

CPI Card Group Inc.

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Earnings Call

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Call Participants

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Presentation

Operator

Welcome to CPI Card Group's Fourth Quarter 2022 Earnings Call. My name is Glenn, and I will be your operator today.

[Operator Instructions]

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

Michael A. Salop
Head of Investor Relations

Thanks, operator, and good morning, everyone. Welcome to the CPI Card Group Fourth Quarter 2022 Earnings Webcast and Conference Call. Today's date is March 8, 2023, 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 take 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-K for the year ended December 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, CEO & Director

Thanks, Mike, and good morning, everyone. During today's call, I will discuss CPI's performance in 2022, provide thoughts on our initial outlook for 2023 and reiterate our long-term strategy.

Amintore will review the financial results in more detail, and then we will open up the call for questions. We will start on Slide 4. 2022 was a great year for CPI. We increased sales 27% for the full year to a record level of $476 million, and we believe we gained significant overall market share.

We grew adjusted EBITDA 28% to $98 million and increased the adjusted EBITDA margin slightly to 20.5% despite significant inflationary impacts on costs. We also improved our net leverage ratio in 2022, ending the year at 3x, and retired $25 million of principal on our senior secured notes during the year.

And we ended 2022 on a high note with fourth quarter net sales increasing 36% and adjusted EBITDA increasing 100%. As we look back on 2022, there were 4 main drivers that were critical to our success. First was our differentiated, innovative products and services and end-to-end solutions; second, our market-leading quality and customer service; third, our strong supply chain execution while the industry faced challenges; and fourth, we benefited from a strong growth year for the card markets in the U.S.

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Our differentiated end-to-end solution, leading quality and customer service and strong supply chain execution, each contributed meaningfully to our market share gains. One example was our innovative eco-focused cards, which posted a 70% increase in sales for the year. Led by our cards made with recovered ocean-bound plastic core, we sold more than 40 million eco-focused cards in 2022, bringing our total to more than 90 million sold since the launch in mid-2019.

Another example is our differentiated Software-as-a-Service instant issuance solution, Card@Once, which delivered another excellent year. Growth was driven by new customer installations, strong printer upgrade sales and ongoing services revenue. At the end of the year, Card@Once installations across the U.S. totaled more than 14,000 customer locations.

Across our portfolio, our market-leading quality and customer service helped us gain more business with existing and new customers, including in prepaid, where we added new customer types beyond the traditional retail channels. In addition, we were able to significantly expand Secure Card production capacity during the year to meet customer needs and to fulfill demand in the market.

And we believe our strong execution and supply chain, including proactive inventory management during the year while the industry was challenged, also allowed us to gain more business in 2022. As you may recall, we entered last year with strong customer demand but faced significant supply chain and labor shortage challenges and the impact of inflation on our cost was escalating.

I would like to thank all of our employees for their dedication and effort to tackle those challenges and deliver a record year, successfully increasing capacity, navigating global supply chains and serving our customers.

Before I discuss our 2023 outlook, I would like to also personally thank Amintore Schenkel for his strong contributions to our success since joining CPI. Amintore has informed us he will be leaving the company this year due to family-related personal reasons, but will stay on while we search for his replacement to help transition the new CFO once named.

In addition to his role in helping us drive profitability and improve our financial position, Amintore has led us towards successful SOX compliance and further developed our financial organization, leaving us with a strong financial team. Amintore will give some remarks and a further financial review in a few minutes.

But first, let's turn to our 2023 outlook on Slide 5. For 2023, we're focused on continuing to execute on our strategies, grow the business, win share in the marketplace, increase cash flow and reduce leverage. We believe we are well positioned to continue to gain overall market share in 2023, with our portfolio of differentiated solutions and market-leading quality and customer service.

We anticipate continued benefits from the ongoing transition to contactless cards, more progress on providing end-to-end solutions to small- and medium-sized issuers, and further instant issuance penetration. Our initial financial outlook for 2023 projects mid-single-digit growth for net sales with higher expected net sales growth in our Debit and Credit segment, which comprised 82% of net sales last year, and Prepaid Debit segment net sales similar to the 2022 levels.

The net sales outlook reflects expectations for slower market growth in 2023 as last year benefited from robust customer demand. We anticipate issuers being more cautious regarding the U.S. economic environment, tightly managing spending and orders as they assess the consumer trends and their own inventory levels and potentially increasing credit underwriting standards.

Debit cards, which today make up the majority of the market, tend to be less affected by economic conditions. And historically, around 90% of payment card issuance is for reissuance and replacements. So we still expect the market to grow overall, but not as strong as 2022.

