8% compared with the prior year, driven by growth with existing customers as well as benefits from price increases.

Third quarter gross profit of $48.4 million increased 29% from the prior year, while gross profit margin increased from 37.8% to 38.9%, driven by operating leverage from sales growth, including benefits from price increases, partially offset by the impact of inflation on production costs, primarily on materials cost. SG&A expenses increased by $3.9 million on the quarter compared to the prior year, but declined $600,000 compared to the second quarter. The year-over-year SG&A increase was primarily due to approximately $2 million of increased compensation expenses and approximately $1.5 million of incremental professional services costs, including costs related to Sarbanes-Oxley compliance.

The compensation expense increase reflects higher head count and labor rate, and $800,000 of incremental stock compensation expense, partially offset by comparisons with severance expense incurred in 2021. Our tax rate was 25.8% in the quarter, down from 30.3% in the prior year. And our year-to-date rate of 28.5% reflects the expected 2022 rate given our current financial outlook. Net income in the third quarter increased 80% to $11.9 million and adjusted EBITDA increased 32% to $28.3 million. Adjusted EBITDA margins improved from 21.6% in the prior year to 22.7% in the 2022 third quarter, driven by operating leverage from the strong sales, including pricing benefits.

Turning now to our year-to-date financial results on slide 8. Net sales for the first nine months of the year reached a record level of $349.3 million, a 24% increase compared to the prior year. By segment, Debit and Credit sales increased 31% and Prepaid Debit increased 1%. Nine-month Debit and Credit sales growth was primarily driven by contactless cards, including eco focused cards, and Card@Once instant issuance solutions. The segment has benefited in 2022 from large eco focused card orders and high printer replacement sales in Card@Once. But we continue to feel positive about ongoing demand for our portfolio of differentiated solutions.

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We're also pleased with the increase in Prepaid Debit sales given the record year in 2021, which benefited from the onboarding of new customer portfolios and retail inventory replenishment following the COVID slowdown in the prior year. Year-to-date gross profit of $128.3 million increased 16% from the prior year, while gross profit margin decreased from 39.2% to 36.7% due to inflationary impacts on production costs, primarily materials, partially offset by pricing benefits.

SG&A expenses increased by $12 million in the first nine months compared to the prior year, primarily due to $6 million in increased compensation expenses, including approximately $3 million of additional stock compensation and approximately $3.5 million of incremental professional services comp. Year-to-date net income increased 58% to $24.1 million, primarily due to the sales growth and the impact of debt refinancing costs incurred in the 2021 first quarter. Adjusted EBITDA increased 12% to $70.5 million while adjusted EBITDA margins declined from 22.3% in the prior year to 20.2% in the first nine months of 2022. The increase in adjusted EBITDA was driven by sales growth and the resulting operating leverage, partially offset by increased production and SG&A cost.

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 44% in the quarter to $29.4 million, driven by the higher net sales and operating leverage, partially offset by higher production costs, primarily material. For the first nine months, Debit and Credit segment income from operations increased 29%, driven by the same factors as the third quarter. Prepaid Debit segment income from operations increased 7% in the quarter to $9.1 million, driven by higher net sales, partially offset by increased materials cost. For the first nine months, Prepaid Debit segment income from operations decreased 12%, primarily due to the inflationary impact on production costs with the majority of the impact on materials.

Turning to the balance sheet, liquidity and cash flow on slide 10. Our cash balance as of September 30 was $21.5 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. With had $290 million of senior secured notes outstanding and our net leverage ratio as of quarter end with 3.6 times. We generated $11.7 million of cash flow from operating activities in the first nine months of the year and utilized $14.4 million on capital expenditures, which result in year-to-date free cash flow being a usage of $2.7 million. In the prior year period, we had free cash flow generation of $9.7 million, which included $9.8 million of tax cash refunds primarily related to the CARES Act and only $4.8 million of capital expenditures.

The free cash flow usage in the first nine months of this year was driven by increased inventory purchases of $14 million to continue to support customer demand and $15 million increase in accounts receivable driven by the high sales level in the third quarter. As expected, we experienced significant improvement in cash flow in the third quarter relative to earlier in the year. Inventory levels decreased $3.6 million from the second quarter, and we generated $19.9 million of cash flow from operating activities and $13.6 million of positive free cash flow in the quarter.

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 expectations to reflect growth in the low-20% range for net sales and high-teens for adjusted EBITDA, while maintaining expectations for an adjusted EBITDA margin of slightly below 20%.

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

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Scott T. Scheirman

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

Thanks, Amintore. The third quarter was the strongest quarter of what has been a very good year despite the ongoing macro challenges. And I would like to thank all of our employees for their contributions in delivering these results. We continue to experience high demand for our portfolio of innovative products and end-to-end solutions, and we generated strong sales growth across our portfolio in Q3, including contactless cards, personalization solutions, Card@Once SaaS based instant issuance and our Prepaid Debit business. This growth translated into strong operating leverage, driving healthy profitability increases.

We also made improvements in our financial position in the quarter, bringing net leverage down to 3.6 times and we will continue to target further reductions. We are pleased to once again to be able to increase our outlook for sales and adjusted EBITDA growth, and continue to be confident in the long-term opportunities for our company.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now open the call for your questions. [Operator Instructions] And our first question comes from Jaeson Schmidt from Lake Street. Jason, your line is now open. Please go ahead.