Also faced challenging comparisons with our 2022 performance as the 27% net sales growth last year benefited from significant contributions by large portfolio additions with existing customers, particularly eco-focused cards, and strong Card@Once printer upgrade sales.

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As we did last year, we will remain nimble and ready to adapt as the market and economic conditions evolve and customers' plans change. On the profitability side, we expect adjusted EBITDA growth for 2023 in the mid- to high single-digit range despite continued inflationary impact on cost as we manage expenses tightly and achieve more operating leverage in our Debit and Credit segment.

We're also focused on significantly increasing free cash flow and reducing our net leverage ratio, which Amintore will discuss in a few minutes. Overall, we expect continued share gains, solid growth and another strong earnings year in 2023 as we continue the momentum we have established over the past few years.

Now let's turn to Slide 6 to discuss our long-term strategy. Over the past 5 years, we have consistently focused on 4 key strategic priorities: deep customer focus, market-leading quality products and customer service, continuous innovation and a market competitive business model.

Successful execution of these strategies has allowed us to gain market share, create and expand market leadership in key categories and deliver strong financial results. Since 2017, we have achieved compounded annual growth rates of 16% in net sales and 33% in adjusted EBITDA. Over the same period, we have increased gross margins from 30% to 37% and reduced net leverage from over 12x to 3x at the end of 2022.

Some examples of strategy success in 2022, as mentioned earlier, include winning new business with our innovative eco-focused cards and prepaid solutions, expanding our SaaS-based instant issuance distribution, providing personalization and print-on-demand solutions for fintechs, and enhancing our market competitive business model to improve capacity and reduce customer lead times following supply chain-driven spikes throughout the industry.

At the end of 2022, we reorganized our structure to help us better execute our strategies going forward. Specifically, we aligned Secure Cards, personalization and instant issuance under one leader, which we believe will optimize our ability to focus on providing end-to-end solutions for our customers.

We also created a leadership position dedicated to Prepaid and a position focused on new growth opportunities, including new product and business development and digital solutions. Some new product and business examples include providing prepaid payment cards for non-retail channels, such as our health savings accounts, and to support businesses that need to provide funds to gig workers and contractors.

We're also exploring opportunities for instant issuance solutions beyond financial institution locations, such as with retailers. To summarize, execution of our strategic priorities has contributed greatly to our success over the past 5 years, driving sales growth, market share gains, product diversification and operating leverage, and we believe there are many opportunities to further expand offerings and capabilities and drive growth in the years to come.

Now I will turn the call over to Amintore Schenkel to review our fourth quarter and full year 2022 results in more detail. Amintore?

Amintore T. X. Schenkel
Chief Financial Officer

Thank you, Scott, and good morning, everyone. I will begin my overview on Slide 8. Fourth quarter net sales increased 36% to $126.4 million compared to the prior year quarter, with strong growth across our Debit and Credit portfolio and in Prepaid.

The Debit and Credit segment net sales increased 35%, with strong contributions from contactless cards, personalization services, Card@Once instant issuance solutions, and various other products. Prepaid Debit segment net sales increased 39% compared with the prior year, driven by new customer additions outside the traditional retail channel and growth with existing customers.

Fourth quarter gross profit of $47.5 million increased 54% from the prior year, while gross profit margin increased from 33.2% to 37.6%, driven by operating leverage from sales growth, including benefits from

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price increases, partially offset by the impacts of inflation on production costs, primarily on materials costs.

SG&A expenses increased by approximately $3 million in the quarter compared to the prior year, primarily to support our growth and strategic execution. This includes approximately $2 million of increased compensation expenses, which reflect higher headcount and higher salaries, partially offset by a reduction in stock compensation expense of $500,000.

Our tax rate was 19.4% in the quarter, due to some favorable adjustment items related to unrecognized tax benefits and state tax settlements, which brought our full year rate to 25.7%. The fourth quarter rate was down from 62.3% in the prior year quarter, which included unfavorable adjustments related to state tax and uncertain tax position items.

We project a tax rate of slightly less than 30% for 2023, excluding any adjustment items that may arise. Net income in the fourth quarter increased from $700,000 in the prior year to $12.5 million in 2022, and adjusted EBITDA increased 100% to $27.2 million. Adjusted EBITDA margin improved from 14.6% in the prior year to 21.5%, driven by operating leverage from the strong sales, including pricing benefits.

Turning now to our year-to-date financial results on Slide 9. Net sales for the full year reached a record level of $475.7 million, a 27% increase compared to the prior year. By segment, Debit and Credit segment sales increased 32%, and Prepaid Debit segment increased 9%.

Revenue credit sales growth benefited from strong sales of contactless cards, including large orders for eco-focused cards. Approximately 75% of our Secure Card volume in 2022 was from contactless cards, up from just under 70% in 2021. We estimate contactless penetration for the U.S. market ended 2022 at about 50% to 60% of cards in circulation, and continue to expect the level to grow to more than 80% by 2025.

We also experienced strong growth in 2022 from Card@Once instant issuance solutions, which represented just under 10% of total company savings, and good growth from personalization services, contact cards and other products.

In Prepaid, we expected a challenging year in 2022 as the previous year benefited from significant retail inventory restocking and the addition of a large new customer portfolio. Thanks to a very strong fourth quarter, we were able to grow the Prepaid business 9% in 2022, which is another record level, driven by growth with new and existing customers and pricing benefits.

Overall, pricing amounted to a low single-digit contribution to the company's 27% growth for the year and to the growth of each segment. For Secure Cards, 80% of sales growth was due to volume, with the remainder due to mix from the conversion to contactless and pricing. Full year gross profit of $175.8 million increased 24% from the prior year, while gross profit margin decreased from 37.7% to 36.9% due to inflationary impact on production costs, primarily materials, partially offset by operating leverage, including the benefits of price increases.

SG&A expenses increased by approximately $15 million for the full year, primarily due to approximately $8 million of increased compensation expenses and approximately $3.5 million of incremental professional services comp. The compensation expense increase reflects increased headcount and salaries as well as approximately $2 million of additional stock compensation, partially offset by approximately $1 million of lower severance expense.

Full year net income increased 129% to $36.5 million, primarily due to the sales growth and the impact of debt refinancing costs incurred in the 2021 first quarter. Adjusted EBITDA increased 28% to $97.7 million, while the adjusted EBITDA margin increased from 20.4% in the prior year to 20.5% in 2022. The increase in adjusted EBITDA was driven by sales growth and the resulting operating leverage, partially offset by increased production and SG&A costs.

Turning now to our segments on Slide 10. 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

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increased 68% in the quarter to $31.2 million, driven by the higher net sales and operating leverage, partially offset by higher production costs, primarily materials.

For the full year, Debit and Credit segment income from operations increased 38%, driven by the same factors as the fourth quarter. Prepaid Debit segment income from operations increased 35% in the fourth quarter to $5.2 million, driven by higher net sales and operating leverage. These benefits were partially offset by increased operating expenses, which also drove the Prepaid operating margin decline in the quarter.

For the full year, Prepaid Debit segment income from operations decreased 5%, primarily due to the inflationary impact on production costs, with the majority of the impact on materials and increased operating expenses, partially offset by higher sales, including the benefit of price increases. Turning to the balance sheet, liquidity and cash flow on Slide 11.

We continued to strengthen our financial position in 2022, ending the year with a net leverage ratio of 3x. We generated $31.3 million of cash flow from operating activities during the year and invested $17.9 million on capital expenditures, which resulted in free cash flow of $13.5 million.

This was an increase from the $10.2 million of free cash flow generated in the prior year period despite significantly increased capital spending in 2022 and prior benefits of $9.8 million related to tax cash refunds. Accounts receivable balances increased $20 million during 2022 due to the strong sales growth in the fourth quarter.

Inventories increased $10 million during the year as we managed our business to support customer demand and a challenging supply chain environment, although we reduced inventory at $4 million compared to the end of the third quarter. In the fourth quarter, we generated strong free cash flow of $16.2 million.

On the balance sheet, at December 31, we had $11 million of cash and $5 million of borrowings outstanding on our $75 million ABL revolver. We had $285 million of senior secured notes outstanding at year-end as we redeemed $20 million of notes in the first quarter of 2022 and repurchased an additional $5 million in the open market in the fourth quarter.

Subsequent to year-end, we repurchased another $5 million of notes in the open market in the first quarter of 2023. 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. Similar to last year, seasonal working capital needs may increase net leverage in the early part of 2023, but we do expect the ratio to improve over the course of the year and end the year between 2.5 and 3x.

To reiterate our outlook for 2023, we expect sales growth in the mid-single-digit range, gain share in a slower growth market. We expect adjusted EBITDA growth in the mid- to high single-digit range as we manage expenses tightly, while still investing for the future and drive more operating leverage from our Debit and Credit segment.

We expect to improve cash flow conversion and we project free cash flow to more than double from the $13.5 million generated in 2022. As always, our first priority is to serve our customers. So if business needs or the supply chain environment changes, we may prioritize additional inventory investments, but our current outlook reflects strong working capital improvement and more than doubling free cash flow.