Jaeson Allen Min Schmidt

Analyst, Lake Street Capital Markets LLC

Q

Hey, guys. Thanks for taking my questions. And congrats on a really strong quarter. Just want to start with the supply chain. Just curious your confidence level in securing supply not only in Q4 but as you start to look out into next year. And I guess, relatedly, are you assuming any supply chain constraints for Q4?

Scott T. Scheirman

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

A

Good morning, Jaeson. Thank you for joining the call. This is Scott. In Q4, we've got pretty good visibility as far as customer orders, what our supply chain looks like. So we're confident in our full year outlook for sure. So, we've got really good line of sight there. Longer term, as you think about, say, 2023, we feel good about our supply chain. We are working closely with our vendor partners every week. There's no guarantees with these global supply chains and markets for sure, but we feel like we've done all the right things to secure our supply chain. At the end of the day, our vendor partners have to deliver at the right time, too. But overall, we feel good about the supply chain.

Jaeson Allen Min Schmidt

Analyst, Lake Street Capital Markets LLC

Q

Okay. No, that's good to hear. And then Prepaid Debit was extremely strong in Q3 and implied Q4 guidance have – it seems a bit more of a pronounced sequential decline than usual. Should we infer that you saw some pull in orders in Q3, or could you discuss some of the other dynamics going on?

Scott T. Scheirman

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

A

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Yeah. I would say for – specifically for our Prepaid segment, Prepaid tends to be the – historically if you look back, Jaeson, of the four quarters in the year, the highest quarter from a revenue standpoint, primarily getting cards ready for the holiday season in December in the US from that standpoint. When you look at our full year guidance, again, at the top line, low-20s growth. So we continue to be confident in the strong customer growth, the pipeline we can see and so forth. So, again, there are some timing differences among quarters for sure. It's probably every company around the globe. But we feel confident in 2022 and the strong customer demand that we're seeing.

[indiscernible] (00:19:14)

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

I wanted to just add some Prepaid perspective. We expect it to be similar for the full year to what it was last year and nine months, we're up 1% on prepaid. So fourth quarter in terms of growth rates would be pretty much in line with that.

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

Okay. Got it. And then just the last one for me and I'll jump back in the queue. I'm just curious if contactless card penetration is tracking relatively to your expectations, or is it outperforming what you had expected? Any color around that would be helpful.

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

Yeah. No, it's – I'll give you our best estimates, Jaeson. There's no pure market statistics out there, as you could imagine. But we think in the US, at the end of 2021, the DI penetration or the contactless penetration was approximately 40%. We think, again, it's an estimate that as we end 2022, that might be somewhere between 50% to 60%. We think by the end of 2025, probably 80% of the cards outstanding will be contactless. So I would describe it as continue to be a gradual transition to contactless over probably – it's been a five-, six-, seven-year period. So it's progressing at a gradual pace as we move forward from that standpoint.

And again, with contactless, what we like about that is they have – it has a higher average selling price. It has more technology behind it. We think the large financial institutions have adopted it a bit quicker compared to the small- and medium-sized FIs. And we're well positioned with the large FIs, but very, very well positioned with the small- and medium-sized financial institution. So we think that'll be a really good opportunity for us as we look over the next few years for sure.

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

Okay. Got it. Thanks a lot, guys.

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

Okay. Thank you, Jaeson. Appreciate your time.

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Operator: And our next question comes from Ivan Strugatsky of Stran Capital. Ivan, your line is now open. Please go ahead.

Ivan Strugatsky
Analyst, Stran Capital LLC

Q

Hi. Good morning. Congratulations on excellent quarter and thank you for taking my question. I'm just curious if you could provide a little bit more granularity or a bit more color on the debit and credit card side of things? Could you maybe help me understand a bit more how much of that was due to renewal – replacement of the cards with your existing – with the customers of your existing clients versus new customers of your existing clients? And maybe if you could also help me understand a bit more how much of that was debit versus credit as we might be entering into sort of low credit cycle, so to speak? Thank you.

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

A

Yeah. No. Appreciate your question and joining for the call today. I would – let me give you some, I would say, broad color. For competitive reasons, I won't get into real granular detail for sure. But if you look back historically, what we believe, if you go back to the 2020 timeframe and prior to that, probably 90% of the cards issued in the industry were, I would describe as, replacement in nature. So they might be due to lost or stolen card reissuance or portfolio churn. That 90% probably is not quite as high in 2022 because new card issuance across the banks have been very strong in 2022.

I would say, broadly, how we're winning in the marketplace, I would say, both it's with existing customers and new customers. In our secure card business, we've gained share historically. And I believe we're on a good path to continue to gain share in 2022 when we finally measure it at the beginning of the year. And I think that's really driven by our quality products, our strong customer service, but also our differentiated products, our retail money – excuse me, our recovered ocean bound plastic card. We said earlier in the year that we expect that to grow by greater than 50% in 2022, and it's going to continue to grow in excess of that 50%. So I believe we're continuing to win in the marketplace and gain share as we move forward. Again, I hope that's helpful. But as I mentioned, for competitive reasons, I don't want to get too granular on some of these items.

Ivan Strugatsky
Analyst, Stran Capital LLC

Q

Okay, understood. Thank you so much.

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

A

Okay. Thank you.

Operator: [Operator Instructions] And there are no further questions. So this concludes today's CPI Card Group third quarter earnings call. Thank you for joining. You may now disconnect.

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