Within free cash flow, we expect capital spending to be similar to 2022 levels, and we expect to improve our net leverage ratio to somewhere between 2.5x and 3x by year-end through EBITDA growth and net debt reduction. We delivered record results in 2022 and further strengthened our financial position, and we expect another year of progress and financial improvement in 2023 despite the more challenging environment.

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I'm also pleased to be able to give you an update on our SOX status. Based on the results of our most recent evaluation, it has been determined that internal control of financial reporting is effective as of year-end 2022 and the previously disclosed material weaknesses have been remediated.

We have devoted significant time and resources to strengthening our processes and controls and are pleased to have completed the remediation. Finally, as Scott mentioned, I will be leaving CPI this year due to personal family reasons. I am proud of the accomplishments we have achieved and results we have delivered since I joined the company.

We have a strong financial team in place, which is well prepared to continue contributing to the company's success, and I intend to stay on board to ensure there is an orderly transition to the new CFO. As we look to the future, I believe the company is well positioned to execute its strategies to drive continued growth and financial improvement. I will now pass the call back to Scott for some closing remarks on Slide 12. Scott?

Scott T. Scheirman
President, CEO & Director

Thanks, Amintore. To summarize, 2022 was an outstanding year for CPI. We delivered strong sales and profit growth while countering inflation and supply chain challenges. We believe we continue to gain overall market share in a growing market.

We continue to provide innovative solutions and product enhancements, deliver high quality and customer service and further diversify our product portfolio. We made investments and process improvements to increase our capacity, advance our capabilities, and we improved our balance sheet and financial position. For 2023, we're focused on continuing to execute our strategies, grow the business, win share in the marketplace, increase cash flow and reduce leverage. Thank you for joining our call today, and we will now open up the call for questions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from Jaeson Schmidt from Lake Street Capital.

Maxwell Scott Michaelis
Lake Street Capital Markets, LLC, Research Division

This is Max on for Jaeson. Congrats on the really strong quarter. Just let's jump into the guidance here. So revenue outlook of mid-single digits. I was wondering -- I know you guys don't guide quarterly, but I was wondering if you could help me maybe with the linearity throughout the year. Is it second half weighted? Or is this more balanced throughout the year?

Scott T. Scheirman
President, CEO & Director

Max, this is Scott Scheirman. Thanks for joining our call today. We're confident with our guidance for a variety of reasons, don't break it into quarterly or color from that standpoint.

Timing depends on customer demand and some other factors. But I would say overall, Matt, we are very pleased with 2022. We believe we're well positioned in 2023 and longer term to continue to gain share and grow and confident with the guidance and where we're heading.

Maxwell Scott Michaelis
Lake Street Capital Markets, LLC, Research Division

All right. And then -- so Prepaid Debit, let's call it flat for 2023. Is this a function of slower customer additions or growth within existing customers or maybe both? Can you kind of help me out with the Prepaid Debit for 2023?

Scott T. Scheirman
President, CEO & Director

Yes. We really like that business. In 2022, we had a bit of a stronger year than we anticipated. Revenues were up 9%. So -- and the fourth quarter, in particular, was strong. So just given the tough comp from 2022, we're going to call 2023 flattish, if you will.

But again, -- we think there's a lot of opportunity in that business to grow long term and also just some different use cases with Prepaid, whether it's for health savings accounts or supporting the gig economy. So there's other things that we're looking at just beyond the retail channels where we traditionally partake them.

Maxwell Scott Michaelis
Lake Street Capital Markets, LLC, Research Division

All right. And then the last one for me, and I'll jump back in the queue. Just given the macro and supply chain, can you help me out, what's giving you guys confidence that you guys can secure supply? Maybe some puts and takes there?

Scott T. Scheirman
President, CEO & Director

Yes. Again, we work closely with our suppliers. At the end of the day, we are reliant on them, but we'd like to strike close partnerships. With one of our primary chip suppliers, we've reached into a long-term -- or entered into a long-term supply agreement, which gives us more comfort that we are going to have chips as we move forward.

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Again, they have to perform, Matt, as you could expect. But just given our strong supply chain team and working closely with our partners and vendors, we feel like we'll have the supplies we need to move forward and serve our customers well.

Maxwell Scott Michaelis
Lake Street Capital Markets, LLC, Research Division

All right. And congrats on the strong quarter, guys.

Scott T. Scheirman
President, CEO & Director

Thanks, Matt. Thanks for joining the call.

Operator

[Operator Instructions] Our next question from Parsa Kiai from Steamboat Capital.

Parsa Kiai
Steamboat Capital Partners, LLC

Okay. Great. Congratulations on a good quarter, guys. Scott, just a couple of questions for you. I guess I'll start with kind of the investor awareness on the company. As you know, your primary publicly traded competitor recently got picked up coverage by a firm called Compass Point. So now they're covered by JPMorgan, Compass Point, Needham and BTIG. I'm curious, how many of these analysts have you guys reached out to see if they would be interested in picking up coverage of your company?

Scott T. Scheirman
President, CEO & Director

Yes. I'll let -- we've been working very hard on our Investor Relations program and it's a critical priority for us. So between reaching out to potential analysts attending conferences [indiscernible] really hard at that.

Mike Salop has done a terrific job. And Mike, I'll let you give some color commentary of the things you've been working on, too.

Michael A. Salop
Head of Investor Relations

Yes, Parsa. I mean as you're aware, we've talked to many firms and many analysts that we've been engaged in. So hoping to get additional coverage at some point in the future. Obviously, comparisons with other companies are challenging.

Some analysts are just in crypto, some analysts may have [indiscernible] transactions with those companies, but we're talking to several analysts.

Parsa Kiai
Steamboat Capital Partners, LLC

I actually think comparisons with this company are rather not as difficult given that they are roughly the same size and similar margins -- excuse me, similar leverage, very similar product line and the earnings contribution are almost entirely from card manufacturing. So I think the comparison is rather apt.

And I would suggest that -- you guys have done a great job getting the leverage where it needs to be providing conservative guidance hitting your numbers, but your stock is very erratic as you are obviously aware you had that period last month where think in 2 days, your stock fell maybe 26%, 27% on absolutely no news.

I think it does your shareholders a disservice when your stock exists in a vacuum of this nature, whereas I think with these 4 analysts that we mentioned, in addition to Lake Street, you can have more -- you can get more attention, you can get more focus on the company, and you can allow an orderly share price so that if some investor wants to come in or to come out, they could do it at a more reasonable price.

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Michael A. Salop
Head of Investor Relations

All right [indiscernible] repeating the same thing. We don't disagree with you. As I said, we're engaged with many analysts. There's a lot of things that go into analyst coverage, as you know. But we're attempting to get more coverage and more awareness of the stock, and we'll continue working on that.

Parsa Kiai
Steamboat Capital Partners, LLC

Okay. Another question for Scott. Can you elaborate further what would it take for you to expand into the premium metal card? And just given the margins that your competitor in that space has, why this is not something that at least should be attempted by the company?

Scott T. Scheirman
President, CEO & Director

Yes. I would say a couple of things. First, we've been razor-focused on 4, 5 key market segments. And if you look over the last 5 years, I think we've been incredibly successful with that, with revenue growing at a 16% CAGR from '17 to '22, EBITDA growing at a 33% CAGR during that same period.

Our leverage, as you pointed to, has gone down from over 12x to 3x. So I think the areas that we really focused on -- we continue to gain share, and we've gained significant share over that period of time. With the metal card segment or heavy cards, we do partake in that. It's not a major revenue source, obviously, for us, but we continue to have some product offerings.

We generate some revenue from that. That is a different line of investment or significant investments that would need to be made and just trying to balance investments with investing in other areas where we've been very successful and also paying down our debt. So it's just a balance that we have to move forward. And we think we've got the right strategies to move forward to continue to profitably gain share.

Parsa Kiai
Steamboat Capital Partners, LLC

Okay. Okay. And then lastly, what is the incremental capital expenditures being used for? Can you give us a little color as to when you look at $17 million of CapEx, what is the breakdown above what is kind of needed to operate the business?

Scott T. Scheirman
President, CEO & Director

Yes. Amintore, I'll let you go ahead and answer that.

Amintore T. X. Schenkel
Chief Financial Officer

Yes. We don't really provide a specific breakdown as it relates to those items. But clearly, as we think about kind of the expenditures that we have for capital, it's typically always a mix of making sure that our capital stays current, our equipment stays current, but then also investing for future items as well.

One thing that we've noted previously is that we did increase our ability to produce by 50% during 2022, and that was definitely a reason for some of the increase in the capital spend. But -- as you might imagine, in a business like ours, there's also a renewal that has to take place as time goes on as well.

Operator

[Operator Instructions] We have no further questions on the conference. I will now hand back to the CPI team for closing remarks.

Michael A. Salop
Head of Investor Relations

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Okay. Thanks, everyone, for joining us. I hope you have a good day, and that ends our call.

Operator
Thank you. Ladies and gentlemen, this concludes today's call. Thank you for joining. You may now disconnect your lines.

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